Company: **AVIAT NETWORKS.**

Conference Title: **Aviat Networks Q3'22 Earnings Call**

Moderator: **Pete Smith**

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Operator: Good afternoon and welcome to the Aviat Networks Third Quarter Fiscal 2022 Earnings Call. At this time, all participants are in a listen-only mode. A question and answer session will follow the formal presentation. Please note this conference is being recorded. I will now turn the conference over to your host [inaudible].

Speaker: Thank you and welcome to Aviat Networks Third Quarter Fiscal 2022 Results Conference Call and Webcast. You can find our Form 10-Q, press release, and updated investor presentation in the IR section of our website at www.aviatnetworks.com, along with a replay of today's call in approximately two hours.

With me today are Pete Smith, Vice President and CEO, who will begin with opening remarks on the Company's fiscal third quarter, followed by David Gray, our CFO, who will review the financial results for the quarter and first nine months of fiscal 2022. Pete will then provide closing remarks on Aviat's strategy and outlook, followed by Q&A.

As a reminder, during today's call and webcast, management may make forward-looking statements regarding Aviat's business, including but not limited to, statements relating to financial projections, business drivers, new products and expansions, the impact of COVID-19, and economic activity in different regions. These and other forward-looking statements reflect the Company's opinion only as of the date of this call and webcast, and involve assumptions, risks, and uncertainties that could cause actual results to differ materially from those statements.

Additional information on factors that could cause actual results to differ materially from statements made on this call can be found in our annual report on Form10-K filed with the SEC on August 25th, 2021. The Company undertakes no obligation to revise or make public any revisions of these forward-looking statements in light of new information or future events.

Additionally, during today's call and webcast, management will reference both GAAP and non-GAAP financial measures. Please refer to our press release, which is available in the IR section of our website at www.aviatnetworks.com and financial tables therein, which include GAAP to non-GAAP reconciliation and other supplemental financial information. At this time, I'd like to turn the call over to Aviat's President and CEO, Pete Smith. Pete?

Pete Smith: Thanks Andrew and good afternoon everyone. Thanks for joining us to review another successful quarter. The company continued to execute on our key long term focus areas of growth, margin expansion, and meaningful bottom line improvements despite continued supply chain and inflationary challenges.

The Aviat team commitment resulted in revenue of $74.5 million, which represents growth of 12.2% versus Q3 of last year and nine month revenue growth of 11.0% versus last year. EBITDA of $9.5 million represents growth of 23% versus the same period prior.

For nine months, EBITDA increased 13.2% versus the prior year period. Non-GAAP EPS increase up 38%, continued rock solid balance sheet and liquidity position, continued share buybacks. These results would not have been possible without the tireless dedication and execution of our operations team, engineering team and supplier partners.

Remarkably, our team produced these results despite a tornado impacting our Austin facility during the last 10 days of the quarter, all of our team members evacuated safely before the event.

Our facility was damaged, but we were able to respond quickly and recover the lost production time prior to quarter end. We do not anticipate any continuing impacts from the event.

Supply chain continues to be a challenge. Let's address the supply environment from Aviat's perspective. We experienced fewer supply interruptions, but we still experienced interruptions. Lead times have improved, but are now stable. However, some suppliers are now shipping ahead of lead times. This is a precursor to an improved environment.

Many semiconductor chips remain on allocation. We have greater than a 100 components that are on allocation. We remain subject to the risk of a supplier push out and de-commits late in the quarter, specifically we overcame six supplier de-commits in Q3. Q3 played by lockdowns in Asia.

Fortunately, our inventory approach buffered the supply interruptions. These lockdowns have impacted three levels down in the supply chain. Overall, we see the environment is improving, but risks still remain.

Now let's move to the key highlights of the third quarter. We continue to see a strong demand environment across our three main market segments -- 5G, private networks and rural broadband. In 5G, operators need to upgrade backhaul capacity to enable enhanced mobile broadband capabilities and new applications like fixed wireless access and private 5G services. While we have seen some 5G related build-outs in certain customers, we believe the lion's share of the 5G opportunity is still in front of us.

In private networks due to the growing need for secure and reliable communications, this business was a catalyst for Aviat's growth in Q3. We remain positive about and committed to our strategy of continued share gain and share of wallet expansion in this segment.

