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SPT.L - Preliminary FY 2015 Spirent Communications plc Earnings Presentation

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PRESENTATION

Rachel Whiting *- Spirent Communications plc - CFO*

Well, good morning, everyone. Welcome and thank you all for coming. I am delighted to be here today to present our 2015 full-year results.

2015 was the second year where we have continued with our focus of investing in the business with the aim of growing our top line and building a sustainable, long-term revenue stream.

The market is constantly changing and as a result, we've again seen considerable volatility throughout the year, particularly in wireless device test. But despite that, we've again made some excellent progress in key parts of the business.

Before diving into the details, I'd just like to draw your attention to the usual Safe Harbor slide. Thank you.

So as we look at this overview of our year, 2015 was most definitely a year of two halves: a weak first half; but with a very strong second half.

We started slowly, with revenue down $2.3 million compared to 2014, but then gained momentum in the second half, with revenue growing by $22.2 million, up 9% over the same period of 2014.

Given our operational gearing, the impact of this was even more exaggerated at the adjusted operating profit line, where we saw first-half profit decline by $14.6 million to $6 million, but then increase by $36.1 million, up 42%, due to the increased revenue, combined with expense constraint.

All this led to the revenue growth of 4% in the year to $477.1 million and adjusted operating profit of $42.1 million.

I'll talk about the individual reporting segments a little later, but we saw a very strong performance in networks and applications, up 9%; and in service assurance up 16%.

Wireless and service experience on the other hand declined by 6% as it was impacted by the change in demand for smartphone development and validation testing.

Regionally, the Americas and APAC were strong, with EMEA somewhat weaker.

We expect seasonality and customer spending to again be a factor in 2016 performance, where activity will be skewed to the second half of the year.

Turning then to the Group's comparative results for 2015, revenue, as I said, was up 4% to $477.1 million and gross margin improved slightly to 69.5%, reflecting the product mix for the year.

We maintained investment in product development and reallocated resources in three areas: firstly, in areas where we see significant opportunities for growth; secondly, where Spirent has a leading market position and can leverage its expertise; and thirdly, where Spirent has the opportunity to drive its strategic priorities such as new market entry and technological leadership. Eric will expand on each of these areas later in the presentation.

As we've said before, we planned to increase investment in sales and marketing significantly in this year. This partly reflects the full-year impact from the 2014 acquisitions, but also investing in targeted areas to create new market opportunities for the longer term.

Those investments have already started to bear fruit. We've added 498 new customers in the year. We've seen growth in our major accounts and we've expanded our channels to market. The operating profit of $42.1 million reflects the continued investments that we're making.

The reported tax rate for the year was 25% and we expect this to be the rate for 2016. The tax credit in the income statement reflects recognition of deferred tax assets and prior-period adjustments, and we're proposing to maintain our dividend at $0.0389 per share for the full year.

So now let me turn to each of the operating divisions. Let's look first at our networks and applications division, which accounts for 51% of Group revenue.

Networks and applications had a very strong performance, growing revenue by 9%, driven by demand for high-speed Ethernet. Demand was particularly strong in the Americas and in APAC, driven by demand from network equipment manufacturers and service providers, but somewhat weaker in EMEA due to a continuing customer consolidation.

Gross margin in this division improved to 69.2%, reflecting the higher margin we're able to achieve on some of our new products.

We maintained our investment in product development, allocating resources where we see the most potential for growth, and increased our investment in sales and marketing.

And that investment enabled us to expand our channels to market, to grow our customer base and to increase our business in key customer accounts.

We saw improved profitability in this division, reflecting the increasing revenue and gross margin and expect further progress in this division in 2016.

Turning now to our wireless and service experience division, which accounts for about 35% of Group revenue. Revenue in this division declined 6% as the wireless test market continued to be challenged. Consolidation of global smartphones, chipset and network equipment vendors continued, giving a fiercely competitive market.

As we highlighted during the first half, we also saw a major customer in Asia failing to repeat the high level of spend we saw in 2014.

Despite tough conditions in the wireless business overall, we did benefit significantly from intense competition amongst chipset vendors in Asia, particularly in China.

The division also benefited from increased business with local vendors in Asia, enabling testing of user experience following the launch of our Fit4Launch lab in Beijing.

The impact we felt in our wireless testing business was also partly offset by strong demand from our high-end positioning solutions, driven by US Government procurement spend.

To mitigate the effect of the challenges in the wireless device test and carrier acceptance market, we constrained our costs during the year and took targeted cost-reduction actions in the fourth quarter to reshape the wireless business.

We're reducing overhead expenditure and outsourced engineering service to provide a flexible resource for 2016 and future years. And we expect the full benefit of those actions to be seen in 2016.

Finally, I'd just like to draw your attention to the fact that the service experience line of business, which accounts for just under $30 million of revenue, has been combined with our service assurance business and will be reported as part of that division for 2016 and beyond.

