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Sonus Networks, Inc. (SONS)

Q1 2015 Earnings Call

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Mark T. Greenquist
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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. Welcome to the Sonus Networks' First 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, April 22, 2015.

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

Patti Leahy
Vice President, Investor Relations

Thank you and good morning. Welcome to Sonus Networks' first 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. So, please, take a moment to locate this on our IR website.

As shown on slide two, 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 condition, 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-K 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. And 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.

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. On March 24, we issued a press release stating that our Q1 results would miss our prior outlook. And that our full year 2015 results would also be below prior guidance.

As CEO of Sonus, I can tell you that this is absolutely not where we want to be. And I'm disappointed with our first quarter results as well as the revision to our full year outlook. I and the entire management team understand the importance of doing what we say we will do. I would have preferred to have hosted a call sooner than today. However, before I spoke with you, I wanted to feel confident that we understood the underlying causes and the likely implications on our full year outlook.

We've worked tirelessly since the March 24 announcement to understand what happened and what we can do to avoid this happening again. In addition to a deep inspection along with our leadership team of our internal forecasts and our processes, I and other members of the team have personally spoken with or met with many of our largest customers.

We do this routinely, but we've stepped up our efforts to reaffirm or adjust our working assumptions. In these most recent conversations, we've discussed their plans and how we're aligned with them both technically and commercially. These customer conversations have given me confidence in Sonus, our technology, and our path forward.

Turning to slide four, I'd like to highlight three key points right upfront. First, based on the significant work we've done since March 24, we believe that our Q1 shortfall and our revised outlook for the year primarily reflects delayed timing of orders, lower spend and longer RFP decision cycles as our customers take time to determine their future network architectures. We do not believe it reflects material competitive losses.

My customer conversations as well as our ongoing RFP activity confirm that Sonus' technology is aligned with the technology strategies of our customers. Second, despite the near-term pressure on our results, we remain well-positioned both technically and commercially as opportunities develop. To expand on this point, it's important to acknowledge that our industry is in the early stages of a major architectural shift to virtualization.

Fundamental changes like this often take time to accelerate. And when they do, they are not linear. To ensure Sonus is best-positioned despite this volatility, we're driving operating efficiency. And as we do this, we're also continuing to innovate in areas that we are confident will matter to our customers.

We're staying close to our customers, so that we understand their needs and are ready to act when they are. We were the first to virtualize all of our growth products, so we are prepared when that shift occurs. We continue to believe that the shift to a software-centric cloud-based architecture is all but certain to happen. And we position ourselves to help lead the industry forward when that happens.

The third key takeaway is that we are controlling what we can in this macro environment, which is now clearly impacting other suppliers in our industry as well. Controlling what we can means also controlling our cost structure. As announced today, we expect to reduce our cost structure by approximately $20 million on an annualized basis as compared to full year 2014 with $15 million expected to be realized in 2015, the majority being in place by the end of Q2.

Let me be clear. These are targeted cuts, not wholesale changes, to our investment priorities. We intend to preserve the strategic progress we've made over the past several years. We remain fully committed to investing in the critical technologies, which represents some of the most vibrant growth opportunities in our industry and which are value-creating opportunities for our customers and our shareholders.

With that, I'd now like to get into the details of what happened in Q1 and our revised outlook for the year. Let's start with what drove the Q1 shortfall. When we provided our guidance for Q1 on the February earnings call, we cautioned that our quarter was back-end loaded. Unfortunately, the vast majority of those late quarter deals didn't occur.

To give you the details, approximately half of the $24 million shortfall is distributed to four of our largest customers' delaying purchase decisions with two of these cases both delaying and reducing their spend to a fraction of what we had forecasted. The other half of the shortfall resulted from a large number of mid-size deals pushing out.

Approximately $1 million or less than 5% of the shortfall can be attributed to competitive losses. And this level would not be unusual against the quarterly run rate of this magnitude. Beyond the roughly $1 million in Q1, we believe that we have not had any significant competitive losses at our major customers.

Let's turn now to understanding the full year outlook. We've revised our annual expectations downward by approximately 25% or approximately $80 million. Slide five summarizes the primary components of that change. Roughly half can be attributed to four large North American Tier 1 service providers.

Specifically with respect to AT&T, which has been our largest customer historically, we are no longer expecting them to be flat year-over-year. We now expect they will be down approximately $30 million from last year, which means we expect them to contribute roughly $25 million to the full year 2015. A handful of other large North American service providers represent the balance of the Tier 1 difference.

We are seeing purchase decisions either push out or reduce in size or both. The reasons include delays in the major technology transition to SDN and NFE and the switch to software as a model; delayed RFP decisions, many of which are related to that transition; and impacts of industry consolidation in both the telco and cable industry.

In some cases, customers have experienced their own shortfalls in end market demand relative to their plans and projections. As a result, they are now likely to delay their plans for additional capacity until later this year or even next year.

The other half of the $80 million is roughly evenly split between federal, enterprise, signaling and professional services. Let's discuss each of these in turn. Our revised forecast anticipates that federal will not contribute meaningfully until at least the second half of 2015.

We are well-qualified and we are participating in interesting opportunities across numerous government agencies, including some software-only proposals. Still, we now believe it is prudent to take a more cautious approach until we see more evidence that federal spending has picked up in our category.

