

## **SONUS NETWORKS THIRD QUARTER 2013 RESULTS**

### **PREPARED REMARKS**

**October 29, 2013**

#### **PATTI LEAHY, VICE PRESIDENT, INVESTOR RELATIONS**

Thank you and good afternoon. Welcome to Sonus Networks' third quarter 2013 operating results conference call. As a reminder, today's press release and supplementary financial and operational data have been posted to our IR website at sonus.net. A recording of this call and a copy of our prepared remarks will be available there later this afternoon as well.

Speakers on the call today are Ray Dolan, President and Chief Executive Officer, and Moe Castonguay, Senior Vice President and Chief Financial Officer.

Please note for purposes of Safe Harbor provisions that during this call we will make projections and 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 projections or 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, and the impact of restructuring activities.

A discussion of these and other factors that may affect 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, unless required by law.

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, as well as in the Investor Relations section of our website.

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

**RAY DOLAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER**

Thank you, Patti, and good afternoon everyone.

We have a lot to cover today, so let me start by giving you my bottom line right up front: Sonus is winning. We have succeeded in turning a once tired, legacy business into an energized, growth business that is rapidly becoming a leader in its class. Progress is not always linear, but we are making great progress.

As you can see in today's press release, we've provided slightly updated guidance for the year. On the top line, we have reduced our total media gateway estimate and increased our total SBC revenue estimate, for a net top line reduction of approximately \$3 to 4 million. Let me provide some color on these variances from our prior outlook.

We now assume approximately \$68 to \$69 million for legacy product revenue for full year 2013 which is an increase from our prior guidance and reflects a slightly slower rate of decline of 20%. Legacy services revenue is now assumed at approximately \$80 million for the year which is below our prior forecast but in line with 2012 results. The net change since our prior outlook is a decline of total legacy revenue of approximately \$5 to 6 million for the year.

Turning now to SBC, as we said last quarter, we were experiencing a greater mix of service as a percentage of total SBC. We now expect SBC product revenue to be slightly lower than our prior outlook but we expect SBC total revenue to be slightly higher as a result of higher services revenue. Consistent with what I told you last quarter, there are a number of large new projects that have big service components

attached to them with initial smaller product revenue. This trend, coupled with a sales cycle for SBC that has lengthened somewhat, have been the drivers behind our revised outlook today. The net change is an increase to total SBC revenue of approximately \$2 million at the midpoint for full year 2013.

While this short-term issue creates a little noise in our results, my confidence in our future remains stronger than ever. We are delivering a roadmap that is resonating with our customers and is helping lead them through their decisions around session- and cloud-based architectures and the evolving trends around SDN and NFV.

Sonus is involved in the right dialogues with our customers and we are very well positioned to partner with them over the long term. As a testament to that, we have recently won three new Tier One SBC accounts: one important international account won with a strategic partner, another international Tier One account won through our direct sales force and a large domestic MSO also won through our direct sales force. We would not have won these strategic bids if we didn't have an industry leading roadmap and the ability to deliver.

Before Moe goes into the details on the quarter, October marks my third anniversary as the CEO of Sonus so I'd like to offer some additional perspective on the status of our turnaround and the path forward for the company.

Put simply, Sonus is a very different company today than it was three years ago. I am very proud of the team's accomplishments so far, but there is clearly more work to be done.

Our goal is to be an industry leader, whether measured on financial, technological or commercial terms. We have earned significant market share, we have taken decisive cost reduction measures and we have begun to demonstrate margin expansion, all of which have contributed to the beginning of a successful financial turnaround. We are returning some of our excess cash to shareholders through our

stock buyback program announced in July. And we expect to be profitable for the full year on a non-GAAP basis.

Going forward, all three financial levers of revenue growth, margin expansion and cost control remain available to us, and we are focused on optimizing all three. Let me take each in turn, starting with revenue:

Our SBC business is growing strongly year to-date up 44% when compared to last year. We continue to expect this business to outpace industry growth driven by our continued success within the service provider and enterprise markets. We have an unmatched product portfolio that spans the needs of small enterprises to the largest service providers and everywhere in between.

We believe that our solution breadth and our financial stability are critical factors that are allowing us to win more strategic bids.

