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DZSI - Q4 2018 DASAN Zhone Solutions Inc Earnings Call

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## CORPORATE PARTICIPANTS

**Il Yung Kim** *DASAN Zhone Solutions, Inc. - CEO, President & Director*

**Mikhail Golomb** *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

**Pei-Hua Hung** *DASAN Zhone Solutions, Inc. - VP of Finance & IR*

## CONFERENCE CALL PARTICIPANTS

**Christian David Schwab** *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

**Gregory Thomas Gibas** *Northland Capital Markets, Research Division - Analyst*

## PRESENTATION

### Operator

Good day, and welcome to DASAN Zhone Solutions, Inc. Fourth Quarter and Fiscal Year 2018 Conference Call. I'm Jonathan, 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 turn the call over to your host, Ms. Pei Hung, Vice President of Finance and Investor Relations. Please proceed.

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**Pei-Hua Hung** - *DASAN Zhone Solutions, Inc. - VP of Finance & IR*

Thank you, operator, and good afternoon, everyone. Thank you for joining us on our fourth quarter 2018 earnings call. Joining me on the call today are Yung Kim, CEO; and Mikhail Golomb, CFO. DZS issued a press release this afternoon announcing the results of its fourth quarter 2018 on its fiscal year 2018. You can access the press release online in Investor Relations section of the company's website, [www.dazanzhone.com](http://www.dazanzhone.com).

During the course of this call, we will refer to forward-looking statements based on our current expectations. These statements are subject to risks and uncertainties. Factors that could cause actual results to differ are detailed in our 8K filed today, and in our other SEC filings. The company undertakes no obligation to update or revise any forward-looking statements. Please also note that certain financial measures we use on this call are expressed on a non-GAAP basis. We have provided reconciliations of these non-GAAP financial measures to GAAP financial measures in our earnings press release. Finally, note that our Q4 '18 and fiscal year 2018 results and forward-looking guidance are provided under ASC 606, which we adopted on January 1, 2018, on a modified retrospective basis.

With those comments of mine, I would now like to introduce Yung Kim, CEO of DZS. Yung?

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**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

Thank you, Pei, and good afternoon, everyone. As I reflect on 2018, it was a year of strong progress for DZS. At the beginning of the year, we made bold plans to elevate our products, research, organization and our business result. I believe our team delivered what we set out to accomplish. From a product perspective, we introduced our new generation of broadband solutions with 10G PON OLTs and ONTs. Given we offer one of the largest interoperability feature sets and the selection of interoperable gateways in the industry, we are finding ways to complement and add value to our service provider customers' existing portfolio.

On the FiberLAN front, we continue to win customers, including deploying our FiberLAN technology to connect over 1,800 wireless access points including the world's largest video display at the Mercedes-Benz Stadium for Super Bowl LIII, a few weeks ago. We also introduced our newly designed generation of plug-and-play FiberLAN offerings for the enterprise market with the launch of the FL-108 series FiberLAN switches. Our vision for the plug-and-play FiberLAN is designed to improve ROI for our customers. The plug-and-play nature of our solutions generate significant cost savings, while freeing up valuable IT human resources to focus on high-value projects. I'm particularly pleased it will also increase manageability



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for small-to-medium and large enterprises that are switching to fiber-based enterprise networks from legacy copper-based LAN. We also introduced our Whole Home WiFi suite of solutions and in keeping with our philosophy of offering our customers open broadband interoperability, our DZS connection platform is completely configurable and hardware neutral to help our service provider customers get the most out of their existing infrastructure.

On the customer side, we continue to demonstrate our 5-year mobile backhaul leadership. We signed a significant contract win with LGU Plus to deploy our carrier-grade M3000 ultra-low latency switches, as LGU Plus rolls out the first commercial 5G wireless network in the South Korea market. We also want to highlight our recent win that excites me. We were selected by the South Korea Ministry of Education to provide software-defined networking or SDN-based wired and wireless infrastructure to connect more than 11,000 elementary, middle and high schools across the country. Over the next 3 years, I expect us to play a critical part in modernizing South Korea's schools network infrastructure and I'm proud that our SDN-based solution will be used to promote next-generation learning.

