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SPT.L - Preliminary FY 2016 Spirent Communications plc Earnings Presentation

EVENT DATE/TIME: MARCH 02, 2017 / 9:30AM GMT
PRESENTATION

Welcome everybody to the Spirent results presentation. Thank you for attending our results. So, let’s move on.

Just note, please, obviously, the contents of the Safe Harbor Statement containing the usual caveat.

So, let’s just hit on some highlights. Whilst the total revenue decreased in 2016, for the reasons that we flagged last year, we actually saw growth in our core business and we saw a growth in profit.

In the networks market, we clearly gained share from our innovative high-speed Ethernet testing and test automation. We had double-digit growth in our Ethernet IP test business.

We’re the first to deliver 400 gigabit Ethernet tests to the market. We launched the industry’s first Quint-Speed Ethernet test product for 10-gigabit to 100 gigabit Ethernet test capability, and the first 2.5 and 5-gigabit Ethernet test platform and, we lead the market in virtual and cloud stress test solutions.

We remain the market leader in positioning, navigation, timing test solutions, and that business grew again this year.

We made significant advances in security tests launching CyberFlood, the world’s highest-performing application layered test solution, and started an ethical hacking team called SecurityLabs.

The business is positioned to capitalize on the need for comprehensive security tests operating at high speed. In our service assurance market, we’re excited about the prospect for our service assurance business, as we offer solutions to transition network functionality from the lab into the operating network, and utilize our active test and analytics system to measure performance over time.

We completed the deployment of our customer and network analytics system, InTouch, with a major operator in Mexico. We booked orders for our 100 gigabit Ethernet probes which we deployed in production networks with a Tier 1 carrier in the United States.

In connected devices in the wireless arena, we expanded the footprint for our Elevate product, winning multiple deals for video and audio quality testing.

We won a deal to reduce the time and cost test IoT devices in a large Tier 1 carrier, and we launched our new next generation channel emulator, Vertex, which addresses the needs for advanced 4G and 5G wireless applications.

So, in short, we’ve strengthened our expertise and product offerings in everything we do, all aimed at future requirements for test, measurement, validation and assurance.
During the year, we undertook a deep-dive business review, with the aim to accelerate progress in executing our strategy. The objective was to focus on the areas we have the highest probability to deliver earnings growth that will target the market opportunities that matter most to our customers. That would achieve internal synergies, both technical and customer product offerings; allow a reorganization of our sales and marketing, to deliver more efficiently and more effectively, and allow a streamlined management structure.

Today, we're announcing three new market focused segments that are driven by the growth trends in our industry: networks and security, lifecycle service assurance, and connected devices.

I will explain the market dynamics; our market share; our expected growth rates for those markets; our solutions and our key customers. You have available the restated financial numbers for the new reporting segment for both 2016 and 2015.

Having said all that, of course, the financial report for 2016 will be on the old segmental format.

So, I'm delighted to introduce you to our new CFO, Paula Bell, who will report on 2016 financial performance on that basis, so over to you, Paula.

Paula Bell - Spirent Communications plc - CFO

Thank you, Eric. Good morning, all.

Just way of introduction, I've met with a lot of you in the room, but, yes, I joined in September. I was previously CFO with John Menzies for the last three years and before that worked with many engineering and technology firms; so, really looking forward to working with the Spirent agenda.

Had the chance to visit some operations; quite a few of them out there. Met with the teams; had a review of the strategic and operational agendas. I think a lot of opportunity, a lot of potential, good momentum and it's quite an exciting time to be joining.

So, let me take you through the results. First, have a look at the financial headlines before we delve into the figures in a bit more detail.

As Eric said, our revenue was down 4%. We saw the predicted slowing in wireless device testing activity. We had a strong comparator year in 2015 for handheld devices.

We did benefit from strong growth in our core businesses, network and applications, in our positioning business. By driving efficiency, we improved both growth and operating margin in the year.

Operating profit was up 10% to $46.5 million.

We are focused on taking action on all areas of the cost base. In the second half of the year, we initiated the sales organization review. External consultants benchmarked the sales force, and recommendations are now being worked on.

As a result, we implemented headcount reductions at the end of the year, to maximize benefit into 2017, and that had a resulting cost of $4.8 million. That will have a further $2 million to $3 million in 2017. That's going to produce annualized savings of about $13 million.