And finally, for rural broadband, our business remains strong. And we look forward to the opportunity provided by large funding sources coming in the quarters and years ahead. I'm referring here to the $20 billion rural digital opportunity fund or RDOF and the $65 billion bipartisan infrastructure fund, which have yet to impact our business.

In the quarter, Aviat announced the new rule band[?]win with Quickline Communications, one of the largest Internet service providers in the UK. Quickline selected Aviat's multi-band radios to deliver highly reliable 10 gigabits per second capacity over extended distances.

Aviat's solutions enable Quickline to add new business and residential customers with faster speeds and more reliability. This win validates our value proposition for ISPs in the international market, which includes fast deliveries and a seamless experience with the Aviat store and the highest capacity radios on the market, including our innovative portfolio of multi-band products.

From a software standpoint, we recently announced the availability of our new health assurance software or HAS. This software, the next offering after our frequency assurance software or HAS in our suite of software applications is designed to enable the highest possible level of network performance and reliability by proactively analyzing a customer's network and identifying potential problems before traffic impact occurs.

Thanks to an intuitive and easy to understand map-based interface and intelligent algorithms, Aviat has reduced the level of microwave expertise required to operate the network, lowering operations cost and improving total cost of ownership. We believe HAS will continue the trajectory of growth in our software applications business building on the momentum created by HAS.

We continue the share buyback program during Q3 repurchasing 2 million of Aviat stock under the previously announced $10 million authorization. Before turning the call over to David, let me provide a couple of additional observations and insights.

First, this was a very good quarter and first three quarters of our fiscal year. We remain focused and continue to execute. And those collective efforts are reflected in our financial and operational results. We've continued to demonstrate our ability to grow and to take share of demand. Looking forward, we see three significant drivers -- 5G, private networks and rural broadband, and believe we are well-positioned to capture significant opportunities with our differentiated products, software and services offerings.

Finally, the Redline Communications transaction is progressing in the regulatory review cycle. We see the Redline transaction as an opportunity to further demonstrate the Aviat operating system. With that, let me turn the call over to David to review our financials before coming back for some final comments. David?

David Gray: Thank you, Pete and good afternoon, everyone. During my remarks today, I will review some of the key fiscal 2022 third quarter and first nine months financial highlights, noting our detailed financials can be found in our 10-Q and press release, both of which were filed this afternoon. As a reminder, all comparisons discussed today are between the third quarter of fiscal 2022 and the third quarter of fiscal 2021 unless noted otherwise.

For the third quarter, we reported total revenues $74.5 million as compared to $66.4 million for the same period last year, an increase of $8.1 million or 12.2%, driven by strong growth in North America and Africa. North America, which comprise 66% of total revenue for the third quarter was $49.0 million, an increase of $7 million or 16.7% from the same period last year driven primarily by our private networks business.

International revenue was $25.5 million for the quarter, an increase of $1.1 million or 4.5% for the same period last year. We are again pleased that our backlog continues to remain above $200 million, and our trailing 12-month book to bill ratio remains above one as it has for every quarter since fiscal 2018.

Gross margins for the quarter were 37.0% and 37.1% on a GAAP to non-GAAP basis, as compared to 38.5% and 38.7% in the prior year. Gross margins remained under pressure from inflationary headwinds and expedite costs related to supply chain disruptions, but continued the sequential improvement increasing by 80 basis points from Q2 and 140 basis points from Q1.

This trend is consistent with our prior earnings commentary where we noted that price actions to offset inflation would gain momentum as the year progressed. In fact, I'm pleased to report that in dollar terms, our price realization fully offset inflation in Q3, a quarter earlier than expected.

Third quarter GAAP operating expenses were $20.1 million, a decline of $1.5 million from the prior year, primarily due to the non-recurrence of a $1.2 million restructuring charge in fiscal 2021. Third quarter non-GAAP operating expenses, which exclude the impact of restructuring charges share-based compensation and deal costs were $19.2 million. This is a decrease of $0.5 million from the prior year due to general cost controls and benefits from prior restructuring actions.

Moving on to net income, last year's income included a onetime $92.2 million benefit from the release of a valuation allowance against the company's deferred tax assets related to our NOLs, based on the company's significantly improved profitability and outlook. Third quarter GAAP net income was $6.0 million compared to $94.7 million last year.

