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Sonus Networks, Inc. (SONS)

Q2 2016 Earnings Call

CORPORATE PARTICIPANTS

Susan M. Villare
Chief Financial Officer (Interim)

Raymond P. Dolan
President, Chief Executive Officer & Director

OTHER PARTICIPANTS

Jess Lubert
Wells Fargo Securities LLC

Mark D. Kelleher
D. A. Davidson & Co.

Greg Mesniaeff
Drexel Hamilton LLC

Dmitry G. Netis
William Blair & Co. LLC

Mike J. Latimore
Northland Securities, Inc.

Ryan Hutchinson
Guggenheim Securities LLC

MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. Welcome to the Second Quarter 2016 Conference Call. During the presentation, all participants are in a listen-only mode. Afterwards, we'll conduct a question-and-answer session. [Operator Instructions] As a reminder, this conference is being recorded Wednesday, July 27, 2016.

I would now like to turn the conference over to Susan Villare. Please go ahead.

Susan M. Villare
Chief Financial Officer (Interim)

Good morning. Welcome to Sonus Networks' second quarter 2016 financial results conference call.

Today's press release and supplementary data have been posted to our IR website at sonus.net and submitted to the SEC. A recording of this call and the transcript will be available on our IR website shortly after the call. During our prepared remarks, we will be referring to a presentation with supporting information. Please take a moment to locate these documents on our IR website.

As shown on slide two, please note that during this call, we will be making forward-looking statements regarding items such as future market opportunities and the company's financial outlook. Actual events or financial results may differ materially from these forward-looking statements and are subject to various risks and uncertainties including, but without limitation, economic conditions, market acceptance of our product and services, the timing of customer purchasing decisions, and revenue recognition, difficulties leveraging market opportunities and the impact of cost containment efforts.

A discussion of these and other factors that may affect our future results is contained in our most recent Form 10-Q filed with the SEC and in today's earnings release, both of which are available on our website. While we may elect to update or revise forward-looking statements at some point, we specifically disclaim any obligation to do so.

During our call, we will be referring to certain GAAP and non-GAAP financial measures. A reconciliation of the non-GAAP to comparable GAAP financial measures is included in our press release issued today.

With that, it is my pleasure to turn it over to the President and Chief Executive Officer of Sonus, Ray Dolan.

Raymond P. Dolan

President, Chief Executive Officer & Director

Thank you, Susan and greetings to everyone on today's call. Before I comment on the second quarter results and our outlook, I'd like to take a moment to personally introduce Susan Villare. Susan's been with Sonus for more than four years and has been instrumental in leading various departments within finance during that time. She's done a terrific job and was recently appointed to the role of Interim-CFO.

In the upcoming months, we'll have the opportunity to participate together in various Investor Conferences, and those attending will have the opportunity to meet Susan. Specifically, we'll be attending the Oppenheimer Technology Conference on August 9 in Boston, the Drexel Hamilton TMT Conference in September in New York, and the Wells Fargo TMT Conference in November in New York.

Now let's move to slide four, and you'll see that we had another very solid quarter as our performance exceeded guidance in every major operating metric. Continued progress on bookings led to improved revenue and gross margin performance. Strong focus on expense controls drove growth in our earnings and generated positive cash flow. I'm very pleased with the team's progress to-date in 2016. We delivered solid earnings, while continuing to invest in technology that leads our industry's transition to the emerging software-based cloud architecture. I'll talk more about our strategic customer engagements later on the call.

Moving to slides five and six, we've laid out our historical past 10 quarters of financial performance both on a GAAP and in non-GAAP basis. The chart shows continued momentum since our first-half 2015 setback. Over the last year, we have rewired Sonus to be a more profitable company through continued gross margin expansion and disciplined OpEx controls.

I'm pleased to announce that we are increasing our full-year non-GAAP EPS guidance to a range of $0.35 to $0.39. The efforts we've taken to control our expenses are paying off, even though we continue to invest approximately 25% of our total revenue in R&D. We expect this level of investment to continue, reflecting our commitment to our customers to lead them through the challenges of moving to the cloud.