On the leadership front, we deepened our management bench, including formalizing our Chief Operating Officer role as well as adding a new Head of Asia-PAC to lead our Asia business, excluding Korea. Additionally, we broadened our board to include 2 new directors in 2018, including one who is a well-respected technology and telecommunications executive in Europe, and the other is an operating partner at a private investment firm, who has advised Fortune 500 companies, particularly in the manufacturing industry. We also closed on the acquisition of KEYMILE earlier this year. Lothar Schwemm, the General Manager of DZS KEYMILE and his leaders will anchor our new European headquarters. We are already finding ways to collectively deliver more value to our customers in Europe and globally.

From a financial perspective, I'm also proud of our achievements. We finished full year 2018 with a revenue of approximately \$282.3 million, which reflects approximately 14% year-over-year growth. We also continue to make strides on profitability. For full year 2018, we generated \$12 million in adjusted EBITDA. We continue to see the same positive momentum heading into 2019 from the product side and with our customers.

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

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### **Mikhail Golomb** - *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

Thank you, Yung. Before we begin, I want to note that the figures that I will be reviewing with you today reflect DASAN Zhone Solutions' organic results and do not include any contribution from KEYMILE. We will be providing our pro forma combined financials for 2018, inclusive of KEYMILE in our 8K filing expected in mid-March.

We provided guidance, which called for Q4 2018 revenue to be between \$74 million and \$78 million, a GAAP gross margin range of between 32% and 33%, adjusted operating expenses of between \$21 million and \$22 million. For an implied adjusted EBITDA range of between \$3 million to \$4 million. I'm pleased to report that our Q4 2018 revenue came in line with the guidance at \$74.7 million, which reflects approximately 9% year-over-year growth. During the quarter, we continued to see strong momentum out of our Asia-Pacific and Korean markets, which collectively contributed approximately \$51.4 million or 69% of our Q4 2018 revenue. North America, EMEA, Latin America generated approximately \$23.3 million, which is 31% of our total revenue for Q4 2018. From a customer perspective, inclusive of KEYMILE, our combined 2018 revenue would reflect that no single customer accounted for more than 10% of our revenue. Now excluding KEYMILE, for Q4 2018, SK Broadband, a leading carrier in South Korea, and then One Communications, a leading carrier in Vietnam, contribute approximately 17% and 10% of revenue, respectively. This will happen from time to time depending on timing of large orders each quarter. For the full year 2018, excluding KEYMILE, SK Broadband was the only significant customer, approximately \$30 million or 10.6% of our revenue. For the full year 2018, we generated revenue of approximately \$282.3 million or up 14% from 2017. This was also in line with our guidance for the full year 2018. This year, we benefited from robust activity out of Asia-Pacific, including Japan, India, Southeast Asia. Our Asia-Pacific business scaled significantly in 2018, growing 65% from 2017. For the full year 2018, EMEA also saw solid double-digit year-over-year growth. Latin America saw high single digit and North America was relatively flat from last year.

Now turning to gross margin. In the fourth quarter, our gross margin of 31% reflected a disproportionate amount of revenue contributed from our Asia-Pacific customers. We are truly a global company, experience margin fluctuations according to our geographic diversification. For the full year 2018, we generated 32.4% of gross margin, which is in line with our implied gross margin range for the year. One reminder is that we can be



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profitable even in the low 30% gross margin range because we benefit from a truly global footprint. To drive this point even further, more than half of our 690-plus staff members are based in Asia and they continue to expand our presence in emerging countries like Vietnam, India and Japan.

