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SPT.L - Half Year 2017 Spirent Communications plc Earnings Presentation

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Good morning, everyone. Welcome to the Spirent First Half Year 2017 Results Presentation. Clearly before we start any discussion, please note the contents of the Safe Harbor statement. So, by way of an overview on the first half year. We continued to focus on strategic positioning to pursue the key market opportunities. Spirent is navigating fast moving and shifting market dynamics across the portfolio. We see medium-term and long-term opportunities. However, as a result of these transitions, there's been a reduction in demand reflected in the first half order intake.

In Networks & Security, we're seeing customers reduce their investments in 100 gigabit Ethernet development whilst they're planning the setup of new 400 gigabit development laboratories. In Lifecycle Service Assurance, the reduction in lab test pending ahead of the shift into live operations deployment is also creating a gap in demand. And in Connected Devices, the fall off of spending on 4G wireless developments is ahead of any increase in 5G wireless development spending. However, we reported increasing operating margin, we reported increasing earnings and we had a very good solid cash generation.

So with that, I'll hand over to Paula to take you through the financial results and then I'll come back and talk about the market dynamics in a bit more detail.

Thanks, Eric. Good morning, all. So, let's take a look at the financial highlights of the first half. Revenue was level compared to the same period 2016 at $213.6 million. We started the year strongly on the back of some late order wins in 2016. Some project delays tightened our second quarter position. Book-to-bill was therefore lower than we would have liked at this juncture and we expect order wins to pick up in the second half. Gross profit remained constant at $151 million and operating profit up 67% to $17.4 million, a solid result driven from growth in our Networks & Security segment and good cost management across the group. As a result, we have improving operating margins now at 8.1% for the half compared to 4.9% in 2016. A refreshed focus on working capital management has led to strong free cash flow in the half of $28.7 million.

And with no real change to tax year-on-year, this profit translated to improved EPS up 86% to $0.210. So, we do propose to keep the dividend level whilst we have bill cover. So, we'll just move on to dive into each of the segments in turn. For the Networks & Security, this segment covers our cloud IP, positioning and security businesses and all have performed very well in the half. Demand for Ethernet testing started well in the first quarter. We experienced some slowing in the second quarter particularly in the Americas. Some of our key customers are now accelerating their transition to 400 gigabit Ethernet testing dampening the second half growth. Positioning remained strong, good performance in the half and cyber security offering gained traction with a new enterprise and government customers.
So, we can see here the increased revenue of the same level of product development expenditure and we do continue to focus our R&D activity to match key growth areas. As a result of the operational gearing impact, strong profit growth was delivered of 63% and operating margins increased here as you can see to 15.5%. This provides evidence that if we focus our investments on key growth trends, we can drive a really strong margin.

Turning to Lifecycle Service Assurance, this new segment is gathering momentum. Those of you who attended our recent Capital Markets Day and heard how Dave Stehlin, the segment leader, is finding ways of bringing together our assurance in customer experience, products and services; which provide a solution for customers to materially reduce their own operating costs.

However, this type of sale is different. It's a business proposition for our customers to consider and we expect to see order placements once made taking the shape of larger size contracts. And therefore, as we previously flagged, order placements are expected to be more second half and many proof of concept trials underway are actually progressing very positively. So as a result, revenue and earnings were down compared to the same time last year in the half. So, turning to Connected Devices. In the first half, we saw ongoing decline of our wireless device testing activities and cost efficiencies drove profit improvement as you can see here. We have exited a few product lines and small businesses at the end of June, which were identified as non-key areas as part of our portfolio review.

This has the effect of reducing annual revenue by around $15 million. These businesses made a small profit in the half so the outlook for the full year remains unchanged working towards near breakeven position for remaining wireless and service experience businesses. We are focusing our product development results in 5G activities, which is really still a few years away from driving any material upward shift in revenue. We are pleased with the progress in the first half. So, if we turn to the cost base and we do continue to focus our efforts on driving effectiveness from our investments in both sales and product development.

