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RSYS - Q2 2012 Radisys Corporation Earnings Conference Call

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CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

Michael Engellant *D.A. Davidson - Analyst*

PRESENTATION

Operator

Ladies and gentlemen thank you for standing by and welcome to the Radisys second quarter earnings conference call with Mike Dagenais, CEO of Radisys. As a reminder July 26, 2012, this call is being recorded. (Operator Instructions). Thank you, Mr. Dagenais, you may begin.

Mike Dagenais - *Radisys Corp. - CEO*

Good afternoon. And thank you for participating in our second quarter conference call. On this call, we will be discussing business highlights and financial results for the second quarter and our outlook for the third quarter of 2012. After the prepared material, we will open the call for questions. Participating in the call with me today are Allen Muhich, our Vice President of Finance, Brian Bronson, our President and CFO, and myself, Mike Dagenais CEO. Before we get started I would like to turn the call over to Allen for a caution about forward-looking statements.

Allen Muhich - *Radisys Corp. - VP-Finance*

Thanks Mike. Any statements in this call regarding future expectations for the business of Radisys constitute forward-looking statements that involve a number of risks and uncertainties. We caution you not to place undue reliance on these statements. Factors that could cause actual results to differ materially from those in the forward-looking statements are discussed in today's earning release and in our SEC filings most recently in our quarterly report on form 10Q for the quarter ended March 31st, 2012.

All information in this call is as of today. Radisys undertakes no duty to update any forward-looking statement to conform to actual results or changes in the company's expectations. In addition, during the call, we will discuss some non-GAAP measures. We have provided a GAAP to non-GAAP reconciliation for these measures in today's earnings release. Now I'll turn the call back over to Mike.

Mike Dagenais - *Radisys Corp. - CEO*

Thank you, Allen. I'd like to start by saying that this quarter has been good in terms of market validation of our vision and strategy. We continue to add new customers to our design win funnel and make strides establishing our market position. Having said that, we're not immune to some of the challenges facing the networking sector and that (inaudible) overall. But, we are holding our own and expect to weather this storm well. I'll speak more on this later.

Onto the numbers. Our second quarter non-GAAP revenue was $77.7 million, slightly below our expectations. Our non-GAAP EPS was $0.17, at the high end of the guidance. Our non-GAAP gross margin rate was over 37%, the highest rate in many, many years. The EPS and gross margin strengths were primarily results of our continuing efforts over the past several quarters to grow our margin ATCA and Software-Solutions revenue, while at the same time reducing our costs.

The combined ATCA and Software-Solutions revenue grew 60% when compared to last year's second quarter. Software-Solutions revenue for the first time in Radisys' history represented over 20% of our total revenue. Additionally, operating expenses were lower than our guidance primarily due to greater than planned synergies and general cost control.

Brian will speak to the Q2 results in more detail later, but first let me say a few words about what we're seeing in the market for both design wins as well as customer demand.

We had another good quarter, broad base design win quarter in the ATCA, Com Express, and [rack] mail server product alliance. We had 24 wins from 21 different customers, 9 of which were completely new to Radisys. The wins were across a broad spectrum of applications and geographies. North America and Asia Pacific were stronger than our immediate region.

In the Com Express we had very good wins in medical imaging, military communications, and photo radar. This provides us with some good balance to our traditional telecom customer base.

Within ATC we had several follow on projects with our new T-Series 40G products. This builds on the existing relationships we had several key customers. Most of these design wins are related to our customer's LTE product plans.

Looking specifically at design wins, in our first year as a combined company this brings our total design win count to 91, with 33 new customers and a future five-year value of over $300 million in revenue. We're very pleased with this performance and believe it's a strong indication of a customer's acceptance of our combined offering.

Shifting to our Software-Solutions business, our media server product had a particularly strong quarter with several of our existing customers deploying and launching new network nodes. The MPX-12000, our new ATCA based Multimedia Resource Function, or MRF, has been very well received by our customers since its launch at Mobile World Congress in February.

We're slated for lab evaluation in multiple tier one [tems] as well as carriers in the coming quarters. We're already in one of our service provider labs. We're very excited about the significant customer attraction we're seeing here. For validation of the MPX-12000 we were recently awarded by Internet Telephony and Next Gen Mobility Magazine the 2012 NGN Leadership Award.

Our new Trillium TOTALeNodeB product has also been very well received by both our customers and the overall industry. We are in the final stages of deployment readiness trials with two important customers and anticipate a positive decision this quarter with revenue starting before the end of the year. One of our European customers has already started deployment this past quarter.

From the industry, the TOTALeNodeB product was recognized in June and the Small Cell Forum Industry Awards held in London as the best enabling technology. We're pleased with this independent validation of our offering and we believe this truly enables our customers with time-to-market advantage as they bring their small cell solutions to market.

Now turning to customer demand. In Q2 we did a nice job closing out and meeting the profit objectives set at the beginning of the quarter. But similar to what many others have recently reported in the telecom and broader macro markets we are now seeing demand soften across many of our telecom customers in most of the geographies we serve. The customer forecasts that drove our prior second half ATCA and Software-Solutions growth expectations have either been deferred or delayed. We expect these decisions will now result in a sequential third quarter revenue decrease.