In enterprise, we continue to make solid progress with Fortune 100 global accounts. Our SBC 1K and 2K and our Sonus Partner Assure channel remain important aspects of our enterprise go-to-market, particularly in the link, which is now called Skype for Business environment.

Additionally, our full SBC portfolio, along with our recently acquired SDN capability, is gaining traction. We continue to make progress with service providers as a channel for these opportunities, including the Business Services Division of AT&T, Verizon, and others, where our SBC 5K and the SBC 7K are very competitive.

Other service providers are engaging as well, domestically as well as globally. These are the relationships which has historically helped us land large blue-chip UC accounts. So we remain optimistic that this is an effective go-to-market approach that will continue to bear fruit over time as the SIP trunking and UC markets continue to develop. Still, as sales cycles remain long and until end user demand accelerate, we've re-evaluated and reduced our expectation from enterprise accordingly.

Turning to signaling, we remain engaged in a number of signaling RFPs for which we feel we are well qualified to win as either a second source or to display as the incumbent provider. These are often highly competitive RFPs and require multiple round of testing given the feature complexity in most signaling deployment.

We are continuing to harden both the SS7 and the Diameter products that were part of the PT acquisition in an effort to capture these signaling opportunities. We will keep you informed as these play out later this year. But for now, we have also reduced our forecasted signaling contribution.

And, finally, we expect less professional services revenue, which is largely just a mathematical function of our lower product revenue outlook. For all these reasons, we're revising our full year outlook and we are adjusting our cost structure accordingly.

We estimate up to 20% of our revised forecast as related to enterprise and federal with the balance in service provider. This is roughly consistent with our revenue split today. We're also estimating that roughly three-quarters is related to growth-related revenue with the balance in legacy, which is roughly consistent with the way our product revenue has been trending in 2014.

Before handing over to Mark, I want to speak to our strategy and summarize on slide six as I remain just as confident in our strategy today as I have ever been. Despite the significant challenges calling the timing of the industry transition to a cloud-based architecture, driven by the transition to SDN, I believe this transition is inevitable. Every discussion I've had and continue to have with customers and partners confirms this to be the case.

The fact is the application layer will control communications networks going forward. Communications enabling the SaaS layer with critical software components that can then interact with the network to configure it in real-time is the primary focus. We have often called that over-the-top as an alternative service delivery model to today's service providers. Going forward, it becomes the primary model.

It changes everything. It's disruptive. It leads to a radically lower cost structure. And it empowers businesses to establish their own service delivery models. In the short-term, this transition is uneven. Longer term, we'll see that workflows drive communications networks and workflows are in the application layer. The customer is the app.

As the CEO of Sonus, I am comfortable that our technology assets are an essential part of the bigger picture as our industry makes this transition. No one knows precisely how this will happen and when, but I do believe the following. Our policy, signaling, session and SDN controller assets, taken together, form a large part of the architecture that will drive our industry forward in the decades ahead. These are the key areas of our investments. And they remain the areas that are resonating with our customers.

To ensure that we continue to invest properly into critical areas and remain financially and operationally strong during this transition, we've taken the steps to reduce our cost structure quickly. We will remain focused on this transition. All of our stakeholders, including our customers and our partners, deserve and will continue to get our best efforts. And I'm proud to lead this team on the journey ahead.

With that, I'd like to hand it over to Mark to discuss our results and outlook in more detail as our cost structure reduction plans. 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 eight for a closer look at the quarter.

This slide summarizes our reported results for Q1. Total revenue was $50.1 million with $29 million or about 58% attributed to our growth business. Total product revenue was $24.9 million and total maintenance and services was $25.2 million.

Gross margin was 61.5% which was negatively impacted by a charge for excess and obsolete inventory of approximately $2.7 million. Excluding this charge, gross margins would have been almost 67%. Operating expenses were $43.5 million which resulted in a net loss of $13.1 million or $0.27 per share based on 49.4 million basic shares.

Cash and investments totaled approximately $113 million at the end of the quarter. When you compare this to our cash and investments at the end of the year, we were down approximately $35 million. $16 million of this was non-operational cash consumed for the Treq acquisition at $10 million and share repurchases of $6 million. Approximately $19 million was used for our operations.

Let's turn now to our outlook for Q2 and the full year on slide nine, starting with the second quarter. Q2 revenue is expected to be in the range of $53 million to $55 million. This outlook reflects our expectations for continued near-term revenue headwinds for the same reasons Ray just outlined a moment ago.

Gross margin is expected to be in the range of 64% to 65%. OpEx is expected to be $42 million to $43 million. And loss per share is expected to be $0.14 to $0.18 based on 49.5 million basic shares. Cash and investments are expected to be in excess of $100 million at the end of the second quarter. And that includes restructuring costs related to severance payments.

Now, turning to our full year outlook. Full year revenue is expected to be in the range of $245 million to $250 million. We no longer guide specifically to growth revenue, but given our revised outlook, I would like to provide some color on the trends we expect to see in our legacy business, which is primarily a media gateway and associated maintenance revenue.

As previously reported in 2014, our legacy revenue, including product, maintenance and services, declined by 10% to $133 million. This aspect of our business tends to be very project-driven because it is tied to replacement cycles and upgrades, which are unique to each carrier.

Consistent with Ray's description of large North American service provider spending trends, we do not know with certainty that this revenue will come back later this year or even next year. So we are not currently forecasting that it will. Therefore, in 2015, we are projecting a decline in our legacy business closer to 30% in order to account for this uncertainty. This would imply legacy revenue in the $90 million to $95 million range with the balance of our 2015 revenue outlook comprised of growth-related revenue.