As Eric said, a fundamental review of all our business lines was performed, to establish priority areas for investment, to match the key growth drivers. Some smaller parts of the business were identified as non-core, and we will actively manage them from the portfolio.

This review clearly indicated there were technical and resourcing issues to be gained from restructuring and realigning our operations. But, as a result, the wireless and positioning businesses, which were together in the old segment, will not be together in the new format. This exposed the wireless acquisition goodwill held on the balance sheet, which required impairment, as you can see on the screen there.
Cash closed at $96.1 million, EPS was up 6%, and the effective tax rate 27%, almost identical to 2015. We expect that to continue, looking forward, and subject to any US Government changes, of course.

In dollars, the dividend remained unchanged. Final payment of $0.0221, making a full-year dividend of $0.0389. In sterling, it’s good to note, this represents a 15% growth for our shareholders.

Let’s take a little look at network and applications. This is the largest segment of the business, and revenue grew by 6%. Continued strong demand for Ethernet testing. Eric’s going to provide more details of new product launches in the year, which, together with cost-focused actions, we held the cost base fairly flat, as you can see here. So, a material increasing in operating profit, and also an increase in operating margin.

Turning to wireless and positioning. As 4G-driven activities [close], the predicted headwind for device testing requirements are in play and impacted volumes by some 25% in our wireless business.

But in contrast, positioning had a very good year, growing topline by 9%, and, importantly, delivering strong growth and profitability. This was due to some tailored solutions, particularly for US customers, and some new product launches, which have been successfully sold into China.

So overall, for this segment, revenue declined 14%, if profit improvement was delivered. This was due to positioning’s higher margin characteristics, again, strong cost management overall. Operating profits up 15% and, you can see here, an increase in operating margin as well.

Looking forward, we do recognize the continued slowing of demand for device testing. Smartphone volumes do continue to decline, and we are repositioning ourselves. We’ve got growth downstream in 5G and the Internet of Things, and we’re going to be looking at with new product launches. This is an area we need to be very responsive to market changes.

Then to service assurance. The one-off higher levels of handheld device sales in 2015 and, as I said, meant a strong comparator year. As previously flagged, revenue was down 17%. The focus during the year was to actively manage the cost base.

The mix of products sold gave rise to improved gross margins. But as you can see here, operating margins were held at 14.6%, but on a lower revenue base.

Right, your pages in the pack are out of sequence here, so I’m going to do the cost base next. So, if you just turn ahead one.

Just looking at the cost base. As I explained earlier, we are running a suite of programs, starting with sales, to ensure we are optimizing our effectiveness. We’re refreshing how we approach the market, how we -- and how we drive return on our investments.

In 2016, despite inflation, you can see the cost here reduced overall. And the sales restructuring program, as I mentioned, is looking at how we best face our customers; develop engrained key account management; and how to increase software sales. We’ll continue to focus on this area, and we have to balance R&D investment, together with an effective cost structure.

Always good to look at cash; just a couple of moving parts on here to explain. Depreciation is down year-on-year. We did make an asset disposal last year, when we outsourced some of our engineering activities to India.

Now, we can see a slight increase in working capital at the end of the year. We did have higher inventory levels, commensurate with some new product launches.

With regards to pensions, we have agreed now the triennial pension funding plan. It is higher than last time, at $6 million, starting from January 1, 2017. We made a one-off payment in July 2016 of $3 million.

For those interested in the accounting base, the pension deficit closed at the end of the year at $12.8 million, which was a $6 million improvement since the previous year.
Turning to tax, you can see 2015 benefited from some tax refunds.

Turning to CapEx, you can see it’s running lower in 2016. In the prior year, it did include some key office moves and higher levels of demonstration equipment. But, going forward, I would expect CapEx to run at a similar level to 2016.

Overall, cash closed at $96.1 million, slightly down on 2015.

So really, just to summarize where we are with financials. We've flagged the headwinds; they've been managed carefully. They have impacted revenue. Key parts of the business are delivering, actually, very well. Profit improvement was still achieved.

Following a busy year of reshape, with a view to focusing on key growth areas, I'll hand over to Eric, who will give you lots more progress -- more color on our progress.

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Eric Hutchinson - Spirent Communications plc - CEO

Thank you, Paula. Let me turn to the markets we serve, and the strategic focus for 2015 -- 2017 and beyond.