As I mentioned in the last quarter, we had begun to see demand softening from our largest customers in both ATCA and other of our legacy telecommunication products. This softening accelerated in the second quarter. Now in addition, we're also seeing reductions in near term growth projections from other ATCA customers and a general slowing in the rollout of LTE small cell deployments utilizing our LTE software, our Trillium software.

Now, finally our Media Server, which enjoyed as I said a very strong first half is expected to return to more normalized levels in the second half. As we have indicated before, this has been historically a fairly lumpy business.

With that, I will now turn over the call to Brian who will speak more about the second quarter financial results and projections for the third quarter.

Brian Bronson - *Radisys Corp. - President, CFO*

Thanks Mike. As Mike previously mentioned, our second quarter non-GAAP revenue was $77.7 million and our ATCA and Software-Solutions revenue rose to $52.6 million, or 68% of revenues, our highest percentage ever. We delivered non-GAAP EPS of $0.17.

Our top five customers in Q2 were Fujitsu, Lestina, NEC, Nokia Siemens Networks, and Philips Healthcare. Most of these customers have regularly bounced in and out of our top five. That being said, one you may be less familiar with is Lestina. Lestina is our Chinese distribution partner that helps us drive business in China. Our Q2 non-GAAP gross margin rate was over 37%, up six percentage points from the same quarter last year which is a direct result of the growth we are seeing in ATCA that typically carried gross margins in the 35% to 40% range, and Software-Solutions that can have gross margins upwards of 80%.

We are also making nice progress in driving cost out of the business. Second quarter spending was very well managed as we are seeing better than planned performance in integration synergy, as well as general cost controls.

There are a couple of additional one-time items in our GAAP results that I want to comment on. First, due to the macro economic softness we are expecting to see in the second half we will no longer be able to achieve in the timeline required our original annual EPS projection and therefore reversed out $2.4 million of performance-based stock compensation expense. Second, given the delays in small cell deployments, we've reversed $1.3 million of acquisition-related royalty earn-out. The liability balance at the end of Q2 is $6.6 million. And, finally, we recorded a $1.2 million one-time lease abandonment charge for the second floor of our unused manufacturing facility in Hillsboro, Oregon.

And, again, to reiterate, these items are excluded from our non-GAAP results. I should also note that effective with our second quarter results we have modified our method of calculating non-GAAP taxes. Non-GAAP taxes will now equal reported GAAP taxes, less any non-cash tax expense. The effect of this change is to eliminate the recognition of tax expense from profitable entities where we have long-lived deferred tax assets. We believe this reporting is more valuable to investors as it more closely represents the true economic impact of our tax positions.

We have included a schedule in our press release providing restated quarterly amounts for both 2011 and the first quarter of 2012 to aid in your understanding.

Switching over to the balance sheet. DSO remained at 57 days in the second quarter. Total inventory and associated inventory deposit balance stayed steady at $30.7 million. We're continuing to target inventory in the mid-20s by end of year despite the near-term slowdown in expected revenue. Our longer-term model has inventory below $20 million as we exit 2013.

On the cash front we generated $4.1 million of operating cash. When combined with the $2.3 million in capital expenditures largely tied to the integration, it resulted in a cash balance of approximately $46 million. Total cash generation of $2 million in Q2 was better than expected.

During the second quarter we also announced an exchange of $18 million of the $45 million of our convertible notes due in February 2013. These new notes are now due in February 2015. The new notes carry essentially the same terms as the old notes except the coupon rate which increased from 2.75% to 4.5%, and the conversion price which decreased from $13.03 to $8.53 per share. The remaining $27 million of the old notes will mature in February 2013 without a change in terms.

With these changes in mind, for fully diluted quarterly EPS calculations between now and February 2013 for net income above $3.3 million the interest add back is $466,000 and the diluted convertible shares is $4.2 million. After February 2013 for net income above $3 million, the interest add back is $213,000 and the diluted convertible shares is $2.1 million.

Now moving over to the third quarter outlook. We expect Q3 non-GAAP revenue between $66 million and $72 million. Much of the decrease from the second quarter is expected to come from our Software-Solutions products given the very strong Q2 Media Server performance and the remaining piece is our other legacy telecom revenue decline.

We expect third quarter non-GAAP gross margin to approximate 34%, representing a three percentage point decrease, again due primarily to product mix. Q3 non-GAAP R&D and SG&A expenses are expected to decrease by approximately $500,000 from the second quarter.

We have overachieved the initial expense energy targets for 2012 and are continually looking at our expense levels and identifying areas where we can realize greater efficiency. This approach will continue to aid us in the face of the softening we're now seeing.

Q3 non-operating expense is expected to be around $300,000. And we currently expect our third quarter non-GAAP taxes to approximate $200,000. We expect third quarter non-GAAP EPS to range from breakeven to $0.06. Our fully diluted shares will be around $29 million.

I currently expect that we'll generate about $1 million of cash in the third quarter. Capital expenditures underneath that will approximate $2.5 million, including about $1 million for our Shenzhen build out.

