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DASAN Zhone Solutions, Inc. NasdaqCM:DZSI

FQ3 2017 Earnings Call Transcripts

Wednesday, November 01, 2017 9:00 PM GMT

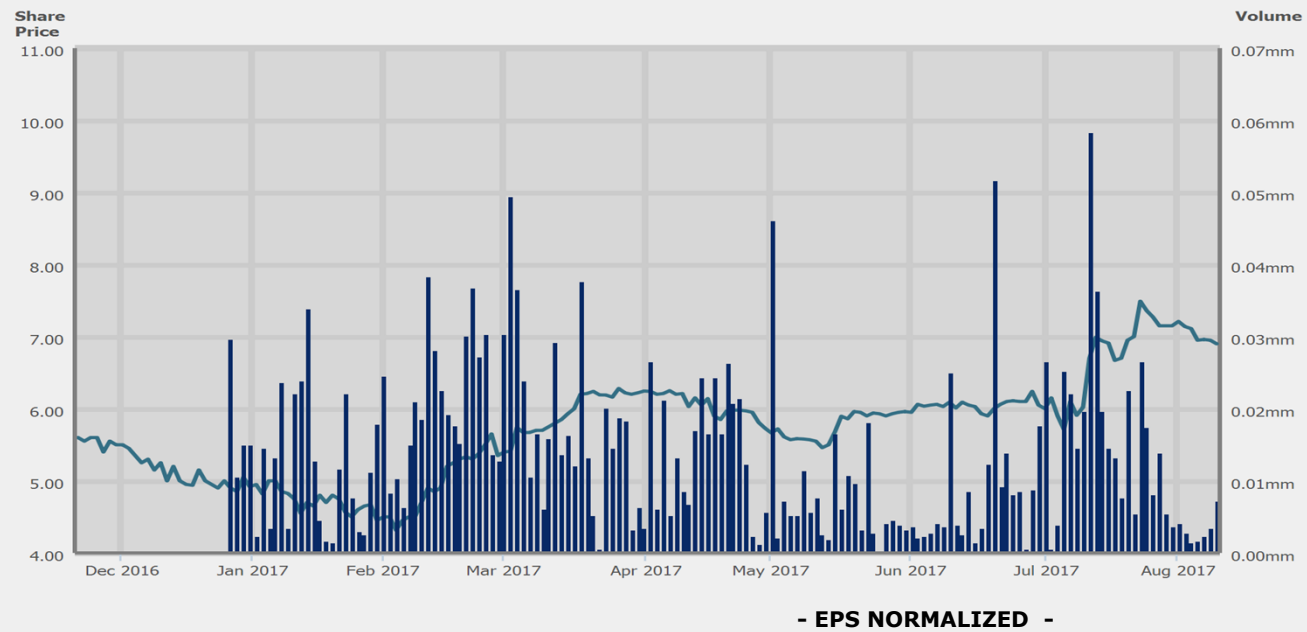
S&P Capital IQ Estimates

	-FQ3 2017-			-FQ4 2017-	-FY 2017-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	GUIDANCE
EPS Normalized	0.03	0.11	▲266.67	0.08	(0.05)	-
Revenue (mm)	62.34	66.44	▲6.58	64.96	240.48	240.00

Currency: USD

Consensus as of Aug-10-2017 12:47 PM GMT

Stock Price [USD] vs. Volume [mm] with earnings surprise annotations



	CONSENSUS	ACTUAL	SURPRISE
FQ4 2016	(0.05)	(0.34)	NM
FQ1 2017	(0.25)	(0.22)	NM
FQ2 2017	(0.07)	(0.05)	NM

Call Participants

EXECUTIVES

Kirk Misaka

Treasurer & Secretary

Yung Kim II

CEO, President, Acting CFO & Director

ANALYSTS

Tyler Leroy Burmeister

*Craig-Hallum Capital Group LLC,
Research Division*

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Third Quarter 2017 DASAN Zhone Solutions Inc. Conference Call. I am Litoya, and I will be your coordinator for today. [Operator Instructions] As a reminder, this conference call is being recorded for replay purposes.

