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Viavi Solutions, Inc. (VIAV)

Q1 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you so much for standing by and welcome to the VIAVI Solutions' First Quarter 2022 Earnings Conference Call. Just a quick reminder, today's call is being recorded. And at this time, I'll turn things over to the Head of Investor Relations, Mr. Bill Ong. Please go ahead, sir.

Bill Ong
Senior Director-Finance & Investor Relations, Viavi Solutions, Inc.

Thank you, Paul. Welcome to VIAVI Solutions' first quarter fiscal year 2022 earnings call. My name is Bill Ong, Head of Investor Relations. Joining me on today's call are Oleg Khaykin, President, CEO; and Henk Derksen, CFO. Please note, this call will include forward-looking statements about the company's financial performance. These statements are subject to risks and uncertainties that could cause actual results to differ materially from our current expectations and estimations. We encourage you to review our most recent Annual Report and SEC filings, particularly the risk factors described in those filings.

The forward-looking statements, including guidance we provide during this call are valid only as of today. VIAVI undertakes no obligation to update these statements. Please also note that unless we state otherwise, all results, except revenue, are non-GAAP. We reconcile these non-GAAP results to our preliminary GAAP financials, and discuss the usefulness and limitations in today's earnings release. The release plus our supplemental earnings slide which includes historical financial tables are available on VIAVI's website. Finally, we are recording today's call, and we'll make the recording available by 4:30 PM Pacific Time this evening on our website.

I would now like to turn to call to Henk.

Hendrikus Petrus Cornelis Derksen

Chief Financial Officer & Executive Vice President, Viavi Solutions, Inc.

Thank you, Bill. Fiscal Q1 2022 reflects a VIAVI record in revenue, non-GAAP profitability and earnings per share. First quarter revenue came in at $326.8 million, up 14.8% year-over-year, exceeding our guidance range of $303 million to $$317 million, mainly a result of better than anticipated supply chain management within our NSE business, as well as favorable timing of shipments in our OSP business segment.

Since the outbreak of the pandemic, quarterly revenues have consistently improved sequentially, exceeding a prior record of $313.7 million in revenue in the December quarter 2019 by $13.1 million. VIAVI's record operating profit margin at 22.7% expanded 140 basis points year-over-year and 190 basis points sequentially and exceeded the guidance range of 21.5% to 22.5%.

EPS, had a quarterly record of $0.24 per share, exceeded the $0.20 to $0.22 guidance range and increased $0.03 or up 14.3% from the year-ago period. The share count of 242.3 million shares includes the dilutive impact of the convertible notes of approximately 8 million shares.

Now, moving to our reported Q1 results by business segment, starting with NSE. NSE revenue at $227.9 million increased 24.2% year-over-year, exceeded our guided range of $210 million to $220 million. Within NSE, NE revenues increased 26.4% from a year ago to $204.9 million, reflecting strength for our fiber, wireless, and cable products. SE revenue at $23 million increased 7.5% year-over-year, a result of recovery from our assurance and data center products. NSE gross profit margin at 64.7% increased 50 basis points year-over-year. Within NSE, NEE gross profit margin at 64.8% increased 100 basis points from last year, primarily a result of leverage on higher revenue volume. SE gross profit margin at 63.9% decreased 290 basis points year-over-year due to product mix.

NSE's operating profit margin at 13.5% exceeded our guided range of 12% to 13%, primarily a result of operating leverage from higher revenue. Operating profit dollars more than doubled, as margins increased 630 basis points from a year ago, reflecting the leverage and growth in combination with the aforementioned higher gross margin and disciplined OpEx control.

Now turning to OSP. First quarter revenue at $98.9 million is down 2.3% from last year's revenue record of $101.2 million and reflects OSB second highest revenue quarter. The revenue exceeded our guided range of $93 million to $97 million, mainly a result of strong customer demand and timing of shipments.

Gross profit margin at 57.7% decreased 260 basis points year-over-year and reflects the impact of product mix, a slightly higher manufacturing variances compared to last year's records. Operating profit margin of 44.1% is near the high end of our guided range of 42.5% to 44.5%, a decrease of 260 basis points from a year ago, as a result of aforementioned reduction in gross profit margin.

Now turning to the balance sheet, the ending balance of our total cash and short-term investments was $921.7 million, an increase of $218 million sequentially on the prior quarter and up to $326.2 million compared to the prior fiscal year. In addition to free cash flow generation, the increased cash possession reflects the recent $400 million high yield bond offering we completed at the end of September, offset by the partial impact of a deeming $275 million in principal value of convertible notes in early September.

