Xtera Communications, Inc.
Prepared Remarks
August 11, 2016
Q3 2016 Financial Results Conference Call

Operator

Good afternoon and welcome to Xtera's Q3 2016 financial results 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)

I would now like to turn the call over to David Allen, Xtera IR. Mr. Allen. You may begin.

David Allen

Thank you, operator, and good afternoon, everyone. Before we begin the call, I want to remind you that this conference call contains forward-looking statements regarding future events, including, but not limited to, our expectations for the future business and financial performance of the Company; the growing recognition of the importance and adoption of Xtera's Wise Raman™ technology to solve the capacity and reach requirements of telecommunication and content service providers as well as enterprises and government entities; the long-term goals and growth prospects for Xtera; our ability to obtain additional capital to successfully execute our business plans and continue as a going concern; our ability to re-engage our supply chain to provide goods and services, our success in improving our internal controls and processes, and the development of new products that we believe will continue to help our customers expand capacity on their networks.

These forward-looking statements are based on estimates, judgments, current trends, and market conditions and involve risks and uncertainties that may cause actual results to differ materially from those contained in the forward-looking statements. I would encourage you to review our SEC filing, including our annual report on Form 10-K for the period ending September 30, 2015, and our quarterly report on Form 10-Q for the periods ending December 31, 2015, March 31, 2016, and June 30, 2016 available at www.sec.gov, as well as other SEC reports, in which we discuss risk factors associated with investing in Xtera. All forward-looking statements are made as of the date of this call and except as required by law, we do not intend to update this information.

Our fiscal year ends on September 30th of each year. Unless otherwise noted, all references in our prepared remarks to quarters refer to quarters in 2016.

In today's call we will be referencing both GAAP and non-GAAP measures. A reconciliation between GAAP and non-GAAP are included in Q3 financial results press release for the third quarter of 2015 and 2016. A reconciliation for Q2 2016 and other quarters can be found on the investor relations sector of the Xtera website.

The non-GAAP measures are provided to enhance the investor's understanding of Xtera's operating performance as they primarily exclude certain non-cash charges for stock-based compensation and amortization of intangible assets which Xtera believes are not indicative of its core operating results. The presentation of these non-GAAP measures is not meant to be a substitute for results presented in accordance with GAAP, but rather should be evaluated in conjunction with those GAAP results.

This conference call will be available for audio replay in the investor relations section of the Xtera website at www.Xtera.com.

Xtera management on today's third quarter 2016 earnings call are Jon Hopper, Xtera's President and CEO and Joe Chinnici, our EVP and CFO.

I would now like to turn the call over to Jon Hopper, Jon?

Jon Hopper

Thank you Dave.

Before we discuss our third quarter results and a business update, let me give you a quick update on our financing activities. Last week our lenders provided waivers and admendments such that we remain in compliance with our existing credit agreements. We appreciate the continuing cooperation from our lenders as we work to restructure our debt. We are also continuing to hold discussions with several potential new debt and equity investors to augment and/or replace our existing lenders, as well we are exploring other strategic alternatives. We have engaged Cowen and Company to assist us on these efforts.

With regards to the market we serve, we continue to see strong interest for the increased bandwidth that our Wise Raman™ technology can uniquely provide by extending a network's reach and capacity. Xtera has over 135 patents today, mostly around utilization of Raman amplification, a competitive differientator. Today, most of our competitors use Raman extenders which they buy from third parties to improve reach. Unlike nearly all of our competitors, Xtera's Wise Raman solutions use a single platform for both subsea or terrestrial applications. The use of one platform provides for a seamless network implementation, and easier training and operation for network operators that have both terrestrial and subsea networks. Most importantly, Xtera's solutions enable our customers to increase both their networks' reach and capacity.

Our solutions use a considerably wider portion of the optical spectrum than our competitors generally rely on. This translates into a 3Xthe capacity on a fiber pair than others can typically provide. We are very encouraged that one of the world's largest Web 2.0 players is currently soliciting an RFP that requires the use of this wider portion of the optical spectrum. While we believe our competition will be forced to ultimately introduce solutions using wider portions of the optical spectrum, we view future introductions as validating a market where we have considerable experience, are well positioned and continue to make further advances.

As you will hear from Joe in a few minutes, while the market is moving in our direction, our third quarter, and results thus far in the current quarter, have been impacted by our liquidiy situation which we discussed on our last earnings call. While it is clear that the need for enhanced broadband continues to build, our ability to achieve our business plans has been and will continue to be paced by liquidity considerations.

To-date, we have not seen any meaningful changes in the competitive landscape or any cancelations of previously won business. As I mentioned on our last earnings call, I was excited about the industry knowledge and experience and that Joe Chinnici could bring to Xtera. Joe has already started to make changes. Over the past few months we have become more disciplined and focus, specifically in the areas of pricing new deals and contract negotiations and contract changes as well as business processes and practices.

