Corrected Transcript

02-May-2023

Viavi Solutions, Inc. (VIAV)

Q3 2023 Earnings Call

CORPORATE PARTICIPANTS

Sagar Hebbar
Head-Investor Relations & Corporate FP&A, Viavi Solutions, Inc.

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

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

OTHER PARTICIPANTS

Michael Genovese
Analyst, Rosenblatt Securities, Inc.

Tim Savageaux
Analyst, Northland Securities, Inc.

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

MANAGEMENT DISCUSSION SECTION

Operator: Hello. My name is Jean-Louis. Welcome to the Viavi Solutions F 3Q 2023 Earnings Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

I'll now turn the conference over to Sagar Hebbar, Head of Investor Relations, Viavi Solutions. Please go ahead.

Sagar Hebbar
Head-Investor Relations & Corporate FP&A, Viavi Solutions, Inc.

Thank you, Jean-Louis. Welcome to Viavi Solutions third quarter fiscal year 2023 earnings call. My name is Sagar Hebbar, Head of Investor Relations for Viavi Solutions. Joining me on today's call are Oleg Khaykin, President and 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 estimation. We encourage you to review our most recent annual reports 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 their usefulness and limitation in today's earnings release. The release plus our supplemental earnings slides, which include historical financial tables, are available on Viavi's website at www.investor.viavisolutions.com.

Finally, we are recording today's call and will make the recording available by 4:30 PM Pacific Time this evening on our website.

I would now like to turn the call over to Henk.

Hendrikus Petrus Cornelis Derksen

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

Thank you, Sagar. The fiscal Q3 2023 was a charging quarter after the pullback in service provider demand earlier in the year and with more muted revenue patterns for OSP, we are now experiencing weaker spending for lab products within our network enablement segment. As a result, fiscal Q3 revenue came in at $247.8 million, down 21.5% year-over-year, albeit at the high end of our recently updated guidance range of $246 million to $248 million.

Viavi's operating profit margin of 11.4% decreased by 4.8% from the prior quarter and 10.1% from the prior year, came in at the high end of our updated guidance range of 10.5% to 11.5%. EPS at $0.08 was down from $0.14 in the prior quarter and $0.22 from the prior year and came in below the initial guidance range for the quarter of $0.10 to $0.12. The current share count was 225.3 million during the quarter, down from 236.8 million shares in the prior year.

The tax rate at 24%, as well as other income expense of $4.7 million for the quarter, arrived at levels consistent with our expectations. Cash flow from operations was $17.8 million for the third quarter versus $28.9 million in the prior-year period as a result of lower revenue levels. Year-to-date, cash flow from operations was $90.6 million compared to $104.5 million the prior year.

On February 1, 2023, the company approved a restructuring and workforce reduction plan to improve operational efficiencies and better align the company's workforce with the current business needs and strategic growth opportunities. The company expects approximately 5% of its global workforce to be affected and estimates it will incur charges of between $10 million and $15 million in connection with this plan, resulting into approximately $25 million in annual savings. We anticipate substantial completion of this plan by June of 2023.

Now, moving on to our reported Q3 results by business segments, starting with NSE. NSE continued to be impacted by current macroeconomic headwinds with quarterly revenues of $177.3 million, declining 23.2% year-over-year. NE revenue of $149.6 million declined 26.8% year-over-year, driven by the weakness in both service provider and network equipment manufacturing spending. SE revenue at $27.7 million increased 4.5% from last year.

NSE gross profit margin at 63.3% decreased by 110 basis points year-over-year. Within NSE, NE gross profit margin at 62% decreased 180 basis points from the prior year, primarily due to lower volume. SE gross profit margin at 17.4% increased 130 basis points from last year, primarily due to an improved product mix. NSE operating profit margin at 1.4% was below our initial guidance range of 7.2% to 8.2%.

