Q2-20 Financial results conference call

Management's prepared remarks and Q&A

August 11, 2020

Operator:

Ladies and gentlemen, thank you for standing by.

Welcome to the RADCOM Ltd. Results Conference Call for the Second Quarter of 2020. All participants are present in a listen-only mode. Following Management's formal presentation, instructions will be given for the question-and-answer session. For operator assistance during the conference, please press star-zero. As a reminder, this conference is being recorded, and will be available for a replay from the company's website at www.radcom.com later today.

On the call are Eyal Harari, RADCOM's CEO, and Amir Hai, RADCOM's CFO. Please note that Management has prepared a presentation for your reference that will be used during the call. If you have not yet downloaded it, you may do so through the link on the Investor section of RADCOM's website at www.radcom.com/investor-relations.

Before we begin, I would like to review the Safe Harbor provision. Forward-looking statements in the conference call involve several risks and uncertainties, including but not limited to the company's statements about its investment in technology and R&D, the expected transition to, and rollout of 5G networks and other trends in the communication market and customers' level of investments in their networks, the company's market position and leadership, the company's execution of its commitments to existing and future customers, and potential growth. The potential of the RADCOM ACE product, the resiliency of the telecom market, company's expectation to be well positioned to handle uncertainties and other impacts due to COVID-19, its revenue guidance and anticipated gross margins. The company does not undertake to update forward-looking statements.

The full Safe Harbor provisions, including risks that could cause actual results to differ from these forward-looking statements are outlined in the presentation and the company's SEC filings. In this conference call, Management will be referring to certain non-GAAP financial measures, which are provided to enhance the user's overall understanding of the company's financial performance. By excluding certain non-cash stock-based compensation expenses, non-GAAP results provide information that is useful in assessing RADCOM's core operating performance, and in evaluating and comparing our results of operations consistently from period to period.

The presentation of this additional information is not meant to be considered a substitute for the corresponding financial measures prepared in accordance with Generally Accepted Accounting Principles. Investors are encouraged to review the reconciliations of GAAP to non-GAAP financial measures, which are included in the quarter's earnings release which is available on our website. I would like to repeat the information about the presentation.

If you have not downloaded it yet, you may do so through a link on the Investor section of RADCOM's website at www.radcom.com/investor-relations. Now, I'd like to turn over the call to Eyal. Please go ahead.

Eyal Harari:

Thank you, Operator. And thank you all for joining us today. Earlier this morning we issued a press release, stating our second quarter results for 2020. We are pleased with our second quarter financial performance, which was in line with our full year growth plans as we increased revenue, continued to invest in R&D and improved our bottom line.

As you may have seen, total revenue for the second quarter of 2020 were 9.2 million dollars and we remained on track to achieve our growth plans for 2020. Based on the current industry conditions and our visibility, we are reaffirming our full year 2020 revenue guidance range of 35 million to 38 million dollars.

Although the full impact of COVID-19 is still uncertain, we remain confident that the telecom industry will continue to prove resilient through this pandemic as people rely on telcos to keep business connected and families entertained in the era of social distancing and lockdowns. We expect that 5G will continue to incrementally ramp up in the later part of 2020 and during 2021. We view this operator transformation as a key opportunity for RADCOM that we are well-positioned to take advantage of, as the market evolves.

At the beginning of August, there were already 92 commercial 5G networks worldwide. We see deployments progress and the telecom industry move forward despite the challenges of COVID-19. In the U.S., AT&T recently announced that its 5G network was available nationwide, which is powered by its network cloud, enabling cost savings and innovation and speed. We continue to have healthy relationship with AT&T as we deliver cutting-edge software releases and provide support for the evolution of their cloud network. In Japan, Rakuten launched full commercial 4G services in April and already announced that they plan to launch 5G next month.