We continue to expect improvement in gross margins over time. This gross margin expansion is primarily a function of higher utilization and software content as the industry inevitably moves toward greater software-centricity. Net loss per share is expected to be between $0.10 and $0.15 based on 49.5 million basic shares outstanding.

Now, I'd like to provide the details of our cost reduction program summarized on slide 10. First of all, our objective with this initiative was to reduce our breakeven point to annualized revenue levels, in line with our revised 2015 revenue outlook, without compromising our continued investment in key products and strategic technology initiatives.

As I just discussed, we are forecasting a loss for the full year 2015, since the majority of the impact of the restructuring is expected to be realized in the second half. In order to accomplish this objective, we will reduce our head count by approximately 150 positions or 12.5%, resulting in a total head count of roughly 1,050 employees.

Headcount reductions, together with reductions in other discretionary spending, are expected to generate annualized savings of $20 million versus 2014 levels, with $15 million being realized in 2015. The cost reduction program will cost roughly $5 million, with $4.5 million of that being paid in Q2.

And, finally, we believe our cash balances will be reduced by a few million in Q2, primarily due to the cost of the restructuring program. However, as I mentioned, cash and investment should remain above $100 million at the end of Q2 and throughout the remainder of 2015. And once the restructuring is complete, we do expect to return to cash flow positive in the second half of 2015.

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

Thank you, Mark. In summary, while we are disappointed with Q1 and the need to revise our annual outlook, we continue to be confident in the business and our market opportunities. This confidence is based on conversations that I and other members of the management team have personally had with our largest customers which underscores the inevitable technology shift in this industry.

Sonus has the technology and relationships to capitalize on this shift. It isn't happening at the pace we expected, but it will happen. As we move forward, I can assure you that all of us at Sonus are focused on doing what we say we'll do for our customers as well as our shareholders.

With that, we now like to open the call for your questions. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question comes from the line of Dmitry Netis with William Blair. Please proceed with your question.

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

Hi, Dmitry. You there?

Operator: And, Mr. Netis, your line is open.

Dmitry G. Netis
William Blair & Co. LLC
Q

Hello. Can you hear me?

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

Yes, Dmitry. We can hear you.

Dmitry G. Netis
William Blair & Co. LLC
Q

Apologies for that.

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

No problem.

Dmitry G. Netis
William Blair & Co. LLC
Q

Good morning, gentlemen. A couple questions. I guess, as we try to reconcile what had really happened here, this is a bit of a loaded question but you've kind of hit the double whammy here. You've got the growth products declining next year and, obviously, you've taken 30% decline in legacy, which I sort of understand. But the fact that the growth products are going down – and I get what Ray had explained as far as the timing and the spending of your carrier deployments.

Maybe you can provide a little bit of color of why you believe this is not a competitive loss opportunity with your customers and why wouldn't the growth product be going up here? So, just, I guess, what I'm looking for is more color on the competitive environment and your growth product situation.

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

Sure, Dmitry. Thanks for the question. So, with regard to our analysis of the competition and competitive loss, that's really based on discussions with our customers. It's not a market-based analysis. And I'm comfortable after those discussions that we remain engaged in all those RFPs that we have been engaged in and that we remain engaged in run rate business with our existing customers.

So, what I think it is, is there's probably a pause as there are often in markets as they develop in the early stages here towards a more over-the-top application-based market. And, frankly, that pause was not forecasted. It's now in our forecast based on those changed circumstances. And that's how I would analyze it.

Dmitry G. Netis
William Blair & Co. LLC
Q

And then to that effect, have you noticed any – or have your discussion with customers exposed any pricing changes with your competitors? Do you see them getting more price aggressive in the market or has that not been a factor? Just kind of if you could comment on that that would be great.

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

Yeah. Sure. Thanks for the question. So pricing has not, at this point, been a huge factor. I do expect pricing to evolve quite a bit as we move into a software model. So as we get more visibility into that, we'll certainly share that with you and others on calls going forward like this. But as we move to software, people will have the agility to do much more pay-as-you-go type of models. They may or may not move into subscription models. But, fundamentally, I don't believe that the data for Q1 or historically for 2014 will show that the industry is competing on price at this stage.

Dmitry G. Netis
William Blair & Co. LLC
Q

Okay. And I couldn't help but notice, Ray, but another company I cover, BroadSoft, they're seeing a bunch of TDM/IP transformation deals. And, as we know, those come with some plumbing attached to it, right? You have the application, you have the plumbing underneath and a bunch of that plumbing is supplied by guys like you and Acme, Oracle and maybe Genband and some of the other competitors you see out there.

So I wanted to sort of – I believe I posed that question to you earlier. But I also wanted to get maybe an additional color on why you may not be participating or, if you are, I would love to know if you're participating in these TDM/IP transformation deals that are going on right now in the market.

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

Sure, Dmitry. So, we are definitely participating in TDM-to-IP network transformation deals. I'm not going to comment on a specific partner or a specific deal. Our outlook today is you and everyone else on this call – our view is to what that looks like in our results and other companies that may have the different visibility to different deals or different portions of deals that will be taken down at different times. I trust that their outlook will reflect that. But we are certainly participating in the broader TDM-to-IP transformation. The company you mentioned is more on the Class 5 edge side than the Softswitch side. We're more in the core at this stage. And so, that's why there may be some of those differences.