Actions taken at the end of last year have benefited our results and we are selective with our reduction in product development results and costs ensuring much investment to our chosen portfolio and this is to drive sustainable earnings growth. Sales restructure plan is on track and driving improved effectiveness from a reduced sales force whilst we do also invest in training to support new product launches and further develop our key account management. Administration costs you can see are obviously up slightly. This is only just due to inflation and some FX benefit last year. So overall, we are very pleased with the progress; a 5% reduction here despite inflation and we will continue to manage this area very carefully. So, turning to cash. We re-energized our focus on working capital management and I'm pleased with the results.

$22 million working capital inflow in the half, outperforming the same period last year. We made demonstrable progress tightening our debt collection processes in particular. But as you know, the last quarter of the year was our busiest so I do expect working capital levels to rebuild during this busy time. CapEx was slightly up in the half, mostly it's done okay and our view of the full year remains unchanged at $17 million, the same as 2016. So overall, pleased with the cash results; $110 million at the end of June, an ongoing key focus area. So, let me just summarize the financial outlook. You know Networks & Securities doing well made up of 3 strong businesses. We see continued positive momentum for security and positioning businesses, which helps to offset potential softening in our cloud and IP business as clients increasingly transition to the next generation, the 400 gigabit.

As we reshape our Lifecycle Service Assurance business, we continue to support our customers with their trials and expect to secure some key wins in the second half. We continue to manage decline of wireless device testing, done a good job in the half and we refocus our activities on to 5G activities. This will take time. So we have, as you can see here, been actively managing our costs and cash. We're well positioned to leverage from market opportunities. I'll pass back to Eric now, who's going to give you a bit more color on how these are taking shape.

Eric G. Hutchinson - Spirent Communications plc - CEO and Executive Director

Thank you, Paula. So let me turn to our view of the markets, our performance and some of our achievements in the period. Just to remind everybody, clearly we focus on providing innovative products and services to help our customers connect devices and equipment to create high performance complex networks, measure and optimize the performance of those devices and ensure that they are safe and secure. And we leverage our competencies in developing test methodologies, our expertise and technologies in active test analytics and automation to deliver these leading edge solutions. As announced at the start of this year, we organized to sharpen our focus on 3 strategic step -- segments; Networks & Security, Lifecycle Service Assurance and Connected Devices.
The strategic focus positions us to meet the emerging needs and expectations of our customers as they develop and operate the devices, applications, networks and services that make up our connected world and will define collectively our smarter future. Our Networks & Security business provides automated performance and security test systems for high-speed Ethernet, network virtualization, cloud infrastructure performance tests, application and security testing and global navigation satellite system simulation. We see our future business driven by network virtualization and security. Our Lifecycle Service Assurance business provides mobile network test systems for the labs and network and active test and analytic solutions for service turn-up, network performance improvement and customer experience management.

We see our future business driven by network virtualization, mobile networks build out and the Internet of Things. And our Connected Devices business provides automated test systems, the smartphone development, location-based applications, PVA testing, channel emulation and services testing to accelerate the development of connected devices and streamline that connection to the network. We see our future business here driven by Internet of Things and 5G wireless development. As Paula reported, we saw strong performance in our core market of Ethernet performance testing, our largest business. Market dynamics strongly support business outlook with the ongoing deployments of 100 gigabit and the new developments in 200 gigabits and 400 gigabits.

Over the last few months, the market has been disrupted by a slowdown in spending by network equipment manufacturers as they transition from 100 gigabit development to 400 gigabit development laying the foundations for terabit developments in the future and the organizational restructuring and network rearchitecting at our major service provider customers. We remain the market leader in high-speed Ethernet performance testing. In June, Spirent supported the new H3C in demonstrating the industry's highest density 100 gigabit Ethernet data center switch performance test and we're well positioned to meet the emerging requirements for future developments in high-speed Ethernet. We've invested and developed new products for several emerging high growth business opportunities.

Specifically, network functional virtualization, cloud infrastructure and automotive Ethernet performance and conformance testing. Today, the contribution to revenues from these products and services are relatively small. However, we are well positioned to capitalize on these emerging business opportunities. NFV and SDN have had a slower start than originally anticipated. Industry deployments are expected to move forward with 3/4 of Tier 1 operators having adopted or planning to adopt NFV and SDN this year. The expectations for cost savings by these customers around 30% to 40%. The NFV market is expected to grow in excess of 40% a year. Cloud data centers are driving the transition towards 400 gigabit per second deployments by 2019.