GAAP income before tax was $7.3 million, an increase of $3.1 million or 76% from the prior year. As a reminder, the increase in tax provision year-over-year will not increase our cash taxes paid.

The company has over $500 million of NOLs that will continue to generate shareholder value via minimal cash tax payments for the foreseeable future.

Third quarter non-GAAP net income, which excludes restructuring charges, share-based compensation and non-cash tax provision was $7.9 million compared to $5.8 million for the same period last year. Third quarter non-GAAP EPS came in at $0.67 per share, compared to $0.49 per share for the same period last year, an increase of 38%.

Adjusted EBITDA for the third quarter was $9.5 million, an increase of $2.2 million or 30% from the prior year. Adjusted EBITDA margins were 12.7% for the quarter.

Moving on to the balance sheet, our cash and marketable securities at the end of the third quarter were $33.8 million, and we continue to have no debt. We executed 2 million of stock repurchases in the quarter. We also, continued to leverage our balance sheet via increased working capital investment to mitigate supply chain challenges, protect earnings and service our customers.

Accounts receivable increased by $7 million in Q3 driven by two factors: 1) higher growth in international regions, specifically Africa in Q3 were longer payment terms [inaudible]. 2) supply chain and logistical issues back loaded invoicing to late quarter. In addition, longer transit times and customs delays further prolonged the collection times.

Crucially, we see no deterioration in overall credit quality. Historically, bad debt issues have been very rare for Aviat with no material bad debt expense in the last four years. The other major contributor to working capital increase was inventory, which grew by $3 million in the quarter. A portion of the increase was driven by buffer stocks to support growth and continue servicing our customers in the current supply environment.

As a result, we haven't missed any revenue opportunities for the past two quarters much to the delight of our customers. Additionally, we began directly sourcing about $4 million of components since the beginning of the year, consigning the stock to our contract manufacturer to eliminate supply risk.

Lastly, we reduced our payables by $2.9 million in the quarter. This leverage of the balance sheet was executed to maintain Aviat in a prioritized supply vision with key vendors. Finally, we made $700,000 in cash payments for previously announced restructuring programs.

Looking forward, we expect the supply chain effects on working capital to stabilize and moderate and eventually normalize over the coming quarters. As this happens, we expect cash flow generation to also, normalize and then accelerate as the mean reversion occurs. Our balance sheet remains very solid, leaving us well-positioned to execute our long term plans. With that, I'll turn it back to Pete for some final comments. Pete?

Pete Smith: Hey, David, just a few additional comments before opening up for Q&A, a housekeeping item. Andrew Fredrickson recently joined us and will be the investor relations point of contact. Now, Keith Fanneron will be focused on FP&A, IT integration planning.

The Aviat team executed well in the third quarter. The Austin tornado was an unexpected test, and Aviat and our partners showed a positive response. Based on our performance today, we are raising our full-year revenue guidance while considering the supply chain risk that remains. Revenue for fiscal 2022 to be in the range of $296 million to $300 million and adjusted EBITDA to be in the range of $37 million to $39 million. With that, operator, let's open it up for questions.

Operator: Thank you, sir. If you would like to ask a question, please signal by pressing star one on your telephone keypad. If you're using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, press star one to ask a question.

We will take the first question from Scott Searle from Roth Capital. Your line is open. Please go ahead.

Scott Searle: Hey, good afternoon. Congratulations on the quarter, great job in a tough environment.

Pete Smith: Thanks, Scott. Thanks.

Scott Searle: Hey Pete, maybe quickly, to just dive in, in terms of the sequential outlook, I see you're raising guidance. I'm wondering directionally how you see gross margins trending attempt to get some of the price increases kicking in, but you're still fighting some of those component headwinds. So, how should we be thinking about the sequential progression of gross margins?

David Gray: Hey Scott, its David. I think it is likely that we'll see continued modest improvement as we close out the year and head into early fiscal 2023. We're still expecting some further inflationary pressures to continue mounting based on what you've seen in the energy markets as well as commodities that will start to run through so, we're planning on more, but we're also, I think well-positioned to offset those. So, we are planning on continued for gradual progression back up into the above the range where we currently are.

Scott Searle: Perfect. And Pete, sorry. Go ahead.

