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# Sonus Networks, Inc. (SONS)

Q2 2015 Earnings Call

# CORPORATE PARTICIPANTS

Patti Leahy
*Vice President, Investor Relations*

Raymond P. Dolan
*President, Chief Executive Officer & Director*

Mark T. Greenquist
*Chief Financial Officer*

# OTHER PARTICIPANTS

Jess I. Lubert
*Wells Fargo Securities LLC*

James Martin Kisner
*Jefferies LLC*

Theodore Joseph Moreau
*Barrington Research Associates, Inc.*

Matthew S. Robison
*Wunderlich Securities, Inc.*

Subu Subrahmanyan
*The Juda Group*

Ryan Christopher Hutchinson
*Guggenheim Securities LLC*

Dmitry G. Netis
*William Blair & Co. LLC*

# MANAGEMENT DISCUSSION SECTION

**Operator**: Ladies and gentlemen, thank you for standing by. Welcome to the Sonus Networks' Second Quarter 2015 Results Conference Call. During the presentation, all participants will be in a listen-only mode. Afterwards, we will conduct a question-and-answer session. [Operator Instructions] As a reminder, this conference is being recorded, Wednesday, July 29, 2015.

I would now like to turn the conference over to Patti Leahy, Vice President, Investor Relations. Please go ahead, ma'am.

## Patti Leahy
*Vice President, Investor Relations*

Thank you and good morning. Welcome to Sonus Networks' second quarter 2015 financial results conference call. Joining me on the call today are Ray Dolan, President and Chief Executive Officer; and Mark Greenquist, Chief Financial Officer.

Today's press release and supplementary data have been posted to our IR website at sonus.net and submitted to the SEC. A recording of this call and the transcript will be available on our IR website after the call. During our prepared remarks, we will be referring to a presentation with supporting information. Please take a moment to locate this on our IR website.

As shown on slide 2, please note that, during this call, we will make forward-looking statements regarding items such as future market opportunities and the company's financial outlook. Actual events or financial results may differ materially from these forward-looking statements and are subject to various risks and uncertainties, including, without limitation, economic conditions, market acceptance of our products and services, the timing of revenue recognition, difficulties leveraging market opportunities, the impact of restructuring activities and our ability to realize the benefits of acquisitions.

A discussion of these and other factors that may affect the future results is contained in our most recent Form 10-Q filed with the SEC and in today's earnings release, both of which are available on our website. While we may elect to update or revise forward-looking statements at some point, we specifically disclaim any obligation to do so.

During our call, we will be referring to certain GAAP and non-GAAP financial measures. A reconciliation of the non-GAAP to comparable GAAP financial measures is included in our press release issued today.

So, with that, it's now my pleasure to introduce the President and Chief Executive Officer of Sonus, Ray Dolan.

## Raymond P. Dolan

*President, Chief Executive Officer & Director*

Thank you, Patti, and welcome to everyone on today's call. I'm pleased to report second quarter results, which are in line or better than our guidance in all key areas of operating performance, representing a strong step in the right direction towards resuming growth and profitability at Sonus.

Let's move right to slide 4 for the highlights of the quarter. First, we are diversifying our customer base with new Tier 1 wins, expanding our presence globally and winning key RFP bids in important growth markets.

I'm very pleased to report that we won two new Tier 1s, one in Asia-Pac and one in Central America. The win in A-Pac is in support of the SIP trunking service for one of the largest communication service providers in the region, supporting over 0.5 billion mobile subscribers in Asia and Africa. And the win in CALA is one of Latin America's largest mobile operators.

Both wins are for our SBC products, which are determined based on a large part on our architectural vision, the strength of our product and the strength of our team in each of those regions.

During the quarter, we had an additional win with another top wireless operator in CALA. Coupled with the Tier 1 win in that region that I mentioned just a moment ago, Sonus is now embedded in three of the largest and fastest growing wireless markets in CALA.

And finally, we've recently won a multi-million-dollar proposal with one of Europe's leading communications and IT service providers for our SBC 7000. This provider will utilize our SBC as part of their unified communication solution for their end customers. We anticipate that this Tier 1 engagement will likely grow each year for many years to come as the overall SIP trunking market continues to develop.

So, while we continue to perceive strong business in North America, we are encouraged by the opportunities we see as SIP becomes more widely adopted globally. Investments we've made over many years position us well as new cloud-based architectures are deployed going forward.

Another key highlight in the quarter was our continued improvement in gross margins. On a normalized basis, which Mark will discuss in more detail, non-GAAP gross margins were almost 400 basis points higher versus Q2 2014.

Finally, and importantly, our cost reduction program is right on track with our expectations. We've established a solid base line for improved profitability in the second half of the year. And we ended Q2 with cash and investments of nearly $114 million, which was comfortably above the $100 million guide from last quarter.

Turning to slide 5. As the industry transitions to NFV and SDN or network function virtualization and software-defined networking, we've continued our multi-year strategy to focus and invest to enable real-time communications in the cloud. Sonus now delivers a completely virtualized product portfolio to service providers, enterprises and web-scale players looking to virtualize their communications networks.

The benefits of network virtualization are mainly in two key areas. The first is a much lower cost of deploying to bigger networks and the second is a much faster cycle time to introduce new services.

Of course, while the promise of these new network architectures is very compelling, calling the precise timing of the overall transition remains difficult. We are ready to lead this transition as it occurs across all market opportunities. Meanwhile, we also remain focused on addressing the near-term opportunities in applications which drive our growth today.

Let's revisit what some of those are. Interconnect remains the bread and butter of SBC revenue for Sonus. Demand for network-to-network IP interconnection continues to grow due to increased session densities across voice and data network. This is a global trend as SIP has increasingly become a global protocol.