Until recently, we competed for and won new projects which at the start required significant working capital commitments with large upside from further network expansion and line card business. For a variety of reasons outside of our control, several of these big projects have taken longer than expected to produce follow-on orders. We are now prioritizing those sales opportunities that generate the near-term cash flow needed to build a stronger company.

We remain committed to prudently investing in our people and new technology solutions, such as next-gen amplifers and repeaters to support our customers and advance our capabilities. We are heartened by the continued support we have seen from our customers and have recently seen an uptick in new orders in the current quarter after a lull in new orders in the June quarter which we believe has been directly caused by concerns about our balance sheet and by our decision to not to pursue certain business that we would have previously considered.

At this point I would now like to turn the call over to Joe. After that, open the call for Questions & Answers. Joe?

Joe Chinnici

Thank you, Jon.

As a reminder, on our last earnings call we did not provide any financial guidance due to the cash constraints we faced and uncertainty of the timing of any financing activities.

With that, Q3 revenue was $5.3 million, compared to the prior quarter of $17.1 million. The decrease is predominately the result of our managing through our cash constraints.

Product revenue accounted for approximately 78% of our Q3 revenue, compared to 89% in the prior quarter. Revenue from turnkey solutions, which is included in product revenue, represented 14% of the total Q3 revenue, compared to 65% in the prior quarter.

We had two customers in Q3 that were each over 10% of revenue, the same number we had in the prior quarter.

Our Q3 gross margin was a negative $(13.8 million) on a GAAP and a non-GAAP basis. The gross margin losss was attributable to a number of factors, such as:

- a $2.5 million increase in the provision for excess inventory, primarily due to the our decision to cease production of certain products;
- a $3.3 million accrual on future purchase commitments of NXT materials that are now obsolete or excess;
- a $3.8 million accrual for the loss associated with two contracts;
- a $1.9 million provision pertaining to liquidated damages since we are unable to meet certain delivery dates;
- and the balance of the loss was attributable to the low volume in the quarter and not being able to cover fixed overhead costs.

Our Q3 GAAP operating expense was $8.1 million, compared to $7.0 million in the prior quarter.

Our non-GAAP operating expense which excludes stock based compensation and amortization of intangibles was $7.8 million compared to $6.5 million in the prior quarter. The increase in operating expenses was primarily driven by:

- increased R&D expenses;
- higher bank fees;
- higher consulting expenses
- the latter two items were primarily driven by the debt refinancing activities.

Depreciation and amortization for Q3 totaled $526 thousand, compared to $484 thousand in the prior quarter.

GAAP and non-GAAP interest and other expenses in Q3 totaled $1.8 million, up from $642 thousand in the prior quarter primarily from currency losses caused by the impact of Brexit relating to our UK operations.

Our Q3 GAAP net loss for Q3 was negative $(23.6 million) or $(1.37) per share based on 17.2 million shares.

Our non-GAAP net loss for Q3 was $(23.3 million) or ($1.35) per share.

The prior quarter the company reported a GAAP loss of $(6.6 million) or (38) cents and a non-GAAP loss of $(6.1 million) or (35) cents per share based again on 17.2 million shares outstanding.

Turning now to the balance sheet.

We ended Q3 with $4.4 million in total cash including cash, cash equivalents and restricted cash, a reduction of $2.0 million from the prior quarter.

At of the end of Q3, the outstanding balance on our term loan was $3.9 million and the senior revolving line of credit was $8.2 million.

The revolving line of credit had a borrowing base that could support an additional line of credit capacity of $3.7 million.

Net receivables at the end of Q3 totaled $5.2 million, compared to the prior quarter which totaled $12.7 million.

Our net inventory was $11.7 million at the end of Q3 compared to the prior quarter where inventories totaled $13.1 million.

Our backlog at the end of Q3 was approximately $89.8 million, compared to the prior quarter of $94.8 million.

Given the uncertainty of the timing of new financing and how quickly we can re-engage suppliers, we are not providing forward-looking financial guidance at this time.

With that, I would like to turn the call over for questions. Gary?

QUESTIONS AND ANSWERS

Operator

Thank you, ladies and gentlemen. There are no further questions at this time. I would now like to turn the floor back over to David Allen for closing remarks.

David Allen

Thank you, Gary. We look forward to keeping your abreast of the progress we make addressing the opportunities in front of Xtera. Thank you joining us today and goodbye for now.

Operator

Thank you, ladies and gentlemen. This now concludes our teleconference for today. You may disconnect your lines at this time. Thank you for your participating and have a wonderful day.