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Spirent Communications Plc (SPT.GB)

Q3 2015 Sales and Revenue Call - Trading Update

MANAGEMENT DISCUSSION SECTION

Operator: Thank you for standing by and welcome to the Spirent's Q3, 2015 Trading Update Conference Call. At this time, all participants are in a listen-only mode. There will be a presentation followed by a question-and-answer session. [Operator Instructions] I must advise you that this conference is being recorded today on Thursday, the 5th of November 2015.

I would now like to turn the conference over to your speaker today, Eric Hutchinson. Please go ahead, sir.

Eric G. Hutchinson

Thank you. Good morning, everybody. I'm Eric Hutchinson, Chief Executive Officer of Spirent Communications. Thank you for joining our Trading Update call on the third quarter of 2015. I'm also with Rachel Whiting, Chief Financial Officer. I will give a brief overview before turning over to questions.

You all have seen from today's announcement that revenue for the third quarter was up about $15 million over the same period last year to a total of $125 million, an increase of about 14%. We saw a strong growth in the Networks & Applications where we have a good start helped by the increased in the opening order book from the second quarter. The considerable growth in Service Assurance reflected the large shipment to meet the handheld test tools contract. This contract is now complete.

We also noted, the 11% decrease in Wireless & Service Experience, a continuation of the trends we reported at Q2, which resulted from the fundamental structural changes and technology shifts in the smartphone market.

Around the world, we saw a strong revenue growth in the Americas and in Asia Pacific but weakness in the European markets. Our reported adjusted operating profit was $14 million up from $9.1 million last year. As per order intake, this was down compared to the third quarter last year. We had good growth in Networks & Applications, but the weakness in Wireless & Service Experience pulled back the numbers. Just note, that Service Assurance order intake is seasonally much stronger in the fourth quarter.

As a result of the continuing changes in the wireless devices and carrier acceptance test market, which we expect to impact our revenue in 2016, we are undertaking targeted cost reduction actions in the fourth quarter this year to achieve $25 million of annualized savings. The cost of this will be taking as an exception expense this year with the benefits occurring in 2016.

Cash generation or free cash inflow of $18 million compared to a $4.8 million outflow last year. Cash flow is $103.4 million half the payment of the interim dividend of $10.1 million. At this stage, the board expects the underlying results in the full year to be broadly in line with its previous expectations.

We've also announced today that Rachel Whiting has decided to retire from a position at Spirent. She will stay with us through until the annual general meeting next year to help and orderly handover to some of the new joining us and we have commenced the search for a new CFO. So, Rachel will have undertaken nearly 30 years, about 30 years of service with Spirent. So, thank you, Rachel, for that.

With that, I'll open up the call to questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Gareth Jenkins from UBS. Please ask you question.

Gareth Jenkins

Q

Yeah. Thanks. Hi, Eric. Just a few if I could. Firstly, I just wondered if you could talk about the phasing of the cost savings that you're making. Are these cost savings that will come in very quickly, or will they take some time to ramp? Secondly, I just wondered if you could talk about the ability to cross-sell the handheld test tool into maybe other operators globally and whether that's something that you feel that you can do, so maybe offsetting some of the decline next year in that business. Thank you.

Eric Hutchinson

A

Okay. Thank you, Gareth. With everything that we did in Spirent in terms of managing expenses, we undertake the actions and you see the benefits immediately in the run rate expense in the following quarters. So, I would expect that expense saving to kick in immediately in the beginning of the new year. So, we will see the full benefit in the run rate from 1st of January.

Regarding the handheld tool, we are taking that to others. We've got some interest from both from the carriers but also cable operators for the equipment. There is some slight development we need to do to make it more suitable for other customers, but we are looking to sell that to other engineering workforces in their operations so that they can see some of the efficiencies that is driving our main Tier 1 customers.

Gareth Jenkins

Q

Okay. And just a follow-up on the cost side. The cost saving of $25 million, I presume that's a net number. So, should we – when we look at OpEx to 2016, we should assume some overhead increase and then just basically strip 25 out?