Our recent expense control efforts include the streamlining of our leadership team as well as the recent reduction from 10 to seven independent members of our board of directors. Furthermore, the process improvements we've made over the past several years have allowed us to continue to reduce our G&A expenses. We've made all these changes, while maintaining our commitment to R&D spending in critical areas.

Additionally, today we're announcing a restructuring program to further accelerate our investment in new technologies, as the communication industry migrates to cloud-based architecture. We expect to record between $3 million and $4 million of restructuring expense over the next 12 months in connection with this action, resulting in an expected annual savings of approximately $6 million to $8 million.

We plan to utilize the entire savings to invest in new strategic initiatives, such as new products, expanded go-to-market footprint in selected geographies, and discrete vertical markets. We'll provide additional information regarding this program when we report our third quarter results.

I'm also proud to report that when I meet with customers, I consistently get feedback that our product and software quality is strong, that our roadmap is more competitive than ever, and it is fully aligned with our customers' growth strategies. We aren't finished. We'll continue to drive our cost lower in parts of our business allowing for even greater investments in other areas such as cloud and security. We plan to do this while delivering strong bottom line performance. I'll provide some further updates regarding our customers after Susan reports the details of our Q2 financial performance as well as our guidance for the full-year.

For now, I'll turn it over to her. Susan?

Susan M. Villare
Chief Financial Officer (Interim)

Thank you, Ray. As a reminder, gross margin, operating expense, operating income, net income and loss per share are all discussed on a non-GAAP basis and have been reconciled for you at the end of today's press release and presentation.

Let's move to slide eight for a closer look at our second quarter of 2016 non-GAAP financial results. Total revenue was $60.9 million, which slightly exceeded our guidance. Second quarter product revenue was $35.4 million, representing an increase of $8.3 million as compared to the second quarter of last year.

Total service revenue was $25.5 million in the second quarter of 2016 versus $27.7 million in the comparable prior-year period. We continued to strengthen and deepen our customer relationships and we had two greater than 10% customers in our second quarter of 2016, namely AT&T and Verizon. These accounted for approximately 29% of our total revenue.

We continue to have a strong pipeline and another solid book-to-bill ratio in the second quarter of 2016. Our top five customers represented 46% of total revenues per each of the first quarter and the second quarter of 2016, this compares to 40% in the second quarter of 2015.

Second quarter 2016 non-GAAP gross margin was 69.2%, which was 70 basis points above our guidance and 330 basis points better than a year-ago. The year-over-year improvement was primarily due to higher product revenue as well as strong margin performance and contribution from our flagship 7000 product that we launched in Q2 of 2014.

Non-GAAP operating expenses were $37.8 million, as compared to our guidance of $38 million to $39 million. Non-GAAP operating expenses decreased by $3.1 million this quarter versus a year-ago due to our 2015 cost reduction efforts.

Our head count has remained at approximately 1,050 employees for the past three quarters. Our second quarter of 2016 represents Sonus' fourth consecutive quarter of non-GAAP profitability. Our reported second quarter of 2016's non-GAAP diluted earnings per share was $0.08. This compares to our guidance of $0.03 to $0.04. The outperformance was due to higher revenue at favorable gross margins, this is coupled with continued cost containment efforts. This compares to a non-GAAP loss per share of $0.10 that we've reported in our second quarter of 2015.

Our balance sheet is much stronger than it was a year-ago. Cash and investments increased by $29.2 million at the end of our second quarter of 2016, as compared to our second quarter of 2015. We generated $43.4 million of cash from operations for the trailing 12 months. This allowed us to repurchase 6.8 million of our common stock over the same period of time.

At the end of our second quarter of 2016, we have approximately $10 million that remains available under our previously approved stock buyback program. Cash and investments totaled $142.7 million at the end of our second quarter of 2016 compared to $142.4 million at the end of our first quarter of 2016. Days sales outstanding remain solid and was 54 days in the second quarter of 2016. This compares to 52 days in our first quarter of 2016 and 80 days in our second quarter of 2015.

