Ceragon Networks Q2 2022 Earnings Conference Call Script

August 1, 2022 – FINAL

Operator

Welcome to Ceragon Networks Second Quarter 2022 Earnings Conference Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation.

[OPERATOR INSTRUCTIONS]

As a reminder, this call is being recorded. It is now my pleasure to introduce your host, Maya Lustig, Investor Relations of Ceragon. Thank you, you may begin.

Maya Lustig

Thank you, operator, and good morning everyone. I am joined by Doron Arazi, Ceragon's Chief Executive Officer.

Before we start, I would like to note that certain statements made on this call, including projected financial information and other results and the company's future initiatives, constitute "forward-looking statements" within the meaning of the Securities Act of 1933, as amended and the Securities Exchange Act of 1934, as amended, and the safe-harbor provisions of the Private Securities Litigation Reform Act of 1995.

Ceragon intends forward-looking terminology, such as believes, expects, may, will, should, anticipates, plans or similar expressions to identify forward-looking statements. Such statements are subject to certain risks and uncertainties, which could cause Ceragon's actual results to differ materially from those projected in such forward-looking statements. Such risks and uncertainties include, but are not limited to, those that are described in Ceragon's most recent Annual Report on Form 20-F and as may be supplemented from time to time in Ceragon's other filings with the SEC, all of which are expressly incorporated herein by reference. Forward-looking statements relate to the date initially made, do not purport to be predictions of future events or results, and there can be no assurance that they will prove to be accurate, and Ceragon undertakes no obligation to update them.

Ceragon's public filings are available on the Securities and Exchange Commission's website at www.sec.gov, and may also be obtained from Ceragon's website at www.ceragon.com.

Also, today's call will include certain non-GAAP numbers. For a reconciliation between GAAP and non-GAAP results, please see the table attached to the press release that was issued earlier today.

I will now turn the call over to Doron. Please go ahead.

Doron Arazi

Thank you, Maya and good morning, everyone.

To kick things off, as you may recall from earlier discussions, we outlined three strategic pillars to propel our business forward. Our first strategic pillar relates to our core business, which is the best-in-class all-outdoor microwave and millimeter-wave market segments. Our second strategic pillar involves the expansion of our business into open network architecture domains. Our flagship product in this domain is our new virtual indoor unit, a first in the market, that can also be used as a cell site router. And our third strategic pillar focuses on strengthening our managed services offering to deepen our relationship with our customers.

In the second quarter of 2022, we experienced gains in market share, particularly at the high end of the market. According to our estimates, Ceragon now makes up approximately 25% of the market for best-of-breed solutions – the largest and fastest growing market segment, driven by the increasing demands on networks as they transition to 5G.

This is the result of execution of our strategic priorities. Starting with our first pillar, we witnessed the strength of our core business and wireless backhaul. A leading tier 1 global operator serving multiple countries in Asia, Africa, and Latin America selected our wireless backhaul solutions to expand their coverage to remote islands and strengthen their transport network. We also signed a new frame agreement with a pan-African Tier 1 operator for the first time in our history, and we have already run a POC with them on our unique Advance Space Diversity Feature. Having true global operators choose Ceragon is a testament to the reputation and performance of our core business.

Our new virtual indoor unit will increase our market potential in our core domain as well as in our second pillar, which is the disaggregated cell site routing. This is a rapidly growing market segment expected to reach $400 million over the next few years. The total value of the overall disaggregated cell site market will reach approximately 1.6 billion dollars, and signals an even bigger potential. We see an opening to disrupt the market with our new IP-50FX product, which helps us leverage the fast-growing Open Network trend. While the market has just begun to takeoff, we already have 216 units booked with average gross margins exceeding our overall margin profile.

Finally, in terms of our third pillar, we have strengthened our managed services offering, and deepened our relationships with our customers. This offering is garnering increasing attention from operators, private networks, and carriers around the world and has become an important growth area for us.