Operating cash flow for the quarter was $53.4 million, a decrease of $10.5 million compared to $63.9 million in the year ago period, reflecting increased investments in inventory to ensure we continue to meet our on-time commitment to our customer. We invested $15.7 million in capital expenditures during the quarter, compared to

$8 million in the prior year. The increased CapEx reflects a new production facility in support of increased future demand built in Arizona.

Early September, we entered into a separate privately negotiated exchange agreement with certain holders of the 1.75% senior convertible 2023 notes and a 1% senior convertible 2024 notes. This transaction reduced the principal value of our 2023 convertible notes from $225 million to $131.2 million, and our 2024 convertible note from $460 million to $278.8 million, resulting in a $85.9 million GAAP only loss included in interest expense and other income. The remaining outstanding balance of a combined convertible note is $410 million in principal value at the end of the quarter, a reduction of $275 million compared to the prior quarter and prior year.

We settled the combined retirement of $275 million in principal value of convertible notes in part in cash for a total of $197 million as well as by issuing 10.6 million shares of VIAVI common stock. Subsequently, the board authorized the repurchase of up to $190 million of these shares, which commenced at the start of the second quarter and is expected to be completed no later than by the end of the third quarter. As of yesterday, November 3, we repurchased 2.4 million shares under this program at an average price of $15.48 per share including commissions. In addition and under the already existing stock buyback program, we repurchased $8.5 million of VIAVI stock at an average cost of $16.52 per share including commissions during the first quarter. In total, as of the end of the first quarter, we repurchased $95.5 million out of the $200 million authorized share buyback plan. This program is now extended until the end of September 2022.

In late September, we completed a $400 million high-yield note offering at an attractive rate of 3.75% interest due in 2029 with net proceeds of approximately $393 million. The proceeds will be used for general corporate purposes including replenishing the funds used to retire indebtedness. Please see our earnings supplemental deck posted on the VIAVI website for more details.

We are pleased with the successful issuance of our first high-yield notes, as well as the retirement of approximately 40% of our convertible notes. This completes an important step in optimizing our capital structure and we expect will create the financial flexibility to allow us to execute our growth objectives.

Now, on to our guidance. The current macroeconomic environment remains uncertain, with significant supply chain challenges as well as the ongoing pandemic. As a result, we expect the fiscal second quarter 2022 revenue to be approximately $303 million, plus or minus $7 million; operating profit margin is expected to be 20.5%, plus or minus 50 basis points; and EPS to be in the range of $0.18 to $0.20 per share. We expect NSE revenue to be approximately $235 million, plus or minus $5 million, with operating profit margin at 16.2%, plus or minus 50 basis points. OSP revenue is expected to be approximately $68 million, plus or minus $2 million; with operating profit margins at 35.5%, plus or minus 100 basis points.

Tax rate is expected to be approximately 17%. We expect other income and expense to reflect a net expense of approximately $6 million, which includes the full impact of the change in interest expense as a result of the high-yield note issuance net of the convertible notes retirement. Absent of any changes to the principal notes, we can expect the net expense of approximately $6 million also for fiscal Q3 and Q4.

At current stock price levels and as we complete the aforementioned share repurchase program, the estimated fully diluted share count used in our calculation is 243 million shares for the second quarter. We also expect the fully diluted share count to reduce to approximately 239 million shares starting at the end of the third quarter and to approximately 237 million shares at the end of the fourth quarter.

With that, I will turn the call over to Oleg.

Oleg Khaykin

President, Chief Executive Officer & Director, Viavi Solutions, Inc.

Thank you, Henk.

Our fiscal year 2022 is off to a strong start with record revenue and non-GAAP profitability in Q1. I'm pleased with both NSE and OSP performance in delivering strong results despite supply chains challenges. The NE segment demand strength was driven by fiber, wireless and cable. Service providers continue to upgrade and expand their networks with fiber, resulting in a record revenue quarter for our fiber field instruments.

Wireless demand continues to be strong, up double-digits percentage from a-year-ago levels. 5G field deployment is accelerating with 5G networks being overlaid on top of existing 4G infrastructure. With 5G O-RAN technology now widely used in the lab, we are now starting to see initial deployment of O-RAN in the field as well.

Cable was also strong and was up from a-year-ago levels. Much of the recent cable demand was in support of MSOs' bandwidth expansion and 5G deployment. Semis and data center demand for [ph] 400Gb (00:13:36) continues to be very strong, with early [ph] 800Gb (00:13:40) products adoption expected sometime in late calendar 2022. While continued shortages of high performance semis have challenged our industry, we have been able to successfully mitigate, for the most part, these supply constraints in Q1 and exceeded our revenue guidance. We continue to see supply challenges persisting into Q2 and Q3 and reflect them in our guidance accordingly. Lastly, we expect to see these supply constraints to start alleviating by mid calendar 2022.