Dmitry G. Netis
William Blair & Co. LLC

Q

All right. And then the last question and I'll cede the floor is related to AT&T. I think you had $55 million last year with them. You're guiding down about $30 million this year. I'm just curious. How much – I don't believe you had any expectations for AT&T in Q1. And if there were, can you let us know if you had expected them to contribute in Q1?

But I remember this. AT&T was a back-end loaded type of discussion related to Domain 2.0. And you had that $10 million deal that had slipped a couple quarters ago that you were kind of eyeing for the second half of this year. So, I guess, the question is what was your expectation for AT&T this year relative to what you had guided just now which is being down $30 million? And then what you had expected from them in Q1?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Okay. So, the AT&T portion of our Q1 outlook was relatively modest, as you said. That represented a substantial shift from where they were in Q1 of 2014 which was, if you look back historically, a large part of our revenue achievement in Q1. I think your question is what is our AT&T outlook? And you gave the data yourself in the question.

Our outlook is really for $25 million revenue relative to our prior outlook at about the $55 million level. So, we're down about $30 million. That reflects a pretty significant pause in their product spending and the continuation of their maintenance and related spend on the gateway side. So, that's our view of AT&T going forward. And I think it's broadly consistent with their desire to run their networks harder and to drive their CapEx utilization as hard as they can as they've stated in public setting.

Dmitry G. Netis
William Blair & Co. LLC

Q

All right. Thank you. I'll jump off. Thank you so much. Bye-bye.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Thank you.

Operator: Our next question comes from the line of Jess Lubert with Wells Fargo. Please proceed with your question.

Jess I. Lubert
Wells Fargo Securities LLC

Q

Hi, guys. Thanks for taking my question. I also have a couple, two for Ray, one for Mark. Ray, first, the full year outlook seems to imply a fairly decent recovery in the back half of the year. Can you help us understand your visibility to this improvement? Perhaps of the $80 million that slipped out of your 2014 forecast, how much you believe you are likely to recapture over time versus how much you think may have been lost?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Sure, Jess. The first, if I understand the question, how much visibility do we have into the second half recovery, which is implied in our annual guide to go back closer to what you might call the normal run rate of our business? And then, I guess, the second half of your question is how much of our total year might be lost as opposed to, say, pushed into 2016.

So first, on the visibility, we've done a lot of work not only in our interactions with customers but in our internal modeling and making sure that we fully understand the operational requirements in order to score the revenue in the pipeline that we have right now. And so I feel pretty good about our second half. Although having said that, I'm also quite aware of the magnitude of our revised outlook. So I would offer you the following.

We will continue to track that and we will continue to drive that in close interaction with our customers. And we'll report out on our second quarter call what the back half of the year looks like. But I feel very comfortable that we've done as much work as we possibly could do. And that the [ph] pausing the first companies (29:34) consolidating the current networks, rationalizing their transition SDN, NFE and planning for their network expansion activity later this year. Many customers have reported, some externally, some just with us, what looks like a first half reduction in CapEx with a back half recovery and our outlook is consistent with that, okay.

Second, with regard to how much of our annual outlook shift has been lost versus pushed, I think it's too soon to say, but I believe that the majority of it will continue to run into 2016. What we'll be looking for is book-to-bill ratios and bookings that will give us confidence in our revenue outlook. And so far, I see a pretty good pipeline to our bookings that would support the fact that these are delays and not losses. But we'll continue to track that and we'll report that as transparently as we can quarter-to-quarter going forward.

Jess I. Lubert
Wells Fargo Securities LLC Q

And then I -

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

Was there another question for me, Jess?

Jess I. Lubert
Wells Fargo Securities LLC Q

Yes. I didn't see the carrier/enterprise split but the prepared comments suggest that you did see some weakness in the enterprise business as well. I was hoping you can maybe help us understand what you're hearing from your enterprise customers. It sounds like enterprise spending more broadly is actually pretty decent here, so just would love to understand what drove the miss on the enterprise side?

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

Yeah. So I'll ask Mark to just give you the numbers here in a second because I think he has them. But I'll speak to the qualitative aspects of our enterprise push. While our enterprise numbers are down and part of our revised outlook for 2015 down, as I broke out in my prepared comments, I'm actually quite pleased by the strategic interaction that we're having with the Fortune 100, both in the linked environment and more broadly in a NaaS IQ which actually – they're inter-related. Because as people look to deploy voice and real-time communications in a Lync to Skype for Business environment, more and more often new network architectures are required in order for them to really turn voice on. So, good strategic interaction, but, again, driving longer sale cycles and a result of being some delay in some of those purchase orders. Mark, can you fill it in with the details around Q1?

Mark T. Greenquist
Chief Financial Officer

A

Yeah, sure. Just enterprise as a percentage of total product revenue was 15% and that was consistent with the fourth quarter. So, the enterprise was down, but as a percentage of total product revenue, it remained the same. And then, with regard to just enterprise as a percentage of the growth-related product revenue, which is where most of the enterprise is, it was 22%, which was actually up a little bit percentage-wise from the fourth quarter, pretty much the same as what it was a year ago in the first quarter. Just note that in the year ago quarter, we did have a pretty good size federal order in there. So, if you strip that out, enterprise was – not counting any federal business as a percentage of revenue was up as well, so.