Now turning to OSP, third quarter revenue at $70.5 million was down 16.8% year-over-year. Revenue was near the high end of our initial guidance range of $67 million to $71 million. Gross profit margin at 50.6% decreased 490 basis points from prior year, a result of lower volume in combination with startup costs related to a new facility in Chandler. The operating profit margin of 36.6% benefited from a year-to-date reversal of variable incentive compensation and as a result exceeded our initial guidance range of 29.5% to 31.5%.

Now, turning to the balance sheet, the ending balance of our total cash and short-term investments was $586.6 million, up $96.9 million sequentially. During the third quarter, we were successful in exchanging 57% of our 2024 convertible notes into a new $250 million face value convertible note maturing in 2026, generating $113.8 million in proceeds, net of debt issuance costs. The $30 million in repurchase of our common stock, we added net $84 million in cash to the balance sheet, the latter in anticipation of retiring of the remaining upcoming maturity of $68 million in face value of our 2023 convertible notes in the fourth quarter.

As mentioned earlier, operating cash flow for the quarter was $17.8 million, a decrease of $11.1 million year-over-year, a result of lower revenues. In addition, we invested $10.8 million in capital expenditures during the quarter, compared to $18.1 million in the prior quarter.

During fiscal Q3, we repurchased 2.8 million shares of our common stock for $30 million under the share repurchase plan announced in September, leaving a remaining authorized balance of approximately $244.8 million for repurchase. You may recall, in September, we announced that the board authorized a new common stock repurchase plan for up to $300 million and ended fiscal Q3 with a planned balance of up to $274.8 million for share repurchases.

Now on to our guidance, we expect the fiscal fourth quarter 2023 revenue to be approximately $252 million, plus or minus $10 million. Operating profit margin is expected to be 11.2% plus or minus 120 basis points and EPS to be $0.07 to $0.09. We expect NSE revenue to be approximately $187 million plus or minus $8 million, with an operating profit margin of 4.5% plus or minus 150 basis points.

OSP revenue is expected to be approximately $65 million, plus or minus $2 million, with an operating profit margin of 30.5% plus or minus 50 basis points. Our tax rate is expected to be around 25% as a result of jurisdictional mix. We expect other income and expenses to reflect a net expense of approximately $4.5 million. The share count is expected to be around 222 million shares.

With that, I'll turn the call over to Oleg.

Oleg Khaykin

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

Thank you, Henk. Fiscal third quarter 2023 was a challenging quarter for Viavi. The rapid slowdown that we saw in the service provider spend at the end of the fiscal first quarter has spread to our systems and semiconductor customers. Viavi revenue and non-GAAP operating margins came in below the lower end of our initial guidance range, driven by weakness in our NSE segment.

NSE declined year-on-year as well as on a sequential basis, primarily driven by our NE business segment. NE was down double-digit percentage year-on-year and sequentially, reflecting weakness in our lab and field products. The pullback in R&D spend at network equipment manufacturers was much higher than anticipated, leading NSE revenue and non-GAAP operating profit margins to come in below the lower end of our initial guidance. This was partially offset by stronger demand for our optical lab products, driven by the development of high-speed optical infrastructure, including 800 GigE.

Our SE business segment grew 4.5% year-on-year, in line with our expectations. Looking ahead, we believe our NSE business bottomed out in Q3 and we are starting to see some early signs of recovery. Specifically, during this quarter, we are seeing initial signs of recovery for field instruments and stabilization and gradual recovery for some lab and production business. We expect the stabilization recovery momentum to continue into the second half of calendar 2023. One bright spot is our avionics and resilient PNT businesses, which continue to see a healthy demand from [indiscernible] (00:11:55) customers.

Now turning to OSP, OSP decreased year-on-year and sequentially, consistent with our guidance. While core OSP came in slightly ahead of our expectations, the 3D sensing demand was slightly lower. We expect fiscal year fourth quarter to be slightly down quarter-on-quarter, driven by lower demand for anti-counterfeiting products due to post-COVID fiscal tightening. The 3D sensing business is also expected to be somewhat weaker than seasonal due to lower demand for smartphones and supply chain transition to new phone model designs. That said, we expect stronger second half of calendar year 2023, driven by recovery in anti-counterfeiting demand and seasonal strength in 3D sensing.

