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DASAN Zhone Solutions, Inc. NasdaqCM:DZSI

FQ4 2017 Earnings Call Transcripts

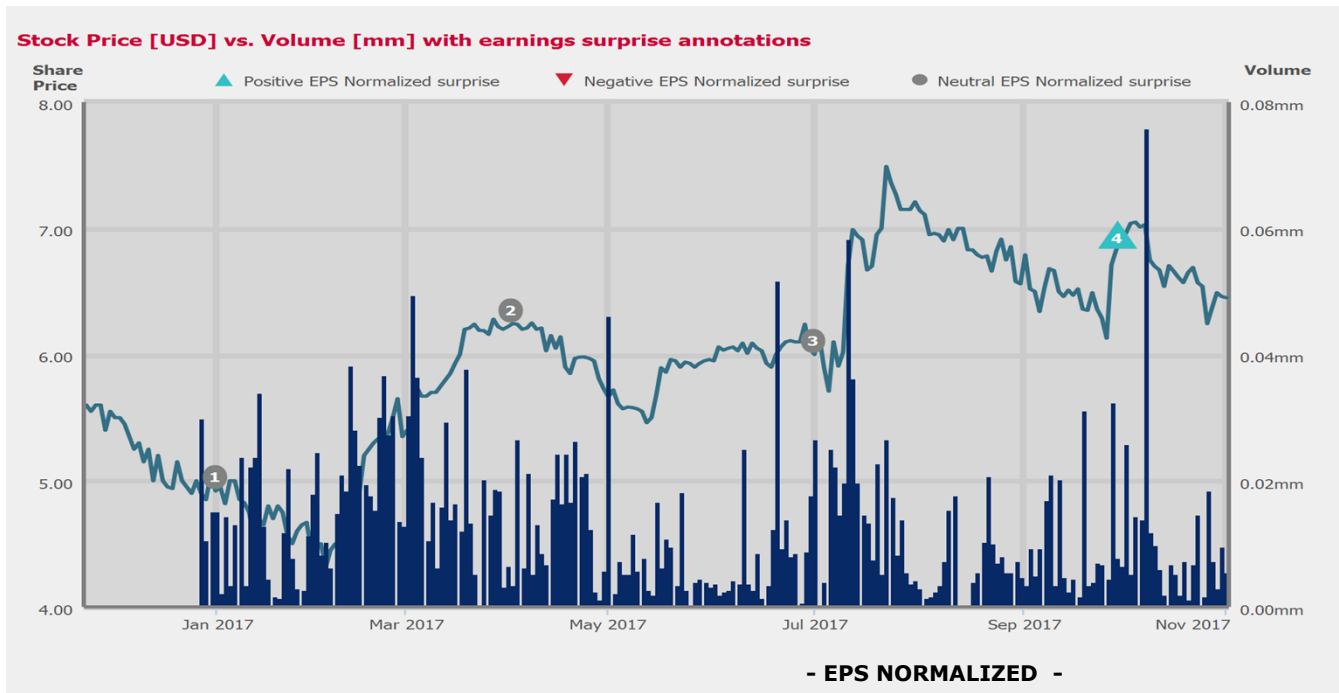
Wednesday, February 28, 2018 10:00 PM GMT

S&P Capital IQ Estimates

| | -FQ4 2017- | | | -FY 2017- | | |
|-----------------------|------------|--------|------------|-----------|--------|-------------|
| | CONSENSUS | ACTUAL | SURPRISE | CONSENSUS | ACTUAL | SURPRISE |
| EPS Normalized | 0.13 | 0.12 | ▼ (7.69 %) | 0.08 | 0.04 | ▼ (50.00 %) |
| Revenue (mm) | 68.10 | 68.62 | ▲ 0.76 | 247.72 | 247.11 | ▼ (0.25 %) |

Currency: USD

Consensus as of Nov-02-2017 11:11 AM GMT



| | CONSENSUS | ACTUAL | SURPRISE |
|-----------------|-----------|--------|------------|
| FQ4 2016 | (0.05) | (0.34) | NM |
| FQ1 2017 | (0.25) | (0.22) | NM |
| FQ2 2017 | (0.07) | (0.05) | NM |
| FQ3 2017 | 0.03 | 0.11 | ▲ 266.67 % |

Call Participants

EXECUTIVES

Mikhail Golomb

*CFO, Corporate Treasurer &
Secretary*

Pei-Hua Hung

*Vice President of Finance &
Investor Relations*

Yung Kim II

CEO, President & Director

ANALYSTS

Christian David Schwab

*Craig-Hallum Capital Group LLC,
Research Division*

Presentation

Operator

Good day, and welcome to the Fourth Quarter 2017 DASAN Zhone Solutions, Inc. Conference Call. I'm Karen, and I'll be your coordinator for today. [Operator Instructions] As a reminder, this conference is being recorded for replay purposes.