SIP trunking continues to have a lot of runway for growth. [indiscernible] (6:35) one-third penetrated in markets such as Europe and APAC are beginning to accelerate, as those markets deregulate and become more open to competition. As I noted before, our new Tier 1 win in APAC was in support of SIP trunking services.

Unified Communications and Collaboration or UCC remains a thriving market due to the benefits of improving productivity and reducing operational costs. Microsoft, a strategic partner of Sonus, has emerged as a market leader among others. As enterprises move to Skype for Business, as one example, our SBC handles inter-working between different VoIP protocols or different vendor standards.

UCaaS or UC as a Service is a growing model for how UC is being deployed. Microsoft Office 365 is just one example. Enterprises want to deploy hosted cloud-based solutions in order to control costs, manage complexity and improve productivity. Service providers look to UCaaS as a way of providing their own over-the-top service.

Our SBCs are purpose-built to help both enterprises and service providers experience the benefits of SIP, as they securely deliver new cloud-ready features and capabilities for the customers they serve.

Royalty, of course, is another incremental driver of growth. SBCs are an integral component of those carrier network transformations to replace existing voice networks.

Voice-over-Wi-Fi is of increasing interest to carriers, especially those which have spectrum constraints or no licensed spectrum at all. Voice-over-Wi-Fi is leveraging the same standards and technology that have been put in place to support licensed royalty services.

More and more operators are now looking to deploy voice-over-Wi-Fi service in conjunction with or prior to the deployment of royalty services. Sonus is actively working with several technology partners to go after this market opportunity.

WebRTC is beginning to show up more often in our customer engagements. WebRTC should drive SIP sessions for both access and interconnect. It allows service providers to extend services to non-traditional devices such as TV and tablets, and bring video and voice started on those endpoints into their networks.

WebRTC also drives the use of SBCs for securing as well inter-working. So, while it's early days, we're very bullish about our market opportunity with WebRTC.

So, with that context of what's driving our near-term opportunity, I'd like to hand it over to Mark to discuss our results and our outlook in more detail. Mark?

## Mark T. Greenquist

*Chief Financial Officer*

Thanks, Ray. As a reminder, gross margin, operating expense, operating income, net income and loss per share are all discussed on a non-GAAP basis and have been reconciled for you at the end of today's press release and presentation.

So let's move straight to slide 7 for a closer look at the quarter. This slide summarizes our reported results for the second quarter of 2015. Total revenue of $54.7 million was at the high end of our guidance of $53 million to $55 million. And $28.6 million or about 52% was attributed to our growth business, compared to 51% in the second quarter of 2014. Total product revenue was $27 million and total services revenue was $27.7 million.

Gross margin was 65.9%, which was above our guidance of 64% to 65%. Included in our cost of revenue was an additional charge for excess and obsolete inventory of approximately $1.6 million. Excluding this charge, gross margins would have been 69% or nearly 400 basis points higher versus the second quarter of 2014, as Ray mentioned. The outperformance was largely due to favorable product mix.

Operating expenses were $40.9 million, as compared to our guidance of $42 million to $43 million. And it's worth noting that, during the quarter, we identified an inaccuracy related to the historical foreign exchange translation of depreciation expense on certain foreign fixed assets.

This resulted in a historical understatement of expense in prior fiscal years, totaling $1.4 million on a cumulative basis. We booked the charge in the second quarter. It was a one-time event. So, on a going-forward basis, we expect depreciation to return to historical levels of approximately $2.5 million per quarter.

Net loss per share was $0.10 compared to our guidance for net loss per share between $0.14 and $0.18. Excluding the two non-cash expense items I just reviewed totaling approximately $3 million, net loss per share would have been $0.04.

Cash and investments totaled $113.5 million at the end of the quarter, compared to our outlook of at least $100 million for the second quarter.

And briefly, regarding 10% customers, AT&T was our only 10% customer in the quarter at 18.9% of revenue, which primarily reflects more spend on network capacity expansions than we originally projected.

Let's turn to slide 8 for our guidance. Q3 revenue is expected to be approximately $65 million. Gross margin is expected to be in a range of 67.5% to 68.5%. OpEx is expected to be $40 million to $41 million. And earnings per share is expected to be between $0.05 and $0.08, based upon 50.5 million diluted shares outstanding. Cash and investments are expected to be around the same level or slightly better than this quarter.

Now turning to full-year outlook. We continue to expect full-year revenue to be in the range of $245 million to $250 million. Based on our conversations with our customers and when analyzing their outlook for CapEx, we believe that second half spend should improve commensurate with our outlook, with Q4 again being the seasonally strongest quarter of the year.

We continue to expect improvement in gross margins over time. This gross margin expansion is primarily a function of higher utilization as well as software content as the industry moves toward greater software centricity.

Net loss per share is expected to be between a loss of $0.10 and break-even, based on approximately 50 million diluted shares outstanding. And the midpoint of this guidance reflects an improvement of $0.075 versus the midpoint of our prior outlook which called for a loss of between $0.10 and $0.15.

Finally, turning to slide 9, I'd like to provide an update on our cost reduction program. As we said last quarter, our objective with this program is to reduce our break-even point to annualized revenue levels, in line with our revised 2015 revenue outlook, and without compromising our continued investment in key products and strategic technology initiatives. And the program is tracking in line with those objectives and expectations.

We continue to expect to achieve approximately $20 million of annualized savings as compared to full-year 2014. Substantially all of the planned head count reductions were also completed during the second quarter.