Let's now turn to slide nine for our guidance. Starting with our third quarter 2016 guidance, we expect revenues to be between $63 million and $65 million. Non-GAAP gross margin is projected to be in the range of 68% to 68.5%. Non-GAAP operating expenses are expected to be between $38.5 million to $39.5 million. The modest projected increase in our non-GAAP operating expenses from the $37.8 million we reported in our second quarter of 2016 is due primarily to higher projected incentive compensation and commissions, as well as some strategic hiring in certain areas of our business. Q3 2016 fully diluted non-GAAP earnings per share is expected to be between $0.08 and $0.09, and this is based on 50 million diluted shares outstanding.

Now let's look at our full-year 2016 outlook. We expect full-year revenue to be in the range of $257 million to $263 million. We continue to expect improvement in our gross margins, primarily as a result of higher revenue volumes, better projected utilization within our service organizations, and favorable product mix.

We are focused on continued control of our operating expenses, which has allowed us to increase our non-GAAP annual diluted earnings per share guidance to be between $0.35 and $0.39 based upon 50 million diluted shares outstanding. This compares to our prior outlook, which called for diluted earnings per share of $0.27 to $0.34, which we provided on our April 27, earnings call.

So with that, I'd like to turn it back over to Ray for his closing remarks.

Raymond P. Dolan

President, Chief Executive Officer & Director

Thanks, Susan. Now, I'll offer some additional comments regarding our strategic customer engagements before opening the line for your questions. As you know, Sonus has been investing in technology for many years, with the main focus of the past five years being the shift from what was the industry's leading gateway architecture to the software-based cloud architecture of the future. That meant porting our SBC policy and signaling assets to software, developing a complete feature set to the access edge, and more recently moving up the stack to unified security and address APIs beyond SIP to include WebRTC and soon others.

Those investments are paying off in key customer engagements. We've seen several large RFP opportunities in last year, with more in progress. Some of these RFPs are triggered by increasing frustration with current suppliers. Some are just time to look at a broader set of suppliers at this critical time, where most service providers and enterprises are shifting to a cloud-based architecture.

Others are driven by market forces like the emergence of SIP trunking in Japan or the deregulation of certain markets in CALA. We believe we're well positioned to leverage years of investment we've made towards software-based cloud-centric end-to-end architectures. These opportunities, to the extent we win them, will likely be multi-year rollouts. As such, they will be challenging to predict exactly when they will be recognized as revenue. We look forward, however, to sharing our progress with you on these exciting opportunities in the future.

At this time, I'd like to open the line for questions. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of Jess Lubert, Wells Fargo. Please proceed with your question.

Jess Lubert
Wells Fargo Securities LLC

Q

Hi, guys, good morning.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Good morning, Jess.

Susan M. Villare
Chief Financial Officer (Interim)

A

Morning.

Jess Lubert
Wells Fargo Securities LLC

Q

First just a housekeeping question. Can you give us the split of growth versus legacy and service provider versus enterprise? I didn't see that in the supplementals.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah, Jess, we're not going to break out growth and legacy. Do you have the service provider to 80/20, is it?

Susan M. Villare
Chief Financial Officer (Interim)

A

Yes, the service provider split...

Raymond P. Dolan
President, Chief Executive Officer & Director

A

It was 20% enterprise, right?

Susan M. Villare
Chief Financial Officer (Interim)

A

Correct. Yeah. It was 20% enterprise compared to 18% in Q1.

Jess Lubert
Wells Fargo Securities LLC

Q

Okay. Thank you. And then your guidance for the year seems to imply a higher than usual weighting towards Q4. So, I guess, I was just hoping you could help us understand what's driving your confidence we're likely to see better than seasonal year-end trends, given the uncertainty in the global macro backdrop. Were there some big deals there? What's kind of giving you confidence that Q4's likely to be end up being a pretty strong quarter?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

So, Jess, this is Ray. We do have some good visibility into the second-half of the year, but I don't know that the math proves then that this will be a higher than average seasonal Q4. I think actually we've had a stronger first-half as a percentage of total year than we've had in prior-years.

And frankly, if Q3 comes in a little stronger and Q4 comes in a little lighter, the way I look at it is, it's the entire second-half – and I think the entire second-half at about [ph] 140 (16:30) is about the right way to call our trajectory right now. So, if the split came in a little lower or higher in Q3, Q4, it wouldn't bother me. It's more the focus on winning some major roadmaps that drive like kind of the next-generation of change in some very large telcos and enterprises, and that's where our principal focus is.