In conclusion, I would like to thank my Viavi team for managing in this challenging environment and express my appreciation to our employees, customers and shareholders for their support.

I will now turn the call over to Sagar.

Sagar Hebbar
Head-Investor Relations & Corporate FP&A, Viavi Solutions, Inc.

Thank you, Oleg. This quarter, we'll be participating at Rosenblatt's Virtual Tech Summit on June 8. Jean-Louis, let us begin the question-and-answer session. We ask everyone to limit [ph] their question (00:13:07) to one question and one follow up.

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] Your first question comes from the line of Michael Genovese of Rosenblatt. Please go ahead.

Michael Genovese
Analyst, Rosenblatt Securities, Inc.

Q

Thank you very much. Hey, Oleg, I'm trying to figure out what kind of implication we should draw from this kind of sudden and big slowdown in lab tests. Basically, what does it mean for the OEMs, because as you said, the field test is – seems fairly solid going forward and I'm just trying to understand, is it more on the semiconductor side that you saw or what do you think that it tells us when they slowdown spending about their own businesses, both for NEMs and semiconductor manufacturers?

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

A

Well, if I look at it, so think of it this way, right? Initially, the service providers kind of slammed on the brakes in September quarter. It took maybe one to two quarters to percolate it to the NEMs and then to the semi players because in September they still delivered because they had backlog. Some more of them had backlog in December. By March, they clearly saw big orders decline.

And I think what often happens, there is a knee-jerk reaction to slam on the brakes on spending. And we expected the lab equipment to be pulled back somewhat because as this lagging effect would get to the NEMs and semi companies. I think what I was surprised is that the size of slowdown. I expected maybe 15% kind of pull back. I mean, we saw, in some cases, 30% to 40%. So, it's been quite significant. It's not any one. It's pretty broad based. It's the wireless NEMs, it's networking NEMs. It's somewhat broad range – broad-based semiconductor companies, storage, processing, communication.

The only area that was a bright spot is the high-performance optical gear and that piece of the business continued to be doing really well. And I think a lot of it is due to a significant backlog of the business that they are still building. And I think probably to some extent sanctioning of Huawei that US carriers and the European carrier – European and US NEMs are picking up some share and that may be driving some of that demand. But on the broad-based communication IC, storage IC, processor ICs, all these companies saw a meaningful pullback, as well as the telecom, datacom and wireless networking gearing manufacturers.

Michael Genovese
Analyst, Rosenblatt Securities, Inc.

Q

Okay. Thanks for that. Just a clarification and my follow-up, I assume that in lab test, that's not an area where inventory is ever really an issue, right? So it's not – we're not seeing an inventory correction. We're seeing sort of a demand slowdown.

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

A

No, no. There is no inventory. It's very much driven by programs. So I think the way I look at it, it was a knee-jerk reaction to hit the brakes on spend. We are seeing – so, well, let's say on field instruments, we saw December quarter was kind of like bottoming out quarter, and we start seeing things kind of gradually starting to recover in the March quarter.

I would say the lab instruments appear to be very hard drop in the March quarter. And in this quarter, we're seeing stabilization with maybe a little bit of the uptick on the lab instruments. So things are starting to kind of come off because I think there's – I think there was a general shock now and overreaction, which was kind of surprising because we had told everybody in October, hey, it's coming, it's just a matter of how quickly it percolates into the supply chain. And I think March was a very hard quarter.

Operator: Thank you. Your next question comes from the line of Tim Savageaux. Please go ahead.

Tim Savageaux
Analyst, Northland Securities, Inc.

Q

Hi. Good afternoon. That was a magnificent pronunciation. Speaking of bright spots, when you noted the sales weakness back toward the end of last year, you noted cable is a bright spot at that point. I wonder if you can give us an update on what you've seen out of the cable market in the March quarter recently and what your expectations are for the balance of the year.

