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SPT.L - Half Year 2016 Spirent Communications plc Earnings Presentation

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PRESENTATION

Rachel Whiting - *Spirent Communications plc - CFO*

Good morning, everyone. Welcome and thank you all for coming.

At the full-year results, we outlined the themes that we expected to continue into 2016. And as you will see from the results today, the factors that we said would influence our performance have done so and I will explain this as we go through the presentation.

During the first half of 2016, we've continued to focus on investing in the right areas of the business, with the aim of growing our top line and building a sustainable long-term revenue stream. I'm pleased to report that we are starting to see revenue growth coming from our targeted investments, proving we are focusing our attention in the right growth areas.

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

As we look at this overview of the first half, I want to highlight a few key aspects of our performance. Although revenue was down by $5.2 million, we finished the first half with an increased order book by $8.2 million, which puts us in a good position for the second half.

I'll talk about the individual reporting segments a little later. But overall, we saw good performance in networks and applications, up 6%, driven by strong demand for high-speed Ethernet and test automation. This was offset by the expected decline in wireless and positioning, down 15%; and service assurance, which was down 4%, reflecting part of the non-repeating contract for handheld test tools delivered in 2015.

Pleasingly though, we've done work to mitigate these impacts, including the rightsizing of our wireless business, and the ongoing strong performance in networks and applications has seen return on sales improve in each of our three divisions. All this led to an adjusted operating profit of $10.4 million, up by $4.4 million.

Regionally, revenue in APAC was up, with EMEA flat and the Americas softer, reflecting the divisional dynamics. As previously highlighted, we expect similar seasonality this financial year, where activity will be skewed to the second half.

Turning then to the Group's comparative results for the first half. Revenue was down 2% to $213.5 million, which was slightly disappointing, as we saw orders received too late in the quarter to convert to revenue. However, we entered the second half with a strong order book, reflected in the book-to-bill ratio of 104.

We saw an improvement in gross margin in the period to 70.7%, due to a favorable product mix.

The increase in operating profit to $10.4 million reflects the actions that were taken at the end of last year to adjust and reallocate resources to growth areas.

The reported tax rate for the first half was 25% and we expect this to be the rate for the full year.

The improved operating profit has led to an enhanced EPS result, coming in at $0.0113 compared to $0.0069 for the first half of last year.

We're maintaining our dividend, in dollar terms, at $0.0168 per share for the first half, which in sterling represents an 18% increase. I think it's also worth, reiterating following recent political events, that the vast majority of our revenue and costs are dollar denominated.

Now let me turn to each of the reporting divisions. And let's look first at our networks and applications division, which accounts for 54% of Group revenue. To remind you, this division tests our customers' new technologies prior to commercial launch, allowing them to develop and deploy new networks, services and applications with confidence.

Networks and applications had a strong performance, growing revenue by 6%, driven by strong demand for high-speed Ethernet and our automation solutions. We built a strong order book in the first half, reflected in the book-to-bill ratio of 112.

Regionally, demand in this division was particularly strong in APAC, driven by infrastructure buildout in China; and in the Americas, driven by demand from network equipment manufacturers and service providers. Business in EMEA was weaker, due to delays caused by customer consolidation in that region.

Gross margin was down slightly, at 69.2%, reflecting product mix in the period. And as planned, we increased our investment in this division, reflecting the reallocation of resources to the areas where we see the most potential for growth, which Eric will describe later.

We've again, seen some improvement in profitability in this division and expect further progress in the second half of the year.

Turning now to our wireless and positioning division, which accounts for about 26% of Group revenue, here we test next-generation mobile devices, predominantly smartphones, as well as satellite navigation and global positioning systems.

Revenue in this division declined 15%, as expected, due to the changes that we have previously highlighted in the wireless device test market, which continues to be fiercely competitive.

In contrast, our positioning business remains robust, and we continue to see growth in the positioning and timing test market, driven by demand for systems to test vulnerabilities and emerging applications, such as drones and wearables.

We saw a gross margin improvement in this division to 71.2%, reflecting the product mix in the first half.

You will also see the reduction in overhead spend in this division, which reflects the actions taken at the end of last year to right size those parts of the business that are in more challenging markets. And as expected, the benefit of these actions, together with the improved gross margin, has resulted in a significant increase in operating profit and return on sales, despite the lower revenue in the period.