The SE business segment continues to recover with the revenue and customer business final growing nicely. We expect SE to continue to improve and grow as enterprise customers reevaluate their IT project needs and 5G assurance opportunities start to materialize in late calendar 2022.

Now, turning to OSP. The OSP business segment delivered strong revenue and profitability led by robust demand for anti-counterfeiting products. During the past five quarters, we have seen significantly stronger demand for anti-counterfeiting products. As we look ahead to 2022, we expect the demand to moderate down from the current run rate as central banks digest their inventories and adjust monetary policies. That said, we expect the anti-counterfeiting revenue run rate during the calendar 2022 to remain above the pre-COVID levels.

3D sensing revenue was up slightly from a-year-ago levels with higher unit volumes due to broader adoption of world-facing applications. In the coming quarter however, we expect the demand to be moderated downward due to supply chain constraints not related to VIAVI. We expect the demand to partially recover in calendar 2022 as component bottlenecks get resolved. Longer-term, we expect our principal growth drivers – 5G, fiber and 3D sensing – to continue driving growth and profitability for VIAVI.

In conclusion, I would like to express my appreciation to the VIAVI team for its continued strong execution and delivering another record quarter. I wish all our employees, supply chain partners, customers and our shareholders to remain safe and healthy.

I will now turn the call over to Bill.

Bill Ong

Senior Director-Finance & Investor Relations, Viavi Solutions, Inc.

Thank you, Oleg.

We will be holding our 2021 Annual Shareholder and Proxy Meeting next week on November 10. We will also be participating at the JPMorgan CES Tech Forum on January 5, 2022 and the Needham Growth Conference on January 10, 2022.

So, let's begin the question-and-answer session. We ask everyone to limit discussion to one question and one follow-up.

QUESTION AND ANSWER SECTION

Operator: Thank you, Mr. Ong. [Operator Instructions] And we'll take our first question today from Alex Henderson at Needham & Company.

Alex Henderson
Analyst, Needham & Co. LLC

Q

Thanks a lot. I appreciate it. Nice quarter, and I think you guys are doing the right thing on the – with the bond offering. So, I'm glad to see that.

In terms of my question, I was hoping you could talk a little bit about the outlook in 5G and to what extent broadly you've been seen supply constraints. If you could give us some quantification on how much the supply constraints impacted the overall business, but in particular the 5G side of it, whether that was a factor or not?

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

Sure. Hi, Alex. So, well, 5G is some of our newer instruments. And obviously, they're using more advanced chips in some ways. Given that advanced chips in some ways. Given that the volumes are just starting, we have some inventory already prebuilt. But it's actually one of the areas where we are probably seeing some of the more insurmountable shortages, at least in the very short-term. And this is one area where we still haven't been able to get all the components in-house. But it's still early in the game in the ramp, so it's not as bad. And we've been able – at least in the Q1, we have had enough material to start initial shipments. Q2, we are a bit more constrained and we continue to work on it.

And when we provide guidance, we base it on the chipset and all the material that we have in-house and we know we can build. When we guided the Q1, we obviously provided a lower number. And we said, hey, we have a greater opportunity, but we don't know if we're going to get components or not. And fortunately, my team has done a great job and we were able to secure the supply, and thus significantly exceeded our guidance.

And it's pretty much the same thing this quarter. I mean, there's a lot of demand. We cannot meet it all with everything that we've have today. Right now, we go off of the assumption that we have material in hand or coming that – and that's kind of drives our revenue. And the good news is the products that we cannot meet, they just basically get pushed out into the next quarter and the customers are not canceling. With a few exceptions, they're not canceling the orders, they're just pushing out the orders into the future quarters.

Specifically to 5G, what we have been seeing on the lab and production side, we have not been having any issues. We've been able to get our allocation of servers to deliver the product, although there were some challenges. On the instrumentation side is really the area on the RF instruments where we have a bit of a tighter supply. But then, a lot of the adjacent instruments especially with fiber related to 5G, we have been able to close the gap on supply and ship all of those instruments as well.

And the nice thing I would say is our wireless instruments are receiving very good adoption and very strong interest coming from leasing companies as well as multiple contractors. So as the 5G gets accelerated, we feel pretty good about strong demand for our products. I think at this point, we are really focused on closing the gap on the – some of the chipsets that we require for volume scaling. And it'd probably will be, I'd say, February of next year that we should be able to close the gap on the supply.