Our net restructuring expense in the second quarter was $1.5 million, which reflects $2.9 million accrued for the severance related to the implementation of the program, partially offset by a $1.4 million benefit in connection with the termination of a facility's lease in Fremont, California.

Of the $2.9 million accrual for severance-related expenses, we paid out $2.5 million in the second quarter of 2015 and we expect to pay the remaining $400,000 in the third quarter. You may recall that we initially expected approximately $500 million in total restructuring expenses pertaining to the cost reduction program, and we've successfully been able to reduce this charge by nearly $2 million versus those original expectations.

Finally, turning to cash. Our plans to return to positive cash generation in the second half are tracking ahead of expectations. Instead of consuming cash in Q2, we generated positive cash flow, including investments, primarily due to strong gross margins as a result of the favorable product mix that I mentioned as well as very good cash collections.

So, with that, I'd like to turn it back over to Ray for some closing remarks. Ray?

## Raymond P. Dolan
*President, Chief Executive Officer & Director*

Thanks, Mark. To summarize our second quarter results, we're solid staffed toward resuming growth and profitability. We're winning key RFPs and expanding our presence both domestically and internationally. Our gross margins are tracking ahead of plan and we have returned the company to positive cash flow with a strong balance sheet.

I am proud of the team for responding swiftly and getting our cost structure aligned with our current revenue profile. The cost reduction program we announced last quarter is on track, as are all of our technology milestones.

This industry is in the early stages of one of the most significant network architectural shifts of this century. These shifts don't happen in an orderly fashion, and this one is particularly disruptive. Telecom and datacom have collided and datacom has won. The cloud is a massive IP data network, but it still lacks the resiliency required by real-time applications like voice and video.

Mobility is driving massive benefits to end users. But when you scratch below the surface of all the hype, mobility networks are simply an IP radio link connected to a very large and very long wired network, which we now call the cloud.

Licensed and unlicensed mobile networks are converging. As core networks are flattening and moving to software, the new model is all about applications. To paraphrase an old political slogan, it's the application, stupid. Going forward, the network is the application and the application is the network.

The mission to migrate real-time capability to the new cloud architecture is a large one, and we believe that Sonus is perfectly positioned for this transition. We've led the transition to software-based SBCs and we have more than a decade of experience in the design and operation of large-scale real-time networks. We have the products, the talent and the financial strength to invest and continue in innovation.

With that, we'd now like to open the call up for your questions. Operator? Susie, if you'd open the call up with details.

# QUESTION AND ANSWER SECTION

**Operator**: Thank you. [Operator Instructions] Our first question coming from the line of Jess Lubert with Wells Fargo. Please proceed with your question.

Jess I. Lubert
*Wells Fargo Securities LLC* Q

Hi, guys. Good morning.

Raymond P. Dolan
*President, Chief Executive Officer & Director* A

Hey, Jess.

Jess I. Lubert
*Wells Fargo Securities LLC* Q

Couple of questions. First, I was hoping you could comment on overall visibility levels into projects you're seeing with some of your large Tier 1 customers, particularly in the U.S.? And given your second half sales outlook, and that's a fairly steep sequential improvement, does that embed equal improvement with the U.S. Tier 1?

Raymond P. Dolan
*President, Chief Executive Officer & Director* A

Yeah. Thanks, Jess. Visibility into Tier 1, I'm assuming you're talking about the telco players. We've got decent visibility, as implied in our guidance, to the large players. There's always timing risk with these folks because they move projects around. But taken together, between Q3 and Q4, I feel comfortable with their component of our outlook in the second half.

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**Jess I. Lubert**
*Wells Fargo Securities LLC*

Q

And can you update us on the status of some of the projects that slipped out of Q1 and to what extent they're still in play or likely to close later this year?

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**Raymond P. Dolan**
*President, Chief Executive Officer & Director*

A

Sure. Most of those projects are still in play and I expect them to close either in the back half of this year or early in 2016.

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**Jess I. Lubert**
*Wells Fargo Securities LLC*

Q

And then, it seems like the international business was fairly weak sequentially and year-over-year. So I guess I was hoping to parse some of the wins you saw in the region and positive comments regarding international demand versus what we saw from reported result in the quarter? What's giving you confidence? Whether it's some of these big deals contributing to revenue in the near term? If you can just put some color around what you're seeing internationally because it seems like the numbers there were fairly weak in the quarter?

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**Raymond P. Dolan**
*President, Chief Executive Officer & Director*

A

Yeah. So, Jess, we're seeing very good RFP activity and I feel very comfortable with some of our outcomes already and what will be our likely outcomes over the next 12 months in those RFPs.

The SIP trends have continued to move offshore beyond Europe and now are, I would say, fairly deeply embedded in Asia-Pac. We're starting to see some of the large carriers peer even within Japan, for example, and then between large nations. So I would expect those to continue into 2016 and 2017.

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**Jess I. Lubert**
*Wells Fargo Securities LLC*

Q

And the big Tier 1s you announced internationally, do those contribute to revenue over the next few quarters?

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**Raymond P. Dolan**
*President, Chief Executive Officer & Director*

A

I would say as long as you go out full year they'll contribute to revenue.

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**Jess I. Lubert**
*Wells Fargo Securities LLC*

Q

All right. Thanks, guys. I'll jump back in the queue.

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**Raymond P. Dolan**
*President, Chief Executive Officer & Director*

A

Thank you.

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**Operator**: Thank you. Our next question coming from the line of James Kisner with Jefferies. Please proceed with your question.