Jess Lubert
Wells Fargo Securities LLC

Q

And then Ray, you mentioned a plan to more aggressively invest in new technologies. I was hoping you might be able to help us understand what some of those areas might be, where these markets are today, and over what timeframe you think some of these investments could begin to bear fruit?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Sure, Jess, thanks. So, first, it's the virtualization of what we have, the virtualization of our policy [indiscernible] (17:16) SBC signaling assets and then getting from the core strength that we had in interconnect down to the access edge, so that we can play more in VoLTE beyond just interconnect. All of those are areas that for us just represent pure growth opportunities, but then reorganizing that stack, so that a, the SBC can play its natural role as a real-time firewall, and as it exists in the software and since can start to participate at the security layer, which I've said on prior calls ultimately will become the orchestration layer of the cloud, I'm convinced of that.

And frankly, from the standpoint of timing that transition, it's very difficult to do. It's probably at least a few years out, because right now the Internet is an end-to-end – I'm sorry – a half-to-half kind of architecture, which is a fundamental challenge to an end-to-end architecture for security. So, voice runs on an end-to-end basis, a lot of other real-time call flows run on an end-to-end basis, but the majority of the data plan runs a half-to-half basis. So, there's a lot of architectural debate that will happen in the industry. The current firewall architecture on the data side, the real-time firewall side, is kind of a local application.

And so, that's where we're moving, and as we move up the stack into security, the SBC's already a security device. It's just never been called a firewall. It terminates traffic on a back-to-back user agent basis, so it's a very powerful tool for us to engage in that industry debate.

Now, as we do that, we'll block and tackle in the gateway business. We'll block and tackle in the SBC and policy business. We'll go after service providers, enterprises and emerging cloud players, but the ultimate trajectory that we're investing towards is the unified security plan that orchestrates basically all bandwidth in the future. So, I hope that's helpful, but it's very difficult to call the specific timing of that transition.

Jess Lubert
Wells Fargo Securities LLC

Q

And Ray, can you tell us what percentage of the portfolio is virtual today, and perhaps what percentage of revenue is virtual today?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah, almost the entire portfolio is virtual today. The gateway really doesn't have a lot of value to virtualize, and the 1000, 2000 is kind of a hybrid, because on the edge of small enterprise networks have a lot of TDM content that's not virtualizable, it's not economically virtualizable. But at the same time, we've created the virtual version of our 1000, 2000 for the link environment. And so, from a virtual CPE at the end of a SIP trunk, we're starting to see some very nice traction in that marketplace.

But now when you say what's the percentage of revenue that's going virtual; on a stand-alone virtual basis without being deployed on our hardware, it's a very, very low percentage, Jess. The majority of customers, and I've said this many times in the past, so I'll just repeat it here, the majority of the customers want to know that we've got a path to virtualization of all network functions, that we've got an SDN story. And at the same time, since it's such a complex transition, they're buying I think from almost all vendors their current hardware instances as they rethink how to reorganize the stack. So, I hope that's helpful from your point of view.

Jess Lubert
Wells Fargo Securities LLC

Q

Thanks guys.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Thank you.

Operator: Our next question comes from the line of Mark Kelleher with D. A. Davidson. Please proceed with your question.

Mark D. Kelleher
D. A. Davidson & Co.

Q

Great. Thanks for taking the questions. Congratulations on a nice quarter.

Susan M. Villare
Chief Financial Officer (Interim)

A

Thank you.

Mark D. Kelleher
D. A. Davidson & Co.

Q

The operating margin improvements have been really significant. Where do you think you can drive that longer term? I saw you got some nice leverage on sales and marketing. Where do you think you can take your operating margins? What's your goal?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

So, Mark, this is Ray. Short-term, our goal is to get into double-digits. I don't want to put a long-term goal out there yet, because I just want to make sure we walk before we run. I do believe that historically, this goes back for 15 years. Sonus had established a gateway architecture that was the de facto standard, but didn't have enough gross margin to drive operating income.

So, we've worked very hard over the last five years to drive our gross margins hard enough through redesign of hardware architectures to get [ph] all the Sun (21:43) servers out of our architecture there, and to make sure that our new products had the kind of gross margins that we had a shot of getting operating income.

