

THOMSON REUTERS STREETEVENETS

EDITED TRANSCRIPT

DZSI - Q1 2019 DASAN Zhone Solutions Inc Earnings Call

EVENT DATE/TIME: MAY 09, 2019 / 9:00PM GMT



MAY 09, 2019 / 9:00PM, DZSI - Q1 2019 DASAN Zhone Solutions Inc Earnings Call

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*

Timothy Paul Savageaux *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the DASAN Zhone Solutions First Quarter 2019 Earnings Conference Call. (Operator Instructions)
As a reminder, this call will be recorded.

I would now like to introduce your host for today's conference, Ms. Pei Hung, Vice President of Investor Relations. You may begin.

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

Thank you, operator, and good afternoon, everyone, and thank you for joining us on our first quarter 2019 earnings call. Joining me on the call today are Yung Kim, Chief Executive Officer; and Mikhail Golomb, Chief Financial Officer.

DZS issued a press release this afternoon announcing the results for its first quarter 2019. You can access the press release online in the Investor Relations section of the company's website, investor-dzsi.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.

With those comments in mind, I will now hand over the call to Yung. Yung?

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

Thank you, Pei, and good afternoon, everyone.

The March quarter was a strong quarter for us, where we outperformed our guidance on all metrics, including on revenue, gross margin, adjusted operating expenses and adjusted EBITDA. However, instead of diving right into the strong March quarter results, I'd like to take some time today to speak about why I'm excited about DZS, our mission and our growth opportunities. I believe we are uniquely positioned to capture several large and expanding market opportunities, all of which can be truly transformative for our company. I'd like to share those both with you.



MAY 09, 2019 / 9:00PM, DZSI - Q1 2019 DASAN Zhone Solutions Inc Earnings Call

DZS is a global leader in fiber solutions to enable the delivery of ultrafast broadband access worldwide, and we are proud of our strong fiber first lineage that dates back to the early year 2000. We believe we are one of the pioneers of the fiber-based broadband access technology, and we played an important role in assuring South Korea into the broadband era.

Through our technology partnership with the leading carriers like Korea Telecom in the rollout of fiber-to-the-home services in the year 2000, we helped to establish the country as one of the most connected in the world. This technology partnership with the leading carriers as well as innovative governments have had a profound impact on our strategy and growth opportunities. For example, we are now playing an instrumental role in rolling out broadband to India, which is just in the early stages of its fiber deployment cycle as well as rolling out broadband to other Asia Pacific markets. That's fundamentally our strategy. We customize solutions for our carriers, and we then leverage our investment in the relationships and the technology to retain their upgraded business.

As the acceleration of fiber-based GPON continues, we have a large runway for growth globally. We are seeing emerging markets like India advancing directly into fiber, as well as copper-rich countries starting to invest in fiber. Meanwhile, fiber-rich countries are upgrading to next generation of fiber-based solutions, such as XGS-PON or 10G-EPON. We are positioned to participate in all of these trends. Indeed, we are clearly a fiber-first story. We can also address the copper market. With the leading G.fast solutions we acquired with KEYMILE, we continue to work with the carriers to help reach the gap from copper to fiber.

Now let me talk about our other growth initiatives outside of our broadband access business. In particular, I believe DZS is strategically focused in 2 significant areas of growth: 5G optical transport and the fiber in the enterprise.

Let's start with the 5G. We are very proud to be one of the very first to market with a carrier-grade 5G mobile backhaul solution to help enable LG Uplus to deploy the first commercial 5G wireless network in the Korean market. This is a multiyear tens of millions of dollars contract for us. I see a parallel here between our evolving 5G story and our broadband access story. We were a pioneer in bringing fiber broadband to South Korea in the early year 2000. We are now doing the same in making 5G networks a reality.

Another point on 5G is that it is a seismic shift to go from 4G to 5G. Most people may not realize this, but successful 5G deployment heavily depends on significant high-capacity, fiber-based connections to carry the huge amount of data from cell sites to the core networks. Autonomous vehicles, the Internet of Things and the smart cities will all require fast and responsive and pervasive network. Simply put, mobile wireless connections will depend on fiber being installed everywhere. As carriers start to upgrade their optical systems, we will be well positioned to be awarded additional 5G spend, given our fiber-first lineage.