Alex Henderson
Analyst, Needham & Co. LLC

Q

So, the question really is how much of an impact they have on revenues in the current quarter that was just reported and in your forecast. I mean, is there $10 million, $15 million worth of products that you couldn't ship? And what are your assumptions for the fourth quarter? I like – the color is great, thank you very much. But that wasn't the question.

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

Sure. So, well, you're talking about this September. So, September quarter, we largely closed the gap and we – I think we had upside of about $12 million, $13 million. And what we needed to ship, there was no impact on the September quarter. I think this quarter, there's probably, I'd say, $5 million to $10 million gap that is outstanding. And Q3 is probably still too early to speculate because we don't know what the deliveries will be.

Alex Henderson
Analyst, Needham & Co. LLC

Q

And then, one last question, just follow-up question. So, you cited the return to pre-COVID levels. Just so that everybody's on the same page, what kind of revenue streams for OSP does that represent? I mean, I know what's in my model, but I'm not sure which period you're specifically referring to?

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

Sure. So, when I talk pre-COVID, I talk about anti-counterfeiting, right, that specifically. So, remember, our base rate was around [ph] $50 million (00:22:04) and maybe slightly higher. In the past five quarters, we were running closer to [ph] $60 million (00:22:11) or even in the low-60s. I think when we say [ph] we got (00:22:14) of the new levels as things kind of work themselves out, it will be obviously running above the [ph] $50 million (00:22:23), probably below [ph] $60 million (00:22:24). So, I'd say taking [ph] mid-$50 million (00:22:26) is probably a reasonable number.

Alex Henderson
Analyst, Needham & Co. LLC

Q

Thanks. And that the time to taper to that is couple two, three quarters or is that [indiscernible] (00:22:36)?

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

I would say, starting in the December quarter.

Alex Henderson
Analyst, Needham & Co. LLC

Q

Okay. So, taper is starting now and you'll taper with that level immediately in the December quarter?

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

Yeah. I'd say, immediately and probably for next several quarters at least. But then again...

Alex Henderson
Analyst, Needham & Co. LLC

Q

Okay.

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

...they could come in just as they took number down, they could come back and pick it up. Especially some of these really big user economies of the anti-counterfeiting, a lot of their printing plants are running at low utilization because of the COVID restrictions, so they're consuming the inventory a bit slower as problems alleviate and they pick up more shifts. I imagine a lot of these will work out and we'll probably see some increased demand. But net-net, I'd say the now, the new kind of [indiscernible] (00:23:25) steady state demand is a higher level than was pre-COVID.

Alex Henderson
Analyst, Needham & Co. LLC

Q

Okay. I appreciate the answers. Thank you.

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

Sure.

Operator: And gentlemen, your next question will come from Samik Chatterjee of JPMorgan.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Yeah, great. Hi, Oleg. Hi, Henk. Thanks for taking my question. I guess just a couple. Oleg, you mentioned in the press release and you've talked about it, the $400 million note offering gives you a lot of flexibility in terms of investments, both in the business organically and inorganically. So, just want to get your thoughts about, first organically, how you're thinking about areas of investment and what capabilities you need to add, and then how does the M&A pipeline look? And I have follow-up after that.

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

Sure. We actually have a number of – we're making quite a few investments. We haven't really talked about some of the product lines. And now, they're starting to materialize. So, clearly, fiber, I mean, wireless has been a big recipient of a lot of our new – our internal R&D. And with a slew of our new products coming out and the reception they're getting, we feel pretty confident about success of these products in the market. We also have a number of other programs. It's probably a bit too early to talk about, but it's a whole new set of revenue streams for VIAVI that we haven't – they are not in our current mainstream. And we continue to spend about I'd say probably, I'd say 10% to 15% of R&D in that area. And we'll be getting more vocal about it in the next calendar year as many of these products are now approaching what I would call a primetime.

And the other element, last one is our SE. So, as you know, I've been always very cautious about it. We're now starting to feel more and more bullish about our Service Enablement business. It's been thoroughly restructured. We have a new architecture and we are getting a lot of good traction from the market in 5G space as well as the – a lot of the various enterprise and service provider applications. So, we are cautiously optimistic that our SE business is starting to grow again. And with every quarter, we'll develop stronger and stronger conviction.

Samik Chatterjee
Analyst, JPMorgan Securities LLC
Q

Okay. Oleg, any comments on the M&A pipeline, sorry, before I ask my follow-up?

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.
A

So, M&A, clearly, we have our funnel. I mean both, we always like to look at the private company opportunities. I mean, there's always, I would say, some public opportunities we continue to explore. And clearly, that $400 million gives us tremendous flexibility to go do deals, especially from the carve-outs and private company acquisitions.