Finally, looking at our service assurance business, which accounts for 14% of revenue in 2015. Revenue was up 16% here primarily driven by the first full-year contribution from our 2014 acquisitions, which added $6.9 million of revenue, compared to the post-acquisition period of 2014.

You will see here a significant increase in investment. As well as continuing to support the core business, that investment resulted in the development and launch of our first virtual probe, which is the virtualized distributed Ethernet probe. And this product is now in trials at major service providers.

We also launched a new high-performance analytic solution, InTouch Customer Networks Analytics, which is a more versatile, easier to use and cost-effective implementation of our powerful CEM software solution. We've already won a significant contract with a major service provider for this solution and plan to expand our served customer base with carriers worldwide.

As we enter 2016, we know that the $16 million field test order delivered in 2015 will not repeat. However, we'll continue to focus our attention in this division on live networks, virtualization and data analytics, where we see potential for growth.

So let's look at our cash position now. Cash generated from operating activities was higher in 2015, as we benefited from the unwind to the working capital increase we saw at the end of the fourth quarter of 2014.

Tax-free funds from prior periods of $2.6 million further bolstered the cash flow from operating activities.

Our net capital spend in the year was lower than in 2014, which included the move to new leasehold facilities in the United States. And we expect 2016 CapEx to be lower again, at around $20 million.

We also made some small acquisitions in the year, totaling $6.7 million. In October, we made a $5 million investment to take a 28% stake in Jolata Inc.

We also made a small acquisition in the UK of Epitiro Limited at an initial cost of $1.7 million. And Eric will talk to you more about those acquisitions a little later in the presentation.

We paid $23.5 million in dividends during the year and, as we've already mentioned, propose to hold the final dividend for 2015 at $0.0221, bringing the full-year dividend to $0.0389, the same as for 2014.

So, in line with our strategy to maintain financial strength and flexibility, we end the year with a healthy cash balance of $102 million and no debt, which enables us to continue to invest in the business, pursue strategic acquisitions and to provide sustainable shareholder returns.

Before I hand over to Eric, I wanted to provide you with a brief summary of the factors that we anticipate will influence our performance during 2016.

As you know, our expectations are unchanged for the year ahead. But there are certain elements which will have a bearing on performance. First of all, we anticipate that revenue will continue to grow in our largest division, networks and applications. And Eric will provide more detail on the drivers here, but Ethernet, mobility and security are all likely to play an important role.

On the downside, we expect that our performance in wireless device will continue to be weak owing to the ongoing challenges in this market. We also see a comparative impact in our service assurance business, owing to the fact that the large handheld test tool contract, which was worth $16 million in 2015, will not recur in 2016.

As for costs, we will continue to invest in those areas where we see the greatest opportunity for growth and success. However, we expect that this will be balanced by the benefits from the cost savings we have made in our wireless device test business.

The upshot of all this, as I mentioned, is that our expectations will remain unchanged for 2016, although the seasonality that we saw in 2015 is likely to recur in 2016, giving a much stronger second half.

Now let me hand you over to Eric, who will discuss the market, our strategy and the outlook. Thank you.

Eric Hutchinson - *Spirent Communications plc - CEO*

Thank you, Rachel. So I'll turn to our achievements in 2015, review/recap the strategy and look at our plans for 2016.

So with the strategy. So let me remind you, in essence, what Spirent exists to do is serve our clients' needs around the verification, assurance and security of their data communications.

We need to keep pace with technological developments and providing the optimal solutions that provide efficient, effective, easy-to-use systems to test their complex needs. And our primary purpose within the strategy is to create a sustainable revenue stream that's got long-term potential, encapsulating subscription sales and services and royalty income.

There are six strategic objectives underpinning this, so let me take you through some of the progress in 2015. We've made good strides in these six objectives.

Turning first to expanding our markets. At the start of 2015, we set out to deliver virtualization capabilities, to enhance everything we did in the mobile infrastructure and assurance market.

We achieved both through the launch of virtual test solutions across our M&A portfolio, of products and development of diameter test capability in mobile infrastructure. We've also expanded and significantly enhanced our cyber security offerings.

In terms of technology leadership. Our strategy to invest for long-term growth has delivered a range of new leading products, solutions and services to address the radically changing requirements within data communications. And I'll provide some more details on those areas in the coming slides.

We made good progress deepening our customer relationships during the year and we continue to work closely with customers in order to develop the capabilities to best serve their needs.

And we grew revenue across our top customer accounts, as Rachel mentioned, in 2015. Our decision to invest strongly in sales and marketing has delivered excellent results, in terms of attracting new customers. And as Rachel said, we signed up 498 new customers in the year.

We acquired new technologies. In October, we made a $5 million investment in Jolata, a California company, which aims to develop a market-leadership position in network visibility for latency management.

We also expanded the coverage of our proactive service assurance suite into the rapidly growing WiFi experience monitoring market with the acquisition of Epitiro.