Eric G. Hutchinson

A

Yeah. No, we – if you take the cost base, and you assume normal increases in both – anything that gets driven but also in terms of just annual pay increases for the normal incentives in place, and that would take place. As I say, we are investing in businesses for growth. So, we will continue to invest now as where we see the growth opportunities. And then we've got the revenue headwind, as I've mentioned on the wireless business. So, net-net, the overhead exiting 2015 compared to full-year 2016, probably they are similar sorts of number.

Gareth Jenkins

Q

Great. Thank you.

Operator: Your next question comes from the line of James Goodman from Barclays.

James Goodman

Q

Good morning. Thank you. Could you elaborate, please, on the structural and fundamental change comment? I don't think you've used that language before. Apologies if I've missed something there. And did I hear that that related to one customer or so? I mean, could you quantify that impact that you're expecting in 2016?

And then just on the OpEx, could you contrast the cost savings that you're putting in place in the final quarter with the – I think with the $30 million investment that you put into the business in 2014. Are those totally unrelated, or are we seeing you reverse some of that previous investment? Thanks.

Eric G. Hutchinson

A

Okay. So, in terms of the fundamental changes in the market really reflecting maturity of the technologies and smartphones. We're seeing now that carriers are no longer funding very large test activities for the pre-deployment testing of the performance of smartphone devices. So, it's not just one customer, it's across the market. That's pushing back on the device manufacturers who are not being compelled to do the same level of testing.

So, the very large test systems that we were producing for that market that declining demand for that. There's also a shift in the way that people are looking at deploying services, so there's much for entity to that how the device is operating in the live network and how the wireless services are being deployed and what the subscriber experiences like. So, there's a change in the market and we are adapting our portfolio of products to meet the needs of a lower impact, more widespread testing and how do you get that assurance of the performance in the live network.

The OpEx, the cost reduction actions are related to, primarily, the wireless business. Since primarily related to the technology areas where were no longer seeing demand. The step up in investment is in – anything to do with virtual technologies, security testing, how the sensors are deployed in the live network, what we can do in the live network to get assurance, investment in data analytics, more efficient management of engineering services and support and customer experience in private carriers. So, the areas where we step up the investment hasn't changed. This is a separate cost management which we're undertaking as you would normally in many business, where you'd see declining prospects.

James Goodman

Q

That's very clear. Thank you. And I presume it's too early then to sort of quantify the FY 2016 sort of decline that you'd anticipate across the wireless business. Is it just more of a sort of fundamental direction at the moment?

A

I think, it's – we are expecting maybe a further $15 million of revenue decrease related to that, to the wireless business.

James Goodman

Q

Okay. Makes more sense.

A

And no synergies into the – as we've noted before, that the handheld test tool contract of around about $16 million, that doesn't repeat. So, $30 million total headwind against this one in terms of top line.

James Goodman

Q

Perfect. Thanks.

Operator: Your next question comes from the line of Nick James from Numis.

Nick James

Q

Good morning. Just a couple of questions. I guess the first one was on wireless in terms of the new Elevate product in that area, which I guess is the [indiscernible] (11:03) that's responsible to developing our market opportunity there. If you could just update us on the outlook for that in terms of when that should begin to generate material revenue.

And then the second one was just on the Networks & Applications business where, obviously, we are seeing some growth. Can you just help us get a feel for the kind of the underlying growth rate that we're seeing at the moment in that business and the drivers of that, and kind of what the outlook could be looking into 2016?

A

Okay. Thank you, Nick. The wireless business, the Elevate wireless test platform, which is a completely different type of test tool, software-based, we currently deploy on developer's desktops. It meets a wide of range of needs.

It also means that it opens up the ability to test devices. So, we look in all devices. So, we're looking beyond the smartphone market into any device being connected to the network. So, that's really the platform that we see the future growth of that wireless test business is coming from.

That really came to market end of second quarter. We're now expecting to see high-single-digit revenues from that platform in 2015 and continued progress through 2016. So, the wireless revenues will transition to the elevated platform through 2016 and 2017.

So, it's got very good acceptance, very positive customer feedback from extremely important Tier 1 and leading device manufacturers and chip manufacturers. So, we're quite close with the acceptance. Clearly, we've got more work to do to enhance that tougher environment as we go through the next two or three years.

In terms of the Networks & Applications business, the underlying growth rate is around 6% to 7%. We see that both as an uptick in the demand for Ethernet test, which is the core business within Networks & Applications. We're now consistently leading the market in terms of innovation in terms of speed rates of Ethernet.