We've got some work to do further on OpEx and we're going to do that over the next 12 months. And I think we've got line of sight to a 10% operating income for the company. And I don't want to call the timing on it and imply any guidance. But that's our short-term interim goal.

Beyond that, I don't see any reason why we can't drive harder. And as the cloud architecture emerges and it becomes more software-centric, that continued improvements in gross margin can't fall to the bottom line and continue to strengthen our operating income.

Mark D. Kelleher
D. A. Davidson & Co.

Q

All right. If I can slip the second question in. Was there any change in the competitive situation during the quarter? Any change to the competition...

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah, I don't see that there has been any material change in the competitive position. We've seen the continued erosion of a couple of industry leaders as we continue to stay focused and others take their eye off the ball. And some very long arduous RFP processes are starting to work their way through the pipeline. I tried to imply that in my commentary. It's hard to call the ball on exactly when those will show up in revenue. But, I like our odds of securing some very large footprints over the next six months to 12 months and playing those out over the next three years to four years.

Mark D. Kelleher
D. A. Davidson & Co.

Q

Okay. Great. Thanks.

Susan M. Villare
Chief Financial Officer (Interim)

A

Thank you.

Operator: Our next question comes from the line of Greg Mesniaeff with Drexel Hamilton. Please proceed with your question.

Greg Mesniaeff
Drexel Hamilton LLC

Q

Thank you. Good morning. Hey, Ray.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Hi, Greg.

Greg Mesniaeff
Drexel Hamilton LLC

Q

Hi. I have a question on the enterprise part of the product business that you just said was about 20% of total sales versus 18% in the prior quarter. That number continues to be relatively not high vis-à-vis the carrier business. How do you see that playing out going forward? I mean, do you really see you guys still being primarily a carrier-centric supplier and not really focusing primarily on the enterprise base? Or do you see that changing over time? I'll just leave it at that. Thanks.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah. Thanks, Greg. I do think 80/20's a pretty reasonable mix. If it went to 75/25, I'd probably be even more pleased. But I doubt it will get much more material in our footprint than that because we do have some very, very strong product offerings to the service provider community. And I expect that spend pattern to continue and become even more favorable to us.

So, as we grow the business, I'd say 80/20 to 75/25 would be a reasonable mix. It really depends on the quality of that enterprise spend, and we're getting some nice design wins, particularly in the financial vertical where we've had some in the past, starting to broaden our reach on the enterprise side. And they start to act – even they start to act like mini service providers.

And it really depends on the trend as to how the cloud plays out. If these enterprises look to the service provider to run either hybrid clouds or private clouds for them or if they decide to run their own cloud architectures off of native Internet access, that's probably going to be the bigger picture as to how that plays out. But, I'd say 80/20, 75/25 is a good ballpark.

Greg Mesniaeff
Drexel Hamilton LLC

Q

Got you. Thank you.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Sure.

Operator: Our next question comes from the line of Dmitry Netis with William Blair. Please proceed with your question.

Dmitry G. Netis
William Blair & Co. LLC

Q

Great. Thank you. Good morning, guys.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Good morning.

Susan M. Villare
Chief Financial Officer (Interim)

A

Morning.

Dmitry G. Netis
William Blair & Co. LLC

Q

So, a couple of questions. First on the restructuring. Just wanted to understand what's the baseline, is that July 1 and is it the savings that you potentially had identified here, $6 million to $7 million, is that going to flow through the next 12 months? And if so, I think I've heard you said, that you will utilize most of those savings and reinvest them back in the business. So, should we not then expect any incremental kind of EPS due to flow from that restructuring plan? Come 2017 timeframe or literally for the next 12 months, I guess.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah, Dmitry, thanks for your question. Yeah, you can consider the baseline chronologically to probably be to July 1. And second, I think you're right, and in fact that's what I was trying to imply in my upfront comment is that we will use that savings to continue to invest and create some open more to our leadership in the new cloud architecture as the second layer and continue our investment in security. As we move beyond just real-time call flows in the real-time firewall into trying to drive a new architecture for people to scale security better.