I would now like to turn the call over to your host, Ms. Pei-Hua Hung, Vice President of Investor Relations. Please proceed.

Pei-Hua Hung

Vice President of Finance & Investor Relations

Thank you, operator, and good afternoon. Welcome to the fourth quarter 2017 DASAN Zhone Solutions, Inc. earnings conference call. Joining me on the call today is the Chief Executive Officer of DASAN Zhone Solutions, Yung Kim; as well as Chief Financial Officer, Michael Golomb.

As a reminder, this conference call will be available for audio replay following this call. The dial-in instructions for the replay are available on our press release issued today as well as the Investor Relations section on our website www.dazanzhone.com.

Before we begin, I'd like to mention that in this call we will refer to forward-looking statements regarding our future financial and operating performance in our growth strategy. 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 are detailed in today's earnings press release, and in our annual and quarterly reports filed with the SEC.

The company undertakes no obligation to update or reverse any forward-looking statements. During the course of this call, we will discuss both GAAP and non-GAAP financial measures, specifically our reference to adjusted EBITDA. Reconciliation of GAAP to non-GAAP measures is included in our earnings press release and will also be posted on our website.

With those comments in mind, I now would like to introduce Yung Kim, CEO of DASAN Zhone Solutions. Yung?

Yung Kim II

CEO, President & Director

Thank you, Pei, and good afternoon, everyone. I'd like to begin by welcoming Michael as our Chief Financial Officer. Michael joined us approximately 3 months ago and has been an invaluable asset to the team. I view him as a key contributor in continuing to drive processes that allow us to scale and capitalize on the strong momentum we are seeing in our business.

As I reflect on 2017, I'm proud that it has been such a watershed moment for us from a focus and execution perspective, but as importantly from a financial perspective. Systems and processes continue to improve. Leadership investments are paying dividends and continue to be catalysts for improved operational and financial performance.

I believe we have leadership of the highest caliber to enable our continued growth. From a financial perspective, we finished the full year 2017 with stronger-than-anticipated revenue of a little over \$247 million, which reflects approximately 18% year-over-year growth over 2016 pro forma combined revenue of approximately \$210 million of the merged companies. I would let Michael to go into more of our financial performance details later on the call, but I'm highly encouraged by the consistent revenue outperformance since the very beginning of 2017.

You may recall, we had initially guided full year 2017 revenue of \$210 million. And after an encouraging first quarter 2017, we raised the annual revenue guidance to \$220 million and continued to raise the annual revenue guidance at the end of each subsequent quarter in 2017. With our last annual revenue

guidance of \$240 million at the end of the third quarter 2017, actual full year 2017 revenue came in even higher at \$247 million.

I see several factors driving our revenue growth. First, we are seeing tremendous platform benefits from the combination of DASAN Network Solutions and Zhone Technologies. The thesis behind the merger of a building a world-class global communications equipment leader with a greater scale, faster speed to innovation and enhanced product portfolio is playing out very well. In addition, we continue to be successful cross-selling a broader set of products into our complimentary loyal customer base. On the legacy DASAN side, primarily selling into the leading Tier 1 carriers in the Asia Pacific region. And on the Legacy Zhone side, primarily selling into alternative carriers in the Americas, Europe and the Middle East and Africa, in addition to several Tier 1 carriers in the Middle East. Second, our customers are validating the transformation that we have been on since the merger of DASAN and Zhone late 2016. Our customers are seeing our leadership evolution, our product innovation and our increasing financial strength. To give you specifics, they are signing larger multimillion dollar longer multi-year deals across wide-ranging deployment, including GPON deployment, expansions, EPON deployments and the VDSL deployments across the U.S., EMEA, Latin America, the Middle East and Asia Pacific. Our loyal base of customers continues to reinforce our value as their strategic partners. We expect that the next leg of growth with our customers will come from our Passive Optical LAN business, as we look to make commercially available the next generation FiberLAN offering later this year. We will discuss this in more detail in upcoming earnings calls.