James Martin Kisner
*Jefferies LLC*

Q

All right. Thank you very much. I just wanted to talk about gross margins. So 69%, backing out this charge, is historically very strong. I think that's the potentially second highest in company history. The first factor Mark mentioned here in terms of driving the strength was improved utilization. Can you just talk about that some more, the comment? Just a little surprising given that your revenue level was not particularly high here.

Raymond P. Dolan
*President, Chief Executive Officer & Director*

A

Yeah. James, it's Ray. Thanks for that question. The gross margin was largely driven by mix. We've been moving our products more towards software. We're seeing some levels of density. And even on the legacy business, we're seeing some expansion opportunities which tend to come at high margin.

James Martin Kisner
*Jefferies LLC*

Q

Okay. That helps. So I know you're not breaking this out explicitly anymore. Can you talk about how SBCs trended quarter-over-quarter? What you're assuming for – I assume that it's driving the Q3 ramp sequentially. And I was hoping you'd also talk about trends in enterprise versus service providers on the SBC business, both in Q2 and what you expect in Q3.

Raymond P. Dolan
*President, Chief Executive Officer & Director*

A

Sure. Let me take a shot at that. First of all, in our growth revenue SBC-related, Q2 wasn't as strong as we'd like and year-over-year comparisons will show that. But in the back half of the year, a lot of that growth resumes and it becomes a really nice piece of our outlook in the second half.

With regard to enterprise versus service provider, we still see the majority of the market in the service provider, but there's some very large enterprise data opportunities that are going on in virtually all parts of the world. And we've been working for years now with the Tier 1 service providers as a channel into them. Some of them are hard to call on the timing, but all of them are I think very strategic to us.

And there's a lot of confusion out in the marketplace. It makes it challenging to call the timing of these issues. But it actually is giving a lot of energy to CIOs and CTOs around the world looking at both on-prem and cloud-based architectures. And what's happening, in my opinion, is that the cloud-based architectures are becoming the theme going forward. You're seeing that in Skype for Business moving quickly in an effort to enable more voice as opposed to just seek licenses and you're definitely seeing it in some of the other web-scale players.

James Martin Kisner
*Jefferies LLC*

Q

Great. Just one final one here. So you guys have talked in the past about your progress amongst cable operators. I don't know if you would hazard a rough estimate of how much cable has been in your business in the past, but some folks have been talking about M&A-related weakness from the cable operators and you're seeing some preannouncements and weak guidance driven by weak cable spend. I'm just wondering is that weighing on your business at all today, any impact at all that you can see from wins in cable. Thanks.

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Raymond P. Dolan
*President, Chief Executive Officer & Director*

A

Sure, James. Thanks. So we don't break out cable as a percent. But I will tell you that it's become increasingly strategic to us over the last few years, and I would expect that trend to continue for the next few years. Of my own time, I'm spending much more time strategically with the cable industry and a number of the CTOs together in conferences like CableLabs. And I expect their network spend to be quite bullish going forward.

It may be that some of the set-top box issues that are – as major platforms like XFINITY move to the cloud, it may or may not put pressure on some of the other things recovering. But from the standpoint of their cloud architectures, their interconnect, their peering strategies, all of those are very, very favorable towards our SIP strategy and our cloud strategy.

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James Martin Kisner
*Jefferies LLC*

Q

All right. Thanks very much.

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Raymond P. Dolan
*President, Chief Executive Officer & Director*

A

Sure. Thank you.

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**Operator**: Thank you. Our next question coming from the line of Ted Moreau with Barrington Research. Please proceed with your question.

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Theodore Joseph Moreau
*Barrington Research Associates, Inc.*

Q

Thank you very much. Good morning. Just first of all, congrats on the customer wins that you talked about. Given the size of the APAC service provider that you won, is there a possibility that eventually they become the size of maybe an AT&T, or is that not really in the cards?

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Raymond P. Dolan
*President, Chief Executive Officer & Director*

A

Yeah. Thanks, Ted. I probably should wait a year or two years before we make that call. AT&T was really the banner customer for our company when we formed Sonus, what, 15 years ago. So it's a little early days to call that pivot.

There are some other customers around the world though, beyond just the Tier 1 in APAC, there are some other North American customers that are really becoming very, very strategic to us and there's a couple of EMEA customers that have the potential to be very, very strategic to us. So I would expect us to be a far more diversified company 18 months from now than we are right now.

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Theodore Joseph Moreau
*Barrington Research Associates, Inc.*

Q

And those other customers that you're talking about, I mean, those are current wins that you have and you expect that just to ramp eventually, or do you still have to go out and win some of those deals?

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**Raymond P. Dolan**
*President, Chief Executive Officer & Director*

A

No, these are current customers. But we've had either gateway or SBC preparing wins in projects that were somewhat isolated and were now far more pervasive in our coverage across the accounts and able to talk about their migration to the cloud, because we've been investing for at least three years moving to software, if not longer.

And as everyone is waking up to just how fast this transition to the cloud is going to happen over the next few years and just how disruptive it is. We've become a much more trusted partner to a much more diverse number of Tier 1s to look at those architectures. So I feel really good about that, as I said, across North America where we're pretty deeply embedded but also in some emerging areas of EMEA that we had missed, say, as much as a decade ago.

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**Theodore Joseph Moreau**
*Barrington Research Associates, Inc.*

Q

That sounds good. And then, you've been talking a lot about the movement to software and virtualization. And where do you stand with respect to recognizing virtualized SBC revenue now? I mean, have you been recognizing it yet? Like, where are we in terms of that revenue recognition in time?

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**Raymond P. Dolan**
*President, Chief Executive Officer & Director*

A

Yeah. So we – I would say that the software portion of our revenue in total is immaterial at this point in time, Ted, and it's probably going to stay that way for the balance of this year. But we'll start to talk more about that next year as we see these cloud strategies play out.