We continue to invest in our people, resourcing appropriately. And we've strengthened our capabilities in areas such as cyber security.

And finally, as Rachel said, in terms of financial strength, we ended the year with a strong cash balance, which provides us with the flexibility we need to best serve the market.

All in all, we feel that we've made positive progress during the past year on these strategic objectives. And that stands us in good stead as we go into 2016.

Turning now to the growth areas that we've identified for the business. The major themes that I referred to in the 2014 report remain key for our strategic development through 2016, 2017 and beyond: namely, high speed Ethernet; cloud and virtualization; mobility infrastructure; cyber security; data analytics; and our longer-term prospects in adjacent markets, anything connected through the Internet of Things and automotive.

I've given you an indication on the slide here of the size of the markets we're targeting. In 2015, there were structural changes in the test and measurement industry, driven by: shifts in technology, such as the emphasis on virtual products and cloud infrastructure; the maturity of the market for smartphones; and the continued consolidation of our major customers.

The relentless growth in data volumes continues, requiring new greater density and higher-speed Ethernet deployments to provide capacity and resilience against the background of increasing cyber security threat.

The world continues to invest in the development of digital network technologies which require innovative test and assurance solutions. And there's an increasing emphasis on the live deployment and assurance of the provision of services moving resources away from lab-based test systems.

We're confident we're on the right course. And over the next few slides, I'll demonstrate the progress we've made in these growth areas, as well as our plans across each of them.

So turning to high-speed Ethernet. As many of you know, this is a market where Spirent has its roots as a test and measurement businesses. There are a number of factors influencing our focus in the area.

Changes in the industry mean that more density is required, and existing technologies tend to move to legacy. So we need to constantly reinvent ourselves. The cost of hardware continues to fall dramatically.

And we move to virtualization, and that delivers more and more in software at greater scale. This will enable us to continue to lead in scale and performance.

There's also been a change in emphasis on testing devices in the lab by carriers. Now the focus is on live testing, and on the quality of service provision. And we're investing in the delivery of new systems, software solutions and services to address these changing demands.

And finally, as you can see from the chart on the right, there are frequent cycles in the industry, as new variants and speed rates of Ethernet are developed and deployed. We've seen this over a long period, and there are six new standards that are up and coming, which look promising for growth prospects, looking forward.

We've invested in this area to make sure we stay ahead of these changes. And that's paid dividends in 2015, enabling us to maintain our leadership position and deliver 10% growth in our Ethernet revenue during the year.

Spirent was first to launch 25 gigabit-based Ethernet switch and test solutions with real capability. And we followed up in the fourth quarter of 2015 with the first to market 50 gigabit test solution.

Our test solutions support all new speeds, and we retain market leadership in 100 gigabit. And we have 400 gigabit deployed with a major equipment manufacturer.

We've also added WiFi test capability to Spirent test center, have updated and enhanced our user interface for the Spirent test center to support software as a service and web-based applications.

Looking ahead, Spirent is well positioned for continued growth in network bandwidth. And the prospects offered by the deployment of 25 gigabit and all of its variants look promising.

We're developing new business models, providing testing as a service, subscription-based and utilization-based delivery, which opens up market expansion, particularly with cloud service providers.

Turning to cloud and virtualization. The IP network industry is in the midst of a revolutionary change in technology, with the virtualization of the compute, storage and network functions enabling technologies such as SDN and NFV to become mainstream. This is driving companies to adopt new processes for developing and delivering the products and services for their customers' requirements.

The growth of cloud services from bandwidth-hungry content and hosting services and applications, to always-connected social media on smartphones, drives the innovation at a rapid pace. And service providers worldwide are investing in their networks to keep up with the performance demands of these cloud services.

The extent of the growth in spend in this area is quantified in the chart on the right-hand side of the scale. So it's crucial that we continue to invest here to build on our competitive advantage, and meet the demands of the evolving industry.

In 2015, cloud represented 2% of our business, so small start. But we expect to see considerable growth coming from this area. We've been investing in developing new cloud-based functionality and orchestration test technologies.

We're now able to deliver Spirent test center, mobile infrastructure, application and security test as virtual machines, enabling the assurance of service provision in the operational network.

Proof of concept trials are now in progress at major customers. And these trials allow telecom operators to confirm the ability of network functions to run in the cloud infrastructure and form an important part of our strategy to expand our served customer base.

In 2016, we will continue to work closely with customers, as they transition to cloud and virtual solutions. The scale of virtual test ports is outstanding.

For example, we expect to supply 50,000 Spirent test center ports to a single equipment manufacturer during 2016. If you contrast that with the purchase of physical ports, they tend to be measured in their hundreds.

Building on Spirent's award winning virtual test solutions, we will further enhance our software solutions across product lines, with features and test methodologies, enabling service providers to successfully deploy NFV and enterprise to assure SDN functionality in their datacenters.