Right now, the spend on security is the only one that's going basically up exponentially and you're eventually going to have a network that you can't afford, because you've spent so much money securing it. It needs to come down the stack and become part of SDN. And that's where we're going to spend our money.

All right, so from an EPS leverage point of view, we'll continue to be disciplined on the old side of the business and on all of G&A and other parts of the business. But, we're going to spend these savings in R&D and continue to invest for our customers.

Dmitry G. Netis
William Blair & Co. LLC

Q

Okay. That probably explains why you're guiding up only $0.06 for the full-year versus the prior guidance. Given the $0.05 beat that you posted this quarter. So, there's only about a penny of upside there from maybe OpEx improvement for the year, for this current year we're in. Okay, just wanted to sort of get a sense of that. Cool.

My next question would be on the service revenue side, I think you showed pretty much, most of the upside was the service revenue of about $1 million. I wanted to get your expectation on the service line going into the second-half. Will that drop in Q3 commensurate with your guidance? And what should we expect out of the service line in terms of the growth profile there?

Raymond P. Dolan
President, Chief Executive Officer & Director
A

Yeah, I don't see that dropping. It's probably going to be flat to modestly up, Dmitry, because sometimes the PS line is just a million or two million heavier than the product line and sometimes it reverses out. So, I don't think of it as a material driver up or down to our revenue outlook in Q3/Q4.

Dmitry G. Netis
William Blair & Co. LLC
Q

Okay. Great. Thanks. And maybe last one, if I could squeeze. On the two customers you printed – that you said were 10% less customers. Can you tell us a little bit about what the strength there was all about? Was it the migration to 7000? Was it maybe a project-related spend? Can you give us a sense whether this was maybe VoLTE versus potentially enterprise service related uptick? Any kind of color or transparency into the two projects with the two major customers would be helpful.

Raymond P. Dolan
President, Chief Executive Officer & Director
A

Yeah. The two major customers were AT&T and Verizon. And in both cases these customers have been long-standing customers and there were growth components in there as well as the continuation of their existing networks.

I'm actually very excited about both of those customers as well as a number of other large customers that are either out for bid now or will be out for bid again in the future and are giving Sonus an opportunity to really look at a bigger piece of the network than we've been able to look at before.

Again, we've been a gateway company. We've been a SIP interconnect company. We've been a little bit at the access edge, but as we've continued to invest and we've virtualized everything we've done, we now have, I think, a reasonable chance of doing more VoLTE work in 2017, 2018 in a number of accounts. And VoLTE is actually now starting to pick up nicely.

When folks initially asked that question in 2011, 2012, 2013, there was so much buzz about VoLTE driving session layer, architectures in a number of environments, and we kind of pushed back saying, we think it's probably more 2014, 2015, 2016. It is actually starting to happen now. People are bending the curve a little bit, and then I think it's going to accelerate into 2017 and 2018. And there is some nature of that in those customers, as well as other customers around the world.

Dmitry G. Netis
William Blair & Co. LLC
Q

Do you think the concentration with those two customers; AT&T and Verizon, will stay pretty much the same in the second-half, or will it change?

Raymond P. Dolan
President, Chief Executive Officer & Director
A

I can't project their specific customers, but they're project-related, so they could easily drop out of the third quarter and fourth quarter and reemerge in 2017 in larger size. So, we're just going to follow their lead and drive as hard as we can to capture their projects and deliver against them. So, I can't commit to a presence of either of those two accounts in our top 10, or 10% customer list on any given quarter, but I do think that both of them are going to be very healthy customers for us going forward.

Dmitry G. Netis
William Blair & Co. LLC — Q

Got it. All right. Thank you very much. Keep up the good work, guys. Thank you.

Raymond P. Dolan
President, Chief Executive Officer & Director — A

Thanks, Dmitry.

Susan M. Villare
Chief Financial Officer (Interim) — A

Thank you.

Operator: Our next question comes from the line of Mike Latimore with Northland Capital Markets. Please proceed with your question.

Mike J. Latimore
Northland Securities, Inc. — Q

Hi, thanks. Yeah, very good quarter. In terms of the – I don't know – next, say, 12 months opportunity, and I guess including some of these RFPs, peering interconnect, does that continue to be sort of the main driver here or biggest percent of the mix, or how should we think about that particular application?