Looking at our service assurance business, which accounts for 20% of Group revenue, this business lets service providers diagnose, troubleshoot and resolve issues within the live networks. It also allows them to understand customer experience through active test techniques and real-time analytics.

Revenue in this division was down 4%, as expected, reflecting in part, $5.7 million of the non-repeating $16 million contract delivered in 2015.

The improved gross margin reflects the product mix in the period, which includes a higher software content. We maintained our investment in this division and the improved profitability reflects the higher gross margin in the period.

Looking ahead to the second half, we will see a $10.3 million revenue headwind in this division, related to the second and final part of a $16 million contract for handheld devices that won't be repeating this year.

Now turning to our cash position. Net cash generated from operating activities after tax was $20.9 million as, once again, we benefited from the unwind of the working capital increase that we saw at the end of the fourth quarter of last year, notwithstanding the payment of $6.3 million of restructuring costs in the period.

Net capital spend in the first half was $7.7 million and we expect full-year spend to be in the region of $20 million. We also made the final payment of $2.6 million to acquire the non-controlling interest in Testing Tech, the small German acquisition we made at the start of 2014.

We paid out $14.1 million in dividends during the first half, and incurred $2.4 million in exchange retranslation and interest costs.

So in line with our strategy to maintain financial strength and flexibility, we ended the second half with a healthy cash balance of $96.1 million.

Finally, looking towards the second half, we see similar factors continuing to influence performance. Once again, we expect to see a strong showing from networks and applications, while we continue to manage the lower revenue in our wireless device test business. And we've already mentioned the revenue headwind in service assurance.

In terms of costs and investments, we will continue to actively manage cost in areas where we face challenges and invest in our targeted growth areas to ensure we remain well placed to benefit from favorable dynamics in that area.

Overall, the Board's expectations for the full year remain unchanged, as we move into the traditionally stronger second half and particularly, the fourth quarter.

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

Eric Hutchinson - *Spirent Communications plc - CEO*

Thank you, Rachel, and thank you for your continuing support in your retirement.

As you saw, the Board announced the appointment of Paula Bell as CFO, and I look forward to introducing Paula to you all on September 5.

So I'd just like to touch on some of our current successes, our key opportunities, and the progress towards our key strategic objectives.

Through customer engagements, we're seeing service providers, equipment manufacturers and social networking companies are looking for assurance and validation of their cloud and virtualization investments and implementations, and we've shown ourselves to be at the forefront of the innovation in these areas.

In the first half of 2016, we've seen sound growth in our core business where we are demonstrating our technology leadership and ever-closer involvement with our customers' plans for their future development.

In the exciting area of cybersecurity, we have launched our new software test solution.

We have a series of successful Proof of Concepts with major wireless carriers for our mobile infrastructure test solutions for pre-deployment testing in their labs and in their operating network. This dovetails with their plans for network expansion, new services and virtualization.

As a result of the improved gross profit margin and our cost management actions last year, that Rachel referred to, we've improved our financial performance of the business on slightly lower revenues. We had good cash generation, as Rachel pointed out, in the first half and we've built the order book.

Let me remind you of the areas that we focus on strategically. They're all in growth markets. Our current products and services and our plans for new products are strongly aligned and positioned in these areas where our customers target and invest for their future top-line growth and profit improvement.

Firstly, we focus on high-speed Ethernet and IP testing, an addressable market of around $400 million. This meets the requirements for service provider networks and data centers as they keep up with the demand for increased data capacity and speed rates.

We develop new products and services for the cloud and virtualization market, currently a $50 million market, but one that we believe will grow substantially over the next two years, as operators adopt virtualization across their networks and operations.

We compete in the mobility infrastructure testing, a $200 million market, which is driven by manufacturers and operators deploying LTE networks and services, again implementing virtualization and preparing for 5G wireless.

We focus on cybersecurity testing, a $300 million market, as security remains a top priority for operators, enterprises and governments, driven by the complexity and challenges that mobile networking and connected services bring.

In the field of data analytics, we focus on applying analytic techniques to network troubleshooting, optimization and understanding subscriber experience. This represents a $500 million market opportunity.

And we have selected some new markets to explore for which we have, or will adapt our products, and we will develop new products and services to expand our business.