David Gray: Yes, so, once, I think after Q4 then we'd be back to assuming no more inflation will be at the margin or go kind of the baseline margin and then fluctuations, the margin will be mix related as long as there's not a new wave of inflation, so.

Scott Searle: Got you. And Pete, there's a lot of government funding, which you talked about in terms of RDOF and IIJA. I missed some of the comments. Is there a timeline of when you start to expect to see some of that contributing RDOF is that later in this calendar year and IIJA was that

2024/2025. What are the current thoughts about when that will start to actually feather into the results?

Pete Smith: Yeah, so, we've kept the RDOF out of the model. We think when we look back, we thought it was the end of this calendar year, maybe the beginning of next calendar year, could be as early as October, could be as late as March. Our government affairs folks are tracking this. Actually, yesterday, the FCC showed a new release of $200 million for RDOF.

We don't know what the specifics of those projects are. But we do know some of our customers are in. So, that's kind of the color on the RDOF and on the use the different acronym, we will track the bipartisan infrastructure fund of this. And so, we don't have -- we think that's going to be great for us.

There's $65 billion for rural broadband. But the gating item on that is that they won't be released until the states submit and the FCC approves the coverage maps. So, and the last forecast we got on that was that those maps in the Department of Commerce would go through the maps this summer. So, let's say, the map issue gets resolved.

I think the appropriation cycle will take us 12 months. So, maybe the middle of next summer, we can expect some lift from the bid[?].

Scott Searle: Perfect, and if I could, two quick follow-ups. Earlier this week, I think Ceragon talked about the relationship in a win with DISH Networks. I know you've been deployed in a couple of geographies there. I wonder if you had any thoughts on that front.

And then as it relates to the Redline acquisition, very complementary to what you guys are doing from a private network standpoint. I'm wondering if there any other metrics to help us understand the longer term opportunity. I know the model is initially built on being immediately accretive without sales synergies. But if you've got any thoughts in terms of how complementary the existing customer base is, and what that opportunity might be, as we start to get out into fiscal 2024/2025. Thanks so, much.

Pete Smith: All right, sure, Scott. So, with respect to DISH, Aviat won DISH on February 2021. We've delivered to DISH over the past one plus year, and we continue to deliver. DISH has always intended to follow through supplier strategy, like most tier one network operators, and they've finally executed apparently on the second supplier.

And for Aviat, the DISH win is meaningful because in the bake-off, we won versus the generalist and the specialist competitors. It proved our technology. Our international customers see it as a bellwether event, meaning that we've clearly distinguished ourselves. And with respect to modeling all along, we've been concerned about the pace for rollout, and we've modeled this conservatively. So, with a competitive environment, it's not going to impact our perspective.

And then on Redline, it's a little too early to talk about synergy upside. But what I can say, is the response from both companies, customer base has been positive. And we think that there's going to be some backhaul pull through for Aviat products, and there is potentially well, there's definitely going to be potential to pull through Redline's private network portfolio into to our customers and particularly utilities. Thanks Scott.

Operator: We will take the next question from Theodore O'Neill from Litchfield Hills Research. Please go ahead. Your line is open.

Theodore O'Neill: Thanks. I echo Scott's comments about the quarter, very good.

Pete Smith: Thanks Neil.

Theodore O'Neill: Hey, so, Pete, Q4 is seasonally a strong quarter for you. And if you had, if guidance didn't exist, I probably would have come up with a bigger number then than you're guiding to for Q4. Is there, is that partly because you've got supply chain risks on COVID and you've got parts[?]and allocation. I mean, could, if it weren't for those things, would Q4 be even bigger?

Pete Smith: So, your question is very fair, Theo. So, the low end of our guidance is a hedge on supply chain and the high end is our target. And as David said, we didn't miss any revenue the last two quarters, but the environment is still like whack-a-mole. So, we wanted to be careful in case we had a supplier de-commit late in the quarter that would hurt us. And that's really the logic that went into the guidance. And I would say our supply chain is executing better than our peer group, and your question is fair, and I want to be careful given the environment.

Theodore O'Neill: Right, okay. Just a philosophical question, looking at how the -- since[?]your product sales are going so, well. It makes me ask about the service side. Why don't we see more growth there, even though there clearly is growth, but it's not up to the level of the product side?