Dell’Oro Group predicts 400 gigabits will be the next major speed after 100 gigabit, an area where we've made significant investment. We've placed a special focus on automotive Ethernet test. The increasing demand for high bandwidth and lightweight materials is driving the automotive Ethernet market globally. Analysts forecast the global automotive Ethernet market will grow over 20% annually over the next 5 years. We launched the first automotive Ethernet protocol conformance and performance test system. This solution enables most of the vehicle manufacturers and suppliers to determine if their data traffic is transmitted correctly and on time over the industry’s highest in-vehicle connectivity bandwidth. Spirent released the first conformance test solution for WAVE-DSRC, the Wireless Access in Vehicular Environments with dedicated short range communications.

The test includes a set of tests required for the U.S. Department of Transport certification. Again, we see ourselves well positioned to capitalize on these emerging opportunities. We remain the market leader in global navigation satellite system simulators. We also provide solutions for vulnerability detection and testing and this business continues to grow. The market dynamics support our long-term business prospects. The GNSS device and services market is driven by the advent of 5G wireless, automated driving, smart cities and the Internet of Things. We saw strong demand from the U.S. government, subcontractors and in China. Earlier this year, Spirent announced the PT TestBench, a testing analysis and reporting application to help developers build more accurate positioning and functions quickly. Additionally, Spirent released GNSS Vulnerabilities and Threats test suite, a continuously updated cloud-based library of real world threats. Our GNSS solutions are being used by the European Union's TREASURE project. The aim of the full-year project is to provide instantaneous and high accuracy positioning anywhere in the world exploiting different satellite systems operating together to provide users with positional accuracy over few centimeters. A 2020-GALILEO, the European GNSS system, will be fully operational and providing positioning data of unprecedented accuracy.

Its integration with other satellite systems through the TREASURE project is key to increasing Europe’s competitiveness in the field, which is being mainly based on the GPS system over the past 20 years. Brings another thing on cyber security, but clearly cyber attacks remain a critical threat. In
the U.K., attacks hitting enterprise firewalls passed a 1,000 per day mark on average. Hackers have shifted their focus from the typical PC database targets to remote control of connected devices. Interestingly, Symantec reported that an IoT device on average is hacked within 2 minutes of being connected to the Internet if there's no further additional layers of security added. Additionally, the number of global ransomware attacks exceeded the 1,000 per day level during 2016.

Moreover the financial extortion demands have increased from an average of $300 to over $1,000 per attack and businesses are especially vulnerable to these attacks as they can cause extensive financial and brand and reputation impact. Last year we introduced a new security product called CyberFlood and a new service -- security service called SecurityLabs and in the first half, we expanded our security coverage. CyberFlood is the first platform to offer proactive testing for the WannaCry ransomware threat. We strengthened our present capabilities with support for IoT and industrial control protocols and for common distributed denial-of-service attacks. The business is growing well in the first half and we project it to grow strongly in the future.

Interestingly, over 50% of our first half bookings came from Asia-Pacific and our bookings from enterprise and government are also growing. Turning to Lifecycle Service Assurance. In this business, the market outlook for service assurance systems remain strong, specifically for active test systems as the networks become virtualized and for analytics to optimize network performance and manage customer experience. As you can see in the chart, investment in NFV and SDN is beginning and significant growth is expected. We introduced our solution VisionWorks, our active test and analytic system. We've had 2 major Tier 1 customer deployments in the first half of 2017. We’re engaged in several customer trials that are progressing very well and we’re confident we’ll close significant contracts during the second half of this year.

As I mentioned, the deployment of VisionWorks in 2 major customers addresses critical challenges stemming from the roll out of virtual and business mobile services. In the first deployment, VisionWorks accelerates service on-boarding by automating the turn-up verification of virtualized LTE Enhanced Packet Core functions. In the second deployment, VisionWorks monitors the quality of business critical mobile services that terminate in enterprise customers’ cloud networks with a focus on IoT use cases. In May, the TM Forum Live in Nice bank collaborated with industry leaders to demonstrate rapid service innovation in virtual networks.