Now turning to operating expenses in Q4 2018, which on GAAP basis were \$23.1 million. Now this number includes both \$1.2 million of merger acquisition related transaction expenses for KEYMILE and a \$1.7 million accrual for a special 2018 performance bonus that is expected to be paid to our employees in this quarter. Q4 2018 adjusted operating expenses were \$20.1 million and came in approximately \$1 million better than the low end of the guidance, which was between \$21 million and \$22 million. Our non-GAAP adjusted operating expenses in Q4 and for the full year, exclude depreciation, amortization and stock-based compensation expenses. For the full year 2018, GAAP operating expenses totaled \$85 million or approximately 30% of our revenue. Once again, this amount includes approximately \$3.1 million related to both nonrecurring M&A related expenses and accrual for a special 2018 performance bonus that is expected to be paid this quarter. On a GAAP basis, this is in contrast to 2017 GAAP operating expenses of approximately \$82 million or 33% of our revenue. We believe the 300 basis points improvement in operating expenses margin point out to our continued focus on efficiency and cost management. For the full year 2018, our non-GAAP operating expenses were approximately \$79.3 million or approximately 28% of our revenue. On a non-GAAP basis, our adjusted EBITDA for the fourth quarter was \$3 million, which came in line with guidance. For the full year 2018, we generated \$12 million of adjusted EBITDA, which came in better than guidance of at least \$11.5 million. Our adjusted EBITDA margins were approximately 4% for both Q4 and the full year 2018. And again, underscore my earlier point that even with gross margin are in low 30% range, we can still be profitable. Our GAAP net income attributed to DASAN Zhone Solutions in Q4 was a loss of \$1.3 million or \$0.08 per diluted share. In Q4 '18, we had approximately \$2.9 million of nonrecurring spend resulting from those 2 categories described earlier, KEYMILE acquisition and a special 2018 performance bonus. For the full year 2018, we generated net income attributed to DASAN Zhone Solutions of \$2 million or \$0.12 per share, which reflected solid year-over-year improvement over full year 2017, which saw net income attributed to DASAN Zhone Solutions of \$1.1 million or \$0.07 per diluted share.

Now looking ahead to the first quarter 2019. We expect DASAN Zhone Solutions' organic revenue to be in the range of \$63 million to \$66 million, or approximately 6% to 11% year-over-year increase from Q1 '18. Now inclusive of KEYMILE, we expect Q1 to be between \$70 million to \$74 million. Inclusive of KEYMILE, we expect our Q1 2019 GAAP gross margin to be in a range of 31% to 33%. Again, inclusive of KEYMILE, we expect Q1 2019 non-GAAP adjusted operating expenses to be approximately between \$26 million and \$29 million. And for the Q1 '19, non-GAAP adjusted EBITDA to be approximately negative of \$4 million. The driver of projected Q1 2019 EBITDA loss is simply due to seasonality in the first quarter versus the rest of the year, which impacts the KEYMILE business much more significantly than the DZS business. We fully expect to return to our proven track record of EBITDA and net income profitability in the subsequent quarters 2019. For the full year 2019, we expect revenue of between \$345 million and \$360 million, inclusive of KEYMILE. One final topic that I wanted to bring up is that we have made great strides in cleaning up our capital structure with regards to our debt. Just yesterday, we closed a new 3-year \$40 million senior secured credit facility with PNC Bank and Citibank for a \$25 million term loan and a \$50 million revolving credit facility. This debt refinancing has been a strategic focus for us, as we wanted to expand beyond funding our business with only an ABL facility and we aim to put in place a long-term permanent financing. Proceeds will go towards refinancing our short-term debt in Asia and to strengthen our cash position to fund continued growth in our business.

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

### **II Yung Kim - DASAN Zhone Solutions, Inc. - CEO, President & Director**

Thank you, Mikhail. To wrap up, we are proud of the progress we made in 2018, where we grew our revenue 14% year-over-year to \$282.3 million and grew our adjusted EBITDA to \$12 million and these financial result exclude KEYMILE. We are quickly growing in scale with the combined revenue exceeding \$345 million and are scaling our profitability as well in 2019.

To wrap up, I would say that we are excited by the business momentum we continue to see in 2019. We see significant greenfield opportunities for underpenetrated regions for fiber-to-the-home deployment. In addition, we expect that our recent product launches, particularly plug-and-play FiberLAN, will drive deep penetration into the enterprise segment. We also see the acquisition of KEYMILE bringing compelling growth and cross-selling opportunities. Lastly, over the next 3 years, we are excited to drive the digital network transformation of tens of thousands of schools across South Korea by leveraging our SDN-based network solutions.

Operator, we are now ready for Q&A.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Our first question comes from the line of Christian Schwab from Craig-Hallum Capital.

**Christian David Schwab** - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

I think I missed it, I'm sorry, what was the non-GAAP gross margin guidance for Q1?

**Mikhail Golomb** - *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

Non-GAAP gross margin for Q1 was 31%.

**Christian David Schwab** - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

31%. Okay. Okay. And then did I hear correctly the non-GAAP operating expenses for the quarter were going to be \$26 million to \$29 million?