Here, we're also moving our revenue model to an annual subscription basis, which, as I mentioned earlier, is more appealing to cloud service providers and social media companies.

Turning now to mobility infrastructure. These charts illustrate why we're investing and expanding our capability in this market. The chart on the left shows the growth in mobile bandwidth. It's being led by the increase in video services, which is projected to grow 14 times over the next six years.

Needless to say, the infrastructure buildout that will need to keep pace with this demand will require test and assurance at scale to verify that the networks are able to support the service levels required.

The growth in demand is also leading to dramatic increases in the number of mobile sessions. This, in turn, is leading to the growth in WiFi, hand-off test needs and the sheer number of devices is driving the need for LTE, LTE advanced, 5G, Voice over LTE services, and WiFi testing combination. As a result of our investments in this field, Spirent now leads the market in test solutions for this control plank.

So how's the investment paying off? 2015 was too early to see revenue and profits coming from these investments. But you can see from the chart, the growth in the business in order intake, up 31% in the year and we increased the order book to $12.5 million.

We're seeing growth across all regions. As we look forward, there are multiple opportunities for test pre-deployment, and active network testing which can be embedded post-deployment.

As Rachel mentioned, we took the 28% stake in Jolata and have expanded our channels to market and technical capacity, enhancing our offerings.

In 2016, we'll continue to invest in this area. And there are multiple product opportunities in session and bandwidth scaling; diameter deployment; and WiFi hand-off. We have a number of trials running with major service providers. The pipeline looks promising across all regions for this product area.

I'd like to turn next to cyber security. As you're aware, security breaches are the stuff of everyday news headlines, with some very embarrassing consequences and dangerous outcomes. Attacks are more sophisticated and threats are developing daily, at significant financial and reputational cost.

Clearly, the spend on advanced threat prevention is set to increase for the foreseeable future, as indicated by the bar chart here. Our expertise lies in the testing of firewalls in development, a specialized and highly demanding market. And we're investing to expand beyond this.

So security in 2015 represented about 6% of our revenue. We expect this proportion to increase moving forward. During 2015, we updated our security solutions for malware, fuzzing, distributed denial of service attacks. We're building a threat intelligence database, and we're building the most relevant and recent database of malware available for test processes.

We've also added security consulting to test, measure and manage security risks. We've invested in a new high-end emulation system for global navigation satellite systems in 2014. This paid back very well in 2015, both enhancing our leadership position and offering increased capability to our customers. We saw a marked increase in activity, especially in the United States, as a result.

GNSS will continue to be a point of focus for us in 2016; and our new initiative is to develop solutions to detect GNSS vulnerabilities. So that's another subset of cyber security to be operated in the field, to develop and test the robustness of GNSS systems.

This is to help reduce the vulnerability of satellite signals that are being used in critical safety, infrastructure and commercial systems. Over time, this area will continue to expand considerably.

We've installed some detectors at our own premises, and it's surprising to see how many incidents are detected on a daily basis. We were quite surprised to see how much of that was going on.

Early in 2016, we will release our next-generation user interface for our security test solution. And this will allow us to take our advanced expertise and deliver it package in an easy to use way, to allow complex and realistic tests be run. We're expanding the platforms on which it will run: 1-gigabit, 10-gigabit, 100-gigabit capabilities, and also deliver the functionality as virtual devices.

In 2016, we'll also invest in building further brand awareness for Spirent as a security test solutions supplier. To kick-start this, as I mentioned, we've launched Spirent security labs, offering consulting and test-hacking services to demonstrate vulnerabilities.

Security is an increasing significant part of our business, and one we expect to grow long term.

Turning to data analytics which is our fifth growth initiative area. Big data and virtualization are changing the landscape of service provisioning and assurance. Advances here have opened up the possibility not only to find errors rapidly, but also predict them so they can be averted.

In addition, virtualization enables test probes to cost-effectively inserted at any point in the network.

Spirent's leadership position in service assurance market, along with our field-proven analytics platform, presents a unique opportunity in the analytics market.

In terms of work already underway, we provide distributed systems to enable service providers to turn up new services; diagnose, troubleshoot and monitor production networks; and also provide end-to-end visibility and real-time analytics.

Service providers are looking to reduce spending and to optimize networks as they transition to network virtualization. We provide a customer network analytics software system named InTouch to telecoms operators, enabling them to analyze the quality of their customers' experience and identify network improvements.

In 2015, we invested heavily to build a new flagship analytics solution, InTouch Customer Network Analytics, or CNA, focused on customer experience, assurance and troubleshooting.

We won our first major customer at the end of the year, a deployment that's contracted to be rolled out over the next five years. And again, this is on a subscription basis.

We also deployed a predictive analytics solution that's flagging up over 80% of network problems before the existing alarm systems are triggered, resulting in significant operational savings for the carrier.

And as I mentioned earlier, we also acquired WiFi capability to add to our assurance systems, with the acquisition of Epitiro. This builds on the strategic partnership we had with them, and has led to deployments at multiple customers, including a Tier 1 US service provider.