Samik Chatterjee
Analyst, JPMorgan Securities LLC
Q

Okay. And for my follow-up and this is more layman question here which is, I mean, you're mentioning the supply constraints that you're seeing strong demand but you're not able to ship to your customers. And if your customers, be it a cable provider or telco, if they are looking to deploy equipment, how are they responding to that shortage? Are they still pushing ahead with the deployments? And then, once in a couple of quarters, the supply eases, is that demand for test equipment permanently lost or do they necessarily just slow down the deployment activity and we just catch up to this pent-up demand in a couple of quarters when supply eases?

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.
A

So, I would say less than 10% of the demand gets lost. If it doesn't get lost, what it does is they go spend money on the next thing, and it's usually when they have some budget flash and they need to spend. By and large, customers are placing orders, and it's a best effort. We deliver whatever we can in this quarter, and then we fulfill the rest of the demand down the line. So, I think in that respect, I'd say majority, I'd say 90% of the demand is not perishable. And what's actually the nice thing about also here is the customers now appreciate the shortages of semiconductor supply. So, even before there was wait and try to place order only as close to the time they needed as they want. Now, they are actually engaging with us much earlier and discussing the needs in the next six to nine months and providing us advanced visibility and placing orders. And many of them are entering into things like material responsibility agreements where they will guarantee taking the product because we have to go and source the material and buy all the components. So, if they later change their requirements, they have to compensate us for that. So, it just shows you the robustness and strength of their conviction and that the demand is real.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Yeah. Thank you. Thanks for taking my questions.

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

Sure.

Operator: And next, we'll move to Mehdi Hosseini of SIG.

Mehdi Hosseini
Analyst, Susquehanna Financial Group LLLP

Q

Yes, thanks for taking my question. When I look at your reported September revenue and your guide for December on aggregate, it's pretty much in line with what I was expecting. And if I were to take your comment that there's a $5 million to $10 million of a gap in supply and demand, to me, that's rather an upside. So, perhaps in that context, you can tell us what are the key end market segments that are driving this upside?

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

Well, so, Mehdi, I think you're way too kind. I am actually – I think we're about $10 million lower than I would have expected. Because I know you're right, you got your model. I mean the area where we have been a bit surprised as you heard about a major mobile phone supplier who was a major customer of ours has faced shortage of components. Unfortunately for us, we were one supplier who delivered our fair share. But as a result, by delivering strong September quarter, we now have to take a pause in the December quarter to allow them to burn off the product that we shipped because of the shortage of the components they're not going to be able to consume it at the same rate.

So, now, we do believe our demand will rebound in the March and June quarter. And actually, our second fiscal half will be stronger in 3D sensing as a result because of the inability for them to prebuild everything earlier on. So, there, we've seen quite a bit of demand push out because of the shortages. And I would say, we were expecting the anti-counterfeiting to start pulling back in the March quarter. Some of it got pushed in a bit earlier.

So, I'd say between that on OSP side, I think on NSE side, I think we're probably leaving about $10 million on the table because of shortage of components. So, there, we would have been around $2.45 million or so revenue range. On the OSP, there's probably about a good, I'd say, $10 million drag in the opposite direction because of the reduction in anti-counterfeiting and a rebalancing of inventories on 3D sensing. So, between the two of them, I mean, I actually thought a couple of months ago, our December [ph] would be the only record (00:31:31) for VIAVI, but [indiscernible] (00:31:36).

Mehdi Hosseini
Analyst, Susquehanna Financial Group LLLP

Q

Got it. Okay. I also want to follow up my second question that has to do with the big picture. Last time we got an update on the model was at Analyst Day back in September of 2019. And so far, you've actually tracked to that model like a $1.3 billion of revenue opportunity and 90%, 95% of earnings. So, when are we going to get the next update especially as we start thinking of FY 2023? Does that hinge on M&A opportunities that you're working on?

You want to wait till you close on a couple of these tuck-ins, or is it more related with just giving it your arms around the core business or combination of the two?

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

Yeah. So, when we give a model, we really based it on the business that we own. Any acquisition will be an upside to that model. And as you know, we are approaching next September, we're going to do the next Analyst Day where we provide kind of visibility ahead. We certainly are pleased that even we discount on some recession or pullback, we did not foresee the once in a century pandemic. But even with that, we are actually spot-on where we were looking to be in terms of both revenue and profitability. We may even be a little better. But we will start, I'd say, beginning of next calendar year talking about what's next, what's for VIAVI in terms of growth. And there, we'll mainly talk about organic, all the inorganic opportunities that we don't discuss as a matter of our policy. They will be all on top of our guidance. And so, by the time the September come, I think you will have a pretty good idea of where we are going and we'll just formalize our strategy, guidance and the projections by then.