And we've seen in our announcements about 400-gigabit Ethernet test. We've got more coming there. We've enhanced our 100-gigabit Ethernet. We've got much more bench testing, and we are demonstrating our 50-gigabit Ethernet capabilities and we've enhanced that low speed rates. So, the hardware systems sale part of that is very robust, and we're also seeing a lot of interest in taking up our virtual test products. So, that's very positive. And over the next two years, we would see that the virtual test requirements will drive the growth rate of that business.

The other area that's positive is where carriers are looking to assure the deployment of their new services, so everything to do with 4G, RCS deployments that we have some unique capabilities are very attractive for both testing and assuring that in the live network. So, we've got some pretty exciting proof-of-concept trials going on during the fourth quarter with Tier 1 carriers on that.

And we're enhancing everything that we're doing. On our security test products, we have the leading position with firewall developers. But we've got some new software enhancements coming out in the fourth quarter, and deploying the 100-gigabit Ethernet platforms. So, we're very positive about the outlook for our security test suite going through into 2016. And there's a little theme of past automation which is also going up everything we do in Networks & Applications.

So, feeling – we're pretty positive about the outlook on the Networks & Applications side of the business. [indiscernible] (15:26) neglect the other side, we do have a lot of enhancements to vulnerability testing [indiscernible] (15:33) to do with satellite navigation. And we're certainly making some real inroads during the fourth quarter and looking to 2016, everything to do with data analytics.

Nick James

Q

Great. Thank you very much.

Operator: And your next question comes from the line of Lee Simpson from Stifel. Please, ask your question.

Lee Simpson

Q

Great. Good morning, guys. Just a couple from me if I could. I'm really just trying to understand this sort of U.S. tail of the CapEx trend until the end of this year. As well as knowing that AT&T is going to increase its CapEx, at least slightly in the second half. I just wanted to see what a sort of redo will be for you guys. Maybe alongside that, I'm trying to understand where the uptake has appeared in enterprise as of yet with Spirent. And we had a rival talk yesterday about displeasing incumbent kit in the finance sector. I just wondered if that has a sort of redo it yourself.

A

Okay. Thank you, Lee. Yes. In fact, the U.S. telcos are the major service providers Tier 1 is in the United States, definitely leading a pick-up in demand for everything we're doing on the network side. And we have a very strong relationship with all the leading carriers. So, indeed AT&T are investing in the deployment of new technologies and we're right in with them, helping them look at the best methodologies may deploy. So, we'll see that as being positive year-to-date. And we hope that that will continue to be at positive trend for us during the fourth quarter and through the next year. That I also believe will still relate general demand across the market from equipment manufacturers as you start to see more deployments going through.

So, of course we're not flagging some huge year-end budget flush, I would certainly see the backdrop was being posted much, much better than it was the same time last year. Regarding enterprise, our exposure to enterprise markets is much, much different. We don't have as much exposure to enterprise. Our main competitors invested considerable amounts of money buying into businesses that had enterprise products.

So, we're also seeing a positive backdrop in some areas. I wouldn't say that that really is something that is today significant for Spirent. As time goes by, we will be putting more capability into some enterprise [indiscernible] (18:33) but that's not today story about the future.

Lee Simpson

Q

Got you. And then maybe some quick follow-up if I could, maybe just some clarification on when you see sales for 100 gig, I mean 100 gig does it look like a very strong spot for one of your rivals, and again I got the sense that this is more a sort of mid-2016 onwards story for you guys.

A

No. 100 gigabit is driving demand for us now. We're seeing a big increase in demand every single day on 100 gigabit through 2015 and that's being a strong part of the next modifications performance, and we would expect to see that concluding through 2016 but further enhanced by the 50-gig, 25-gig technologies in data centers.

Lee Simpson

Q

Got you. Very clear. Thank you so much.

Operator: And the next question comes from the line of Robert Lamb from Jefferies.

Robert Lamb

Q

Good morning. Thanks for taking my questions. Just quickly, I just wanted to clarify on the OpEx. So, essentially, the whole $25 million saving is being reinvested. Is that correct?

A

Yes. Well...