Lastly, I wanted to touch on our FiberLAN initiatives. We are delivering a plug-and-play turnkey solution that allows enterprises to replace their 30-year old copper LAN infrastructure, and we believe we are in the very early stages of disrupting a very large market. We are getting positive feedback from reseller partners who were previously trained on legacy enterprise 3Gs and who are now affirming to us that our FiberLAN solutions are seamless to set up and manage.

I'm very excited about these broad-based growth opportunities across multiple markets, product lines and technologies and customer growth. We're well positioned to capitalize on these opportunities, given our global footprint, deep and high-quality customer roster and experienced deploying next-generation solutions including 5G. Certainly for a company of our size, we are thriving.

With this introduction, let me now turn to our Q1 2019 results, which I'm pleased to report better than expected with a revenue of \$74.1 million, exceeding guidance of \$72 million, \$74 million, representing a 25% year-over-year increase. We saw broad-based strength with our Asia Pac region continuing to deliver significant growth. We also benefited from increased revenue in Europe, primarily from KEYMILE, which is performing ahead of expectations in the quarter as well as strength in our Middle East region.

Now let me turn this call over to Mikhail to review the quarterly financial performance in detail, and then we will take your questions thereafter. Mikhail?



MAY 09, 2019 / 9:00PM, DZSI - Q1 2019 DASAN Zhone Solutions Inc Earnings Call

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

Thank you, Yung. I will start by discussing our first quarter results and then outlook.

First quarter revenue of \$74.1 million was above our guidance of \$70 million to \$74 million and grew approximately 24.5% year-over-year. Our organic revenue growth was in mid-range of guidance at 8% year-over-year growth, and KEYMILE contributed a little over \$9 million, which exceeded expectations of between \$7 million to \$8 million. From a customer perspective, no single customer accounted for more than 9% of revenue as we continue to enjoy a very diversified customer base.

In terms of market segmentation of our revenue, we saw particular strength in our Asia Pacific and Europe and Middle East markets. Asia Pacific, including Korea, represented approximately \$39 million or 52% of our total revenue and grew 45% year-over-year. EMEA contributed approximately \$18 million or 25% of total revenue with KEYMILE, giving us tremendous scale in Europe. We also saw strong customer traction in Middle East with a Tier 1 carrier contributing at high single-digit millions of backlog, which should contribute nicely to revenue in Q2 through Q4. The North America markets remain soft at approximately \$11 million or 14% of total revenue. Latin America market contributed approximately \$7 million or 9% of total revenue.

Now turning to gross margins. GAAP gross margin for Q1 of 33.6% exceeded our guidance range of 31% to 33% and compared favorably against last quarter gross margin of 30.8% but was down from Q1 2018 gross margin of 36.5%. The quarter-over-quarter increase in our gross margin reflects the immediate and accretive impact of KEYMILE, while the unfavorable year-over-year comparison reflects an unusually large revenue contribution from North America in the prior year period.

In the quarter, our GAAP operating expenses were \$25.7 million. Our non-GAAP adjusted operating expenses of \$23.4 million (sic) [\$23.6 million] came in better than our guidance range of \$25.5 to \$27 million, demonstrating our continuing solid efforts on cost controls.

We generated positive adjusted EBITDA of \$1.8 million or 2.5% margin against our previous guidance of an adjusted EBITDA loss of between \$3.8 million to \$2.6 million. We are very pleased with this significant outperformance on adjusted EBITDA and attribute this lead to our stronger-than-expected gross margin as well as our tight cost controls in the quarter, particularly around headcount management and discretionary spend for both DZS and KEYMILE businesses.

Once again, the difference between the reported GAAP and non-GAAP results in this quarter includes stock-based compensation, depreciation and amortization expenses approximately \$337,000 in acquisition-related expenses, noncash step-up in fair value amortization of acquired inventory and gained on a bargain purchase price of KEYMILE.

Our GAAP net income attributed to DZSI for Q1 was a loss of approximately \$1.6 million or \$0.10 per diluted share.