Rakuten is moving fast with its cloud platform, which has already been packaged to sell other operators and enterprise in Japan and worldwide. Network transformations are multi-stage process and we are currently at the early stage, where operators have selected their network equipment providers. Some operators are starting to move to the next step and roll out services. Still, once operators begin to deploy advanced use cases over 5G, assurance vendors will be evaluated and then selected. In these 5G networks, operators will need to upgrade their existing service assurance solutions to cloud-native solutions, as they will require proactive real-time insights and dynamic solutions. We are starting to see initial customer requirement requests for next-generation capabilities and cloud-native features, as operators begin to plan for assurance vendor selection.

We are excited to have announced the launch of RADCOM ACE last week, our new automated assurance solution for 5G. This announcement is a significant milestone in our multi-year journey that started with the transition to virtualization. I am proud of the team's accomplishment in reaching this critical milestone that position us well as the leading assurance solution for 5G. RADCOM ACE is the outcome of our product vision to provide operators with the automated assurance solution for 5G. RADCOM's innovative software will automatically monitor the operators' services, pinpoint critical issues and help resolve them. Ushering a new paradigm for assurance capabilities, RADCOM ACE will help operators accelerate their network transformations by continually monitor the customer experience and provide tools to rapidly optimize the network to ensure smooth migration for an operators' customers to 5G.

Combining cloud-native technologies with cutting-edge artificial intelligence and machine learning to deliver real-time network intelligence, RADCOM ACE significantly reduce the total cost of ownership for assurance. This is provided by creating the expense savings for operators through the automated optimization of the network, as well as decreased CapEx requirements through our containerized software efficiency and cloud-native capabilities. In bringing RADCOM ACE to the market, we took advantage of our use of cloud-native expertise, as well as our close working relationship with some of the leading telecom operators in the industry today to design a solution for 5G and the advanced use case of the future. Currently, we are involved in multiple 5G opportunities and trials at selected customers.

We believe that RADCOM ACE answers the needs of operators for automated assurance solutions and are ready to deliver RADCOM ACE to operators as they move forward with their assurance investments. We are pleased with our second quarter performance as we continue to execute on our plans and invest in R&D to support our customers' needs. The transformation to 5G is a key opportunity for RADCOM that we are well-positioned to take advantage of, as more and more operators make their transition. Given our engagement with industry-leading customers on cutting-edge projects that utilize our cloud-native solutions, we are in a strong position to benefit from this network transformation. With that, I would like to turn the call over to Amir Hai, our CFO, who will discuss the financial results in details. Amir, please go ahead.

Amir Hai:

Thank you, Eyal, and good morning, everyone. In this quarter, we maintained revenue growth and together with healthy gross margins, as well as reduction in operational expenses mainly due to COVID-19, and as a result, improved our bottom line.

Now, please turn to slide 6 for our financial highlights. To help you understand the results, I will be referring mainly to non-GAAP numbers, which exclude share-based compensation. We ended the second quarter of 2020 with revenue of 9.2 million dollars, an increase from 8.5 million dollars in the second quarter of 2019. Our gross margin on a GAAP and non-GAAP basis was 77% in the second quarter of 2020. We expect full year non-GAAP gross margin to be at the similar level as previous year. Please note that our gross margin can fluctuate depending on the product mix. Our gross R&D expenses for the second quarter of 2020 on a non-GAAP basis were 4.5 million dollars, a slight increase of 100 thousand dollar compared to the second quarter of 2019.

During the quarter, we received grants from the Israel Innovation Authority for the first half of 2020 for 572 thousand dollars. Sales and marketing expenses for the second quarter of 2020 were 2.2 million dollars on a non-GAAP basis, compared to 2.4 million dollars in the second quarter of 2019. The decrease is mainly related to reduction in travel expenses due to COVID-19.

G&A expenses for the second quarter of 2020, on a non-GAAP basis were 804 thousand dollars, compared to 754 thousand dollars in the second quarter of 2019. Operating income on a non-GAAP basis for the second quarter of 2020 was 102 thousand dollars, compared to an operating loss of 715 thousand dollars for the second quarter of 2019. On a GAAP basis, as you can see on Slide 5, our net loss for the second quarter for 2020 was 200 thousand dollars or a net loss of 1 cent per diluted share, compared to a net loss of 900 thousand dollars or a net loss of 7 cents per diluted share for the second quarter of 2019.