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**Theodore Joseph Moreau**
*Barrington Research Associates, Inc.*

Q

Okay. Sounds good. Final question, you talked about AT&T capacity additions, was any of that tied to Voice-over-LTE or is that more traditional stuff?

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**Raymond P. Dolan**
*President, Chief Executive Officer & Director*

A

Most of that was more traditional stuff. You'll see some of the Voice-over-LTE start in future periods.

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**Theodore Joseph Moreau**
*Barrington Research Associates, Inc.*

Q

Okay. Great. Thank you so much. Good luck.

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**Raymond P. Dolan**
*President, Chief Executive Officer & Director*

A

Thank you.

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**Operator**: Thank you. Our next question coming from the line of Dmitry Netis with William Blair. Please proceed with your question. Mr. Netis, we cannot hear you at the moment. Dmitry Netis, we cannot hear you at this time. Please verify your mute function.

Patti Leahy
*Vice President, Investor Relations*
A

Operator, let's go ahead and jump to the next question. Dmitry can hop back on.

**Operator**: Thank you. Our next question coming from the line of Matt Robison with Wunderlich. Please proceed with your question.

Matthew S. Robison
*Wunderlich Securities, Inc.*
Q

Yeah. Thanks for taking the question, and congrats on the cash flow and the customer wins. I was hoping you could talk a little bit more about how UCaaS is changing the way you address the market. What products that you use to target those kind of customers and applications?

Also, it sounds like your number of new customers is down from a year ago as well as your number of total customers. But it seems like you're winning some pretty big ones. And I was wondering if you could talk about the tone of the kind of customers you're winning in this quarter versus a year ago, maybe some of the discriminators that got you the mobile business?

Raymond P. Dolan
*President, Chief Executive Officer & Director*
A

Sure, Matt. So, on UCaaS, we basically go to market at the edge with our SBC 1000/2000, which is – in SBC, they also have some hybrid TDM content in it because, a lot of the edge of the enterprise network still does some TDM work. And then, of course, we have our 5K and 7K in core, and that's probably where people have done the most work with our software version. At some of the smaller channels, they're starting drive the SWe in small density deployment.

We see that happening more and more. And I think as the big plays like Office 365 and like Google Hangouts and even Apple and others start to drive enterprise consumer kind of hybrid solutions, you're going to see UCaaS I think take off and move to a cloud-based architecture. And I think things are going to move off-prem pretty darn quickly in the next, say, 24 months.

As regarding new customer win, yeah, we have had a lot of focus for multiple years now on Tier 1s around the world. Some of those were long RFP processes that are starting to come to bear. I'm excited with our wins. We're learning when we don't win, why, and we're doubling down our efforts and we're starting to get to a critical mass across some of the mobility requirements of the VoLTE marketplace. So I would expect there'd be some more things for us to talk about going into 2016 as we drive that as well. I think that was the tail-end of third part of your question.

Matthew S. Robison
*Wunderlich Securities, Inc.*
Q

Yeah. And do we – so when you look at the UCaaS opportunity, especially the interconnect piece, how big is that relative to the edge portion?

Raymond P. Dolan
*President, Chief Executive Officer & Director*

A

Well, it's hard for me to say, but the interconnect piece in, say, a Skype for Business environment would I think be very large. It'd be both in the cloud deployment, there'd be a breakout function across a number of express through partners and then there'd be an edge function. Probably the largest piece of revenue would still be on the edge so until things move to a hosted model, which is probably still a few years out.

Matthew S. Robison
*Wunderlich Securities, Inc.*

Q

Last question. And it's nice to see the DSO come in. Can we – is it possible for you to bring it back down to last year's levels down into the 17s and have another strong operating cash flow report this quarter?

Mark T. Greenquist
*Chief Financial Officer*

A

Yeah. I think it's possible. I mean, it's going to be mostly dependent upon the linearity of revenue within the quarter, as it always is. So our guidance reflects sort of normal historical linearity. To the extent that some of the revenue comes a little bit quicker than what we have experienced historically, then certainly we should see that. One of the benefits of that would be a lower DSO.

So I think it's a little early to call the ball on that. And again, our guidance is right down the middle. But that would be the main factor that would allow us to do something like that.

Matthew S. Robison
*Wunderlich Securities, Inc.*

Q

Thanks.

**Operator**: Thank you. Our next question coming from the line of Mike Latimore with Northland Capital. Please proceed with your question.

Q

Hi. Thanks so much. This is [indiscernible] (32:42) for Mike Latimore. I've got a couple of questions here. One on the services business. Give me some color in terms of what could be the growth opportunity for the services business?

Raymond P. Dolan
*President, Chief Executive Officer & Director*

A

I don't understand the question. So the professional services component of our business or...

Mark T. Greenquist
*Chief Financial Officer*

A

The entire services.

Raymond P. Dolan
*President, Chief Executive Officer & Director*

A

...the entire services and maintenance business?

Q

Yeah. The entire services business. Yeah.

**Raymond P. Dolan**
*President, Chief Executive Officer & Director*

A

Yeah. So the entire services business is probably flat to slightly up, presuming that we continue to get professional services attach rates that we have right now to our product outlook. So I'd say there may be some low-single-digit growth opportunities there between now and the end of 2016.

Q

Okay. With regards to maintenance revenue, could you tell me what the renewal rate is?

**Patti Leahy**
*Vice President, Investor Relations*

A

Renewal rate.

**Raymond P. Dolan**
*President, Chief Executive Officer & Director*

A

The renewal rate was very high. We don't break that out, but it was immaterial, lack of renewal.