Now looking ahead to the second quarter of 2019. We expect revenue of the between \$82.5 million and \$86 million. You may recall we had a significant quarter in Q2 of last year with a large order from our Indian customer worth approximately \$16 million. We are not anticipating an outsized order from a single customer in our Q2 2019 guidance so this is a tough year-over-year comparison. In spite of this, we're still expecting to grow approximately 8% to 13% year-over-year from Q2 2018.

Now we expect Q2 2019 GAAP gross margin to be between 32.5% and 33.5%. We expect Q2 2019 non-GAAP adjusted operating expenses to be between \$24.5 million and \$26 million. Now this reflects continued cost controls and operating leverage. We expect Q2 2019 non-GAAP adjusted EBITDA to be approximately between \$2 million and \$3 million or approximately 3% margins.

At this junction, we are not revising our full year 2019 guidance and continue to expect full year '19 revenue to be between \$350 million and \$360 million; GAAP gross margin, between 32.5% and 34%; non-GAAP adjusted operating expenses of \$97 million to \$102 million; and adjusted EBITDA to be between \$17 million and \$20 million.

Finally, one topic that I wanted to bring up is the China tariff headline. We actually view it as a more of an opportunity for us given the trade tensions and security concerns are top of mind for our customers. We have in-house manufacturing capacity in the U.S. and Germany as well as outsourced



MAY 09, 2019 / 9:00PM, DZSI - Q1 2019 DASAN Zhone Solutions Inc Earnings Call

manufacturing relationships in Korea, Vietnam and India, so we are well positioned to meet our customer orders and deliver schedules. We also have diversified revenue streams globally. So our U.S. revenue impact is muted if trade tensions should escalate.

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

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

Thank you, Mikhail.

To wrap up, we are excited about how strong our first quarter was without beating guidance across all metrics. We have the same excitement for our full year outlook as I walk you through our broad base of opportunities at the start of the call. We see significant business momentum across different products, including our early 5G traction as well as different market segments, including our focus on the enterprise segment with the FiberLAN and our School-Net SDN win and the different geographies, including emerging economies like India.

Operator, we are now ready for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Christian Schwab with Craig-Hallum Capital.

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

As we look at the growth drivers that we highlighted, Yung, what -- of the multiple growth drivers, which one in the next, say, '19 and '20 have the opportunity to be the most substantial?

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

I think it's the 5G backhaul and the fronthaul, and we are already working with the Tier 1 operators in Japan and Korea to discuss the technical specs, and I expect opportunities in both countries materializing into numbers next year.

This is rollout is a -- every operator who has the license or spectrum, they were going to spend in billions, and the large portions of that is in the front hall or backhaul, the access side. And I think we are really well positioned in there.

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

And can you -- I know you mentioned in your prepared comments earlier LG, but can you give us an update on how many carriers that you have currently won in Japan and Korea for 5G mobile backhaul? Or in addition, how many you think that you will be able to sell to as the entire world kind of moves forward there?

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

We are in the final stages of negotiation with the one carrier in Japan. And other one, we are working together to final digital technical spec for that. And then we have another carrier in Korea have already have our system on their lap.



MAY 09, 2019 / 9:00PM, DZSI - Q1 2019 DASAN Zhone Solutions Inc Earnings Call

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

Okay. Fabulous. And then if I -- as we think about FiberLAN and its disruptive power, how should we be thinking about how long it takes for your reseller partners to begin to bring material deals to you? And can you give us an update on who your -- if you can, who are some of your leading reseller partners there?

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

Okay. We already signed one of the big ones in France, and we have our systems already with them, and the very positive feedback we got is the equipment is so easy to install and operate. We have already some of the potentials in our numbers for this year. But having said that, I think this is more of probing the ground and building that distribution. I think in the next year, we'll see double-digit millions in the lower part. And then I think 2021, I think we will see higher tens of millions. That's the kind of things. But initial starting point is a pretty -- very encouraging for us to start putting up efforts in building the distribution.