Turning to gross margins, we have made terrific progress here. Gross margins are up approximately three percentage points year to date when compared to the same period last year. Our current annual outlook of 63.5% is slightly below our previous goal of 64 to 65%. The majority of this difference can be attributed to inventory reserves of over \$2 million associated primarily with the transition from Sun to HP servers. Gross margin expansion will continue to be a big area of focus for the company going forward.

Looking at operating expenses, year to date we are tracking slightly below our spend from last year on a non-GAAP basis, which basically says that through cost reductions we have more than fully absorbed NET's prior cost structure. We have found that we are actually more productive, more agile and more innovative now than before. But, here again, there is more work to be done.

We will continue to focus on our cost structure, with the goal of driving to double digit operating margins over time. Looking at 2014, I would expect our operating

expenses to be roughly in line with our current outlook for 2013, although we do expect the seasonal opex uptick in Q1.

About six months ago we launched a program we refer to internally as Whole Process, which is a comprehensive process improvement effort leveraging the methodology of Six Sigma. It is designed to simplify all of our processes, create a better customer experience, accelerate our go-to-market in the enterprise and channel and, ultimately, drive sustained profitability. This rewiring is an ongoing effort and has already uncovered further cost reduction opportunities as we simplify our business.

Despite cost reductions, Sonus has become a technology leader in a short period of time. The recent announcement of our software-based SBC has catapulted Sonus over the competition and, I believe, will have a profound impact on our business as the trends around NFV and SDN evolve. Sonus not only embraces the fact that our industry is changing – we will lead that change. We will have more important news to share about our roadmap in the coming weeks and commit to going in depth with you on this topic at our next investor day.

With that, I will now ask Moe to take you through the details of the third quarter and our outlook, after which I'll come back with the status of our progress on the key performance metrics laid out for you at the start of the year and then open it up to your questions.

**MOE CASTONGUAY, CHIEF FINANCIAL OFFICER**

Thank you, Ray, and good afternoon everyone.

Total revenue for the third quarter was \$68.1 million compared to \$57.0 million in the third quarter of 2012.

Total SBC revenue, including products and services, was \$29.3 million in the third quarter and \$25.4 million in the third quarter of 2012.

Our top five revenue customers represented 36% of revenue this quarter, down from 41% in the third quarter of last year.

AT&T was the only 10% customer in the quarter.

We reported revenue from 560 customers in the third quarter. This compares to 403 customers in the third quarter of 2012.

Looking at revenue geographically, domestic revenue accounted for 66% compared to 76% in Q3 of 2012.

Before I go into further details on our financials, I would like to point out, that the following are non-GAAP numbers that exclude stock-based compensation, acquisition costs, restructuring charges, impairment charges, incremental depreciation due to acquisition accounting and write off and amortization of intangible assets.

Total gross margin for the third quarter was 63.4% compared to 58.1% in Q3 of 2012. Our third quarter performance reflects lower product gross margin offset by higher service gross margin.

Product gross margin for the third quarter was 63.6% compared to 66.3% in Q3 of last year. Product gross margin may fluctuate, quarter to quarter, based upon software content and product mix.

Service gross margin for the third quarter was 63%, compared to 46.4% in Q3 of last year.

Total operating expenses for the third quarter were \$39.5 million, compared to \$38.6 million in Q3 of last year.

Net Income for the quarter was \$2.8 million, compared to a net loss of \$6.3 million in Q3 2012.

We ended the quarter with total cash and investments of \$267.5 million which reflects the use of \$37.3 million to repurchase shares of Sonus stock.

Our DSO for the quarter was 70 days, as compared to 52 days in the second quarter. The increase in DSO in the third quarter reflects a higher percentage of shipments occurring later in the quarter due to summer months.

Now I would like to provide details for our outlook for the fourth quarter and fiscal year ending December 31, 2013. I will remind you that the outlook provided in the press release is also available on our IR website.

The total revenue outlook for the fourth quarter is anticipated to be between \$70 and \$75 million. Our fiscal year 2013 revenue outlook is expected to be between \$270 and \$275 million. Included in the fourth quarter outlook is Total SBC revenue of \$34 to \$38 million.

Total SBC revenue for fiscal year 2013 is forecast to be \$122 to \$126 million, reflecting year over year growth of at least 40%.

Turning to gross margins: For the fourth quarter, we expect total non-GAAP gross margins to range between 64 and 64.5%. For the full year we expect non-GAAP gross margins of 63.5%, reflecting slightly lower margin products contributing a greater percentage of total revenue.