Q

Okay. And finally, is there any opportunities with the federal contract or something like that?

**Raymond P. Dolan**
*President, Chief Executive Officer & Director*

A

Is the question are there any opportunities in the federal vertical?

Q

Yep.

**Raymond P. Dolan**
*President, Chief Executive Officer & Director*

A

Yes, there is. In fact, we're engaged in a number of opportunities in the federal space. We'll see if they come in under this fiscal budget or get pushed to the next one. Those are very hard engagements to call.

We've not only been going direct over the last year or more. We've actually built a vibrant channel into the federal space. We've also get certified our 5K and our 1K, 2K. So we will soon begin certifying the rest of our SBC suite.

And I think between that and our software capability, federal as an opportunity contribute nicely to 2016. But it's too early to make that call.

Q

Okay. Yep. Thanks a lot. Yep.

### Raymond P. Dolan
*President, Chief Executive Officer & Director*

A

Thank you.

**Operator**: Thank you. Our next question coming from the line of Subu Subrahmanyan with The Juda Group. Please proceed with your question.

### Subu Subrahmanyan
*The Juda Group*

Q

Thank you. Ray, if I could ask a sort of big picture question, if you look at the trajectory in 2014 and the step-down we're seeing for 2015, do you see this primarily as a result of some changes ahead of transition to software models? Do you see this as in terms of specific customer timing? Can you talk a little bit about that? And how are you thinking about 2016? Are we working off of sort of that lower point this year, but still in terms of growth opportunities you see similar sort of growth rates for your set of product? Just trying to understand sort of the dislocation this year and how you see that as part of the larger trend.

### Raymond P. Dolan
*President, Chief Executive Officer & Director*

A

Yeah. Subu, I'll certainly do my best to answer that question, but there's a lot of risk in trying to call a market that's in this level of flux. I think most of the 2014 to 2015 transitioning came from traditional telco spend being under pressure and the web-scale spend not yet growing sufficiently to displace that.

So the telco model is under tremendous stress. And so, I know you and many of the others on this call are following very, very closely all the commentary on the big Tier 1s in North America and around the world. And I would expect those trends downward to continue because I think that model is going to stay under stress for the next several years. So I would not return that component as spend into any larger component than it is in our 2015 model as we transition to 2016.

The web-scale players have an opportunity to become a meaningful driver as early as 2016. We're seeing some very good traction with the number of folks across that industry. And here's what's happening, they're beginning to realize, despite the religious debates that go on out there both on the edge and in the core cloud architectures, that in order for voice and video to work they need to be managed.

And second, in order for it to happen securely between networks, and the cloud is actually a collection of networks, it's not one unified network, in order for them to happen securely, you need an SBC, which is essentially a session-aware firewall, okay? So, for those reasons, I would expect the web-scale spend as a percentage of our total revenue to start to become more meaningful next year.

Now, what does all of that mean mathematically? I believe this year re-baselines the company in the zip code that we're in right now, we'll see how the year ends way before we guide to next year. But presuming that we stay on our track, which is where we are right now for the second half, I'm tracking our book-to-bill and we've had a successful first half, above 1. And I do expect our second half will be above 1, and if that's the case, we'll return to growth next year, okay? But we'll make more comments on that in our next quarter's call and then we'll ultimately guide on the following call.

I hope that's helpful to you and everybody on the call as to how we're thinking about our growth trajectory.

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Subu Subrahmanyan
*The Juda Group*

Q

Yeah. Absolutely. And from an underlying market trend perspective, you in the past talked about sort of growth rate for the SBC market sort of declined in the legacy. I think you made the point, the telco market's spending pressure, both because of architectural shifts and I guess because of aggregate dollars, remains under pressure, quite a bit of growth comes from the web-scale.

So do you think of next year as the telco market remaining relatively flat and growth been layered on by web-scale, or is the set of markets you're in, the SBC market especially, still that growth market that you think about just having had a hiccup this year?

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Raymond P. Dolan
*President, Chief Executive Officer & Director*

A

I think it's too soon to tell. It's probably between the two, and we're just going to track our bookings quarter-to-quarter, our traction with Tier 1s and how fast we can broaden beyond, say, being a dominant interconnect player to being a big part of their access network to being a big part of their emerging cloud architectures and software. And we'll keep you posted as we progress there, Subu. But I wouldn't want to call 2016 at this stage and 2015 yet, okay?

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Subu Subrahmanyan
*The Juda Group*

Q

Totally understand. Thank you.

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Mark T. Greenquist
*Chief Financial Officer*

A

Thank you.

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**Operator**: Thank you. Our next question coming from the line of Ryan Hutchinson with Guggenheim Securities. Please proceed with your question.

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Ryan Christopher Hutchinson
*Guggenheim Securities LLC*

Q

Great. Good morning, guys. So, a couple of clarifications questions here. On the Tier 1 component that you talked about in the guide, when you look at that versus years prior, maybe as a percentage basis, how does it compare to years past? I'm just trying to get a sense of how much your expectations for the second half are tied to the Tier 1s and in the event that some of these things that you've outlined with respect to architectural shifts, et cetera, continue to sort of drag on results.

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**Raymond P. Dolan**
*President, Chief Executive Officer & Director*
A

Yeah. Thanks. It's Ray. And so I would say it's about the same. It might be a little bit less going forward. So it's probably the same to a little less concentrated on Tier 1s. The enterprises are starting to track, although it's really hard to call the ball now and say there's just probably even more timing risk on the enterprise in some cases than there are in Tier 1s. And then, the web-scale players have to come in and start to drive Lync transitioning to Skype and other places like the Google environment, have that opportunity to displace that as well.