A

No. That's not entirely correct. I'd say half of it is to cover off decreases in revenue in the wireless area, and the other half is being offset by just budgeting for normal sort of increases in the business. And we will be reallocating resources within the total to higher growth opportunities and deemphasizing other parts.

Robert Lamb

Q

Okay. Hence, the flat year-on-year comment?

A

Yes.

Robert Lamb

Q

Yeah. Okay. Okay. Understood. And then, just on the, I guess, we have [indiscernible] (20:34) consensus around $500 million revenue and you've spoken about $15 million in wireless and some of the handheld, should we be thinking around $20 million moderation in expectations on that basis, does that sound fair?

A

That would appear sensible.

A

That sounds sensible.

Robert Lamb

Q

And just focusing more on I guess future product. I think you touched on security. Could we have any more detail there in terms of whether that's driving new product introduction this year, when we should be thinking about revenues from security products going through at the full year. Is that 2016, 2017?

A

So, yeah. So, these are really launches we're only taking now in the fourth quarter and we'll do further enhancements during 2016. But we'd expect it to drive some revenue increase during 2016 and 2017. The specifics will be announced later in the quarter.

Robert Lamb

Q

Okay. Great. Thank you very much.

Operator: Your next question comes from Eoin Lambe from Liberum.

Eoin Lambe

Q

Hi there. Good morning. It's Eoin. Three different questions, if I could. Firstly, just taking a step back. I think you used to say Spirent's markets are growing at almost 8% or 7.9% per annum over the next few years. Should we still think about that as a sensible base case, or should we lower that expectation given what's going on in the smartphone market?

Eric G. Hutchinson

A

Morning, Eoin. So, the market in the Network & Applications, which includes infrastructure, we would still support that market growth rates. We see, at least, that growth rate, if not more, in everything to do with analytics. And we'll see positive growth in satellite navigation. In the one market niche on performance testing, there's been a fundamental change in the way devices are tested. That market is transitioning away from the traditional large-scale systems test into a much wider testing market of how you connect any device to networks, to cellular networks or Wi-Fi network.

So, the overall market, we still feel, is positive. It's just for one niche that we're in is changing. So, for Spirent, we won't see that top-line rate in the next 12, 15, 18 months. But you will see strong growth in part of the portfolio.

Eoin Lambe

Q

Okay. Thank you. And the book-to-bill, I think, for the group was [ph] 0.8 (23:28) in the quarter. By division, was it above 1 in Networks & Applications?

Eric G. Hutchinson

A

Yes. Well, it's about one or just above – which is about [ph] one in monthly (23:46) patients.

Eoin Lambe

Q

Okay. Thanks.

Eric G. Hutchinson

A

[indiscernible] (23:50)

Rachel Whiting

A

Yeah. [indiscernible] (23:53) overall for the group, Eoin, it's around one, if you take out the hand held test tools and distortion, and we expect to see about one for the full year.

Eoin Lambe

Q

Okay. Thank you.

Eric G. Hutchinson

A

[indiscernible] (24:10)

Eoin Lambe

Q

Okay. And then just on consolidation, I'm interested in your view on your outlook for consolidation in the space. It seems that slowed down a touch, but do you still expect this space to consolidate over time?

Eric G. Hutchinson

A

Well, it's [indiscernible] (24:24) measurement [indiscernible] (24:25)...

Eoin Lambe

Q

Yeah. Yeah. In general.

Eric G. Hutchinson

A

I think there were lots of pure-play companies out there. I would still expect it to be narrow, where you would see consolidation. And I see you've done some initial moves. I think there's bit of digestion of what's going on happening at the moment. This [indiscernible] (24:49) make the next step.

Eoin Lambe

Q

Okay. Perfect. Thank you.

Operator: And your next question comes from the line of Rahul Chopra from Citigroup.

Rahul Chopra

Q

Hello.

Eric G. Hutchinson

A

Hello, Rahul.

Rahul Chopra

Q

Yes. Could you just give us some sense in terms of the costs – where you're cutting costs within those [indiscernible] (25:13) silicon marketing specifically? And how should we think in terms of margins for next year on an underlying basis excluding those cost savings?

Eric G. Hutchinson

A

So, the cost reductions will be across all of the overhead department. And I think that right. Rachel...