**Mikhail Golomb** - *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

That's correct.

**Christian David Schwab** - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Okay. It's kind of a material increase from previous run rates, can you kind of walk us through that step up, is that all KEYMILE?

**Mikhail Golomb** - *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

Sure. I'm happy to provide the breakdown. So we had -- so its \$21 million to \$24 million, that's the range for our organic business, and the rest comes from KEYMILE.

**Christian David Schwab** - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Okay. Perfect. And then as we look to future growth drivers, now that we've reintroduced the FiberLAN product, I understand we have 1,800 access points currently. But as we look out 2 to 3 years, how big of a revenue opportunity are you guys thinking this is for the company?

**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

I think that's really a good question. I think currently, we don't put in our 2019 earnings much, because our new product is just launched in end of January. I think this year it's not going to have significant changes in our revenue. I would say maybe between extra \$5 million, which may come. But I think in the longer term I expect that segment to grow around 30% per annum easily and certainly that's our aim.



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**Christian David Schwab** - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Okay. And can you talk -- remind us of your success in backhaul and 4G, and how big the opportunity is -- it appears everyone in the world is moving to 5G over the next few years?

**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

The LGU Plus, we have a 3-year contract. And that 3-year contract is in -- I can't -- because of a NDA I can't tell you exact. But it's tens of millions of dollars over 3 years for 1 customer.

**Christian David Schwab** - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Okay. That's very helpful.

**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

So it's not insignificant, but that's for a 3-year contract.

**Operator**

Our next question comes from the line of Tim Savageaux from Northland Securities.

**Gregory Thomas Gibas** - *Northland Capital Markets, Research Division - Analyst*

This is Greg on for Tim. First, just wondering how we should think about the cadence and timing of contributions from Indian state fiber rollouts? And I guess how -- what are your assumptions for Indian deals in the 2019 guidance?

**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

So Indian deals that -- you're talking about 2018 or -- 2018 it was...

**Gregory Thomas Gibas** - *Northland Capital Markets, Research Division - Analyst*

2019.

**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

Oh, 2019 -- 2018, we did \$27 million in India. And that Indian deal, we expect it to grow at least 20% to 30%. That's our planning from what we did in 2018. So \$27 million and our planning is to do about 30% more.

**Gregory Thomas Gibas** - *Northland Capital Markets, Research Division - Analyst*

Great. Very helpful. And then secondly, just wondering if you can break out the expectations for growth on an organic basis in 2019, so for the full year guidance? So excluding KEYMILE?



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**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

Excluding KEYMILE, we expect it to grow, year-on-year, between 7% to 12% from existing business.

**Gregory Thomas Gibas** - *Northland Capital Markets, Research Division - Analyst*

Perfect. And then I guess, lastly, just wondering how was 5G traction in Korea in the quarter? And how do you expect this to change throughout 2019?

**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

What do you mean IP traction?

**Mikhail Golomb** - *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

5G.

**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

Oh 5G, okay. 5G that all 5 operators, carriers are launching, and 1 customer has a definitive contract, as I mentioned earlier. And we are still working on the other 2. But I think the first tranche of the backhauls are coming from the radio technology suppliers and backhaul is not separated and they are still using existing radio technology suppliers. So we are still looking for the opportunities to be able to substitute with our technology in there. And we are really working closely with the carriers to do that, and we are also showing this technology in Japan and some other place outside Asia.

**Gregory Thomas Gibas** - *Northland Capital Markets, Research Division - Analyst*

Got it. That's helpful. And then I guess, one last quick one. Was just wondering will KEYMILE be accretive to operating income in 2019 as well?

**Mikhail Golomb** - *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

Yes. That's correct.

**Il Yung Kim** - *DASAN Zhone Solutions, Inc. - CEO, President & Director*

So -- yes, Pei. You can answer.

**Mikhail Golomb** - *DASAN Zhone Solutions, Inc. - CFO, Corporate Treasurer & Secretary*

Yes, that would be accretive to our guidance. So when we said \$345 million to \$360 million revenue, that's inclusive of KEYMILE.

### Operator

This does conclude the question-and-answer session as well as today's program. Thank you ladies and gentlemen for your participation in today's program. You may now disconnect. Good day.



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