Jess I. Lubert
Wells Fargo Securities LLC

Q

And then just last one from me, a clarification on the restructuring. Is Q1 the point of comparison for the savings? And are we looking at $20 million in expected run rate savings versus your previous plan? Or should we be looking at total OpEx run rate to be $15 million lower from this point in time by the end of the year and then $20 million lower at some point in 2016? Any help there would be great.

Mark T. Greenquist
Chief Financial Officer

A

Yeah. The reference point we were using was 2014 costs because you've got that actual. So, that's what we were using. And actually, the first quarter not completely inconsistent with that run rate. I mean, there were some reductions because, obviously, there is, for example, less of an accrual for incentive comp and things like that. But it's really against the 2014 levels.

Jess I. Lubert
Wells Fargo Securities LLC

Q

Thanks, guys.

Mark T. Greenquist
Chief Financial Officer

A

And I think also just FYI that if you look at the $20 million annualized, about $15 million of it is employee-related costs, about $5 million of it or so is the discretionary costs that I mentioned.

Jess I. Lubert
Wells Fargo Securities LLC

Q

Thanks, guys.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Thank you, Jess.

Operator: Our next question comes from the line of Ted Moreau with Barrington Research. Please proceed with your question.

Theodore Joseph Moreau
Barrington Research Associates, Inc. Q

Thank you very much. I just was wondering since a significant amount of the full year takedown in revenue is occurring on the legacy side of the business, if we think about your restructuring actions, is it in equal proportion of the restructuring targeting legacy or how do we think about the legacy versus growth restructuring actions?

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

This is Ray. Thanks for the question. We don't break that out. But rest assured, as I said in my prepared comments, our primary focus, as we look at spend going forward, was to preserve our investment in future growth products. So, it would imply that we target it where we could, still protecting our customers and their networks on the legacy side, targeted more efficiencies there.

Theodore Joseph Moreau
Barrington Research Associates, Inc. Q

Okay. Thanks for that. And then one of the reasons cited for the takedown in numbers is industry consolidation. If any of these major deals gets rejected, do you view that any more or less favorably and how it might impact your business? I mean, if a deal gets rejected, does it accelerate maybe the deployment timeline as opposed to if a consolidation does proceed, then the integration takes time to play out and it continues to impact the delays?

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

Yeah. It's a great question, Ted, but unfortunately, it's kind of a speculate thing. Here's how we try to resolve all of this industry flux as we've established our outlook. We stayed close to our customers, as I said, and we try to really expect that these delays will create flux. And we're just linking ourselves to the underlying operations of each of the businesses that we're attached to and not trying to call the timing of mergers either pro or con.

So I feel good about our outlook. I believe we properly hedged the risks associated with delays and upsides. And I believe we now have an outlook that we can achieve. And it's independent of those timings, at least to the best of our ability to do so. And we will continue to stay close to our customers going forward, so that, should that change, we'll revise our outlook accordingly.

Theodore Joseph Moreau
Barrington Research Associates, Inc. Q

Okay. And then you also cited some signaling delays as well. How much of it is traditional signaling versus say next-generation Diameters at all, more on a Diameter side? And then, can you talk about the competitive dynamics and specifically on the Diameter business?

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

Sure, Ted. So, first of all, our signaling revenue remains – majority of which is to the SS7 side as the Diameter market evolves, so the majority of the delays building that SS7 side. But they're correlated because these companies are running kind of combined networks and they're looking at us both for the SS7 side as well as the Diameter side. I expect the SS7 to be a vibrant market and the STPs are going to be around for quite some period of time.

Now with regard to the competition of the Diameter side, we're in play for a number of Diameter-related RFPs. As we talked about RFP activity in my prepared remarks, we've seen a number of global Tier 1s in North America, in Europe, in Central and Latin America bidding out their SBC business as well as their signaling business, driving towards this new network architecture. And Diameter is definitely a part of that. We'll comment on the Diameter outcomes as they come along, but I feel like we've done a good job hardening, virtualizing our Diameter platform. Now it's just a question of whether we can get embedded in these networks if they continue to go.

Theodore Joseph Moreau
Barrington Research Associates, Inc.

Q

Okay. And then some of these Diameter opportunities – I mean, do you see those decisions happening later this year or is that more further out?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

I do see the decisions happening later this year although that could change because customers could change their RFP cycles again on us. But right now, our outlook has those decisions occurring largely this year. The revenues associated with them could happen this year, but they're more likely to start modestly this year and flow into 2016 revenues.

Theodore Joseph Moreau
Barrington Research Associates, Inc.

Q

Okay. Fair enough. Sounds good. Thank you so much.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Thank you.

Operator: And, participants, please limit yourselves to two questions. And our next question comes from the line of James Kisner with Jefferies. Please proceed with your question.

Timur Ivannikov
Jefferies LLC

Q

Yes. Hi. This is actually Timur Ivannikov for James Kisner. And we had a question – I guess, it's a broader market question and maybe a specific product question. So, given the transition to the Unified Communications and Voice over LTE, I guess, we're just trying to understand how can the carriers delay spending? Have they bought enough capacity already? Is there some kind of market saturation? So, we're trying to understand what specifically could explain this delay?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Sure. I guess the question is what could explain the delay. And looking into the UC and VoLTE markets, I'll be happy to comment on them. But I don't know that that would be fair to characterize that arguably it would be principally associated with those end markets. A lot of the push-out is either in the legacy side gateway piece or on the SBC piece, more broadly.