Given the positive market dynamics, and the backdrop to the industry, we’ll [acquire] and grasp the opportunities that are offered. Spirent offers customers high-performance systems to test, measure, validate and assure devices, and network at high volume; high speed; high density; in a highly reliable and high-quality way.

This allows them to increase their -- our customers to increase the product quality; reduce time to market; grow revenue; assess the security of their solutions; and get visibility into network performance and customer experience.

Our key capabilities: our expertise in developing test methodologies; active test in the lab and in the network; real time and predictive analytics; and test automation. This realizes efficiencies, scalability and reliability.

We help our customers transform their products, networks and business, and outperform their competitors and their customers’ expectations. We give our customers the solutions to help them build a smarter future, by providing leading-edge, first-to-market solutions to help our customers connect, perform, and secure their products in our connected world.

The industry is defined by the relentless growth in [IP] traffic. The business imperative is to reduce operating costs and capital expenditure. This explosive growth, in IP, drives innovation. Cisco reported that IP traffic will triple by 2020.

Operators cannot afford to match the traffic growth with spending on new transport equipment. The cost of telecoms equipment is dropping 13% a year, and traffic is climbing at 22% a year.

Operators are challenged to reduce operating expenses, and to adopt new architectures and operating practices, as these challenges drive network operators towards software defined networks, and network functions virtualization.

Spirent is positioned to meet the network virtualization challenges, leverage our expertise and products in both laboratories and production networks.

There are several areas that are bringing strong market disruption and driving new investment. They are virtualization, the Internet of Things, cyber security and 5G wireless. These create new challenges to the industry, but they also create business opportunities for Spirent.

Network virtualization is the only way to support the exponential growth of data cost effectively. Not only does virtualization radically reduce the capital costs of network deployment, it also allows rapid adaptation to new demand on the network.
To setup and tear down services quickly, active test techniques are required to understand the performance of the virtual network function, under various conditions, before deployment, and at various times during operation, as network conditions change.

The thing to note is that hybrid networks, with all their inherent complexity, will exist for a decade or more. We offer test systems, but do both physical tests and virtual network testing.

On security, high-profile security incidents continue to make headlines across all industry segments. The overall prevalence of sophistication of cybercrime is on the rise. According to a recent report from the UK National Crime Agency, cyber-enabled fraud surpassed all other types of crime.

The US Government is set to spend 35% more on IT and cyber security during 2017. We expect the overall spending on cyber security testing to increase with the need to better detect and protect against these threats. We have tools to help customers test their security of devices and networks.

The Internet of Things is growing rapidly. The volume of variety of things connected to connected devices creates new challenges, for developers and network operators.

Special insurance is critical to avoid network overload, disruption and security breaches.

5G wireless will allow new applications to access extreme bandwidth, and offer ultra-low latency, such as virtual and augmented reality. A myriad of new test capabilities will be required to support 5G. 5G will enable a further revolution in ubiquitous use of high-definition video.

So, in summary, we've aligned our investment and product plans with these key market disrupters to meet the challenges and to grow the business.

During 2016, we undertook a fundamental review of what was working well; what showed the best future outcomes; and what was underperforming. And, we've reorganized accordingly.

We've realigned the business units to focus on the top opportunities. There are three new segments: networks and security, lifecycle service assurance, and connected devices.

Our networks and security business will maximize the opportunity presented by virtualization in security. We're including resilient positioning, which is really driven by security concerns. We're looking to provide scalable and modular test systems, for high-speed, complex traffic.

Lifecycle services assurance will maximize the opportunity in the operational networks for virtualization, mobile networks and Internet of Things, providing active service assurance and analytic solutions for service providers operations, and lifecycle management for virtualized network functions.

Our connected device business will maximize the opportunity presented by 5G wireless, and Internet of Things, providing cost effective, automated test systems, for connected devices, to accelerate the development and simplify network connectivity.

With the sharp focus on our target business opportunities, we're leveraging our technologies and core capabilities, to increase the long-term value of the business.

If I turn to networks and security, you'll see we serve a market of about $1.2 billion, in 2016. We project the growth rate of the market to be about 10% each year, over the next three years, and we had $262 million last year, about 22% market share.

Clearly, a highly profitable operation with operating profits that are running at 18% margin.

Our customers are network equipment manufacturers; service providers; e-commerce companies; security equipment developers; governments; and large enterprise customers. The focus is on -- the focus is product and network quality prior to launch; through testing network functionality; performance in real-world conditions; the security of firewalls, and application of fire walls; and application of ware network.
In this segment, we had many achievements in 2016. I’ve noted some of these. I’ll just comment on a couple here.