Rachel Whiting

A

That's right. It is a close the whole of year overhead.

Eric G. Hutchinson

A

And in terms of [indiscernible] (25:49). Sorry, what was your supplemental question, Rahul?

Rahul Chopra

Q

Margins from underlying business. If [indiscernible] (25:57) cost savings?

Eric G. Hutchinson

A

So, in terms of the operating margins that we see the business is running at 10% to 11% for the return on sales in the near term. But, as you see the business developed and that should expand.

Rahul Chopra

Q

Thank you. And how should we think in terms of long term margins for the business. I mean, will you expect 15% to 20% margins maybe towards next few years [indiscernible] (26:35) should expect that in medium term?

Eric G. Hutchinson

A

We expect to see the margin with expanding during 2017, 2018.

Rahul Chopra

Q

Okay. Okay. Thank you.

Operator: The next question comes from the line of Johannes Schaller from Deutsche Bank. Please, ask your question.

Johannes Schaller

Q

Yeah. Hi. Hi, Eric. Hi, Rachel. Thanks for taking my question. I just wanted to come back on the wireless division. I mean, what you're saying on performance testing and you're really putting a big kind of structural question mark behind that part of the division rather than the declines being driven by market share shifts, so any short term kind of demand momentum here. So, you could just remind us of how much of the wireless business is currently performing to testing? I mean, I guess the $15 million, in tech next year that's not all of it I guess. And also if you could maybe help us understand how the other parts, how big they are roughly, how big is GPS currently, and how are these growing if we strip out the performance testing so there would be good turns then? Thanks.

Eric G. Hutchinson

A

Okay. So, the wireless device test business is just under 25% of its group total revenue. Three quarters of that really relates to the large scale system tests on carrier acceptance with location-based services. And that's the area where we've been seeing the decreases. There will be really quite marked decreases from 2013, 2014 into 2015. So, that's the area that it's related to.

Part of that portfolio we see as being quite resilient at the moment. So, everything to deal with channel emulation, tracer technology is pretty solid. There's a lot of work being done on the physical testing. So, that continues and we've got – we're in the top one or two serving that particular part of the market.

The satellite and navigation business is running about 10% of the total revenue and is performing extremely well. But clearly, it's only 10% of the group.

Johannes Schaller

Q

I mean, so you're basically saying 75% is essentially the part of the business where you've seen the structural declines. And I guess that has to do just with the fundamental change in customer behaviors.

Eric G. Hutchinson

A

Correct.

Johannes Schaller

Q

And that suggests that this 75% are really under some longer term pressure then or am I getting that wrong?

Eric G. Hutchinson

A

No. That's correct. It is. But what we're seeing is that we are shifting the business away from that performance testing into the interoperability testing and the testing of all devices in the network environment, so with the new test platform. So, we will be transitioning that revenue to the new platform and new customers.

So, yeah, at the moment, we are thankful – quite thankful with the transition in terms of product lines within the wireless business unit.

Johannes Schaller

Q

Okay. That's very clear. That's understood. And then maybe just a last one related to that. I guess few of your competitors are already active in those areas where you want to go into. So, just if you could give us maybe a bit of a sense how you feel you can differentiate versus some of the bigger guys out there and what's your go-to-market strategy would be, that would be great. Thank you.

Eric G. Hutchinson

A

Okay. So, the main differentiation is that we're bringing everything that we model and the wireless infrastructure into our software tool, and we've also, we have a single solution for interoperability testing. Competitors – even our major competitors have multiple pieces of equipment to do [indiscernible] (30:51) testing between devices. So, we have a single platform. Those are our key differentiators and then we're making it have a much simple-to-use interface as well.

Johannes Schaller

Q

That's helpful. Thanks very much, Eric.

Eric G. Hutchinson

A

Okay. Thanks, Johannes.

Operator: We have no further questions. Please continue.

Eric G. Hutchinson

Okay. So, if there are no more questions in the queue, I'll thank you for joining the call and for your attention and interest in Spirent, and I look forward to meeting you and talking to you in the future. Thank you.

Operator: Okay. That does conclude our conference for today. Thank you for participating. You may all disconnect.

Eric G. Hutchinson

Thank you, operator.