But with regard to UC and VoLTE, I don't see the UC end markets really slowing down at all from the standpoint of the Class 5. The VoLTE market has had a lot of flux in it. I'll look for others to comment that more broadly over the next couple weeks. We'll see where that comes out.

But I think it's safe to say that the complexity of the shift to VoLTE remains a problem for the industry, more broadly. And it's both in their local deployments and also in the international roaming opportunities. And those complexities will get worked out over time probably through the balance of this year. And then, you'll see additional expansion in the VoLTE market and the wireless UC market, more broadly.

Timur Ivannikov
Jefferies LLC

Q

All right. And also, a question about your acquisition. Could you explain it a little bit, the $10 million?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

The question is on the acquisition of Treq. Do you want us to explain the strategy behind it or what the $10 million was about?

Timur Ivannikov
Jefferies LLC

Q

Yeah. Sure. Just the strategy would be fine. Yeah.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

So yeah, we went into this at length on our last call. But I'm happy to repeat it here. We acquired a company called Treq Labs. And they came with an SDN controller and an agile software platform that interoperated with our network assets, our session and signaling and policy asset, and basically allows us to drive dynamic WAN optimization in the enterprise through the service provider.

That is in fact what looks like the emerging model for people to move the enterprise to real-time communications and cloud-based architectures. So we'll continue to integrate Treq Labs. We'll continue to fund what was developed when we acquired it. And we're seeing some good traction in our discussions. But the revenue aspects of that are mostly expected later this year or into 2016.

Timur Ivannikov
Jefferies LLC

Q

Okay. Thank you.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah.

Operator: Our next question comes from the line of Paul Silverstein with Cowen & Company. Please proceed with your question.

Paul J. Silverstein
Cowen & Co. LLC

Q

Ray, how about if I just asked some very discrete questions as opposed to speculative questions? But I'm going to ask more than two. Again, I'm going to try to keep them very discrete. First off, I trust, given the numbers with the Huawei relationship, you're not expecting much, if anything, from this year?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

We may see some Huawei but it won't be – I don't think it will be material and I don't think it will be a 10% type of relationship, Paul, if you want to use that as a threshold.

Paul J. Silverstein
Cowen & Co. LLC

Q

Okay. And can you just – you said on the call, but can you remind me how much of the revenue is lost revenue as opposed to delayed?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

At this point in time, I don't see any of it being lost revenue. But it is too soon to call because I think to the extent it moves into 2016, we haven't commented on that guide at this point in time.

Paul J. Silverstein
Cowen & Co. LLC

Q

My apologies. I thought you all had decided that a certain dollar amount will be thought as lost. My apologies.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Oh, okay. So yeah, you're right, Paul. Let me just interrupt before you go on the next question. We did say that in our miss in Q1, we could attribute from our forecast there was about $1 million in aggregate small deal loss, but none of them from our large customers that would imply a material competitive loss from one of our top customers. That's what we said.

Paul J. Silverstein
Cowen & Co. LLC

Q

Got it. And I assume that Diameter RFP activity is robust in terms of the opportunities out there. But can you remind – I know you're reluctant to give a lot of disclosure, but can you remind us what you said historically about the number of Diameter wins you've had to-date in terms of your set up and the prospects of you winning these deals?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah. I think we've disclosed probably a small handful of Diameter wins in the past, one of which was in the funnel when we acquired PT and the balance of which would have been earned under Sonus.

Paul J. Silverstein
Cowen & Co. LLC

Q

All right. And just one or two more, I promise. On U.S. federal, I know you've reduced your expectations but what's the base? What was in 1Q and what was in calendar 2014? I assume it was relatively small.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

I didn't understand that question.

Paul J. Silverstein
Cowen & Co. LLC

Q

U.S. federal government in terms of revenue contribution.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Okay.

Mark T. Greenquist
Chief Financial Officer

A

The federal government deal in Q1 2014 was probably about 7% of the growth-related revenue, Paul. So I want to say it was close to $3 million – $2.5 million, $3 million.

Paul J. Silverstein
Cowen & Co. LLC

Q

And, Mark, that was specific to Q1. So there wasn't any U.S. fed revenue in the rest of the year?

Mark T. Greenquist
Chief Financial Officer

A

It was very small. That was the – we had a big deal in Q1 2013 and then we had a big deal in Q1 2014. And then the rest of the year was really very modest. And then in Q1 2015, it was really next to nothing.

Paul J. Silverstein
Cowen & Co. LLC

Q

I appreciate that. My last question. Ray, in terms of visibility in your processes, I understand you feel confident now in the outlook. But what most change? What did you do the last two weeks to four weeks versus whatever processes you had in place previously that gives you the incremental confidence?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah. So, a lot of it is just the customer interaction, Paul. And as I said in my prepared comments, it's not that we didn't do that before. So, a lot of the circumstances have changed for our customers. And we've been able to confirm where they are in these changed circumstances. And we've revised our outlook accordingly. We had some back-end loaded deals that didn't come in and we've just gone out and confirmed, are they gone, are they coming in later and what programs are they tied to and what the end market demands look like. And so, therefore, I feel comfortable that we've got as much visibility as we can.

Now, we can't control those end markets. We can't control our customers' drawdowns. But in order for them to hit their revenue goals, they have to have some level of market development. People aren't going to stop communicating and the fundamental technology drivers remain in place towards Unified Communications. And the SBC's role in UC is evolving in a very favorable way. And the trend to software is favorable to us.