Looking ahead to 2016, we aim to drive value through reducing service providers' OpEx and CapEx, by rapidly characterizing network performance and user experience.

We have a virtual test capability; we have a 100-gigabit assurance systems for deployment in 2016; and we are also in a number of trials where we seek to expand our served customer base and carriers worldwide.

The sixth area covers adjacent markets. These are long-term growth initiatives, namely the Internet of Things, where we're looking at connected devices; and automotive.

Turning first to IoT. Our Internet of Things initiatives combine capabilities across Spirent portfolio, as well as the development of new solutions. As billions of devices become connected, mobile network operators and service providers face major challenges to manage service provision and quality levels.

The development of our new wireless test platform provides a framework to reduce test time, cost of service and application testing, as well as laying the foundation for device qualification beyond smartphones, to meet the needs for testing the Internet of Things.

During 2015, we've been building out products and service that enable our customers to develop, launch and operate IoT devices and networks.

We plan to supply embedded software; test and assurance tools; and systems to enable the development of the Internet of Things. The initial offerings will be software as a client; connectivity; and analytical tools. Releases are planned throughout 2016 across all these areas.

Indeed, we've just announced at Mobile World Congress, Smart SIM technologies in partnership with Oasis, to introduce device activation and global subscription provisioning for IoT connected devices. Spirent provides a unique automated access point name and remote subscription-management system.

The revenue for this will be linked with the number of devices enabled. This is expected to commence during the fourth quarter of this year. And this is a new revenue model for Spirent.

We also aim to build our marketing presence in this field and we are looking to lead, through interactive conferences such as the IoT Slam that we chaired in December.

Automotive is the second long-term prospect for us. It's estimated that by 2025, all cars will be connected, and that by 2035, three-quarters of all cars will be autonomous. Applications such as on-board diagnostics, infotainment, safety sensors, mobile connectivity will no longer be the preserve of high-end automotive manufacturers, but will be present across all marks and models.

This connectivity clearly presents a significant opportunity for a test company like Spirent. Our strategies to enter the test market for automotive data networks is to utilize our expertise in Ethernet testing, to focus initially on the development and deployment of Ethernet for in-vehicle system communications.

The deployment of 2-wire Ethernet in vehicles not only enables the seamless management of devices and systems on the vehicle, but also facilitates connectivity with mobile devices and the transport infrastructure. A not-inconsiderable benefit is that it reduces the weight of the vehicle, paramount in the next generation of environmentally sound vehicles.

We'll continue to supply other automotive test needs in positioning, and tools to test emergency calls systems, as required by legislation.

So, by way of conclusion. I think we're demonstrating that we're making some real turns on the investments that we've made. We're leveraging Spirent's capabilities and enhancing Spirent's reputation in the market. And we're investing to embrace the opportunities that we see in growth markets.

We'll manage our overheads tightly. As Rachel said, we see some revenue headwinds equivalent to about 6% growth, but we see underlying growth in the rest of the portfolio growing strongly, that should offset this in 2016; and hence our statement today that our expectations are unchanged for the year.

So thank you for your attention. And with that, we'll take questions. Nick?

QUESTIONS AND ANSWERS

Nick James - *Numis Securities - Analyst*

Nick James, Numis. I guess a few questions. First was on the new customers. I think you said 498 new customers.

Eric Hutchinson - *Spirent Communications plc - CEO*

Yes.

Nick James - *Numis Securities - Analyst*

it sounds like a very large amount. So I guess in isolation --

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Eric Hutchinson - *Spirent Communications plc - CEO*

It was a record number this year.

Nick James - *Numis Securities - Analyst*

But I guess in isolation, each one must be quite small, so --

Eric Hutchinson - *Spirent Communications plc - CEO*

Correct.

Nick James - *Numis Securities - Analyst*

What -- do they have potential to grow over the longer term? Or are these always going to remain quite small companies?

Eric Hutchinson - *Spirent Communications plc - CEO*

We always have a raft of new customers. I think it's reflecting the investments that are going on in the new technologies. And we're seeing new start-up companies, and we're seeing some customers coming back into the market. So that lays the foundations for maybe 5% to 10% of them to grow into being meaningful customers.

Nick James - *Numis Securities - Analyst*

Okay, great. Thank you. The second one was just on the new standard in Ethernet, because I guess, typically, it's always been about going faster and faster, but you're now talking about 25 gig and 50 gig, which is actually slower than what you were talking about four or five years ago. So, just to put that in perspective, why are we going backwards in speed?

Eric Hutchinson - *Spirent Communications plc - CEO*

Well, of course, we're not actually going backwards we're going forwards, because it's an upgrade to 10 gig. What this does, it increases the capacity in the data center. So, if you think of all the 10 gig feeds into a 40-gig switch, you can replace that with 25 gig and have a 100-gig switch without having to re-cable the whole of the infrastructure of the data center.