Raymond P. Dolan
President, Chief Executive Officer & Director — A

Yeah, Mike, it's Ray. Yes, that application's so powerful that just the growth off of existing project is going to help form the foundation of some of our results for the three quarters to six quarters. Second, it's going to broaden into other geographies. There's an NNI project in most of large carriers in Japan.

As SIP trunking becomes more pervasive in Asia-Pac, you're going to see much more IP to IP interconnect in those markets, so it's going to drive growth over the next 12 months to 24 months as well, but then there will be more drivers of access type of opportunities for us that start to fill in and hopefully drive some greater growth than what we've been able to deliver in our outlook for this year, which is low to mid-single-digit growth as we stabilize the company and build for the future.

Mike J. Latimore
Northland Securities, Inc. — Q

And when you talk about more VoLTE opportunity over time, is that also largely peering, or are there some access opportunities there?

Raymond P. Dolan
President, Chief Executive Officer & Director — A

Well, I think it will probably start with peering and broaden into access. And then ultimately, VoLTE will converge with Voice-over-WiFi, and you'll have voice over all radio modalities. And a lot of our core technologies will resonate more and more as radio technologies kind of fade into hodgepodge of Ethernet. I believe there's going to be a renaissance of the core technology, which is going to play to our strength in the out years of 2017, 2018, 2019.

Mike J. Latimore
Northland Securities, Inc.

Q

And you're not breaking out growth versus legacy, but in terms of the growth segments you're in, what's your latest view on market growth rate, let's say, for the growth segments? Is it a 20% growth arena? 10% to 15%? How do you think about kind of the growth segment here? What kind of market growth rates are you looking at?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah, about 20% is probably a good number for a market-based growth number, Mike. On any given quarter that could be choppy.

Mike J. Latimore
Northland Securities, Inc.

Q

Okay. And then service, it sounds like relatively stable – in the second-half versus first-half. I mean, long-term, is that kind of a stable line or does that start growing at some point?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Yeah, I think it's a stable line right now, and I think there's probably an even amount of upside build and downside pressure, because we do have a substantial amount that's affiliated with some of our legacy products that could run off at a gradual rate.

And it's probably going to be – any risk there is abated by the fact that our growth trajectory over the last several years has started to build a nice backlog of maintenance for the growth side. So, I'd call that flat for now to be conservative; and if we have any upside, it will just add to our EPS trend.

Mike J. Latimore
Northland Securities, Inc.

Q

And last, you said the book-to-bill was solid, does that mean it was over one?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

It was close. On the first-half basis, we were over one.

Mike J. Latimore
Northland Securities, Inc.

Q

Okay. Thank you.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Sure.

Susan M. Villare
Chief Financial Officer (Interim)
A

Thanks, Mike.

Operator: Our next question comes from the line of Ryan Hutchinson with Guggenheim. Please proceed with your question.

Ryan Hutchinson
Guggenheim Securities LLC
Q

Hey, good morning. So first off, just on gross margins, how do we think about these longer term, Ray? Obviously, you outperformed this quarter and you're guiding down a little bit, but given the potential change in the business and the outperformance over the last few quarters, how should we think about that?

Raymond P. Dolan
President, Chief Executive Officer & Director
A

Yeah, Hutch, thanks for the question. So first of all, in Q3, we've already booked a small – it's not small project. It's a modest size project at the federal government level that is a little bit lower than our average margin, so I think that it probably has like a 50 basis points drag on our margin, and that's why we guided there. I don't see it being material long-term impact on our margin expansion program.

Second, I think we'll end the year somewhere close to 70 basis points. Certainly, 69 basis points to 70 basis points, and we may have some upside opportunity there, we don't know. It's too soon to call. And that – if we do that, we'll generate about 150 basis points improvement year-over-year. My goal would be to lead the team and make sure that the bottoms up forecast call for, say, another 100 basis points to 200 basis points margin expansion.

Certainly as the move to software continues, as some of our initial sales, which were high razors, low blades, if you will, if you spare me that analogy, continues, as we sell more software content than to existing installs and if the industry moves towards software, those are all favorable to our margin expansion. So, I'm hoping that we can be in the low-70%s within a year or two.