One of these is automotive testing, covering both in-vehicle networking and connected car technologies.

Another is connected devices testing driven by commonly known as the Internet of Things, as developers create new connected devices and operators seek to connect these devices to their networks, the wide variety of new connected devices and challenges for developers and operators to radically streamline their processes and reduce costs.

And I'll give you a progress update on each of these strategic growth initiatives.

We've annotated these markets with the Spirent segments that we report them in today. So the first is networks and applications, service assurance and then the new growth opportunities are across the portfolio.

So turning to the first one, high-speed Ethernet. As the world consumes more and more data, speed and density of the network has to increase to serve demand. This is achieved by the evolution of Ethernet speed rates, now at 100 gigabits per second, and the increase from 10 gigabits per second to 25 gigabits per second for both data center and service provider markets.

Market commentators see the growth of the Ethernet equipment market running about 6% in the first half of 2016, and this is being driven by the rollout of 2.5 gigabit, 40 gigabit and 100 gigabit.

Moreover, there is a long-term direction to 200 gigabit, 400 gigabit and beyond, as we project past 2020.

Our order intake, or bookings, exceeded the market growth rate in the first half-year. We saw a 23% growth over the first half of 2015. Not all orders could be shipped and recognized as revenue in the period, building our order book for the second half.

Growth was especially strong in 100 gigabit per second, and for us with some new products in 1 gigabit ports. This is higher than the market growth rate, and it was achieved as a result of the introduction of new innovative products.

Notably, we launched the industry's first Quint-Speed product covering the range of speed rates, and another first is our 2.5 gigabit and 5 gigabit BASE-T Ethernet test solution, enabling fast and efficient deployment of scalable high-capacity systems.

Further, we added the most realistic and highest performing wireless LAN capability to Spirent TestCenter, giving the best multi-client wireless local area network emulation on the market. We had major wins with equipment manufacturers and contracts with social networking companies.

Another aspect of this market is the drive for automation. Our customers seek to reduce test cycle times and costs, move to an agile development and testing in the operating network. This is also driving lab consolidation in equipment manufacturers and services providers. Our automation solution, Velocity, is enabling the use of software robots, eliminating errors and increasing scale.

This allows our customers to significantly reduce test cycle times and the use of their engineering time.

In cloud and virtualization, this is really an emerging market from an assurance point of view. It will grow significantly. The total spend by service providers on virtual solutions is forecasted to be around $11 billion by 2019. And we're in an early phase with carriers demonstrating capabilities and running Proof of Concept trials. So we're laying foundations for increasing the business over the next six to 18 months, setting us up for growth in 2017.

Service providers are going through a process of key supplier selection. Some major carriers are looking to set up virtual benchmarking laboratories and are setting standards to which each supplier will need to conform.

Spirent is involved in setting those standards with and for the carriers and providing test systems to validate the implementation of virtual technologies.

With industry partners, Spirent participated in drafting the ETSI specification for pre-deployment testing, and active monitoring and failure detections. Our cloud stress solutions can emulate virtual machine footprints across the network.

We launched a new software as a service solution named Temeva for network and cloud testing offers web-based applications covering network traffic testing, and of the infrastructure benchmarking, cloud performance, and capacity planning.

Our methodologies have earned us a seat at the top table in test measurement and validation of cloud-based networking and virtualization.

The mobile infrastructure market. The mobile network test market is large and growing. There are nearly 500 LTE or LTE advanced commercial networks across the world, and this number continues to grow. There are over 5,000 LTE devices, and over 1 billion LTE subscribers.

Mobile subscribers have now surpassed fixed broadband subscribers, and considerable investment is being made in wireless equipment and software, this combined with new services using VoLTE and IMS; this creating a demand for active test solutions in the operating network and analytics.

Our solutions allow operators to actively measure the performance of both the equipment and network in the lab, and in the production network. Our core business addresses LTE scale and performance on both control and user planes for VoLTE, WiFi, WiFi offload in physical and virtual deployments.

In operational networks, we test the virtual enhanced packet core; we can emulate handsets or network elements for active testing. And this technology is aimed at reducing network outages currently costing the industry $20 billion a year.