In the catalyst project sponsored by AT&T, Orange and Telecom Italia and working with Huawei, IBM, Infosys and Tech Mahindra; Spirent developed and demonstrated the automated validation of service enhancements in virtual networks using Spirent VisionWorks. The project demonstrated how NFV and open interfaces enable radically faster service innovation with fewer resources. The project addresses the core need for rapid service innovation, streamlining and automating the process by which virtual network functions are enhanced, validated and then deployed in the production network. June, at Mobile World Congress in Shanghai, Spirent and China Mobile Research Institute demonstrated the automated testing of virtual core networks.

The demonstration was part of a joint program to develop a methodology for automated testing of the functionality and performance of the China Mobile's telecom infrastructure cloud. The system will fully automate the testing of services and will pass the complete virtual core network environment built by the China Mobile Research Institute. These achievements illustrate and demonstrate the high impact Spirent solutions deliver for virtual network virtualization in test, management and automated assurance. In our Connected Devices business, we're managing the business to improve profitability in a declining market. In the first half, the sales of new Spirent channel emulator product Vertex was strong and we won a very important competitive (bakeoff) at a major equipment manufacturer.

We delivered product enhancements for our carrier acceptance, location and video testing products. And revenue from our wireless device test products and service experience systems and services remained roughly flat over last year after many years of decline. We divested the Device Intelligence and Development Tools business and we're managing expenses to offset revenue decline. The future potential for the Connected Device business is looking forward to 5G wireless development and further developments on Internet of Things. There were several achievements in Connected Devices in the first half. Again in June at the Mobile World Congress in Shanghai, China Mobile used our UMetrix system to demonstrate enhanced voice service.

In March, the Signals Research Group completed the first study of a commercial video service over an LTE network. With video content exploding worldwide, operators are exploring enhanced Multimedia Broadcast Multicast Services as an advanced method of delivering video content. In summary, our first half results show an increase in margin and strong cash generation as Paula reported and we're confident we'll meet our Board's
expectations for 2017 albeit on unchanged revenue year-on-year. We believe we've got the right strategy in place and have prioritized our investments with a sharp focus on the target market opportunities that matter most to our customers, the areas in which they're making their largest investments.

We have a strong leadership position in several business areas; high-speed Ethernet performance testing, GNSS simulation, mobile infrastructure testing in the laboratory and the network. We have strong products and capable sales organization to grow our business in security test products and services, active test analytics, service assurance solutions, NFV and cloud infrastructure and in channel emulation. So we are investing for the next cycle of 5G wireless, the impact of the Internet of Things across all connected networks, the development of automotive connectivity and autonomous vehicles.

Thank you for your attention. With that, we'll take some questions. As we are being webcast, could I ask you to state your name and your firm.

**QUESTIONS AND ANSWERS**

**Nicholas Peter James** - Numis Securities Limited, Research Division - Director of Technology Equity Research

It’s Nick James from Numis. I guess the first question was on this kind of hiatus in the Ethernet testing with the shift to 100 gigawatt to 400 gigawatt. I mean I guess shifts like that, tend to think of it as a good thing because it’s disruption in the testing so kind of why it’s being a bad thing at the moment and I guess how long is it going to be a bad thing for?

**Eric G. Hutchinson** - Spirent Communications plc - CEO and Executive Director

So, there’s a gap between the de-emphasis by major equipment manufacturers, particularly based in the United States, on the development spending. We’ve seen 100 gigabit demand accelerate and grow in Asia, but the big customer relationships with our Top 5 customers in United States, they’ve turned off some of their very large lab developments in 100 gigabit. They’ve pushed that out to their Indian operations to the extent they’re continuing with that. We’re also seeing major top tier equipment manufacturers in China doing the same thing. So, they’ve de-emphasized 100 gigabit and that’s really because 100 gigabit is becoming commoditized as a technology pretty rapidly now. What’s happening is that before our customers start investing and turning up the new teams and equipment in those labs, then clearly we see a bit of a gap in the demand and that certainly hit during the first and second quarters this year, particularly sharpening in the second. So, it’s a fairly temporary phase in the gap between the dip on one and the uptick in the other. We’re expecting to win orders in the second half. There is a risk that by the time that turns to revenue and that may be 2018 before we start to see scale of 400 gigabits. So, it’s just a temporary gap. The long-term trend and change, as you rightly point out, is a good thing and we certainly invested over the last couple of years to make sure that we’re at the forefront of that cycle.