A leading equipment manufacturer started a new project to develop their next generation, 400-gigabit Ethernet platform, and they purchased our 400-gigabit boost program, allows customers to start testing early. The standards are still evolving, and if they change, we’ll swap hardware with industry-compliant versions, until the standard is ratified.

We introduced the innovative software as a service solution, TeMeVa, for network and cloud testing. We contributed actively to the ETSI specifications for pre-deployment testing, and active monitoring of failure detection, as an illustration of our test methodology expertise.

In cyber security, we launched our new CyberFlood test tool. CyberFlood is the world’s highest-performing testing solution, emulating realistic application traffic, while validating security coverage from enterprise, to carrier-grade network capacity.

We’ve won key deals in a US network operator, leading security product companies, and major financial institutions. In positioning, navigation and timing, we launched three major new products.

One to note is our Interference Detector, which monitors live RF environment, for potential sources of interference and automatically detects potentially disruptive events.

We’re able to simulate and test navigational systems, to enable mission-critical functions to be tested for resilience, against failure, error, [spoofing] and blocking.

Turning to lifecycle service assurance, we’re serving an $800 million market. We project this to grow at around 7% a year. We have just under $100 billion of revenues, 12% market share; and, on a restated basis here, you can see it’s about 11% margin business.

Our customers are service providers, primarily wireless carriers. The focus is on real time, active testing and analytics in the operational network; managing network functions, virtualization, in hybrid networks.

Active tests and analytics reduces operating costs; avoids downtime; provides real time monitoring; and provides insight about user experience.

Our system can validate network functionality and test network quality, under many conditions, giving visibility and allowing proactive rectification.

Again, in this segment, we’ve had a number of achievements in 2016. Just have a look at a couple of examples again. We launched Lumos, our service assurance system for turn-up monitoring Ethernet IP networks.

This year, Lumos helped a North American operator accelerate their turn up of small cells, so they were able to deliver 10 times increase in their rate of small cell turn up.

We also launched VisionWorks, a new active service assurance solution for mobile networks. We closed several large orders, in two Tier 1 carriers, in the United States.

This is an attractive near-term growth business for Spirent, starting this year, and continuing for years to come, as virtualized networks are deployed and managed, and network operators adopted active test and analytic solutions.

What does this mean in the real world? Special events with enormous crowds pose unique challenges for mobile service providers. Attendees expect the same level of service as they do normally, whilst exerting huge pressure on the network, with extraordinary voice, data and video demand.

As a service provider, and as reported for Super Bowl 51, a major sporting event in Huston, Texas, this year, they deployed more than 220 small cells to increase capacity, adding 18 times the normal capacity.
Over -- about half of the attendees used the network, consuming 11 terabytes of data, on Super Bowl Sunday; an increase of about 50%, over the same even last year. Top five uses were uploading and watching videos, social media, web browsing, uploading to the cloud, and sports apps, such as NFL mobile.

The moment of highest usage was when Lady Gaga did her swan dive into the arena, at half time, surprisingly, more than any other time during the Patriots spectacular comeback, during which I suppose the fans were watching the game rather than blogging it.

Where do we come in? Via an in-touch system, facilitated monitoring for subscriber service during Super Bowl, providing insights into the individual service platforms, and overall quality of experience.

We provided real-time data analytics, from different network data sources. This ability to monitor and troubleshoot, enables network operators to deliver superior levels of service under strenuous conditions, whether these are special events or during regular network operations.

Looking at connected devices, the market is about $550 million, declining at an average projected rate of 3% over the next three years. There's been a severe market decline in 2015 and 2016. We forecast the market will recover again from 2018, with the adoption of 5G wireless and more Internet connectivity. Spirent has revenue of just under $100 million and 18% market share.

In this business, we provide technologies to test the performance of wireless devices, smartphones and any connected device. The market is in a hiatus between 4G rollouts, the services, and the development of 5G wireless.

Demand for connected devices is starting to heat up rapidly. Innovation is driving us towards the age of hyper-connected -- hyper-connectivity and pervasive computing.

Our business focuses on accelerating the development and deployment of all connected devices in a secure and reliable manner. We have strong products for both voice and video testing; location-based services; channel emulation; and security.