The third factor driving our revenue growth is that we are seeing a receptive carrier-spend environment with ongoing investments being made. Specifically, around NGPON2, however, while we ourselves are working with large carriers to explore this technology at the trial level quantities, we believe this is a longer-term proposition for it to be commercially viable given the high price of components today. Another major watershed moment for us is that we turned profitable in 2017 from an operating income, adjusted EBITDA and net income perspective.

I do not believe Legacy Zhone in its history since its founding in 1999 was ever profitable, so this is a turning point for our company. Michael will discuss those details in a minute but recall that we had previously discussed with you that we believed 2018 was when we are going to be breakeven on a GAAP basis.

I am highly encouraged that we are actually a full year early in achieving our profitability goal, revenue growth and cost efficiency were the major contributors to reaching profitability in the year.

With that brief overview, let me turn to call to Michael to provide more details about our financial results for the fourth quarter and the year-end financial, and our financial guidance for the future. Michael?

Mikhail Golomb

CFO, Corporate Treasurer & Secretary

Thank you, Yung, and good afternoon. I will speak today about our fourth quarter and full year 2017 results and discuss what we see for the first quarter 2018. We last provided you with a guidance regarding Q4 on November 1, and the guidance we called for Q4 to be \$68 million, and GAAP gross margin of between 32% and 33%. Adjusted operating expenses, which exclude depreciation and amortization and stock-based compensation expenses to be approximately \$0.5 million lower than Q3 2017 adjusted operating expenses of \$19.5 million. And lastly, positive and increasing adjusted EBITDA.

Relative to that guidance, our actual revenue for the fourth quarter came to about \$68.6 million, up 15.4% compared to \$59.5 million reported in Q4 2016, and up 3.3% compared to \$66.4 million from the prior quarter Q3 2017. This quarter marks the third quarter of consecutive quarter-over-quarter revenue growth. Overall, revenue strength came from broad base of geographic regions and broad categories. As Yung previously mentioned, some of our key wins in 2017 were in North America, which had been a very reliable market for us, and represents approximately 19% and 22% of Q4 2017, and full year 2017 revenue, respectively.

Our company is very global in nature and generates approximately 81% of our revenue outside of North America.

Across international markets, Asia-Pacific countries to contribute approximately 54% and 55% of Q4 2017 and full year 2017 revenue, respectively. We are seeing strong customer traction EMEA and Latin America, which collectively account for approximately 27% and 23% of our Q4 2017 and full year 2017 revenue. From a product revenue perspective, we are seeing broad-based strength across all 5-solution offering, including broadband access, which continues to be our core product strategy, as well as Ethernet switching, mobile backhaul, Passive Optical LAN or POLAN, and of course, software-defined networks, SDN. From customer perspective, we have successfully defined our customer base across the DASAN and Zhone platforms, such as that no one customer represents more than 10% of our full year 2017 revenue. This is a significant achievement as you might recall that as recently as full year 2016, we had 3 customers that each comprised 10% or more of full year 2016 revenue, and it collectively comprised of approximately 40% of full year 2016 revenue.

Our Q4 2017 GAAP gross margins of 32.7%, and full year 2017 GAAP gross margins of 33% are significantly higher than our roughly 30% performance historical norms. We attribute this improvement of -- to gross margins to economies of scale, including benefits from flexible material sourcing and production efficiencies as we continue to scale our revenue base.

On production side, we can benefit the combined DASAN and Zhone platform, and we are able to bring production to where it's mostly efficient, whether it is in-house in our Florida manufacturing facilities, or outsourced to OEMs in Asia.

For the quarter, total operating expenses on GAAP basis were \$20.1 million, a decrease of \$1.4 million compared to \$21.5 million for the fourth quarter 2016, and \$0.3 million less than \$20.4 million reported for Q3 2017. On a non-GAAP basis, our Q4 2017 operating expenses totaled \$19.1 million compared to \$19.2 million for the fourth quarter 2016, and \$19.5 million for the prior quarter. We were slightly under \$0.5 million decrease in non-GAAP operating expenses that we guided in November on our Q3 2017 earnings call but remain encouraged by our continued cost management efforts. Full year 2017 GAAP and non-GAAP operating expenses totaled \$80.8 million and \$76.1 million, respectively.