Mehdi Hosseini
Analyst, Susquehanna Financial Group LLLP

Q

Got it. Thank you.

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

Sure.

Operator: And next, we'll go to Michael Genovese of West Park Capital.

Michael Genovese
Analyst, WestPark Capital, Inc. (Securities)

Q

Thanks. Yeah, I appreciate all the detail on the call so far, and I really just have a few clarifications of things that I missed because I'm slow. On the core OSP, I didn't quite understand, are we going to the mid-50s level in 2Q? Was that the guidance?

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

Sorry. Could you repeat again? I missed – are you talking about which guidance?

Michael Genovese
Analyst, WestPark Capital, Inc. (Securities)

Q

Core OSP, anti-counterfeiting, right?

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

Core OSP, so we said that includes mainly anti-counterfeiting. The run rate pre-COVID was around $50 million. It went up a little bit, but the last five quarters we were running closer to $60 million or even low $60 million. All we are saying is starting in the December quarter, it's starting to moderate somewhere in between the COVID run rate and pre-COVID run rate. So take somewhere in the middle of mid-50s as kind of base demand.

Michael Genovese
Analyst, WestPark Capital, Inc. (Securities)

Q

Got it. 2Q is December. Got it. Okay.

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

2Q, exactly.

Michael Genovese
Analyst, WestPark Capital, Inc. (Securities)

Q

Now, the other thing, I know you've said a couple of times, but I kept missing it. Did you say that 3D sensing in the quarter was slightly up or slightly down year-over-year?

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

So we had a September quarter was up. It was very strong quarter. We had a very robust customer forecast because they saw a significant increase in unit volume because of the world-facing cameras. So, even with the ASP reduction roadmap, the volume was – more than offset the ASP reduction that we shipped in the September quarter. Well, come the December quarter, given the shortages of other components to the forecast that our customer anticipated, we now actually have a bit of a surplus in their inventory of our filters. So they reduced their demand for the Q2 to work off the excess from Q1 that they cannot consume because of the shortage of components. And I would say the Q3, Q4 will restart again on the regular run rate.

Michael Genovese
Analyst, WestPark Capital, Inc. (Securities)

Q

Yeah, I understand that. But I guess if 2Q is just roughly order of magnitude down year-over-year and sequentially, it's not the same number but roughly 50% down year-over-year and sequentially. But do you expect that – I know you made comments in the back half, but do you expect that to be sort of flattish year-over-year? So on the comparison, we're basically just down half of the December quarter. I mean, is that a good way to think about it? Or we're down year-over-year half of last year's December quarter and that's where we should model the year. Does that make sense?

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

Are you talking about 3D sensing?

Michael Genovese
Analyst, WestPark Capital, Inc. (Securities)

Q

Yes, 3D sensing, yes. So basically flat year-over-year except that the December quarter is basically half of what it was last year.

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

Yes. So...

Hendrikus Petrus Cornelis Derksen
Chief Financial Officer & Executive Vice President, Viavi Solutions, Inc.

A

Yes.

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

Right, we were looking at beginning of the year kind of anticipation how many units our customers going to build, the mix of two filter, world facing and rear facing camera or just only one camera. We had actually – just kind of looking at the forecast of units and with the ASP reduction, we felt to be roughly flat year-over-year, right? With the reduction in unit volume, we now think it would probably be for the year will be about 10% down, right?

Michael Genovese
Analyst, WestPark Capital, Inc. (Securities)

Q

Yes, perfect.

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

So there is fundamentally going to be fewer units consumed because of shortages of the other components. They're going to build fewer units.

Michael Genovese
Analyst, WestPark Capital, Inc. (Securities)

Q

Okay, great. I appreciate that answer. And sorry, I made you clarify the other things so many times, but I appreciate it. Thank you, Oleg.

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

No, sure. Sure. No problem.

Operator: Thank you. Gentlemen, your next question will come from Tim Savageaux of Northland Capital Markets.

Tim Savageaux
Analyst, Northland Securities, Inc.

Q

Good afternoon. And congrats on the great first fiscal quarter. Let me try this OSP thing one more time and then I'll follow up on the test side. So just you're guiding basically down $30 million sequentially. It sounds like that's more than 50% 3D sensing in terms of the impact, maybe – I don't know, maybe two thirds of that. Is that fair to say? Can you characterize it in that fashion? So, if you look at the total sequential decline, what's coming out of 3D and what's coming out of currency? And then I have a follow-up.