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**Ryan Christopher Hutchinson**
*Guggenheim Securities LLC*
Q

Okay. And then, as part of that, I guess why are you comfortable that the SBC component comes back in the second half?

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**Raymond P. Dolan**
*President, Chief Executive Officer & Director*
A

Just based on customer engagements, what we see in our first half bookings, what we see in our progress in July, for example, and I've been on the road a lot talking to all of our customers. And so I feel comfortable with our outlook. If there's an issue at all regarding the spread between Q3 and Q4, always there's modest exposure towards slipping between the quarters. But I think from the standpoint of the outlook on the second half in total, I feel very good about our outlook.

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**Ryan Christopher Hutchinson**
*Guggenheim Securities LLC*
Q

Okay. And then, finally, can you just talk to the competitive environment, it hasn't been brought up, specifically around other vendors' virtual strategies? There is some commentary from some of the competitors that they're farther along than where you are. And I know that that may have been the case. How do you look at that? How do you stack up against some of the other emerging competitors that are focused on this virtual opportunity?

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**Raymond P. Dolan**
*President, Chief Executive Officer & Director*
A

Ryan, thanks for that question. I don't believe it ever was the case. It is not now the case that any of those competitors, if I presume who you're talking about, the chase Domain 2.0 press releases for open source commitments and things like that, they've never been ahead of us. They've never been able to scale more than us. And we've won a number of engagements that have gone to them early and come back to us because we can scale.

So I feel very comfortable about the resiliency, scalability, reliability of our products, and our transition to software. And we do it off the common code base and we can do it in the cloud off general-purpose compute platform and we can do it in almost every virtual environment that exists today and we will get to all of the virtual environments that exist going forward.

So I've had discussions with CTOs and other senior execs in the MSOs and the Tier 1 telcos as well as the Fortune 50, and all of them are very, very comfortable with where we are now and where we're going architecturally.

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**Ryan Christopher Hutchinson**
*Guggenheim Securities LLC*
Q

Okay. Great. Thanks, guys.

Raymond P. Dolan
*President, Chief Executive Officer & Director*

A

Thank you.

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**Operator**: Thank you. Our next question comes from the line of Dmitry Netis with William Blair. Please proceed with your question.

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Dmitry G. Netis
*William Blair & Co. LLC*

Q

Good morning, gentlemen.

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Raymond P. Dolan
*President, Chief Executive Officer & Director*

A

Good morning.

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Dmitry G. Netis
*William Blair & Co. LLC*

Q

Okay. Great. Just making sure you can hear me. Sorry about the technical difficulties. I would like to ask a couple of quick ones. First, I think we've beaten this horse to death, but as we look out into the next leg of growth, how many of the wins, for example, with Tier 1s or not can you attribute to this virtual SBC/policy sort of product? Is there a number you can kind of disclose? I know – and it's very early but I mean I was trying to gauge the number of engagements, but perhaps you can talk about some of the projects and RFPs that are out there that you are competing for?

---

Raymond P. Dolan
*President, Chief Executive Officer & Director*

A

Yeah. Dmitry, I would say you cannot engaged very many Tier 1 RFPs around the world unless you have a committed path of virtualization and can demonstrate that. And actually that might be one of our greatest competitive advantages, is that we've been committed to that for so long, we do it off the common code base and we scale very, very nicely.

So our 7K architecture, which puts them in a video-ready capability with the 10-gig interfaces, it's the highest density box by far on the marketplace. And in fact, that it's that code base that in fact allows them to go to the cloud is very compelling to the Tier 1s.

Now, when you add our policy engine, which was actually the first network element that we virtualized, and when people realize how important policy is to arbitrating applications that are all trying to control the network, and that's what Tier 1s are realizing is that the application is controlling their network and they're fighting amongst each other. There needs to be an orchestration layer that arbitrates, if you will, the needs of the app, okay?

When the app goes off, in old fashion terminology, somebody needs to manage the party line that's going on right now in the cloud. The policy engine does that. So the combination of our SBC and policy assets in software is a very powerful part of our architecture story, and that has been part of almost every – actually every Tier 1 engagement we've had.

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Dmitry G. Netis
*William Blair & Co. LLC*

Q

Okay. I was really hoping to see more of kind of the software virtualized product in terms of the number of engagements, but it sounds like you're not ready to disclose that just yet?

Raymond P. Dolan
*President, Chief Executive Officer & Director*

A

Was there a question in there, Dmitry, because, yes.

Dmitry G. Netis
*William Blair & Co. LLC*

Q

No, no, no. Just – okay. I'll move on. Okay. And then...

Raymond P. Dolan
*President, Chief Executive Officer & Director*

A

Okay.

Dmitry G. Netis
*William Blair & Co. LLC*

Q

...on the AT&T Domain 2.0, is there an update there? I'm just curious, has that RFP been decided? I know that that might include virtualized SBC and policy. Could you give us an update there? I mean, that's a fairly large project that's potentially slipped late last year and moved into second half of this year. Where are we with this one? I know the question's been asked before, but give us an update if the RFP is decided or not and whether you're still in the mix there?

Raymond P. Dolan
*President, Chief Executive Officer & Director*

A

We have been engaged with AT&T for a long time and we remain actively engaged with AT&T. But I'm not going to comment on their Domain 2.0 program. You can certainly ask AT&T on that. But that's a huge opportunity I think for all vendors in this space. It's all about the path to virtualization, the cloud architecture and getting to the right unit cost structure.