Pete Smith: Yeah, so, our businesses is project-based and the kind of mix between products and services, it ebbs and flows. And I think when we think about our business, we think the long term revenue split is about two-thirds to one-third and what you are just seeing is the mix of projects deal.

Theodore O'Neill: Okay, thanks very much.

Pete Smith: Sure.

Operator: The next question is from Dave Kang from B. Riley. Please go ahead. Your line is open.

Dave Kang: Thank you. Good afternoon. My first question is, regarding last quarter, you talked about test with a large US state. Just wondering if you can give us an update on that?

Pete Smith: So, the routing, right, so, that's the routers and the high availability routing software. That test went fantastic. So, we do mission critical networks that was about a 400 node network. It required seven links to be broken to make the network fail. The customer was impressed. And that's helping us build an additional pipeline around that router and the routing software, so, thanks for asking about that Dave. It's great.

Dave Kang: Sure. And then regarding the DISH situation you and Ceragon have they tell you -- I mean as far as like allocation, what do you think the allocation will be between you and Ceragon? Is it going to be 50/50, or somebody will have a larger share?

Pete Smith: Yeah, so, look, we're all hopeful to over the last year, we've had 100% share and we think we're in a more competitive environment. We think we've proven our technology. But I don't want to speculate on how that's going to split out Dave. So, it's a fair question. Let's see who wins on the competitive landscape.

Dave Kang: Got it. And then on gross margin, I think you kind of talked about heading into next fiscal year. You know baseline. So, how should we think about the baseline? Is there something like 37%, 38%?

David Gray: Yeah, I mean, I mentioned that we are anticipating in modeling additional inflation in the next year based on the current environment. Having said that, we're still continuing to gain traction or momentum as the pricing actions we've already taken working our way through our backlog. So, we feel like we're in a good position to continue, not just offsetting, but starting to claw back some of the margin points involved there.

So, yeah, I think from a baseline, certainly the 37% to 38% range is fair. And then we're still working on our plan for fiscal 2023. So, we'll have a better idea of our how much mix will drive anticipated improvements for next year as well. But I think as a baseline, the mid 37% is good.

Dave Kang: Got it. And then Pete you talked about sourcing directly from your suppliers. I think you mentioned like $4 million. Well, what does it mean for gross margin because actually, one of your peers talked about by going directly, do you expect some margin improvement because obviously, you're not paying like a broker's fee?

Pete Smith: Right. So, that was part of our margin improvement plan and it's factored into the perspective David shared. So, it certainly did. And so, that impacts inventory, right, so, we carry more inventory instead of our supplier partners that does help margin. But we did not do this for -- we did this for security of supply as opposed to the improvement in margin, right. And look, our supply chain results compared to a lot of technology companies, we're distinguishing ourselves, so, bringing that $4 million of buy-ins in-house has helped us satisfy our customers.

Dave Kang: Got it, thank you.

Operator: The next question from Tim, Northland Capital Markets. Your line is open. Please go ahead.

Tim Savageaux: Just bailed on the last name. I like that.

Pete Smith: Hi Tim.

Operator: Sorry about the name.

Tim Savageaux: Good afternoon. So, you talked about the potential variability in timing of even though we've seen a fair bit of disbursement of funds, and when you'll see the material RDOF ramp. My question is more on the kind of magnitude of that pipeline that you see right now. And maybe it says if we didn't see it roll on October what do you think that can contribute or do you want to talk about the wins and aggregate and the potential value there, either in total or annually? But as we get closer here, I'd love to get a little more granularity on how that's shaping up?

Pete Smith: Yeah, so, we -- Aviat wins in rural broadband because of our ecommerce platform and our WTM radio platform, and that's delivered 38%, 39% market share from what we can tell. And so, we think we have all of the -- we have a significant amount of customers.

And what we've said over in the past is that the RDOF funding is good for us, it's $20 billion. 2% to 4% of that funding should go to microwave projects, and then we have our share. And we think the program is 10 years. We think the peak funding is going to be in four years out.

Now the challenge that we have is how are those programs going to roll out. Is it going to happen in October, December, March? We don't know. We're engaged with 38%, 39% of the market. We're ready. We have a significant amount of inventory. So, when the demand comes, we'll be ready. And we largely keep this out of our guidance because of the uncertainty around when the projects are going to flow and impact the top line. So, that's what we know Tim.