Managed services bookings for the first half of 2022 were roughly $8 million, which is already around 40% higher than our managed services bookings for the full year 2021. We also expect our software tools business to achieve continued growth via direct sales or as tools for our managed services business. We expect these new software tools to drive enhanced margins and recurring revenue as we take market share.

When it comes to our overall addressable market, it is growing. Demand for microwave transmission equipment is expected to increase over the coming years thanks to 5G deployments which rely more on wireless backhaul than fiber. 5G spectrum auctions and launches around the world drive further demand. We believe we will see more 5G deployments in India, Latin America, parts of Asia, and Middle East and Africa.

On the delivery front, in Q2 component shortages and the shipment costs were still a headwind across the industry. That said, we have begun to witness positive results from the different initiatives we took to improve our operational and financial performance, which we will address later in this discussion. As a result of our actions, our Q2 gross margin rose to 30.5%, compared to 27.7% in Q1 2022, while still lower than our 31.5% in Q2 2021. We expect to drive further revenue growth and margin expansion going forward.

We experienced healthy bookings across different regions, and we enjoy a very strong backlog. We expect that this backlog, when converted to revenue, will translate to a gross margin that's higher than in Q2, also thanks to the many gross margin enhancing initiatives we are taking.

We are excited about the momentum that we are seeing across our business. That is because we know that our technology development capabilities are a key competitive differentiator. Our ability to develop cutting-edge products in-house is rooted in our strong innovative culture and continuous investment in innovation.

For example, as I mentioned earlier, we are the first to bring a virtual indoor unit to market that can also serve as a cell site router. This unit has demonstrated all elements of an open network

– including radio units, software/OS and networking units – fully aggregated and integrated as part of a true OpenTransport and Open Networks. We just launched these products in February and have already begun to see strong customer traction with orders received, as well as numerous trials and POCs during the first half of the year.

We are also enhancing our suite of revolutionary IP-50 products using our new radio chip developed inhouse. These products are expected to be launched in 2023 and are expected to reduce bill of material costs by approximately 40%, allowing us to gain market share and drive higher margins.

Further, we believe that our System-on-a-Chip, or SoC, our fifth-generation chipset, is three years ahead of competing technologies in the market. We expect our SoC to generate significant cost savings and deliver enhanced performance. Because it is developed in-house, it will be a key competitive advantage for years to come.

Being first to market with new chip technology is extremely important to our customers. We are in the productization phase of our next chipset, while we estimate that our competitors and merchant chip manufacturers are only now introducing high-level concepts of their next generation chips. We strongly believe that our strategy of developing chips in-house allows us to create better products with superior technology and lower costs while remaining ahead of competition. We expect this trend to continue.

I'd now like to give you an overview per region.

For the first time in our history, **North America** now represents the largest region for us, tied with India. In the second quarter, our bookings in North America represented 26% of our total bookings and grew by 38% over the first quarter. When we compare this with our full year projections, we see that we are on track to achieve bookings of at least 15% above our internal projections. Q2 was, to say the least, a record quarter.

5G building and rollouts are in full swing in North America. In Q2, we capitalized on this momentum. A leading Tier 1 mobile operator who is looking to maintain its position as the largest and fastest national 5G network is now utilizing our comprehensive portfolio of solutions as well as installation services as part of their ambitious 5G network expansion project.

In Q2, we also made solid progress with new potential customers. We began to see signals of success in our new strategy to capitalize on the growth of private networks and rural broadband, demonstrated by recent wins.

In Q2, we continued to expand our activities with Tier 1 and Tier 2 operators, as well as expand services activities. We onboarded new employees across the board to strengthen our presence and relationships with our customers.

When we look at the future, we expect to continue to grow and add market share in North America, which will contribute to enhanced overall margins. We have become the number 1 wireless transport vendor in this region for Tier 1 operators, and we expect to accelerate our growth among Tier 1 operators as part of broader 5G adoption and also increase our services portion in this domain. In addition, increased investment in rural broadband infrastructure is expected to drive our growth among small carriers, private networks, and wireless broadband providers in multiple domains.