For the fourth quarter we expect non-GAAP operating expenses to be between \$39.5 and \$40.5 million.

Total non-GAAP operating expense outlook for fiscal year 2013 is now reduced to \$165 to 166 million.

For the fourth quarter, we expect non-GAAP earnings per diluted share of \$0.02 and for the full year we expect non-GAAP earnings per diluted share of \$0.02.

Fully diluted share count for the fourth quarter is anticipated to be approximately 277 million. Weighted average diluted shares for the full year are expected to be approximately 283 million. These forecasted weighted average share counts do not reflect any possible stock buybacks in our fourth quarter.

We expect year-end cash and investments of \$265 to \$270 million, excluding any reduction related to possible stock buybacks.

While we are not providing detailed guidance yet for 2014, I would like to provide a couple of data points to assist you with your modeling in the first quarter. We expect to see normal seasonality in Q1 for both lower sequential revenue and higher operating expenses.

With that said, I will now turn the call back to Ray.

**RAY DOLAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER**

Thanks, Moe.

In keeping with my usual framework, I'd now like to review our progress with the four key performance metrics that we identified for you at the start of the year.

I'll start with **SBC Growth**. Year to date, SBC product revenue is up 39% and SBC total revenue is up 44%. Both are comfortably ahead of industry growth projections.

The next key operational metric I will discuss is **New Customer Growth**. We secured 171 new customers in Q3, 77% of which are new SBC customers. As I



mentioned, we recently won three Tier 1 accounts, in addition to many other key SBC wins. We feel great about our progress here and our pipeline is very encouraging.

A third key metric for 2013 is the percent of product revenue we generate from the **Channel and Enterprise** – important areas of new growth for Sonus this year. The Channel contributed 27% of total product revenue in Q3. Year-to-date, it has contributed nearly \$25 million to our total product revenue and is on track for the year.

I'm particularly pleased with our Enterprise results this quarter. In Q3, Enterprise contributed nearly \$12 million or 28% of our total product revenue. Year to date, enterprise has contributed almost \$38 million, or 31% of total product revenue. This strong performance is already within the range of full year expectations we established at the start of the year of \$35 to \$40 million. While we did score a large government contract in Q1 that got us off to a quick start, the vast majority of our success since then has been driven by an increasing number of enterprises making the move to UC, cloud services and SIP Trunking, and we expect this trend to continue. Given our success with new enterprise customer growth and the strength of our enterprise revenue to-date, we are increasing our outlook for the contribution from enterprise in 2013 to approximately \$45 million, or approximately 28% of total product revenue.

The final key operational metric I will discuss is our path toward **Profitability**. After raising our outlook last quarter for the full year, we delivered the non-GAAP profit we committed to in Q3 and I'm confident we will deliver on our full year commitment as well.

To wrap up, I am very proud of the team for these results and the progress we are making. But as I said in my opening remarks today, progress is not always linear, especially in the face of the industry changes our sector is undergoing. Change can sometimes cause customers to pause and think a little longer about their network

architecture decisions. But through this, we are learning every day. We are engaged in the right discussions. We are delivering an industry leading roadmap which is allowing us to become increasingly strategic to our customers and partners. In fact, as a testament to this, Gartner has just published their second annual Magic Quadrant for SBCs for the Communications Service Provider market. Sonus not only remained in the Leader's quadrant, but we strengthened our position based on our roadmap, vision and ability to execute. I'd like to thank our team for their steadfast hard work and I'd also like to thank our shareholders for their continued support.

One final word before opening the call up to your questions. As you saw in today's press release, I am very pleased to announce the appointment of Mark Greenquist as our new CFO. Our search process turned up a number of highly qualified and desirable candidates in large part because these professionals recognize the tremendous opportunity that's in front of Sonus. Mark surfaced to the top of that list because he truly is a world-class executive with deep financial and operational experience. I've known Mark for a number of years and couldn't be happier about his joining the team on November 1st and look forward to what I expect will be a seamless transition. I also want to take this opportunity to thank Moe again for his service over the past couple of years. Moe, we couldn't have come this far without you and we wish you every success in your next endeavor.

That concludes our prepared remarks this afternoon. I'll now open the call up for questions.