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

Well, so we don't break down, but substantially less than half is the 3D. We are a very strong September quarter anti-counterfeiting demand. In fact, that one was substantially higher than the normal run rate. And 3D sensing, it's combination of, I would say, probably – it's a bit more than half is anti-counterfeiting and a little bit less than half is 3D sensing.

Tim Savageaux
Analyst, Northland Securities, Inc.

Q

Excellent. Thanks. And...

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

Sure.

Tim Savageaux
Analyst, Northland Securities, Inc.

Q

...on we go to the comms side of things. So obviously you saw some upside in Network Enablement in the September quarter or guiding for further sequential growth in December, and you've heard this question for me before. But to what extent does that contemplate sort of a strong yearend spending dynamic. One might even call it a budget flush amongst some of the big US carriers in particular. C band spending looks to be ramping into yearend as well as cable spend, or to what extent is that kind of more normalized demand as soon as...

[indiscernible] (00:40:08)

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

Yes. So I would say this year there is very little budget flush because reality is budget flush happens when you have plenty of inventory, plenty components and you can quickly – you place an order in the end of November and you get product by the end of December, right? In this environment, you cannot even pivot that quickly. And also we look at the orders that we are getting. They are very much programmatic. Orders is a big program where they're doing a wholesale and new network deployment or upgrade or refitting their field staff with new equipment.

So we're actually seeing a big change in the mindset for a lot of operators and the way they approach maintenance of their network. And I think first time I would say in the five years since I joined that I'm seeing the maintenance and network operations becoming a much more dependent on highly automated, intelligent test and measurement, which improves productivity of the field staff and the resiliency and performance of the network. And also what we are seeing is it's not just handheld tools. We are selling a lot of big iron, what I would call it, like racks of test equipment that sits in the network and monitors, polices with a lot of software. So, I mean, even though it's still called NE for us, it's not just like your little handheld, by and large. It includes a lot of the – I would call big iron type products that go into core of the network.

Tim Savageaux
Analyst, Northland Securities, Inc.

Q

Right. And I take your point on delivery of product, maybe we see an order flush, sort of a budget flash or something like that where you have carriers kind of getting in line there, which...

[indiscernible] (00:42:07)

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc. A

Yeah. But a lot of the orders, they provide guidance. And if it was purely a flush, they say, hey, I need this much, can you deliver? If not, they'll move on to the maybe the next thing they want to buy. But we can tell them, I cannot deliver. Okay. Well, when can you deliver? Let's schedule – put a schedule because we need that, right, rather than we need to spend the money.

So, actually, at this point in time, I'm not seeing much flushing. That's why if you look at a lot of service providers' announcement, they all massively underspend their CapEx. And it's not for the lack of trying. It's just – fundamentally, there's just not enough supply.

Tim Savageaux
Analyst, Northland Securities, Inc. Q

Yeah. Great. Thanks very much.

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc. A

Sure.

Operator: We'll hear next now from Meta Marshall at Morgan Stanley.

Meta A. Marshall
Analyst, Morgan Stanley & Co. LLC Q

Great. Thanks. A couple of questions for me. Maybe on the first question just on supply chain, understanding some impact but relatively minor for you, guys. Just wondering if customer demand – like you're seeing kind of your customer demand come down any just because they can't put all of the pieces of the project together, so they don't need kind of the test and measurement, just kind of a derivative of supply chain impacts on customer demand. And then maybe just a second question, are any of the limitations that you're seeing something that would – you're having to pay more for that equipment? Are there any price changes that you think you'll need to pass on or relative ability that you think you'll have to pass on some of those price changes? Thanks.

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc. A

Sure. So I think the first question about the – how they spend, I mean, fundamentally, they have plans. A lot of what drives our spend is fiber plant expansion and deployment and the 5G deployment. And all of that is, you can't build out, turn on, optimize, troubleshoot, without the instruments. So you need to equip your technicians or construction crews with all the instruments. So that's part of the demand. And the other one is improving the reliability of the network and performance of network. That one is kind of more, I would say, heavier demand on the equipment that sits inside the network, right?

So I think, on there, it's just part of their just general strategy build-out plans that they've been talking to us for multiple quarters and now it's materializing. So it's not a flash in the pan, I would say, right? In terms of the components, I tell you, I think we've been probably better than most of our competitors at being able to get components. But also, to be fair, it's a lot easier to get – we don't need that much volume to meet our demand because our gross margins on our products are fairly high. So, even if – when we pay significant premium on our components, the net impact is not that great on the margins or the pricing. And we have been passing on increased cost like cost of logistics and various surcharges, but more importantly, we're also being systemically implementing over the last several quarters price increases which in some cases already started going into effect very early but really will kick in beginning of the calendar year.