The difference between GAAP versus non-GAAP operating expenses in Q4 and full year 2017 was due to a depreciation and amortization and stock-based compensation expenses. On a non-GAAP basis, and our adjusted EBITDA for the fourth quarter and for the full year 2017 was \$2.6 million and \$4.7 million, respectively. Our adjusted EBITDA margin was 3.7% and 1.9% for the fourth quarter 2017 and full year 2017, respectively. This level of profitability that we saw particularly in the second half of 2017 reflects our continued and laser-sharp focus on growing revenue and probability scale. In the fourth quarter 2017, we continue to be profitable on a GAAP basis, posted net income attributed to DASAN Zhone Solutions are \$4.2 million or \$0.26 per fully diluted share. As you may recall, our fourth quarter 2017 net income of \$4.2 million, significantly higher than the \$1.4 million in net income or \$0.09 per fully diluted shares were generated in Q3 2017. Prior to Q3 2017, we were not profitable on GAAP basis. So I'm highly encouraged by both the revenue growth and the level of profitability that we were able to achieve. For the full year 2017, GAAP net income attributed to DASAN Zhone Solutions was \$1.1 million or \$0.07 per fully diluted share.

Now looking ahead to the first quarter 2018, we expect our revenues to be in the range of \$59 million to \$60 million or approximately 13% to 15% year-over-year increase from the first quarter of 2017. This reflects the continued broad-based revenue strength across customers, products and geographies. As Yung mentioned earlier, we're also excited about the next-generation FiberLAN that we look to make commercially available later in the year and expect good customer traction. We expect our GAAP gross margins to be in the range of 31% to 33%, which is generally in line with the gross margin level achieved in 2017 but does reflect the impact of some recent significant wins in our Asia Pacific region. We expect first quarter 2018 non-GAAP operating expenses to be approximately \$0.5 million lower than our Q4 2017 non-GAAP operating expenses of \$19.1 million. And for Q1 2018, non-GAAP adjusted EBITDA to be in the range of breakeven to approximately \$0.5 million to \$0.6 million. As we have communicated, we consider profitability to be an important financial goal, and are cognizant of balancing growth and profitability.

At this point, let me turn the call back to Yung.

Yung Kim II

CEO, President & Director

Thank you, Michael, for the good color. As you have heard on today's call, we are excited about our growth prospects and strongly believe that the market opportunity is ours to seize. Particularly on the back of highly encouraging Q4 result, the merger and our broader platform have unlocked significant value for our customers and the investors.

Operator, we are now ready to open for any questions that our listeners might have.

Question and Answer

Operator

[Operator Instructions] And our first question comes from the line of Christian Schwab from Craig-Hallum.

Christian David Schwab

Craig-Hallum Capital Group LLC, Research Division

So Yung, could you help us with what you think your 2 -- the market growth rate of your target market before we talk about passive LAN sometime in the future, you would expect to grow at in '18 on a yearly basis?

Yung Kim II

CEO, President & Director

I think 2018 -- I think we will continue to grow. At this stage, early in the year, I would say that 5% growth is something that I can see. We will try harder to grow further but that's where I'll stick my neck out. Certainly that I'm encouraged by our customers buying more of our optical products than the copper-based products, which shows -- I think the world, North America, maybe possibly Europe are turning more into now fiber-based broadband access. That's quite encouraging. And that's where we've been shifting our focus internally as well in our resources.

Christian David Schwab

Craig-Hallum Capital Group LLC, Research Division

Great. And along the lines of that 5% growth rate, which geography would stand out as you think the best opportunity for the company with the broader platform?

Yung Kim II

CEO, President & Director

I certainly see that North America's turning more and more into fiber-based ones. We see growth. But I see growth right across all areas. I mean, one area that we are not particularly as strong as I wish to be is Europe. But all other -- Middle East is starting to come up again, which was traditionally a very strong hold of Zhone -- ex-Zhone Technologies. So there is no particular area that's not going to grow. All of those regions are going to grow.

Operator

Thank you. And that concludes our conference call for today. We thank you for your participation, and you may now disconnect. Everyone, have a great day.

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