The wave of wireless technologies drives a cyclical demand for test equipment. We saw the ramp in demand. As network equipment and devices are initially developed and manufactured, test equipment spending subsides as the market adopts that generation and, eventually, the market looks forward to the next generation.

In 2016, we clearly had market contraction for 3G and 4G test equipment, driven both by the consolidation of smartphone vendors and network equipment manufacturers. We're in an investment trough, but 5G R&D spending is already starting to emerge.

We're optimistic about the future of 5G development and compelling new applications in 5G that will be enabled. Some new underlying technologies will be required, including massive multiple input/multiple output technologies; small cells; network virtualization; and the use of automation and analytics to streamline network operation and management.

Again, we've got some achievements to note in this segment. We enhanced our wireless test platform, branded Elevate, introducing the industry's most compact and powerful enhanced packet core and IMS network emulation for evaluating the next generation of mobile services.

We won several deals in chipset vendors and carriers for video and audio quality testing. We delivered first-to-market solutions for the industry's new Enhanced Voice Services, which is a high definition audio codec.

We see the business opportunities for 5G and IoT device and network testing as a mid-term growth business for Spirent.

Last October, Mirai virus turned millions of people's security cameras into weapons, in a distributed denial of service attack that brought down most of America's major Internet sites, such as Netflix, Twitter, Reddit, Airbnb for hours. The attack targeted the dying company that controls much of the infrastructure for the Internet domain name system.
Was this a complex security attack? No, not really. Devices with poor passwords were exploited. For example, user IDs and passwords that were both set to their default or admin passwords; the passwords were simple; some were saved in plain text. And so, Internet logins could be grabbed.

Typically, these types of attack infect and utilize computers. This one was different; it infected devices, the Internet of Things for connected devices, such as home security cameras, and Internet-enabled child monitors.

It's not the first time we've seen this type of attack, but the scale of this was extraordinary. It's also the first time we've seen a significant recall of equipment due to it. What made it worse was that these devices were not designed to be recovered in the field. They had to be recalled and replaced; so very expensive.

Also, last November, 900,000 routers in Deutsche Telekom crashed, due to the exploitation attempts by a variant of Mirai, which resulted in interconnectivity downtime.

Where do we come in? The functionality and performance security of devices that will be connected to the network should be tested as they're developed, before they're sold and deployed. They should also be tested periodically after being connected to the network.

We have wireless device test products and automation test management products suitable for testing connected devices. We have a new security test product an ethical hacking service that can identify those security vulnerabilities, prioritize the risks, and make recommendations. And, we have an analytics system that can detect abnormal device behavior on the network.

No developer or operator wants to be tarnished with the reputation of being culpable in a large Internet cyberattack that damages their business customers, and consumers.

What are our strengths? Why do we believe that we can win in this market? We've got strong relationships with blue chip customers and the fast-moving developers.

We've always worked closely with customers to understand their business challenges, develop innovative solutions to meet, or ideally exceed, their expectations. We've gained deep expertise through working with many of the world's most innovative companies, as they develop products and applications, or as they operate and manage networks.

We have highly respected expertise in these test and measure -- in these and measurement across our industry, providing insight into changes and developments to ease our customers through demanding transition.

We win business and our reputation has been earned, from our four core competencies, which are the basis of our competitive edge: expertise in developing test methodologies; active test capabilities in the lab and the network, real time and predictive analytics and test information.

Our technologies and insights allow us to deliver first-to-the-market solutions. We now talk about launching zero-state solutions that is not the first, but even before first. Our service levels are second to none and our portfolio is among the strongest in the industry.

In summary, we've got a sharp focus on the target market opportunities that matter most to our customers. We've developed new products and solutions to meet these key market disruptions. We expect ongoing success in our high-speed Ethernet virtualization and security businesses.

We expect growth, in 2017, in our active test and analytic solutions for the operational network. And, we've realigned to realize internal synergies, allowing us to manage our expenditure more closely.

All of this gives us confidence that we'll see a return to growth in 2017.

Thank you for your attention. With that, we will open up to questions. Gareth?
QUESTIONS AND ANSWERS

Gareth Jenkins - UBS - Analyst

Gareth Jenkins, UBS. A couple if I could. Firstly, I wondered if you could talk about market share in gig-Ethernet and whether you feel the acquisition by Ixia -- or of Ixia by Keysight is an opportunity for you or a threat.