I would now like to introduce your host for today, Kirk Misaka. Please proceed.

Kirk Misaka

Treasurer & Secretary

Thank you, operator. Hello, and welcome to the Third Quarter 2017 DASAN Zhone Solutions, Inc. Earnings Conference Call. I'm here today with the CEO of DASAN Zhone Solutions, Yung Kim. Yung will begin with comments about the current state of DZSI's business and his strategy for the future of the company. Following Yung's comments, I will discuss DZSI's financial results for the third quarter and provide guidance for next quarter. After our prepared remarks, we will conclude with questions and answers. This conference is being recorded for replay purposes and will be available for approximately 1 week. The dial-in instructions for the replay are available on our press release issued today. An audio webcast replay will also be available online at www.dazanzone.com following the call.

Before we begin, I'd like to mention that during the course of this call, we may make forward-looking statements that are subject to the safe harbor created under the Securities Act of 1933 and the Securities Exchange Act of 1934. In addition, forward-looking statements include, among others, statements that refer to financial estimates, projections of revenue, margins, expenses or other financial items. Listeners are cautioned that actual results could differ materially from those expressed in or contemplated by the forward-looking statements. Factors that could cause actual results to differ, include, but are not limited to, the company's ability to realize the anticipated cost savings, synergy and other benefits of the merger of DASAN Network Solutions team and the legacy Zhone technology team and any integration risk relating to the merger. The ability to generate sufficient revenue is cheap or sustained profitability. The ability to raise additional capital DASAN's existing and future operations or to refinance or repay the company's existing indebtedness. These facts or other performance problems in the company's products. Any economic slowdown in the telecommunications industry that restricts the ability of the company's customers to purchase its products. Commercial acceptance of the company's products. Intense competition in the communication's equipment market, higher than anticipated expenses that the company may incur. Any failure to comply with the periodic filings or other requirements for the NASDAQ stock market for continued listing. Material weaknesses or other deficiencies in the company's internal controls over financial recordings and the initiation of any civil litigations, regulatory proceedings, government enforcement actions or other adverse effect relating to the audit committee investigation for errors in the consolidated financial statement of Legacy Zhone Technologies, Inc.

In addition, please refer to the risk factors contained in the company's SEC filings, available at www.sec.gov, including without limitation, the company's filings on Forms 10-K, 10-Q and 8-K. Listeners are cautioned not to place undue reliance on any forward-looking statements, which speak only as of the date which they are made. The company undertake no obligation to update or revise any forward-looking statements for any reason.

During the course of this call, we'll also make reference to adjusted EBITDA, a non-GAAP measure we believe is appropriate to enhance an overall understanding of the company's past financial performance and prospects for the future. These adjustments to our GAAP results are made with the intent of providing greater transparency, with supplemental information used by management in its financial and operational decisions. These non-GAAP results are among the primary indicators that management uses as a basis for making operating decisions because it provide meaningful supplemental information regarding the company's operational performance, including the company's ability to provide cash flow to invest in research and development and to fund capital expenditure.

In addition, these non-GAAP financial measure facilitate management's internal comparisons to the company's historical operating results in comparisons to competitors' operating results. The presentation of this additional information is not meant to be considered an isolation or as a substitute for measures of financial performance prepared in accordance with GAAP. We have provided GAAP reconciliation information for adjusted EBITDA within the press release, which has been posted on our website at www.dasanzone.com.

With those comments in mind, I would now like to introduce Yung Kim. Yung?