So it's a rapid way to increase capacity; that's why the industry has adopted 25 gig, and then you have all the variance around it. So 2.5 gig replaces 1 gig.

Nick James - *Numis Securities - Analyst*

Okay, great. And just also on that area, there's been a bit confusion and speculation that the trend towards virtualization is, in fact, bad for a business like Spirent. So if you can just clarify how the trend to virtualization is affecting your business in Ethernet.

Eric Hutchinson - *Spirent Communications plc - CEO*

The thesis is that if you move to virtualization, then the value of hardware declines, and demand for hardware systems declines. What we're seeing is that, in fact, the scale of requirement for virtual is growing dramatically, and the physical world isn't going away.

So rather than seeing decline in hardware demand, we're seeing steady to low growth, and we expect to see that over the next few years as virtualization becomes a meaningful part of our revenue stream.

Nick James - *Numis Securities - Analyst*

Okay, great. Thanks very much.

Eoin Lambe - *Liberum - Analyst*

Eoin Lambe, Liberum. A question on your move to more recurring or subscription-based revenue. What percentage of your revenue at the moment is recurring? And if you were to roll forward three to five years' time, where can this get to? Because it obviously makes Spirent a much more defensive investable business if you've got a higher level of recurring revenue.

Eric Hutchinson - *Spirent Communications plc - CEO*

Yes. So there are two parts to recurring revenues. The existing revenue stream that's recurring relates to the maintenance support and services of equipment that we've deployed; that's typically running at around 25% of the revenue stream. So that is recurring, it's under annual contracts, or even triennial contracts.

The part that I'm flagging here is that rather than selling large systems as a CapEx sale, which is our traditional business with service providers and equipment manufacturers, as we move into virtual deployments and the deployment in live networks, we are seeing that this becomes more of an operational type of spend for our customer, and that they would prefer to contract with us on a subscription basis.

Indeed, as I indicated, where we're looking to deploy software on devices, then that actually becomes more like a royalty on a device type of business.

The subscription piece at the moment is probably 1% of the business, but the prospects are that we're seeing a likelihood of about three years' time, that might be more like 20% of the revenue. Because the new areas in the live network deployments are likely to be subscription, and some of the new business models are on a subscription basis. And indeed, everything we're doing on the new deployments on data analytics is on a subscription basis.

I am getting some equipment manufacturers who are starting to want to buy testing as a service and they're looking either to contract with us on a subscription basis, or indeed, buy licenses so they pay on a utilization, so they can scale up and scale down. And there, we'd be providing those test services from our hosted data centers.

Eoin Lambe - *Liberum - Analyst*

So could we assume just under half of revenue in three years' time is broadly in the bag?

Eric Hutchinson - *Spirent Communications plc - CEO*

Yes.

Eoin Lambe - *Liberum - Analyst*

And then coming back to the smartphone or wireless piece; how much of Group revenue is now smartphones? And more specifically around the carrier acceptance, which I think is the weaker piece, how much of wireless or of Group revenue is carrier acceptance?

Eric Hutchinson - *Spirent Communications plc - CEO*

So the carrier acceptance testing is at just under 8% to 9% of revenue; it's about $40 million.

Rachel Whiting - *Spirent Communications plc - CFO*

Yes, that's correct.

Eric Hutchinson - *Spirent Communications plc - CEO*

There is a related location test system that is linked to that. It tends to be a bit more robust because it's driven by location-based services, which we would put into that same, what you might call, wireless legacy area. That would probably push us up to around about 12%.

Rachel Whiting - *Spirent Communications plc - CFO*

So the location bit is we expect to be steady; it's the carrier acceptance that we expect to decline.

Eoin Lambe - *Liberum - Analyst*

And then just one final one on OpEx. You're taking $25 million out of the OpEx in smartphones, but you're saying OpEx broadly flat. I think that implies that a 9-ish-% growth in core OpEx.

Eric Hutchinson - *Spirent Communications plc - CEO*

So there are some specific investments in the areas that I've elucidated today, where we've stepped up development and significant amount of marketing spend. And some of that OpEx increase is building back into our cost base an assumption that we'll be paying people incentives as they hit targets for growth this year. So there's a variable cost element within that.

Unidentified Audience Member

Just as a follow-up on the first question, do you think that you'll hit a kind of trough on the carrier acceptance business in 2017? Or are we getting to the level where it won't go much lower, you've had a couple of years of step-down?

Eric Hutchinson - *Spirent Communications plc - CEO*

Yes, so in terms of the wireless device test revenues, which is really what you're capturing, we'd expect the carrier acceptance business, traditional business, to continue to decline.

But we're seeing growth opportunities in interoperability testing and the new platform that will offset that from 2017 onwards. So, hopefully, 2016 will be the bottom of the trough for wireless.