**Nicholas Peter James** - Numis Securities Limited, Research Division - Director of Technology Equity Research

And then on the Lifecycle Service Assurance where there’s these big kind of orders out, there are a number of trials. I mean how big is big in kind of dollar terms? And also geographically, is this more North American based as usual or is that sort of the geographical reach that business extended?

**Eric G. Hutchinson** - Spirent Communications plc - CEO and Executive Director

So, the individual contracts. So, we’d look at specific use cases around the deployment of the active test technologies. Typically we are looking at a $3 million, $4 million, sometimes $5 billion contract for those use cases. They are with the Tier 1 wireless carriers in North America. We’re focusing on getting the adoption and getting the system working really well in those key customers because we can get our resources behind that and build success. We have got some business with other carriers in North America and we’ve got an initial position with a European carrier, but it would be perhaps a distraction at this stage to try and cover too many customers across the world when we need to get behind the key deployments. The big guys have big budgets on this and if we get it right there, then we’ll have a really solid place to build for the long-term future.
David Hall
And just following up on the question on the opportunity on Networks & Security into H2 on the booking side. How would you expect the progression in bookings to be? Obviously that’s been quite weak, particularly in Q2, but how should we think about that into the second half?

Eric G. Hutchinson - Spirent Communications plc - CEO and Executive Director
Just say who you are and where you’re from?

David Hall
David Hall from UBS.

Eric G. Hutchinson - Spirent Communications plc - CEO and Executive Director
We saw a pretty slow start in the first quarter. We had a book to bill over 1 -- over 100 in the second. We had a pretty tough comparative in terms of order intake in the second quarter. We had a lot of sizable contracts for multi-year services in the second quarter of last year, which probably exaggerates the real change to the business in underlying demand terms. So, perhaps a start, we’ve not quite (inaudible) second quarter as if you may look at the first part. We started to see some of the contracts that we thought we would get in the second quarter that come in in July. We are forecasting a fairly solid demand pattern through the third quarter. We’ve certainly landed one of the key contracts on our Service Assurance business at the beginning of the third quarter so. But the seasonality of the business is still very skewed towards fourth quarter generally. We’ll see. We're now entering August, which is never an exciting time, so it’s all about September and Q4.

Janardan Nedyam Menon - Liberum Capital Limited, Research Division - Technology Analyst
Going back to the Lifecycle Service Assurance, you said $3 million to $4 million. Sorry. Janardan Menon from Liberum. You said $3 million to $4 million worth contract by use case. 2 questions on that. How many use cases per operator are you addressing, is it just 1 at this point? And the billing of that revenue, does it come within a quarter, does it get spread across multiple quarters? And also just if you could give us the guidance for how you expect your margins to trend? You’ve guided for a full year of flat revenue. How do you expect your margins across the businesses to trend into the second half of the year?

Eric G. Hutchinson - Spirent Communications plc - CEO and Executive Director
In terms of the use cases, there are 2 or 3 that are in the critical initial phase and then they will extend by another 2 or 3. Those contracts are for initial deployments and that will continue to build in future years so it’s not just done. In terms of revenue recognition on those contracts, it’s a mixture of immediate recognition on the sale of that capability, some of that is a perpetual software license and then there’s about 25% that would be recognized over the 12 months following that initial contract win with the support cases. Some of them include some [bespoke] developments that they want to do around the deployment. So, we do get a bump in the revenue when we win business to some extent, yes.

Janardan Nedyam Menon - Liberum Capital Limited, Research Division - Technology Analyst
Operator, it could be sort of $5 million to $10 million or slightly higher.
Eric G. Hutchinson - Spirent Communications plc - CEO and Executive Director

Yes. And then in terms of the margin development, as you see that topline come back in, then we'd expect to achieve similar margins to slightly enhanced compared to second half -- sorry, the full year last year and that seems to be the trend also in our core business in Networks & Security and Lifecycle Service Assurance. And as we said, on Connected Devices, it's about getting the business to breakeven small profit.