In India, there is a highly dynamic regulatory, technological, and competitive environment. The market is gearing up for the rollout of 5G services country-wide. The 5G spectrum auction started at the end of July. 72 GHz spectrum in many different bands are on sale. E-band frequencies are part of the 5G auctions, which presents a significant opportunity for us. We expect demand for E-band products to start ramping up in Q4 2022.

Our Q2 bookings were strong, and we see great potential in India.

In Europe, we had another strong quarter. Like in other regions, here too, 5G private network deployments are gaining traction, especially in Western Europe. We are making progress across the board with nation-wide Tier 1 operators as well as infrastructure companies that operate in rural environments.

Our revenues exceeded our internal projections, and we have a strong backlog. That said, we continued to experience ongoing delivery issues.

In **APAC,** the market has been ultra-competitive. In Q2 we focused on securing and growing existing accounts and to transform business to our new product portfolio to include solutions such as IP-50FX.

We also showcased our Disaggregated Wireless Transport Solution in the 2022 TIP Open Network Event in Indonesia. The response was phenomenal as the value delivered to operators is the utmost flexibility to achieve TCO savings.

In **LATAM,** the impact of the pandemic has finally subsided. Despite some political instability, we see rising investments in different countries. We have made progress in pushing our managed services offering, now discussing potential new arrangements with customers. We see very strong interest.

5G roll outs are starting in some countries while in other expansion projects are underway. Here, we are working hard to increase the traction of our market-leading IP50FX product.

In **Africa,** we had a slow start to the year. That said, as modernizations, upgrades, and new routes are beginning to take place, we see many long-term opportunities. As I mentioned earlier, we signed with a pan-African operator and have already run a POC.

Before turning over to our financial results, I'd like to comment briefly about the current business climate. The recent disruption to the supply chain has adversely impacted our financial performance. While these seem to be temporary headwinds – and are industry-wide, they have resulted in a significant slow-down in our backlog conversion into revenue and adversely impacted our gross margins.

As I mentioned, we have been implementing a series of initiatives aimed at improving our backlog conversion into revenue and enhancing margins, including:

- Adding surcharges,
- Improving contractual terms with our partners,
- Redesigning our products and subsystems to improve the pace of backlog conversion and reduce production costs,
- Replacing one of our contract manufacturers, and
- Streamlining the shipment process with the addition of new vendors.

We are also increasing our focus on software and software upgrades as well as maintenance contract sales.

It will, of course, take time until we start seeing more significant results, but I am confident that all these actions will contribute to more robust financial performance.

Lastly, I'd also like to share that we are close to hiring a strong candidate for our CFO role with recent experience in our industry. We hope to be in a position to announce our new CFO in the next few weeks.

Now the financials. To help you understand the results, I will be referring mainly to non-GAAP numbers. For more information regarding our use of non-GAAP financial measures, including reconciliations of these measures, we refer you to today's press release.

Let me now review the actual numbers with you.

Revenues for the second quarter were $70.7 million, up by 3.1% compared to $68.6 million in Q2 last year. As I mentioned earlier, even though demand continues to be high, we are still experiencing component shortages and supply chain disruptions which impact our ability to convert our backlog to revenue.

Our strongest region in terms of revenues for the quarter was **India** with $21.7 million, reflecting ongoing deliveries for our main customers and in line with the strong demand we see in this region.

Our second strongest region in terms of revenues was **North America** with revenues of $15 million, followed by **Latin America** with $11.4 million. **Europe** was fourth with $10.9 million.

We had 2 above 10% customers in the second quarter.

Gross profit for the second quarter on a non-GAAP basis was $21.5 million, giving us a non-GAAP gross margin of 30.5% compared to 31.5% in Q2 2021, and 27.7% in Q1 2022. Our improved gross margin in Q2 as compared to Q1 of this year was primarily due to the increased software portion, a certain reduction in our shipment costs as well as other measures taken to reduce our BOM costs.