We've launched two new Landslide test solutions; a high capacity server that has allowed customers such as Nokia to test at very high scale; and the Landslide Edge product, a small form factor to allow widespread active testing in the operational network where we're running several trials with major carriers.

We have commercially live deployments in Japan, and pre-production deployment testing in leading service providers in North America, and we expect to see many more opportunities in 2016 and into future years.

Turning to cybersecurity, clearly security is top of mind for everyone. The US Government has increased its budget spending by $5 billion to $19 billion. The EU has a security law which is requiring firms to disclose cyber threats, and I don't see that Brexit will change that position as far as the UK is concerned.

And the banking system, SWIFT, warned that there have been multiple cyber frauds, notably the theft of $81 million from the Bangladesh Central Bank.

So high profile security incidents are making headline news daily; hacked banks, data breaches, hospitals falling victim to ransomware attacks. The prevalence and sophistication of cybercrime is on the rise. And recently published UK crime statistics show cyber fraud and computer misuse has exceeded all other crime.

We addressed three main areas of threat; network security equipment; infrastructure protection; and security services.

We've launched new services and software solutions in the first half. SecurityLabs is our new ethical hacking service, where organizations contract us to probe the networks to report back to them on their vulnerabilities, and we already have three contracts for the new service.

And CyberFlood is our new security and applications performance test product. This is the highest performance layer 4-to-7 test solution, emulating realistic application traffic at scale, while validating security coverage from enterprise to carrier grade network capacity.

We also addressed security in virtual, mobility, critical infrastructure, automotive, Internet of Things, and government networks.

We saw high double-digit growth with our existing customers, the security equipment manufacturers, so the firewall developers. We're running fuzzing evaluations with major security equipment vendors and service providers.

Additionally, we have new solutions to address the vulnerabilities around positioning, navigation and timing technologies, notably a new system to detect interferences in the field. Again, the objective here is to set ourselves up for success going into 2017.

Looking at data analytics across the market, there's strong demand for analytic solutions by operators. It's driven by their need to increase revenues, improve profitability in highly competitive markets. Spirent developed software solutions to analyze all the relevant data across communications networks, with the objective to significantly improve service performance and subscriber experience.

We are fully embedded with a major US carrier where we analyze over 50 billion voice data text and video transactions a day to troubleshoot and optimize the network, and understand subscriber experience and the impacts.

We are already deploying solutions that have moved from reactive analysis to predictive analysis, allowing the prediction of errors and failures which can be corrected automatically, or by staff intervention.

Analytics are even more important as operators meet the challenges of virtualized networks, and as large numbers and wide variety of devices are being connected to their networks.

Overall, this is the large market of $3 billion a year, growing at a rate of about 26%, and we estimate the segment that we serve is currently around $500 million.

So what have we been doing? We completed the first release of the InTouch CNA product which supports sophisticated wireless control plane analytics. This has been implemented in an important regional carrier in the Americas. We're expanding our customer base with carriers worldwide, but sales cycles are long as this is a complex software solution.

We built our analytics into our active mobile infrastructure test system Landslide, and this integrated solution is called VizionWorks. And we expect to grow our business with the deployment and expansion of LTE networks, the launch of new services, virtualization, high-speed 100 gigabit networking, and 5G wireless will also be a catalyst for further growth opportunities.

So new market areas, where we're investing. We're exploring automotive and the Internet of Things as emerging new businesses. In automotive, we've fulfilled the demand for test data systems, driven by the development of eCall, telematics, vehicle interaction, traffic efficiency, traffic safety, infotainment, WiFi connectivity. It is all underpinned by the in-vehicle Ethernet network.

We've released our audio video bridging performance test system in the first half and with this, combined with our broad reach Ethernet system, we've won business with major automotive manufacturers in the US.

Looking at the Internet of Things, we're developing solutions to support developers and operators designing, deploying and managing IoT devices, networks and applications.

For developers, we will simplify their implementation in an environment of many IoT protocols and we will provide solutions for testing, connectivity, security and battery life management.

For carrier tests, we will address their top challenges for simplified device qualification, and we will help them assure the flood of new devices does not overwhelm the network and they can detect and deal with abnormal device behavior, whether related to operational performance or security.

We had a very successful demonstration of our capabilities at Mobile World Congress and IoT World, and IoT SLAM which is a virtual conference system. These initiatives again are aimed at the long-term development of business for Spirent.