Net income for the second quarter of 2020 on a non-GAAP basis was 200 thousand dollars or a net income of 2 cents per diluted share, compared to a net loss of 400 thousand dollars or a net loss of 3 cents per diluted share for the second quarter of 2019. At the end of the second quarter, our headcount was 273.

Turning to the balance sheet. As you can see on Slide 9, our cash, cash equivalent and short-term bank deposit at the end of the second quarter of 2020 was 66 million dollars. We believe that our strong balance sheet provides us with the flexibility to execute the opportunity ahead of us and adapt the ongoing global uncertainty. That ends our prepared remarks. I will now turn the call back to the Operator for your questions.

Operator:

Thank you. Ladies and gentlemen, at this time, we will begin the question and answer session. If you have a question, please press star-one. If you wish to cancel your request, please press star-two. If you are using speaker equipment, kindly lift the handset before pressing the numbers. Your questions will be polled in the order they are received.

Please stand by we poll for your questions. [pause] The first question is from Alex Henderson of Needham & Company. Please go ahead.

Alex Henderson:

Thank you and congratulations on turning to profit in the quarter. It's quite an achievement. A couple of simple questions. The commentary on the NRE, it sounds like you are expecting roughly 500 in NRE for the year now. Is that a reasonable conclusion?

Amir Hai:

Hi, Alex. I will take this call, it's Amir. Basically, we received an approval from the Israeli Innovation Authority of 1.3 million dollars for all 2020. So, the half of year we recognize an income of 572 and the rest will be in the second half a year.

Alex Henderson:

I see. Okay. And then, given the very strong results in the quarter, obviously your gross margin was, heavily skewed to a software mix. Are you expecting the margins in the back half to revert back towards the 70% level? Is that a reasonable expectation?

Amir Hai:

I will take that also. Yes, it's a reasonable expectation. The – as you see in the last quarter, the gross margin was around 63% and in average, it's around 70%. And I think, basically, when we look at the year end and take it annually, this will be approximately the gross margin between 70 to 72, 73%.

Alex Henderson:

All right. So, under that scenario, it doesn't sound like, although you were popped up to profitability here that we should be expecting profitability again in the back half, more like break-even-ish type numbers?

Amir Hai:

Yeah, basically, our, you know, global expenses on an annual basis is around 40 million dollars. So – and of course, there is some cost savings regarding the COVID-19, but give or take, this is the number that we will be break-even at.

Alex Henderson:

Right. And then, just wanted to talk a little bit about the trajectory in the back half on expenses. Can you remind us, given the shekel has had a big – very steep decline over the March, April timeframe and then completely rebounded – how does that impact you guys' numbers?

Amir Hai:

It doesn't impact, but the shekel is – now trading between – we can see in the second quarter of 2020 is trading between 3.4 to 3.5. This is the range that we are looking it. This is the range that basically was taken in our assumptions regarding the expenses.

Alex Henderson:

Were you able to take any advantage of that steep decline? Or is that – was that already locked in?

Amir Hai:

It's locked in, but basically it was in Q1, most of it, and it's locked in.

Alex Henderson:

I see. Okay. And then, just on the technology side, if I could. Obviously, this is a pretty big news event with the ACE product we love cloud-native architectures and there are really significant improvements in design. So, as we look at that, the question comes up – kind of, actually, it's two questions, related.

One, does it change the timeline for evaluations from potential customers, because they are now looking at a different architecture than what they had been looking at before? And two, does it accelerate, you know, is it reasonable to think that the people will be accelerating this transition to a cloud-native architecture, or will you be carrying both the traditional architecture and the cloud-native architecture?

How do we think about, you know, the adoption pattern, given this major new product announcement?

Eyal Harari:

So, first of all, good morning, Alex. I think it's definitely an exciting time for us, and we are very pleased with this critical milestone of launching the RADCOM ACE, which is a very advanced cloud-native containerized architecture product. This is an outcome of hard work of multiple years and it's part of our long-term strategy to focus on the 5G market and its needs. It's aligned with our plans in a way that we talked in the previous calls that 5G is about to start – I mean, in the service assurance space, second part of 2020 and primarily in 2021, while the market is expecting to get to peak in 2022, 2023. So, I think it's a great timing.