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

Great. And then my last question if I may. As we kind of look at your emerging markets, in particular, India, and the opportunity there, can you kind of walk us through how long do you think it will be until that becomes material and consistent?

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

Okay. I think -- I don't know -- India, we had a tremendous business last year. And this year, the whole country went into election, and their election and voting takes a month, okay? Voting is still in progress, and the politicians are not putting any efforts into sort of dishing out the contract and all that. But having said that, we still have orders, which are fulfilling. But I think what I see, once election is finished in May, I think this activity will rejuvenate.

Operator

And our next question comes from Tim Savageaux with Northland Capital.

Timothy Paul Savageaux - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Congrats on a good quarter. So maybe following up on that discussion. My question was going to be, as you look at the strong sequential growth that you're forecasting for Q2, are there any particular drivers there you can call out from either a geographic standpoint or an end market standpoint? And I was going to ask about India, but sounds like that not it, more kind of on a run-rate basis, but any other areas that you see driving sequential growth from Q1 to Q2?

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

I think we have a lot of activities going in Middle East as they upgrade their network. So I naturally see that's one area. We don't see any -- Asia Pac is going just usually very strong growth. The rest of the world is just our run rate. I think U.S. is sort of a -- we see it reasonably flat, and flat meaning not a lot of growth and run rate. So I don't think there will be something particular customer or geography, so to speaking out in Q2, which is sometimes is good.



MAY 09, 2019 / 9:00PM, DZSI - Q1 2019 DASAN Zhone Solutions Inc Earnings Call

Timothy Paul Savageaux - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Right, and you mentioned no 10% customers in Q1. Focusing back on APAC for a moment. I think you mentioned 45% growth in the aggregate year-over-year. Wonder if you could talk about that in greater detail. In terms of in Q1, what was kind of driving that growth? And did you see contributions from the LG Uplus deal that you mentioned in Q1? Or is that expected later in the year?

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

I think LG Uplus rollout, the first phase, we did it quite a lot in last -- Q4 last year and a small amount in Q1. And that original 50,000 cell sites is going to increase to 230,000 cell sites for whole of 3 operators in Korea. So we naturally see in Q2 to Q4, LG Uplus will buy significantly more equipment. So LG Uplus figures in Q1, they got into the top 5 of our customers. So their spending is going. Their contract is valid, and they may be more acceleration.

My excitement in Asia is Japan. Japan is really kicking in with everybody gearing up for competition with the Rakuten becoming the #5, for example, for carrier in Japan, which really a putting fire into the competition, which is good for us.

And everybody is trying to build up their 5G network and earmarking billions into building networks, which is really -- I'm really excited about that.

Timothy Paul Savageaux - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Okay. And maybe last one for me for now. Mikhail, you mentioned the tariff or overall kind of trade tension with the U.S. and China not really impacting you guys. Kind of the flip side of that is there may be some competitive headwinds for some of your larger, traditional competitors out of China, China-based OEMs, Huawei, ZTE. I wonder if we can get an update as to whether you're seeing any impacts in the marketplace. Are there any of those kind of political headwinds facing China OEMs as of yet?

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

Okay. So on that front, we are seeing some renewed activity in Lat Am, Latin America. We see some competition coming in there. And the European front is not that much. But we don't compete a lot in Africa, so I don't know about that part. Asia Pac, certainly, instead of a Huawei and ZTE, the smaller Chinese supplier or the vendors are coming into Asian market to compete because Chinese fiber-to-the-home rollout is tailing off, and overcapacity is impacting in Asia Pac. But we are competing successfully, and we beat them because we have a track record. It's not like a new vendor having some capacity coming out of China with no reference customers, and that makes -- they make a lot of noise, but I don't think they are landing any big contract despite of that.

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

Just to add to what Yung just said. People -- our customers want quality and performance, and that's where we continue to beat and win.

Operator

Ladies and gentlemen, that's all the time we have for questions. Thank you for participating in today's conference. This concludes today's program. You may all disconnect. Everyone, have a great day.



MAY 09, 2019 / 9:00PM, DZSI - Q1 2019 DASAN Zhone Solutions Inc Earnings Call

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2019, Thomson Reuters. All Rights Reserved.