Operating expenses on a non-GAAP basis for the second quarter were $21.2 million, in line with our expectations.

Research & Development expenses for the second quarter on a non-GAAP basis were $7.5million, the same as in Q2 2021, and up from $6.8 million Q1 2022, as we projected. We expect our R&D expenses to remain relatively consistent for the remainder of the year.

Sales & Marketing expenses for the second quarter on a non-GAAP basis were $9.1 million, compared to $8.3 million in Q2 2021 and $8.5 million Q1 2022. The year-over-year increase is primarily due to a boost in sales commissions, intensified face-to-face travel expenses, as well as investments in our salespeople in North America and Latin America.

General and Administrative expenses for the second quarter on a non-GAAP basis were $4.6 million as compared to $5.2 million in Q2 2021, and $4.8 million in Q1 2022.

Financial and Other Expenses for the second quarter on a non-GAAP basis were $2.5 million, significantly higher than our expectations. The forex expenses came approximately $1 million higher than our expectations. This is primarily due to our cash balances and accounts receivable in local currencies related to services and sales of local equipment, primarily in India, APAC, and Latin America that have eroded due to the strengthening trend of the USD during the quarter. Going forward, subject to a stabilized forex environment, we expect our finance expenses to be in the range of $1.5-$2 million.

Our tax expenses for the second quarter on a non-GAAP basis were $0.3 million.

Net loss on a non-GAAP basis for the quarter was $2.5 million, or $0.03 loss per diluted share.

As for our balance sheet, our **inventory** at the end of Q2 2022 was $60.7 million, up from $58.1 million at the end of Q1 2022. The level of inventory still reflects our need to stock long lead-time and strategic items as a combined result of increased customer orders and the ongoing component shortages. In addition, our decision to replace one of our contract manufacturers with minimum disruption to deliveries, also resulted in temporary inventory increase and impacted our cash flow and working capital. We expect this impact to gradually decline in the coming quarters as we finish that transition period, and the new contract manufacturer is fully up to speed. We strive to keep our inventory levels lower and expect an inventory reduction as the components industry improves.

Our **trade receivables** are at $122.7 million, up from $120.7 million at the end of Q1 2022. Our DSOs now stand at 152 days.

Our cash flow from operations and investing activities was higher than Q1 2022, and it was primarily driven by the changes we have been making to the composition of our contract manufacturers. We have $23.6 million of cash, and we have available unused credit facility of $18.1 million.

Net cash used in operating and investing activities for the second quarter was $6.3 million.

Net cash provided by financing activities for the second quarter was $5.0 million.

Looking forward, we are reaffirming our 2022 revenue guidance of $300 - $315 million, and our 2023 revenue guidance of $325 - $345 million. Our guidance is of course subject to potential downsides and upsides as we continue to address supply chain challenges facing the industry. Our 5-year revenue target is approximately $500 million, and we also target increasing our gross margins to at least 34-36% over the same period.

Finally, before turning to Q&A, I want to take a moment regarding Aviat's purported offer. As you have seen, we have issued several communications reviewing our record of engagement with them, and our commitment to serving the best interest of all Ceragon shareholders. Our position remains the same, and **we do not have more to share** on Aviat today.

With that, I now open the call for your questions. Operator?

If pressed in Q&A portion of call:

As I mentioned in my prepared remarks, we are here to discuss our business and earnings results, and we ask that you keep your questions focused on these topics. We will not be commenting further on Aviat at this time. Thank you.

Doron's Closing Remarks

Thank you.

In closing, I'd like to reiterate that we are effectively executing our growth strategy. The initiatives we have taken and the tough decisions we have been making to improve our financial performance have begun to bear positive signs.

We will continue to implement measures aiming to mitigate the impact of the ongoing supply chain disruptions and component shortages. Like with any large well-established company, this was not the first storm we have faced, and I doubt that it will be the last. With strong market and technology drivers, skillful people, and a robust growth strategy, we remain confident about our short- and long-term business potential.

I look forward to updating you further on our next call.

Have a good day everyone.