Dmitry G. Netis
*William Blair & Co. LLC*

Q

Okay. All right. And then, lastly, Ray, maybe if you could give us a sense where Diameter was this quarter and where it may be heading in terms of visibility of the pipeline for you? I know you had two wins. Is there any update to that? And how comfortable are you with Diameter growth going forward?

Raymond P. Dolan
*President, Chief Executive Officer & Director*

A

Yeah. So Diameter was not a material contributor to our revenue this quarter, Dmitry. Our signaling revenue was really about our SS7 piece. But it's the interplay between those two that I think over time will give us more traction in the broader signaling marketplace. And as we become more wireless-oriented through some royalty bids, I think you'll see us get some more diameter traction into 2016.

**Dmitry G. Netis**
*William Blair & Co. LLC*
Q

Okay. Perfect. And maybe one more if I may. Just kind of as I look into the enterprise side of the business, I know, Ray, you mentioned Skype for Business and Microsoft relationship. I don't know if there's any comment you can provide on that front. I know that could be a potentially large opportunity for you. Have you thought about in terms of the growth projection there? I know maybe it's off a low base today, but is that the business that can grow 20%, 30% for you going forward? Are you investing in that side of the business? Give us a sense where that as an opportunity may lie for you. Thank you.

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**Raymond P. Dolan**
*President, Chief Executive Officer & Director*
A

Yeah. Sure, Dmitry. So the enterprise business is larger than just the Skype for Business relationship. I'll comment on them separately. We have a huge opportunity in the enterprise, which we deal with directly until we get the design win and then largely through the telcos of the channel. And we've got some great Fortune 50, Fortune 100 enterprise opportunities in our pipeline. And as we score those, we'll report out and then to the extent we can. So I feel very good about our overall enterprise story.

Now, more specifically on Skype for Business, we've been invested in Lync for many, many years. That relationship strengthened when we bought NAT and the 1K, 2K, which is Lync certified. Now all of our products are Lync and now Skype for Business certified.

But one of the things we did years ago was decide not to build the phone-in-a-box because the phone-in-a-box was an end market cul-de-sac that the entire end market was going to move into the cloud and then ultimately into a hosted model. So we invested heavily, both technically and commercially, in the relationship side as that opportunity for the day when the world was moving to the cloud.

So I would not want to be a competitor out there that's waking up to the fact that there's a stall and a Lync market, because it appears to be moving to the cloud. We're thrilled about that transition. And to the extent that it happens in 2016, it's a huge opportunity for us.

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**Dmitry G. Netis**
*William Blair & Co. LLC*
Q

All right. Thank you very much.

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**Raymond P. Dolan**
*President, Chief Executive Officer & Director*
A

Thank you.

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**Operator**: Thank you. Our next question coming from the line of Paul Silverstein with Cowen & Company. Please proceed with your question.

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Q

Yeah. Thanks you. This is [ph] Greg McNiff (50:09) in for Paul. I just had a quick question on long-term deferred revenue. I noticed it was down slightly sequentially. And I would have expected it to be up given that you had more traction with Tier 1 service providers and more long-term contracts this quarter. Can you just comment on that briefly?

Mark T. Greenquist
*Chief Financial Officer*

A

Well, the long-term is down a little bit. But the short-term was up and in fact total deferred revenue was higher. And as Ray mentioned, I think when somebody asked with regard to when do you expect these Tier 1 engagements to revenue, he said over the next 12 months or so. So, that's – you would see it in the short-term, not the long-term deferred revenue.

Q

Got it. And it's just a short-term shift. Okay. Thank you very much.

**Operator**: Thank you. And we have time for one more question coming from the line of [ph] Steven Collins with [indiscernible] (51:04) Partners. Please proceed with your question.

Q

Hi. Continuing on the discussion of those Tier 1 wins, I guess what you just said is that they're setting in deferred revenue. Trying to get a sizing, would you expect that they would be material contributors? When you finally get around to scoring that revenue, could those names show as 10% customers in a quarter?

Mark T. Greenquist
*Chief Financial Officer*

A

We'll see, [ph] Steve (51:31). I don't know. It really will depend on how they develop, but it's unlikely. If they do, we'll be pleased to break them out for you.

Q

Okay. And totally different kind of question, I noticed there was a jump in stock comp this quarter. Can you just say what that was about?

Mark T. Greenquist
*Chief Financial Officer*

A

I'm going to have to look at that and get back to you.

Q

I mean, sequentially.

Mark T. Greenquist
*Chief Financial Officer*

A

I think that there was – from the grants that were done earlier in the year, I think that's what drove it. But I can look at and get back to you on that particular question.

Q

I appreciate that, Mark.

**Raymond P. Dolan**
*President, Chief Executive Officer & Director*

A

Thanks, [ph] Steve (52:20).

Q

That's it for me.

**Raymond P. Dolan**
*President, Chief Executive Officer & Director*

A

Okay. Operator, I think that's the end of the questions. Could you confirm that, Susie?

**Operator**: Yes. Thank you, sir.

**Raymond P. Dolan**
*President, Chief Executive Officer & Director*

Okay. Thanks, everyone. I know the market is going to open soon. I won't beleaguer my ending comments, other than the fact that I'm very, very proud of the team for its resiliencies and demonstrated over many years in Sonus. But yet again, we've deal with the challenge in the first quarter, we've achieved our second quarter goals and we've confirmed our outlook for the second half. We're going to get back to business and run a great company, and we'll keep you posted as we make progress. Thanks for all of your support along the way. Have a great day.

**Operator**: Ladies and gentlemen, that does conclude the conference for today. We thank you for your participation and ask that you please disconnect your lines. Have a great day.