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Unidentified Audience Member

And just secondly, I wondered if you could just talk about your long-term margin aspirations. I think historically, you've talked about an aspiration of going back into the high teens. Does that still remain the aspiration? If so, what's the timetable for that?

Eric Hutchinson - *Spirent Communications plc - CEO*

Again, it continues to be our plan. And as we build up the repeat business, based upon provision of software systems, then we'd expect to see a more robust gross margin. And as that mix increases and the scale of the growth in the business in 2017/2018, we'd expect to be high teens by 2018.

Rachel Whiting - *Spirent Communications plc - CFO*

Yes, yes.

Unidentified Audience Member

And then just a last one on the new areas. You've got a lot going on in the new areas. Are you -- in some of these cases, you're presumably selling to completely different end customers than you've had previously. But in the carrier side of things, you're actually selling to the same people.

So would someone on the gigabit Ethernet side at AT&T be also responsible for purchasing test equipment for mobile infrastructure, for example?

Eric Hutchinson - *Spirent Communications plc - CEO*

Typically not. They're usually different parts of the operational management. Some of the things that we are looking to sell to the carriers are more based upon a business case rather than a technology sale.

So we are talking to different executives within the carriers, and they're looking for different objectives. So, although it's broadly the same customer, we're now having dialogs with different people in the organizations.

The one area where it's more of a new channel for Spirent, would be anything on the security. So selling into the enterprise market, we'll be creating new channel.

Robert Lamb - *Jefferies - Analyst*

Robert Lamb, Jefferies. Just on cyber security, when we've spoken before, you expressed, I guess, some reluctance to spend kind of big checks to get the skills that are needed in cyber security. They're very high value. And yet, you now seem to have the kind of products rolling out.

So I just wanted to understand how you've gone about tackling that? Have you kind of just opened up the check book, or have you been creative? I just wanted to understand how that --

Eric Hutchinson - *Spirent Communications plc - CEO*

I think we've managed to make some connections with some guys who are very, very capable. They've done this before and they like the idea of working for the size of organization that Spirent is, as opposed to something that is much, much bigger.

So we've got some good guys on board. They're doing some good things and we're letting them have their head and go at it. So yes, it's a qualitative rather than quantitative thing.

Robert Lamb - *Jefferies - Analyst*

And just switching to the analytics. As I understand it, that falls under the OSS, BSS type, peaceful -- an operator longer term.

And being at Mobile World Congress, we've seen Ericsson, Nokia, etc., trying to push their offerings there and I guess they've got the equipment in the network as well. Why would an operator pick DAX, or what's the differentiation versus the vendor solution?

Eric Hutchinson - *Spirent Communications plc - CEO*

The differentiation is that we talk to everything in the network, so all network elements, all probes will talk to anybody's equipment, any device.

And because of the way that it's been configured, it's much faster to implement and see the business payback on the implementation.

So we're well proven with a very large Tier 1 carrier where we've demonstrated that's the case, and now we've won a regional carrier within another Tier 1 with the new platform where they're seeing a very rapid take-up.

So the business return on our deployments are very attractive. So, as we get engagement, then they're looking at our system as something, even if they've got existing systems, that it's well worth implementing alongside or instead of.

Robert Lamb - *Jefferies - Analyst*

And just mentioning those Tier 1s, it sounds like that they're mainly US-based, is that fair? And over time, is there a different model for selling into that other part of the world?

Eric Hutchinson - *Spirent Communications plc - CEO*

So the deployments are with the Tier 1s, we do also have a European carrier. But we've got trials going on with other European carriers, and we're talking to an Asian carrier.

Gareth Jenkins - *UBS - Analyst*

A few more if I could.

Eric Hutchinson - *Spirent Communications plc - CEO*

A few more (laughter)!

Gareth Jenkins - *UBS - Analyst*

[Gareth Jenkins], UBS. Hopefully, quite a short one. Could you give us the splits of your operator custom versus NEMs; and maybe how you see that going forwards?

It seems that you'll be doing a lot more business with the operators, rather than traditional equipment manufacturers going forwards.

Eric Hutchinson - *Spirent Communications plc - CEO*

So I'll let Rachel get the statistic. In terms of the trends going forward, certainly, the service providers are likely to write some bigger investments in some of these systems, especially where we're looking at deployment in live networks. But the demand level from the equipment manufacturers is still quite healthy.

So yes I think we'll move the needle towards service providers, but it's probably not going to be so dramatically significant. It really depends on the pace of the take-up of the deployments of car mobility infrastructure solution. That could move the needle by 10 percentage points.

Rachel Whiting - *Spirent Communications plc - CFO*

So this year we saw a switch to service providers, away from equipment manufacturers, but it does vary each year.

So equipment manufacturers, about 50%; and service providers, about 25% of the Group; and then you've got enterprise, government and others making up the balance.