Yung Kim II

CEO, President, Acting CFO & Director

Thank you, Kirk, and greetings to those participating on today's call. It's been just over a year since we merged DASAN Network Solutions and Zhone Technologies to create one of the largest and most innovative communication equipment providers in the world. The merger generated a greater value than expected through the adoption of the best practices, successful integration of our complimentary products and the cross-selling of those products to our customers. We are also seeing improved financial information -- performance sooner than expected, which has been led by stronger-than-expected revenue growth. As we have discussed before, we begun cross-selling to each company's loyal customer base with a unified sales and support team in every major geographic regions, immediately after the merger. Prior to the merger, the combined companies were generating about \$210 million of annual revenue. In a year's time, annual revenue has grown dramatically and they're now expected to exceed \$240 million. That top line growth comes from gaining market share because of the broad -- broader product portfolio of the combined companies as well as an improved carrier-spending environment. Revenue growth and cost efficiency were the major contributors to reaching profitability in the third quarter of 2017. Kirk will discuss those in details in a minute.

We are encouraged to see that revenue strength for the quarter came from all of our geographic regions, driven by global sales force collaborating together. As you know, DASAN was a leading telecom equipment provider in the Asia-Pacific region, with the customers representing some of the largest carriers in the region, including the 3 largest carriers in Korea and other Tier 1 carriers in Japan and Vietnam. So on the other hand was a leading player with alternative carriers in the Americas, Europe and Middle East and Africa, in addition to several Tier 1 carriers in the Middle East. As excited as we are about the breadth and strength of our customer base, we are equally excited about the breadth and strength of our products portfolio. As I mentioned, the combined -- a combination of a DNS and Zhone, resulted in a robust complementary product portfolio that enables service providers, enterprises to manage their network more efficiently and effectively while allowing them to migrate to the latest technologies to satisfy the exploding demand for bandwidth. We will continue to focus our efforts on delivering best-in-class products in our 5 key product areas: broadband access, Ethernet switching, mobile backhaul, passive optical LAN or POLAN, and software-defined networks or SDN.

In the near future, we expect that revenue growth to continue to be driven by 2 major product catalysts. First, we will continue to cross-sell DASAN's Ethernet switching and mobile backhaul product to legacy Zhone customers. Second, we will grow revenue in the passive optical LAN business through our enhanced global sales force. Meanwhile, we expect our broadband access product to continue to be the core of our product portfolio that will enable the growth in our other product segment.

With that brief overview, let me turn the call back to Kirk to provide more details about our financial results for the third quarter and our financial guidance for the future. Kirk?

Kirk Misaka

Treasurer & Secretary

Thanks, Yung. Revenue for the third quarter of 2017 was \$66.4 million, up 11% from second quarter revenue of \$59.9 million, and much higher than our upwardly revised guidance of approximately \$62 million. As Yung mentioned, revenue strength came from all geographic regions and all product categories. Backlog also continue to increase, giving us confidence that fourth quarter revenue will increase to about \$68 million, and annual revenue will easily exceed our upwardly revised forecast of \$240 million.

Annual revenue is now expected to grow by more than 15% over the 2016 pro forma combined revenue of the merged companies. We are well on our way to closing out a strong year of top line growth and are beginning to focus on our business plan for 2018, which we'll discuss with you on our next earnings call.

Gross margins for the third quarter of 2017 were also strong at 33.2% as compared to 32% for the second quarter, at much higher than our roughly 30% pro forma historical norms. Earlier this year, we mentioned that longer term gross margin expansion should come from product cost reductions and manufacturing economies of scale and now we are seeing those benefits being captured. Gross margins for the fourth quarter should be roughly the same as the last few quarters around 32% to 33%.

Operating expenses for the third quarter of 2017 totaled \$20.4 million and included depreciation and amortization of approximately \$800,000, and stock-based compensation of approximately \$200,000.

Operating expenses were higher than our forecast, largely due to unexpected legal and accounting cost. For the fourth quarter 2017, we expect operating expenses to be lower by about \$500,000. Depreciation and amortization should continue to be about \$800,000, and stock-based compensation should continue to be about \$200,000 for the fourth quarter.