So you've seen we've reported growth in our core business; an improving gross margin; a focus on growth opportunities; and we've launched a series of new products and services. We've got many major Proof-of-Concept trials that have been completed or are still underway, and we've got a good pipeline of business for the second half of the year.

So despite the headwinds on the top line revenues that we reported previously, we feel confident to maintain our outlook for 2016.

So thank you very much for your attention and with that, we'll take questions.

QUESTIONS AND ANSWERS

Gareth Jenkins - *UBS - Analyst*

Gareth Jenkins, UBS. I guess a few questions.

Firstly, I just wondered if you could talk about the order bookings, the $221 million; what the shape of bookings was between Q1, Q2 and what you're seeing currently.

And related to that, you've highlighted the growth areas. Can we talk about the bookings specifically for those new areas or maybe quantify how much of revenue and how rapidly those five key areas are growing for you at the moment?

And I've got some questions (inaudible).

Eric Hutchinson - *Spirent Communications plc - CEO*

Okay. The profile of order intake, so we had a relatively slow start in the first quarter, a much stronger second quarter. We're actually very pleased with the second quarter. We hit our planned numbers.

We saw very strong growth for networks and applications business where the order book ratio to revenue was 112, so 12% over revenue was the increase in the order book. And as you saw from my presentation, a good deal of that was related to Ethernet IP testing and test automation.

In the wireless and positioning business, we also saw a positive growth in the order book which was pleasing to see, it was about a 107 ratio.

The service assurance business, we shipped out of order book which is the main characteristic of the service assurance segment in any case, as we win a lot of that business in the fourth quarter.

In terms of the activity levels in the second quarter, a huge amount of it was skewed towards the end of the period, which has been a characteristic of the business for some time. If anything, it's becoming more exaggerated.

So in terms of the near-term business and looking at the second half-year, the really strong growth areas in terms of volumes are related to Ethernet testing, test automation and we expect to start to see some business flowing on virtualization through the second half and going into 2017.

The actual levels of business in virtualization per se is low single-digits of revenue.

In terms of the mobile infrastructure test market, we're seeing steady progress, but those contracts are expected to close in the second half rather than in the first half, so we didn't see a pickup in the business in terms of bookings in the first six months of the year. That's to come. But the prospects look very attractive.

And with the security test business that's steady state, really. We're just under about $30 million of revenue with the new product releases coming out towards the end of the first half. So again, that's all to come.

Automotive is really putting our position in the market so as to gain mindshare at this stage rather than driving significant revenue, and Internet of Things is at a very early stage of development.

Data analytics; we have an established position with a major carrier in North America. We've won a new contract with the regional carrier in the Americas and we're demonstrating that capability to a series of new carriers.

So again, the trajectory is for steady growth, at the 20%-plus sort of level.

Gareth Jenkins - *UBS - Analyst*

I'll ask a follow up. I think I caught it right that you said that you're seeing capacity constraints in some areas in Ethernet? I'm not sure if I heard that correctly but --

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Eric Hutchinson - *Spirent Communications plc - CEO*

Capacity? No.

Gareth Jenkins - *UBS - Analyst*

So you're struggling to fulfil demand at the moment?

Eric Hutchinson - *Spirent Communications plc - CEO*

No.

Gareth Jenkins - *UBS - Analyst*

No. Okay.

Eric Hutchinson - *Spirent Communications plc - CEO*

No we don't have capacity constraints. The only issue was that a lot of the business, the orders were placed very late in the period so it was impossible to fulfil them.

Gareth Jenkins - *UBS - Analyst*

Just a last one from me. I wondered if you could talk about the fact that you're offering a modular approach to high-speed Ethernet solutions. It seems like a bit of a differentiation versus your peers. And whether you feel you're gaining market share or whether the overall market is expanding at the moment. Thank you.

Eric Hutchinson - *Spirent Communications plc - CEO*

Users of the solutions want to be able to put the test system in place, cable it up so that you can run any of the speeds from the equipment. It's actually re-cabling and reconfiguring test labs that is very expensive for carriers to undertake. So having the multiple speeds within one platform is very attractive and yes, we are the only supplier on the market that can do that today.

And that certainly is driving demand towards us at the moment.