Lee John Simpson - Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst

It's Lee Simpson from Stifel. Couple of quick ones if I could. Just had a curiosity almost just to understand how you would in an event like WannaCry monetize a lot of the position you have now in app security. Did we see that in the print and how do you anticipate that growing the next couple of years? And then alongside that, anything you can update us with 5G? Obviously 5G I know is stabilizing now so does that present itself as an opportunity or are we passed the initial phase in development for 5G for you, how does that look?

Eric G. Hutchinson - Spirent Communications plc - CEO and Executive Director

So in terms of the security test systems, there are 2 aspects to the business. One is providing much more realistic testing for the firewall equipment developers. So, we're gaining inroads to actually recover market share from Spirent point of view in that core market with the firewall developers and all of the threat database needs to be realistic and up to date. So WannaCry is one aspect of that, but there are thousands of these things that get built into the test system. We package that so that we have an enterprise-based system that can be used by think of Fortune 500 companies, large institutions, financial or healthcare so that they can continually run tests against their networks to see whether the networks are robust against the latest threats. We've also been working together with an industry group to set up a new security open standard. So, NetSecOPEN is now out there where there's a security standard for testing the security of networks. So hopefully, that will prove to be (inaudible) to us to win business in the security test market. In 5G developments, it's -- really at this stage it's about the early development capability. We are seeing demand for offerings in channel relations so radio frequency transmissions so the multiple input, multiple output over the development of large scale chamber testings around those technologies. So, it's still very much open for us to see our participation in that demand. But 5G itself has a huge impact across everything that we do across Spirent and so it's not just what we're doing in the Connected Device test business. There's demand across everything that we do in terms of simulating networks and the traffic loads that it pushes back on to the core wireless support and services.

Oliver Knott

Olly Knott, nPlus1 Singer. Just on the cost base so you've done a lot of good work in there already. Was just wondering how much more flexibility over the timing of some of those costs if some of the opportunities in H2 don't come through in quite the timeframe that you're hoping?

Paula Bell - Spirent Communications plc - CFO and Executive Director

So looking at the costs, we've actually implemented a lot of the changes that benefit the second half already so there's not necessarily a risk around that. We reduced our salesforce at the end of Q4, the end of last year and a few more reshapes during the course of the first half 2017. We've continued to keep looking at product development cost as a percentage of revenue making sure that we're driving to best practice there, ensuring that we're investing in the right areas and removing investment from areas that are technology firm during the end of their life. So long story short, for this financial year, the cost savings are [set aside] that improve the profitability of the full year. The actions of those have already been taken so little risk there.

Eric G. Hutchinson - Spirent Communications plc - CEO and Executive Director

I'll just add one gloss to that is as you're aware, we have now a completely new Board of Directors and there's very much a view that driving operational excellence across the portfolio, looking for productivity improvements, series of initiatives that we're working at behind the scenes to make that the way of life aspiring going forward. One more question?
David Hall

David from UBS again. Maybe one accounting follow-up. I just wonder if you could comment on how you see IFRS 15 impacting and what preparations you’re making into 2018?

Paula Bell - Spirent Communications plc - CFO and Executive Director

So, our piece of work is ongoing. Reflect that at this stage from a knowledge of the work done so far, there's pretty material impact. We continue to work through the remainder of the year. But there's a couple of items that we went aside and since last year's annual reports look at the areas that are affected the most. But suffice to say, we're not going to see a material impact effect in these statement of results. We have chosen that we will do a retrospective approach so that means from the commencement of 1st January 2018, we will be making the (inaudible) i.e. this year on the same basis. So, hope so that gives you a bit of an updating.

Nicholas Peter James - Numis Securities Limited, Research Division - Director of Technology Equity Research

Nick James again. So just on Connected Devices, I just wanted to clarify did the exit of the Device Intelligence business, these H1 results includes the Device Intelligence business with the revenue declining in that business and was it losing money in the first half?

Paula Bell - Spirent Communications plc - CFO and Executive Director

No, the revenue's been fairly flat. It's about $12 million, $12.5 million a year and looking backward, it actually made a loss in 2016 and it made a small contribution in the beginning of 2017.

Eric G. Hutchinson - Spirent Communications plc - CEO and Executive Director

Any more questions from anyone? No? Thank you very much for attending the presentation and for your questions and discussion. And with that, I'll bring the proceedings to a close. Thank you.