Then secondly, if I roll up all of your market targets, it looks like you get to about 7% growth for the top line for the overall business. Is that something you feel is achievable in the current year, or is that a medium-term target?

Eric Hutchinson - Spirent Communications plc - CEO

Okay, so in the Ethernet test market, we've been seeing strong double-digit growth. Our key competitor, actually, reported a decline in the network test business throughout 2016 and, really, a very marked decline in the fourth quarter where they're down about 16.5%.

We know from our customers that we've been gaining share and, really, that really endorses that. We are making advances, and we've put a lot of investment, as you know, over the years to put ourselves into a better position, both in terms of capability, but also support of the utilization of those test pools by our customers. So, we're feeling very good about that.

The acquisition of our major competitor, Ixia, which was announced by Keysight a few weeks ago, clearly, puts some uncertainty into the market about what will happen. Clearly, both very capable and competent companies; putting them together will allow them to merge some of those activities. That creates uncertainty near term.

There's a bit of a scramble going on, at the moment, for both ourselves and our competitors to hang on to the market share they've got and gain share. It is causing some concern. There may be a near-term opportunity for us to take advantage of that.

I think the thing to remember is whilst we compete on some key areas, such as Ethernet, we do have new capabilities that are neither part of Keysight's portfolio nor Ixia's. We do have very strong offerings in live, active test technologies, test automation. In the whole area of connected devices, we're differentiated.

I think there is some threat, in that Keysight are stronger in some regions than Ixia were in some channels, so that may make life slightly more uncomfortable for us. But generally speaking, I think we are rising to the challenge and we see it as an opportunity to be seen as the independent expert in the [Ethernet] test market and we will expect confidently to continue to gain share.

In the short term, I can just note, on that particular product line, 2017 has started extremely well.

In terms of our growth projections on the market, that's clearly a projection based upon the next three years' expectation. I think there's some modest growth in expectations for 2017 on top line. That's really because we've still got the mix effect. As I indicated, we're still seeing some headwinds, probably in the wireless test market.

In the near term, we're confident that we'll see growth in the other segments. So, probably the way to project it is that not really guiding to any changes on expectations for 2017. But we're certainly setting ourselves up for a stronger growth in 2018, 2019 and onwards.

Yes, question here?
Unidentified Audience Member

I was just wondering what the OpEx guidance would be going forward? You've talked about a $13 million reduction in cost structure. So, will that all kick in through the course of this year, or is that something that will be felt more next year?

In the strategic review, did it throw up anything where you probably shouldn't be in, which is not your area of competence, or where you're slightly sub-scale and a little bit difficult? And is it better for you to exit some of those businesses and invest more in other businesses? And if so, what would those be?

Paula Bell - Spirent Communications plc - CFO

The OpEx question, yes, the actions that we're taking with the restructuring, will give us the OpEx savings, which we'll implement during the course of 2017. That's going to give us a good protection against cost inflation and protection against investment in other areas that we'll need to be doing.

Our overall intention is to try to keep the cost base level, year on year, which will mean that we get a good operational gearing effect, once we get revenue increases coming through, which will drive margin improvement. That's the general direction of travel there.

Offsetsing inflation, yes, it's maintain a flat level cost base instead of increasing, yes.

Eric Hutchinson - Spirent Communications plc - CEO

And then, a lot of that has been skewed towards making sure that our connected devices business is -- that it's not a loss-making business, even though we see some headwind.

Some of that revenue change is because we are pulling back on areas. It's flagged in the press release, where we've taken the impairment. It's based upon reducing activity levels. So, some of those areas in protocols and connectivity, we're pulling back.

It's not that we don't think those businesses can succeed, it's just we don't think that they're going to succeed in a big way within the next three years. So, we'd rather put our money into growing our capabilities in virtualization, in active-based testing and test information.

Those are the areas that we're pulling back on, and we will actively manage those down through the year.

There's not something that I could put a book together and do a sales process with a high degree of confidence. That's not to say that we won't try to spin them if we can; we will.

Will Kirkness - Jefferies - Analyst

Will Kirkness, Jefferies; two questions. Just to follow on, on that portfolio trimming. Will that be assuming some revenues might come back, or will it largely be the EBIT neutral?

And then secondly, I just wondered if you could talk about when some of the investments or some areas of the business come to you with investment ideas, can you talk at all about the internal hurdle rates, or what metrics you look to press go?