Eric Hutchinson - *Spirent Communications plc - CEO*

Any other questions?

Robert Lamb - *Jefferies - Analyst*

Robert, Jefferies. Just in terms of the OpEx, you've steered previously that that should be fairly flat this year versus last year. And looking at the statement you've made around the underlying rate of investment in the second half of 2016, it should be at a similar level to second half of 2015 which is suggesting a kind of mid single-digit growth half on half.

So I just wanted to understand what the investment priorities are in terms of the cost base in the second half of the year.

Eric Hutchinson - *Spirent Communications plc - CEO*

So the investment areas all relate to the key initiatives I've set up. In terms of where that would increase during the second half, it's likely to be more focused on the security test business as we develop that market, and on the development of the mobile infrastructure business.

One of the effects of changes in OpEx is that with more activity and more profitability in the second, then people would tend to earn more incentives if they hit the numbers in the second half. So there's a bit of a cost increase because they're driving the profits and the revenues up. And therefore, people get paid incentives. So that's actually part of the sequential cost increase.

Robert Lamb - *Jefferies - Analyst*

Great. And in terms of the wireless business, there's obviously been a tick up in gross margin there. I know that you've taken actions. But is there specific products within that mix that are helping versus previously? Or is just you've cleared out the drag basically?

Rachel Whiting - *Spirent Communications plc - CFO*

There's a greater proportion of positioning business now in the mix which has got a higher gross margin. And I think it is that there's perhaps more -- within wireless itself, there's higher gross margin business in that particular business. So it's overall mix.

Eric Hutchinson - *Spirent Communications plc - CEO*

The new products we're introducing into the wireless test business are fundamentally higher software content. So the apparent gross margin, therefore, looks more attractive.

Ollie Knott - *N+1 Singer Capital Markets Ltd. - Analyst*

Ollie Knott, Singers. You just touched on it there but there's clearly an increasing software element across the Group. And with new products that's going to become more so. Can you give us a feel for, at the moment, what the current amount within the overall revenue of recurring software is? And probably more importantly, where that can get to over the next three or four years?

Rachel Whiting - *Spirent Communications plc - CFO*

It's about 20%, low 20%s, of software within the overall revenue mix.

Eric Hutchinson - *Spirent Communications plc - CEO*

We see the development of that being 1% to 2% in terms of the mix change. Your question about recurring is one that is -- it's an evolution of the business. Most of our customers are still buying perpetual licenses. But we are, particularly on test automation, and cybersecurity, and as we get the mobile infrastructure test systems into the live network, then that will all be on a subscription basis.

Ollie Knott - *N+1 Singer Capital Markets Ltd. - Analyst*

So watch this space.

Eric Hutchinson - *Spirent Communications plc - CEO*

Watch this space, yes. Gareth?

Gareth Jenkins - *UBS - Analyst*

Two follow ups.

Firstly, dividend policy. I wonder whether you feel, for the full year, that your dividend is likely to be stable on last year.

And secondly, you've talked a lot about the new areas and it seems like you've got an expansion of customer base going on over from automotive OEMs through to social media companies. Is that coming or do you expect that to come at an incremental cost in terms of the service and sales provision? Because you're having to address more channels to market than perhaps you've ever done before. It's not just operators and NEMs any more, it's a wide array of customers. Thanks.

Eric Hutchinson - *Spirent Communications plc - CEO*

So I don't expect any change in dividend policy in the sense that I think we'll be maintaining our dividend. We haven't determined the final dividend for the year yet. But I would expect it to be maintained. I think we want to see expansion in the earnings before we start to move any changes on dividend distribution.

Regarding the service, in terms of the social networking companies, they're really using our datacenter test equipment. So it's the same service support team. It's the same salesforce, our direct salesforce who are involved in supplying those. So no real change there. In the development of new businesses, we would start to employ specific people to support that technology in different locations. But that would be funded from the revenues that we derive from the growth in those businesses.

I think the area where, somewhere down the track, probably next year, you'll start to see us expand would be on building an enterprise channel to market, and enterprise customer support resources. But that's not something you'll see in this year's numbers particularly. That of course runs through cost of goods sold anyway.

Any other questions? Okay, well with that, thank you very much for coming to the meeting. And thank you for your participation.

Operator

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