As you would expect, our Q4 visibility is limited. That said, we do expect the third quarter to represent the bottom and we anticipate showing modest sequential revenue growth in Q4. With that I'll hand the call over back to Mike. Thanks.

Mike Dagenais - *Radisys Corp. - CEO*

Thank you, Brian. As stated, we met the profit expectations set at the beginning of the quarter, but unfortunately the deterioration of the telecom market that we, and our customers, and the industry are reporting will prevent us from achieving our prior second half growth expectations. That said, we continue to maintain our leadership position and good design win momentum. We believe that both the ATCA and Software-Solutions' annual long-term market growth rate will be somewhere between 10% and 15%. The unique combination of both hardware and software technology, low cost development, flexible manufacturing partnerships, and our portfolio of design wins positions us exceptionally well to capture this growth when the markets return to a more normalized level.

The fundamental market driver of mobile consumer bandwidth demand has not changed. But carriers will have to meet the ever-expanding capacity requirements and will need to build out their respective LTE network infrastructure and service capabilities.

When these short-term market conditions improve, Radisys will be ready. With that, we are ready to open the lines for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). And at this time there are no questions. Actually, we do have a question that has come through from the line of Aalok Shah with D.A. Davidson.

Michael Engellant - *D.A. Davidson - Analyst*

Hi guys. This is actually Mike Engellant sitting in for Aalok Shah. Just a couple quick questions for you guys. Any update on the full year number?

Mike Dagenais - *Radisys Corp. - CEO*

At this time we're not providing any update on the full year number. We do believe that Q4 will be an increase over Q3. But in this environment it's very difficult to make those projections.

Michael Engellant - *D.A. Davidson - Analyst*

And that increase in Q4, would that be based on design wins at all? Or is that just kind of thinking that macro will improve?

Mike Dagenais - *Radisys Corp. - CEO*

Actually, we have some design wins basically from '11 and early '12 that are going to see some material increase, so some customer diversity and some additional deployments. As I said, I think we're approaching some deployment on our small cell. We expect to see some uptick there. We're not counting on a big change and we cannot plan on a big change in the macroeconomics happening at this time.

Michael Engellant - *D.A. Davidson - Analyst*

Okay. That makes sense. Can you tell me what the percentage Nokia Siemens was of revenue?

Brian Bronson - *Radisys Corp. - President, CFO*

20%.

Michael Engellant - *D.A. Davidson - Analyst*

20%? Perfect. And then you guys talked about it a little bit, but on the Media Server side, you know, design wins, etc. improving. Just talk about that a little further forward, like what you're seeing there. Is most of the weakness then just based on macro there?

Mike Dagenais - *Radisys Corp. - CEO*

So on the Media Server side of the business actually the revenue we got in the second quarter was from existing customers that have bought the product in past years and are just adding new nodes.

What I really find exciting about the Media Server business though is that with the launch of the new product, the excitement it has generated in the market, especially among the tier one equipment providers, as well as the service providers, I think there's a tremendous amount of forward looking optimism with that product. I'm really excited about that right now, especially with the traction we're getting and the fact that we are now already into labs, and anticipate to get into actual trial deployments by the second half of this year.

Materially, though, I don't see much revenue from that new product launch till 2013.

Michael Engellant - *D.A. Davidson - Analyst*

Okay. And then on LTE you said you are seeing a little weakness just based on macro, but long-term how has the demand been?

Mike Dagenais - *Radisys Corp. - CEO*

Well, we're continuing to win a lot of design wins in the LTE area. LTE will happen. Right now I think we're going through a little period of time where people are delaying their decisions. You've seen it with some of the major equipment providers that have announced recently or guided recently. There is some softness there and we sell to these folks. But, nothing has changed from the demand side, from a consumer demand side, from a device side.

It will come. I just -- right now there is some uncertainty and I just can't identify the exact order in which it's going to hit. I mean, we're seeing some deployments, but some carriers have decided to slow their investment at this time.

Michael Engellant - *D.A. Davidson - Analyst*

Okay.

Brian Bronson - *Radisys Corp. - President, CFO*

Yes. And just to punctuate, these 90 design wins and over $300 million in revenue, a good chunk of that is LTE.

Michael Engellant - *D.A. Davidson - Analyst*

Okay. Got it. Perfect. Well, that's all I got for you guys. Thank you for the questions.

Mike Dagenais - *Radisys Corp. - CEO*

All right. Thank you, Michael.

Operator

(Operator Instructions). And at this time there are no further questions. Mr. Dagenais, are there any closing remarks?

Mike Dagenais - *Radisys Corp. - CEO*

All right. Well, thank you, Holly. In closing, we remain pretty confident that our strategy is right and that we're well-positioned to capture the long-term growth in the market, the telecom market, especially as LTE rolls out.

I believe Radisys will enjoy the benefits of our reduced cost structure and our -- sorry -- will enjoy the benefits of our reduced and more efficient cost structure, and deliver consistent earnings and expectations to our shareholders. With that, I want to say thank you for your support and I look forward to speaking to you throughout the quarter.

Operator

Thank you. This does conclude today's second quarter earnings conference call. You may now disconnect.