So, what we did was confirm that we're being viewed properly as a strategic partner and I can confirm that. We've reviewed their underlying programs that are driving their demand and their visibility. And we believe we have properly hedged the risks associated with further delays. And I say that with the caveat that we only know what we know and we'll continue to drive visibility going forward. I hope that -

Paul J. Silverstein
Cowen & Co. LLC
Q

I'll take the rest offline. Thank you.

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

Okay. Thank you, Paul.

Operator: Our next question comes from the line of Subu Subrahmanyan with The Juda Group. Please proceed with your question.

Natarajan Subrahmanyan
The Juda Group
Q

Thank you. Two questions. I guess the first one, on a similar tone as the earlier ones, Ray. It seems like many things happened at the same time, which is sort of unusual. You usually get one or two carriers to change. But across carrier, enterprise, federal, multiple things happened and, obviously, it's impacting guidance as well. So, I'm just trying to understand kind of what is the kind of level of conservatism thrown into it and kind of how you think about all these things happening sort of in parallel, which is somewhat unusual?

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

Okay. Subu, thanks for your question. With regard to many things happening at the same time, we've tried to break down the Q1 miss versus the full year outlook. And so, I wanted – just to make sure I'm responding to your question. In the Q1 miss, we described where we are on primarily the legacy, the enterprise and the service provider growth sides of the business. So, when you bring in the federal piece and others, here is what we did. We looked at our Q1 outcome relative to our prior guide and spoke with all of our customers that we could and that would include federal and others. And while federal wasn't a big piece of our Q1 outlook, it was a bigger part of our year than I think is still justified given these circumstances.

So, we've revised downward. Your question is how much conservatism is in there? We think it's properly balanced. We think we struck the right balance, giving customers time to work through the technology issues of this shift. It's an architectural shift, for sure. Time to work through in industry consolidation phases, whatever is right for their business with the politics of it and the net neutrality aspects that are going on in the broader environment and just make sure that what we could control was in our guide as long as we stayed close to our customers and continue to develop competitive products. So if you want to label that conservative, you're free to do so but I consider it to be kind of a down to middle guide. And to the extent that we have upside, we'd be very happy with that outcome.

Natarajan Subrahmanyan
The Juda Group

Q

All right. And I totally appreciate the detail of kind of what drove the miss. And many things happening at the same time was almost referring to that which is there were – it wasn't one carrier. It wasn't even four carriers. It wasn't just service provider. It was literally every – across segments of business which is unusual for all of this to happen in the same time. I'm just wondering if you think there are individual reasons for each but then kind of you put it all together, it's fairly a broad number of things. I was wondering if you think that's being influenced by something.

And then my other question was just if you look at kind of what the numbers imply exiting the year depending on how you kind of project out the next couple of quarters. You should be back on the kind of flat year-over-year double-digit operating margin, sort of, assumptions in order to make the kind of the full year kind of number. Is that the right way to think about it? And I know it's too early to tell but do you think that the first half is just going to be a kind of an anomaly and we're back on at least an improvement trajectory out of that 2015?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

So in a word, yes. That is how I would look at it, Subu. Now we're not guiding to the specific financial outcomes in Q3 and Q4 but the implications of our guidance are consistent with what you just said. We assume that the revenue will continue based on the visibility that we see in, not only our backlog, but our bookings coming out of Q1 and what we see in Q2. And that presuming that the industry stays on its current trajectory, we've got a really good shot at returning to that trajectory where, one, the revenues look more consistent with last year and, two, our margins look more consistent with continued margin expansion as we drive the software, as Mark said, and then the operating income outcome of that would be consistent with what you said.

Natarajan Subrahmanyan
The Juda Group

Q

And how do you factor in the deflationary potential aspect of the shift to software as you kind of throw the things into the mix? 2015 is a transformation year, but beyond 2015, do you worry that that's going to be a headwind on revenue? It may not be on margins but on revenue.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Well, it could be. We haven't really looked into 2016 sufficient enough to discuss it or guide to it, for sure. But maybe that some of those headwinds are actually in our 2015 numbers. So, we'll just see how 2015 plays out and then we'll come back to you and look at next year if you don't mind.

Natarajan Subrahmanyan
The Juda Group

Q

All right. Thank you for taking the questions.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Thank you, Subu.

Operator: Our next question comes from the line of Ryan Hutchinson with Guggenheim Securities. Please proceed with your question.

Nate Cunningham
Guggenheim Securities LLC

Q

Hi. This is Nate Cunningham on for Ryan. Two questions. First, in the event that growth revenue doesn't rebound in the back half, what further actions would you take and would you have to look at financing alternatives? And then on SDN, NFE, can you tell us what exactly your carrier customers are telling you and explain your role in more detail for when that transition takes place? Thank you.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah. Sure, Nate. So, first of all, should the back half not play out that way, we will probably make some further adjustments, some of which will just come out of the COGS associated with the revenue. That wouldn't happen if it didn't happen. But under all circumstances, I don't believe we'd need to look at any financing alternatives, just to be clear about that.

And then the second question is what we comment on what customers are saying about SDN, NFE. Our customers are quite pleased with the progress we've made moving our policy, signaling and session assets to software. And we are engaged with some of the largest service providers, both the ones we currently serve as well as a number of new ones, to look at major deployments. And those would include trials in laboratories and as part of an RFP response. And what we're doing is completely consistent with where that SDN, NFE transition is going.