Tim Savageaux: Okay, I wanted to follow-up on rural broadband, but more short term kind of in the quarter in the outlook. What kind of trends did you see with rural customers in advance so, that what growth are you seeing in rural broadband as we possibly approach the 10% of revenue mark, but are we there yet, I guess.

Pete Smith: So, Tim, we're [inaudible] too below the 10% level. I think our growth was steady. And while we wait for the RDOF funding, we think a lot of the demand that we're getting is still tied to the CAF-II funding, which is still flowing. And in our conversations, we talk about this 10% threshold in our international business and our private network was up, right, so, that's really what's going on there.

Tim Savageaux: Got it. And one last question for me. And you obviously did a nice job managing all these supply curve balls. But is there a quantification of what the overall supply headwinds might have cost you in the quarter, I guess on the top line versus gross margin increased costs? And as you look into Q4, I mean, to the extent that you're the high end, I mean, as it was mentioned, before, you normally are seasonally up pretty good. High end of the range puts you flat.

I gather ex[?]any real supply impact. So, is there something changing in the business from a seasonality standpoint or are we looking at conservatism here or are you baking some kind of additional continued supply impact carrying over from Q3 to Q4?

Pete Smith: Yeah, so, there is -- so, right now, the supply environment we've had a couple of supplier interruptions this quarter, right, so, we are baking in some supplier impact, right. And the earlier question was about the range, right.

So, the low end of the range is factors in that we can't resolve those supply interruptions then the top end of the range factors what we're targeting and if we do better then we'll be above the range. So, that's really the truth. And this has been every quarter for the last two years where you're working on the interruptions or the critical shortages or begging for more allocation.

So, it's pretty similar to the previous quarters. And that's the color that we can give. And I would say we talk in a week. It will be different, right. And sometimes it gets better, and sometimes the problems get more pronounced. Look, I don't like having this conversation because it seems like a dodge, but this is what happens to Aviat as well as a lot of our peer group. And that's why it's difficult to be more precise with respect to the next eight weeks.

David Gray: And then to answer your question on inflationary impacts in the quarter, we think it cost us about the 330 basis points of margin, just the inflation. But then our price realization, we're up about 360, so, net favorable by about 28 basis points.

But then, of course, you've got a bit of dilution from increasing your revenue line to keep your gross margin dollars just a little bit better than you would have been. So, all in all, those are still the kind of headwinds that we're facing on the inflation side.

Tim Savageaux: Great, thanks. And I look forward to talking in a week to see how things have evolved.

Pete Smith: Thanks Tim.

Operator: The next question is from Orin Hirschman, AIGH Investment Partners. Please go ahead.

Orin Hirschman: Hi, thank you and congratulations on the progress especially with the supply chain issues. Just two quick questions from a technological point on the new radios you've announced and some of the wins that you have, how big is the technological differentiation versus the competition? And the second question is on the software side product that you mentioned that helps run the microwave network, is that going to be sold as a separate SaaS offering or bundled?

Pete Smith: Okay. So, on the radio differentiation, we have the highest capacity, highest system gain, and where operators want to optimize for capacity or distance, we win. That's where that differentiation matters and I will also, talk a little bit more about the health assurance software.

We will push that for Software as a Service. The exceptions will be where we can't run it as a service due to network security issues. And I'd like to say a little bit more about this. It is the latest release in our assurance software portfolio. As we've talked for the last couple years, we want to add more and more software.

So, this is the next leg in the stool, if you will, following on our frequency assurance software, and it principally reduces network downtime and lowers the customer's operational costs for microwave network that has predictive algorithms that continuously analyze the network, and basically avoids downtime. So, we're really excited. And we hope in the next 12 months that we can add another leg to the stool, enjoy the growth of HAS and then look out further where we can bring more software to bear. Thanks for that question, Orin.

Orin Hirschman: Sure, thank you.

Operator: It appears there is no further question at this time. Mr. Pete, I like to turn the conference back to you for any additional or closing remarks.

Pete Smith: Yeah, so, I'd like to thank everyone for joining the call; our investors, our customers, our employees, and in this environment, particularly our suppliers. We're looking forward to updating you in August on our full-year results and providing perspective on fiscal year 2023. Stay safe everyone.

Operator: This concludes today's call. Thank you for your participation. You may now disconnect.