Eric Hutchinson - Spirent Communications plc - CEO

So the -- whatever we're doing on trimming we'll certainly look to be EBIT neutral in terms of our plans for 2017, compared to 2016. Some of those areas were losing money.
So, it helps the positioning in terms of improving the EBIT result, the operating margin in 2017, in a modest way. These are not huge numbers.

In terms of our investment hurdles. We're really looking at what revenues do we get from the new investment over the next three years, ensuring that the gross margins are at acceptable levels. Often, the gross margins are actually better than the existing product.

So, we're looking -- we tend to look at how quickly does that investment pay back. We're ranking it on that type of metric. We're looking to see if we can improve the way that we do that, and Paula's taken the challenge to do some work on improving our metrics on that area.

Gareth?

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**Gareth Jenkins - UBS - Analyst**

Two questions. Firstly, border tax -- or US potential for taxes. I presume that most of your components are primarily US made, and your production is largely based over there as well. But would there be an impact in terms of if there were an import duty in place?

**Paula Bell - Spirent Communications plc - CFO**

We're looking at that very carefully, as you'd quite imagine. You're quite right, we do have a lot of inbound stuff. But, actually, we're exporter still, because we still sell a lot of our kit from the US into other areas.

There's going to be changes on both sides. Now, we don't know what those are going be yet. We'll monitor it carefully, but we're very mindful. But you are right, we do export but we also do -- we're still a net exporter in the round.

**Eric Hutchinson - Spirent Communications plc - CEO**

We generate a lot of the intellectual property. Most of the product value that we sell is in the intellectual property in the equipment. The actual physical hardware is offshored. So, as Paula says, we import, but our net export position, we are a much stronger exporter [net].

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**Gareth Jenkins - UBS - Analyst**

This next question's on virtualization. If we go back a year ago, Eric, you weren't quite sure if this was going to be a threat to your business moving towards a software business model or a real opportunity. It feels now it's moving towards more the opportunity than maybe a threat. Would you agree with that one year on?

**Eric Hutchinson - Spirent Communications plc - CEO**

Yes. I think the threat was that with bare metal switches going in, that the value in the hardware test business could be undermined. It's been pretty clear to us that the physical test requirements don't go away. You may be selling to different people in the industry, but they certainly go away.

But what we do see is that the challenges of deploying virtual network management technologies is a huge challenge, and that's actually created some significant business opportunities for us. We've moved quickly to be able to give people some very strong validation tools around the deployment of those new technologies.

On net-net, we now feel that this is a positive for the Company and that, certainly, the physical test requirements are still there. We certainly haven't seen any diminution in that. In fact, when we sell virtual test technologies, from our perspective it, actually, pulls through additional demand for our physical test equipment with that same customer.
Unidentified Audience Member

You didn’t mention automotive, which, I think, you had mentioned last year as one of your target areas. Is that because it’s a slow burner and you’re seeing attractiveness there?

Also, on the IoT side you seem to have got a little bit more interested than you were previously. I’m talking about the attacks and things like that. Is that becoming a more tangible revenue contributor as we see it, or is that still somewhere down the line?

Eric Hutchinson - Spirent Communications plc - CEO

So, automotive is still there. In our terms, automotive, the connected vehicle, everything to do with that world, is a specialized part of a connected device.

We haven’t -- we’re still driving an initiative where we are adapting our Ethernet test tools to apply to the Ethernet network within the vehicle. We have sold that to major manufacturers, in terms of their development activity. So we still see that as a significant opportunity within our networks and security business.

The connectivity of vehicles, we’ve won contracts for a connected device on large, earthmoving trucks, so you can’t get much bigger in terms of a device connected. From a technology perspective, we’re looking at it more as a device connectivity question rather than purely automotive.

In terms of the development of the network on the vehicle itself, then it is slow burn. It takes a long time to get into the industry. We’re still going at it and we’ve won some interesting contracts. But in terms of being a significant growth driver for us in the next couple of years, it won’t be significant, but we will be there.

It may be that in 10 years’ time that that will be a key part of Spirent’s portfolio, in both the vehicle, but also, more importantly, in the Smart highway in the infrastructure side, because none of this works unless you’ve got Smart highways to go with it. That really does play to our network testing strength.

Any other questions?

Okay. Well, thank you very much for your attendance and interest in the Company. We look forward to driving the business forward in 2017. Thank you.