Gareth Jenkins - *UBS - Analyst*

And then you helpfully have given some numbers on percentage of revenue for some of your areas, but I just wondered whether you can segment the new areas of growth, the kind of totality of your revenue today. And maybe what the aspiration is.

Eric Hutchinson - *Spirent Communications plc - CEO*

So about 30% of our business sits in the Ethernet world, which is a growth market. We've probably put that as more like a 5%, 6% growth.

The other areas that I've detailed are probably about another 20% to 25%, and there, we see the potential growth rates in the region of 20%.

So about nearly two-thirds of the business we think is firmly in a growth market. And the others are pre-revenue or we've put wireless and service assurance which are going through a bit of a dip in 2016.

Gareth Jenkins - *UBS - Analyst*

Okay. And then just the last one is on competition gigabit Ethernet. Can you see any changes with Ixia currently?

Eric Hutchinson - *Spirent Communications plc - CEO*

So Ixia reported very healthy results for Q4, which reflects the increased activity levels, both in Ethernet. I think if you look at their results, you'll see that they've done extremely well in everything to do with security, and channels to enterprise in particular.

We're certainly more than holding our own in Ethernet. And in some areas, clearly, we are pulling ahead.

Rob Sanders - *Deutsche Bank Research - Analyst*

Rob Sanders, Deutsche Bank. Just a follow-up on the Ethernet question. Can you just talk about your market share in 100 gig against Ixia?

And are you gaining market share? You seem to be sounding a bit more optimistic.

Eric Hutchinson - *Spirent Communications plc - CEO*

Well, we certainly have gained share in some of the major equipment manufacturers. So, if you remember, we lost share during 2013, and we certainly regained that position.

I think it will be fair to say that we've pretty much split the market between us, to be quite honest. So market share gain, against -- we jump -- we sort of leapfrog a bit.

But it's a healthy market opportunity, I think there's a lot of money to go around. I think it's -- what we're trying to do is make sure that we are the most relevant and we've done some initiatives that have given us some edge on some of the optical connectors, for example.

Rob Sanders - *Deutsche Bank Research - Analyst*

And just a follow-up on virtualization. Let's assume that the operators of the Tier 1s roll out commercial off-the-shelf servers, virtualize really aggressively. Are you completely agnostic to that development, given that you have relationships with existing equipment providers, who may have different interoperabilities after everything else?

Eric Hutchinson - *Spirent Communications plc - CEO*

Well, we're not. We're not agnostic in the sense of if the pace of change is rapid, and you were to see a serious degradation in the revenues of major equipment manufacturers into the service providers network, then yes, clearly that would hurt because the ramp up in virtual would have to be huge, really dramatic, to offset that.

What we're seeing is that the major equipment manufacturers' initiatives are on virtual, but they are putting significant investments in there, and they are spending with us for test solutions.

I think in terms of the timing of the shift, probably long term, we're probably relatively agnostic. But near term, it could be a hairy ride if things move faster than we anticipate. Nick?

Nick James - *Numis Securities - Analyst*

Thanks. It was just to follow up on -- in the press release, I think you noted that seasonality in 2016 will be similar to 2015. I guess in 2015, we had the service assurance made things a bit more back-end weighted than normal.

Rachel Whiting - *Spirent Communications plc - CFO*

It did. We're going to see a similar back-end weighting, so we're expecting it to be similar in terms of 45%, 55% split on revenue, which then has a much more exaggerated impact on the operating profit.

Nick James - *Numis Securities - Analyst*

Is there -- I think because specifically, there was the big order (multiple speakers)?

Rachel Whiting - *Spirent Communications plc - CFO*

There was specifically that impact last year, which went to Q3. This year, I think it's more because of activity ramping up with the customers as we put out more new products.

And it's just the way that we're seeing customers spending now, that Q2 and Q4 are stronger, Q1 and Q3 are a little bit weaker. And again, we're just seeing that going through into the fourth quarter in particular, so second half stronger.

Nick James - *Numis Securities - Analyst*

Great, thank you.

Eric Hutchinson - *Spirent Communications plc - CEO*

Eoin?

Eoin Lambe - *Liberum - Analyst*

Yes, one final one. On your wireless business, given the rest of the business is now doing quite well, is the wireless piece still core to Spirent, or could it sit, just that segment, a bit better within somebody who's 100% focused on wireless?

Eric Hutchinson - *Spirent Communications plc - CEO*

So the -- what we're doing in the wireless business helps underpin the testing of connectivity on any device for the network. So we still see that it's got value in the portfolio, as we look at the world of more and more connected devices.

And it does give us cellular device test capability in the portfolio, that we wouldn't have otherwise. So we still think it's got value, albeit it's a smaller part of the revenue at the moment.

I can't speak for anyone else, whether they consider it would be of more value to them to have; maybe.

Okay, great. Well, thank you very much for attending, and your questions. With that, we'll close the meeting. Thank you.

Operator

Ladies and gentlemen, that will conclude today's conference call. Thank you for your participation. You may now disconnect.