Nate Cunningham
Guggenheim Securities LLC

Q

Great. Thank you.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Thank you, Nate.

Operator: And our next question comes from the line of Mike Latimore with Northland Capital. Please proceed with your questions.

Mike Latimore
Northland Securities, Inc.

Q

Great. Yeah. Thanks a lot. Just on the services revenue, what percent of your services in the quarter was maintenance?

Mark T. Greenquist
Chief Financial Officer

A

It would have been roughly $20 million of the $25 million, a little bit higher than that, but roughly that, which is consistent with what we would have seen in prior quarters in 2014 as well. So, really nothing [ph] to miss (54:22) there.

Mike Latimore
Northland Securities, Inc.

Q

Got it. So, that means this line should be relatively stable going forward?

Mark T. Greenquist
Chief Financial Officer

A

I would expect that to be true.

Mike Latimore
Northland Securities, Inc.

Q

Okay. And then you mentioned the kind of legacy $90 million to $95 million for the year. So roughly what percent of that would be kind of product versus service?

Mark T. Greenquist
Chief Financial Officer

A

There is going to be some decline attributed to the legacy services effectively offset by growth. So, I think on the maintenance side, as I just mentioned, I think that that's going to remain relatively stable in total. There could be some change in the mix between growth and legacy. And then I think the bulk of it or a big chunk of it is going to be related to the product side.

Mike Latimore
Northland Securities, Inc.

Q

Got it. And then on the enterprise side of things, did you see any – was it possible there were any delays just on the kind of renaming, relaunching of Lync to Skype for Business or were there other effects there related to the enterprise business?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah. Mike, this is Ray. I don't think that renaming really had anything to do with it. But the broader strategy launch is actually material. And I wouldn't attribute delays to Lync. I think that would be inappropriate. But even if you look at the restrategization, if you will, of the Lync for Business push and the desire by Microsoft and the entire ecosystem, we're really focused on deploying voice and other real-time collaboration, it's a pretty big industry-wide deal and it's a major competitive battle between them and some of the other UC suites that are out there.

And so, it's very much a part of our enterprise push. Whether or not it literally caused the delay, I think that's too speculative. But I do believe that we're in a hunt for all those deals. And, ultimately, it will push through and drive the architectural shift that we're talking about here and it will be very favorable to our business when we do.

Mike Latimore
Northland Securities, Inc.

Q

Clear. Thanks.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Thank you.

Operator: Our next question comes from the line of [ph] Steven Collins with Provo Partners (56:42). Please proceed with your question.

Q

Hi. Thanks for taking the call. Going back to the precipitousness of the guidance reduction and matching that against how broad-based the takedown was, I'm trying to understand kind of what happened in the months between the time that you set the original outlook in March 24. Is it changes in the net neutrality discussions and did that cause CapEx changes among your large carriers? Do you think these were issues that were external to Sonus or they are internal to Sonus, forecasting issues that got ameliorated when you did revised outlook? I'm just trying to understand how things could have gone so far negative, so broadly, so quickly.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

With regard to the 30 days between the guide and the recap, if you will, it really links to the fact that, A, the forecast was back-end loaded as disclosed. And then, two, circumstances in the market changed for a lot of these customers. We tried to highlight which segments but you're commenting broad-based. It is broadly out there.

I am reluctant to call it net neutrality. I think that would be a little bit too simplistic. But the significance of the architectural shift, the fact that a lot of these companies are under their own stresses with regard to forecasting their end market demand, their own capital budgets, their own capital allocations, and the industry consolidation, all of those things interplayed in there. And I understand the magnitude of the miss. We're all accountable to it. But I don't have a better way to explain it than what I did in my prepared comments.

Q

I guess, as a follow-up to that then, Ray. What I'm trying to understand is the forecasting process and, therefore, the confidence that you have in that process going forward. What you're describing seems to be that these were industry-wide changes that, for whatever reason, didn't get picked up sooner in the forecasting process as opposed to sudden changes in the environment.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah. So, [ph] Steve (59:22), what we did was we described the process that led to this outlook. And we have always had collaboration with our customers but we really focused harder in the midst of this miss to, one, understand what happened in Q1 and, two, understand its implications on our outlook. And so I spent a significantly more time with our customers as have other members of the leadership team, so that we really understand their end markets. So that's how I would explain that miss.

Raymond P. Dolan
President, Chief Executive Officer & Director

So thanks for that question. I just want to close this as I know a number of folks are moving on to other things, including the market opening shortly and just reemphasize that, A, we accept accountability for this miss and we're on it. We've revised our outlook consistent not only with the Q1 miss but our view of the industry going forward. And that we remain very comfortable that we are a strategic partner to this industry, including all of our customers, as they make this difficult transition.

Ultimately, the reward will be a more fully communications architecture that serves us going forward for decades to come. I'm proud to lead Sonus going forward in that transition. And I appreciate all of your support out there not only on this call but going forward. Thanks a lot.

Operator: And, Mr. Dolan, there are no further questions at this time. I will now turn the call back to you. Please continue with your presentation or closing remarks.

Raymond P. Dolan

President, Chief Executive Officer & Director

So, operator, we just did that. We'll go ahead and tear the call down now. Everyone, have a great day.

Operator: And, ladies and gentlemen, that does conclude the conference call for today. We thank you for your participation and ask that you please disconnect your lines.