Ryan Hutchinson
Guggenheim Securities LLC
Q

Okay.

Raymond P. Dolan
President, Chief Executive Officer & Director
A

And that's probably where the industry will stay. I think the initial outcome of the industry being at, say, 80% margins might have been a bit of an anomaly with a single horse leading the industry for a long, protracted period of time. I'm not sure that's sustainable, but someplace in the low-70% probably is. Is that helpful, Hutch?

Ryan Hutchinson
Guggenheim Securities LLC
Q

Yeah, that is, yeah. And then you alluded to some RFPs that could translate into some bigger opportunities, so I just want to get a sense of your dialog with service provider customers relative to last year and two years ago when spending was challenged. Obviously, it sounds better, but just any comments would be helpful there.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Sure. So, I'm not sure that – so our dialog with large service providers – and I'd say both telcos and cablecos is definitely better. Whether or not that reflects their total CapEx spending being better or not is hard for me to call, because we're relatively small footprint in these players, but our product suite has dramatically improved over the last, say, 36 months. Our ability to drive towards virtualization is now proven and tested in almost all of their labs, and I think it's fair to say, as I commented up front, that I'm getting very good feedback there.

Second, we scale better, and people are starting to drive to a scalable cloud architecture. The fact that we can drive towards a security discussion I think people find compelling, although they also find it a little bit confusing and people are trying to work their way through that. And other players have started to stumble, so it gives us an opportunity to leverage the work we've done on our access edge features and become more of an end-to-end company than a core company.

So for all those reasons, Hutch, I like the tone of our discussions with the majority of large North American telcos. Certainly a number in Asia-Pac. Certainly a few in CALA, and a selected number in EMEA. So, I'm getting increasingly confident that the work that we've done over the last three years, four years is really – it really does matter to these large spenders. This is exactly why I want to pick up the pace, go through another modest restructuring. If you just give it a shirt size, it's probably 3% to 5% of our total OpEx spend. It's not a huge number, but it's another drive towards efficiency on the old side, so that we can double down on the new side and create some open water there.

Ryan Hutchinson
Guggenheim Securities LLC

Q

Great. Thanks. Appreciate it.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Sure. Thank you.

Susan M. Villare
Chief Financial Officer (Interim)

A

Thank you.

Operator: Our last question comes from the line of [ph] Fahad Najam with Cowen and Company (39:50). Please proceed with your question.

Q

Hi. I had a couple of questions. One, can you comment on the linearity that you saw in the quarter against the backdrop of Brexit. Any meaningful impact you noticed?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

No. We didn't notice any Brexit impact. And our linearity in this quarter was solid and if you look at our DSOs, it was virtually flat quarter-over-quarter.

Q

All right. And then the second question I had was related to customer concentration. If I look at your top five customers, they almost now account for 46% or greater revenue. How should we be thinking about customer concentration? It seems you're trending towards a highly concentrated customer base. Can you comment on the customer concentration going forward and how do you see that trending?

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Sure. So, on a quarter-to-quarter basis, our concentration probably is in the mid-40%s. If you annualize that though, it's lower because different customers cycle through those top five names on a quarter-to-quarter basis. And it spreads out that distribution and our top five customers on an annualized basis drops by at least 100 basis points – or 10%. So, I'm comfortable that that concentration is probably right. Remember, we are 75% to 80% service provider centric and that's a highly concentrated large spend in North America's hit market at this point in time.

Q

Got it. Thank you.

Raymond P. Dolan
President, Chief Executive Officer & Director

A

Sure.

Operator: Ladies and gentlemen, we have no further questions from the phone lines at this time.

Raymond P. Dolan
President, Chief Executive Officer & Director

Okay. Thank you very much. Thanks to everybody that was on the call. Appreciate your questions and your interest in Sonus and your support throughout the year, as we look forward to meeting you in the market at various conferences. And we'll be back on the line in 90 days. Thanks, folks. Have a great day.

Susan M. Villare
Chief Financial Officer (Interim)

Thank you.

Operator: Ladies and gentlemen, that does conclude today's conference call. We thank you for your participation and ask that you please disconnect your lines.