Our Non-GAAP adjusted EBITDA profit for the third quarter was \$2,668,000, significantly better than the \$853,000 of the second quarter. We also became profitable on a GAAP basis, posted net income attributable to DZSI of \$1,399,000 and \$0.09 per basic and diluted share as compared to the net loss of \$809,000 in the second quarter. Based on our revised financial guidance, we expect that our positive adjusted EBITDA and GAAP net income attributable to DZSI will be even better in the fourth quarter.

As we've talked about all year, profitability was and is our immediate and primary financial goal. We're able to achieve profitability sooner than expected because of the quick and successful integration of our business. As Yung mentioned, that profitability was driven by revenue growth from cross-selling opportunities and new growing markets in mobile backhaul and passive optical LAN, improve gross margins through manufacturing cost reductions and economies of scale, and operating expense reductions from cost synergies associated with the merger.

With that overview, we'd now like to open the call up to questions. Operator, please begin the Q&A portion of the call.

Question and Answer

Operator

[Operator Instructions] The first question is from Christian Schwab of Craig-Hallum Capital.

Tyler Leroy Burmeister

Craig-Hallum Capital Group LLC, Research Division

This is Tyler on behalf Christian. First, the CEO position, is there any update there on a plan or possibly timeline?

Yung Kim II

CEO, President, Acting CFO & Director

Yes, we have, for now, shortlisted 2 people and literally we are days away from making that decision. And with that, we know, both of them can start in November. So yes, we are progressing well and both of them have experiences in public company accounting.

Tyler Leroy Burmeister

Craig-Hallum Capital Group LLC, Research Division

Great, great. All right then, could you possibly talk to us and maybe rank specifically two or three things that you're focusing on to try to top line growth going forward?

Yung Kim II

CEO, President, Acting CFO & Director

The couple of things to our top line growth for 2 areas. I would say that the first one is a mobile backhaul, even though we call it mobile backhaul, it can be used as a carrier Ethernet for enterprises and -- so we see a lot of application in that. We already doing some enterprise or -- enterprise sales in Taiwan and also a mobile backhaul in Vietnam and other places. In U.S., we also do a few trials. So that's one area. The other one is passive optical LAN. This is one area that we have successfully did a big stadiums and university campuses, but next year, we are going to launch a very simplified version with easy to install and catching more enterprises of the smaller sizes. I think that would be the one to -- we'll do the increases, and if I may put another one is a cross-selling to some customers of Ethernet switching.

Tyler Leroy Burmeister

Craig-Hallum Capital Group LLC, Research Division

All right. Great, thank you. And then lastly, maybe a little bit more of a modeling question. So at the inflection point of profitability here and I know you mentioned you expect Q4 to be \$500,000 lower on the OpEx line. Do you see that is a kind of base? Would you expect any more cost to come out? And if that is the base, is that the spending level that you think you could support revenue growth for the foreseeable future?

Kirk Misaka

Treasurer & Secretary

Yes. We -- the \$500,000 is a reduction that we expect in the fourth quarter and we think that can stay at that level or approximately at that level, and leverage significant additional growth on the topline. We would expect in 2018 at least that OpEx would stay at that level.

Operator

[Operator Instructions] I'm not showing any further questions at this time. I'd like to turn the call back over to Yung for closing remarks.

Yung Kim II

CEO, President, Acting CFO & Director

Thank you, again, for joining us today and for your continued support. The successful merger and integration of our 2 great companies has been accomplished. We are now fully prepared to compete successfully in a unified and the stronger company going forward. The merger also has created a significant value for our customers and the investors. Our financial results are already reflecting that value and we expect the momentum will continue into next year. We look forward to speaking with you again on next quarter's earnings conference call when we will discuss our 2018 business plan and the financial goal. Thank you.

Operator

That concludes the conference today. Thank you for your participation.

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