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

A

So, March quarter, I mean, we saw cable players have kind of finalized their CapEx decisions and they started releasing the orders or communicating orders in March and kind of finalized orders early this quarter. And we already expect to see some revenue this quarter being shipped and in the fiscal Q1.

Generally, cable players, they pretty much blow through whatever they're going to spend. They spend it in the June and September quarter, with maybe a little bit in December. So there is still – I mean, clearly, they are trying to close the gap with a lot of fiber and also counter some of the 5G risk for consumer access. So that's been a positive, and it's mostly a North American story.

Tim Savageaux
Analyst, Northland Securities, Inc.

Q

Okay. And thanks for that. Switching over to the March quarter results, I mean, to the extent you saw what looks to be about a $30 million sequential decline in NE, any way to break that down, I guess, between greater-than-expected lab weakness, or I'd imagine you normally see some seasonality on the field side, but sounds like you said you might have seen some sequential growth on the field side. So if we look at those couple of moving parts there, what were the real drivers between field and lab?

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

A

I would say on the field side, what we saw is stabilization, and the June quarter is the beginning of recovery. Predominantly, the drop was from lab and production, which is very painful because this is revenue at much higher gross margins than average, so it also put the pressure on the mix. So predominantly, I would say a lion's share of the quarter-on-quarter drop was a drop in lab and production. And we view this quarter, it's going to be largely stabilized and maybe even start recovering. So I'd say this quarter, it's flat to slightly up [indiscernible] (00:20:27) lab and production and beginning of recovery for the instruments.

Tim Savageaux
Analyst, Northland Securities, Inc.

Q

Okay. Thanks very much.

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

A

Sure.

Operator: [Operator Instructions] Your next question comes from Meta Marshall. Please go ahead.

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

Q

Great. Thanks. Maybe just if we could get a rough mix of the NE business between lab, production and field instrumentation, if there's any kind of like rough buckets, just to kind of help us contextualize when we're seeing recovery in one element of the business versus the other, if there's just any directional guidance that we could have there.

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

A

I'll start and I'll turn it over to Henk. We've been working very hard over the last six years or so to reduce our dependency on the service provider field instruments. One of our very bright stars was really significant growth in lab and production. So it actually got to the point where it's a meaningful share of our revenue. That's the sharp pull back during the March quarter was great impact.

And I'll turn to Henk to provide some general guidance.

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

A

Thank you, Oleg. Yeah. Typically, the mix within NE is more than 50% field, a 55% or 45% what we call lab products, lab and production includes wireless components. In the March quarter, it was slightly different. It was closer to 60%, 40%. So that sort of speaks to the significance of the decline that we saw in that lab business as we've just discussed.

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

Q

Okay. Perfect. And then on the 3D sensing side, you guys noted just kind of some headwinds in fiscal Q4 on new phone model designs. I just – is there a change in content that we should be mindful of or it's just you don't know what model it is, so you just – they're not holding as much inventory of any filters.

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

A

Well, there is going to be obviously new model launched as well as the older models will stay. But even in the new and the old models, some of the modules are being redesigned and they're going to use the newer – even though the same size, but more a more advanced higher performance filter. So, all the contract manufacturers and OEMs that are trying to work down the existing inventory, which is not that big. But also they are transitioning to the new model year. So, of course, everybody wants to consume whatever they have on hand and then do a switchover. And, of course, as you know, the phone sales are down year-on-year. So combination of lower demand and a consumption of the – whatever inventory anybody has on hand is what's muting some of the volume.

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

Q

Okay, perfect. Thank you. I'll pass it on.

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

A

Sure.

Operator: There are no further questions at this time. I will turn the call back over to Sagar Hebbar, Head of Investor Relations.

Sagar Hebbar
Head-Investor Relations & Corporate FP&A, Viavi Solutions, Inc.

Thank you, Jean-Louis. This concludes our earnings call for today. Thank you, everyone.

Operator: This concludes today's conference. You may now disconnect.