And it very closely matches what we are seeing on the semiconductor space. You're seeing across the board 10% to 20% price increases on semi components, probably starting out, say, in earnest beginning of January. So we figured we need to be ahead of that, and get all our contracts and get all the customer pricing adjusted sooner or rather than later. That's why even though we had significant expedite fees and surcharges and premiums to secure these components, we're not getting them just because we have a nice smile and say pretty please. We actually pay quite a bit of money to get our unfair share of components. But we have also been communicating that we're going to pass these increased costs to our customers. And so far we have not had a single customer that declined to take the business. And they're seeing the same thing that prices are going up across the board.

Meta A. Marshall
Analyst, Morgan Stanley & Co. LLC

Q

Great. That's super helpful. Thanks so much.

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

Sure.

Operator: And next, we'll hear from Richard Shannon of Craig-Hallum.

Richard Cutts Shannon
Analyst, Craig-Hallum Capital Group LLC

Q

Well, thanks, guys, for taking my questions. You had hit over the topic of 5G field instruments, Oleg. I think you made a brief remark in the prepared section on how that's going or I think you said, things are moving along well here in the early stage. Maybe you can kind of characterize the rate of success where it kind of leads you to share relative your expectations as you really started to do kind of do R&D into this area a couple of years ago and give us a color there, that'd be great please?

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

Sure. So what we're seeing right now is the initial deployment. Our people are starting to go beyond the engineering or the NEM field technicians putting up the pilot projects, so it's starting. And in a way, I'm actually very happy that it's only just starting and it's relatively slow because I could not deliver if they truly place full orders. I couldn't deliver thousands of units today even if I wanted to.

So in a way, it's kind of fortunate that some of the deployment got delayed and we're in the early stages and we have enough material to support it. But we also see that as things accelerate, we'll need substantially more material that probably will not really be available till I'll say February of next calendar year. So in that respect, we've had enough material in stock to kind of get everybody going thereby no means they're all getting what they want but it's enough to keep them locked in into VIAVI cash flow, VIAVI methodology and enough to get everybody trained and prepped for the accelerated rollout.

Richard Cutts Shannon
Analyst, Craig-Hallum Capital Group LLC

Q

Okay, that's fair color. Appreciate that. My second question just quickly on cable TV, it's mainly – for the most part of last years, you haven't highlighted that much but I think it's the second quarter in a row that you have. I guess maybe you can give us some color within the SE business how big of a contributor that is, and how sustainable do you see the upswing here in cable TV?

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

So the cable – so it's not – we're still, obviously, selling some of the handheld instruments, but it's significantly down because DOCSIS 3.1 was deployed already for quite a while, and it's really more of a replacement and maybe some additional things we are providing. The next, I would say, big wave will be with DOCSIS 4.0, but it's probably a couple of years out. But we're still selling quite a bit of equipment.

But what's really driving cable for us, it's not really copper, per se. It's fiber, okay? Because, increasingly, cable companies are no longer cable. They are fiber operators. And more and more, what we are shifting towards is they're buying a lot of our fiber equipment, pretty much in line with the telcos and wireless carriers. And what's even more interesting, as they push fiber deeper and deeper into the network, they're losing visibility of all the different segments of their network because, before, you had copper and you had these amplifiers, and they provided feedback and visibility.

Now, as you replace it all with fiber and you have multiple node splits, you need to start to monitor fiber plant. So we actually see in cable companies becoming big buyers of our fiber monitoring equipment where you monitor hundreds of lines of fiber over a large area, and you put these things all over their network to provide visibility and monitoring of their fiber performance.

So I think, very quickly, the distinguishing factor between telcos, wireless carriers, and cable are becoming more and more diminished, and they are becoming predominantly fiber customers, but a different flavor of fiber tech, but the platform is very similar across all three.

Richard Cutts Shannon
Analyst, Craig-Hallum Capital Group LLC

Q

Okay. That's a great perspective, Oleg. Thanks. That's all for me.

Oleg Khaykin
President, Chief Executive Officer & Director, Viavi Solutions, Inc.

A

And one thing I would add also. Many cable companies are also getting into the 5G. They're provisioning 5G, kind of infrastructure. So they are also buying 5G equipment from us, which is very counterintuitive, obviously.

Operator: Thank you. And gentlemen, it appears we have no further questions today. Mr. Ong, I'll turn the call back over to you for any closing comments.

Bill Ong
Senior Director-Finance & Investor Relations, Viavi Solutions, Inc.

Thank you, Paul. This concludes our earnings call for today. Thank you, everyone.

Operator: And again, thank you, all, for joining us. We wish you all a great afternoon. You may now disconnect.