We are now in a, really, the very early adaptive stage. When we start to see the first operators globally announcing they are moving to the next stage with their 5G networks and starting to invest in their 5G core, which is exactly the indication that this would follow by investments on a service assurance solution. While you are going through those 5G implementation in the –

including the 5G core, and building it on the cloud-native technology, which is a consensus these days, you will not be longer be able to use the previous architectures. You need something new that is containerized, that is built to the 5G requirements, and this is why we were building the last few years to make sure we are ready on time and we are very pleased that we meet this milestone.

Now about your question in terms of the timing of the investment, I think this is in line of – with the operators' readiness on selections of tools. I would say that, from initial trials we were doing and we just launched this last week, so – but we already introduced these technologies to some of our selected customers. And the feedback is very exciting. So, we believe that it's going to be in line with the plan.

Some operators are still looking on 4G and still looking on virtualization technology of the current stage I would say, but the early adopters of 5G are moving already to this cloud-native architecture. So, having both solution and, I would say, this complements our current stock, and allow operator to have end-to-end visibility into his 4G and 5G network, whether he is using the software technology, or up to the cloud-native latest and greatest architecture that operators are adopting today.

Alex Henderson:

I'm pretty sure I know the answer to this, but is the competition able to deliver a cloud-based architecture? Or are they still well behind you guys? And I'll cede the floor after that. Thanks.

Eyal Harari:

Yeah. We believe that our deep knowledge on virtualization being engaged with the top carriers doing virtualization in the last four, five years, is giving us a clear advantage in this space.

We were waiting for the virtualization technology to start pick up pace, and we are very excited that in 5G, everything is going to be virtualized. So, we believe our deep experience including very large scalable implementation in virtualization is going to come to play once we are starting to implement 5G. So, yeah, it's definitely an advantage for us.

Alex Henderson:

Great. Thank you very much.

Eyal Harari:

Thank you, Alex.

Operator:

The next question is from Matt Stotler of William Blair. Please go ahead.

Matt Stotler:

Hey, guys. Congrats on the results, and thank you for taking my questions. I guess, first, I would like to start with, you know, obviously the results are better than expected in the quarter, it was good to see.

Could you, you know, maybe just quantify or speak to what you are seeing in terms of the ongoing impacts of COVID on customer spending or customer conversations in the quarter? And any change or, you know, how that behavior evolved as you kind of move from the, you know, March, April timeframe through May and into June and July?

Amir Hai:

Yes. COVID-19 has an effect, of course, in Q2. We mentioned it in a couple hundred thousand dollars, in this quarter. But basically the saving were in the travel expenses, and of course, the … expenses on conferences and et cetera.

Moving forward, and due to the reality that we are facing, we don't see any increase. And we believe that we can keep the saving going forward, most of the saving going forward in the second half a year.

Eyal Harari:

Maybe adding to that, Matt, if we take the market perspective, overall, the telecom is continuing with its plans to migrate to 5G. We are seeing more and more operators taking the decision and starting to invest in the 5G radio frequencies. As mentioned, 92 carriers already announced they are starting to launch initial 5G implementations. We are seeing that despite the COVID-19, the transformation to 5G continues.

Overall, it is going as planned. So, we don't see any significant effect and we are happy to see that the journey to 5G is strategic to the telcos, and they feel this is something they need to continue and implement. And we actually see some acceleration in some operators in terms of the 5G implementation, which is very encouraging.

Obviously, the full effect of COVID-19 and the overall atmosphere is not – is making telcos investment in long-term projects in some risk. But, from what we see today, we are seeing very positive signs on the investments in 5G.

Matt Stotler:

Right, right. That's good to hear. And then, you know, obviously, the revenue result was better than expected in the quarter. While your guys reiterated, you know, about 11% growth in the midpoint – obviously, there is still some, you know, inherent lack of visibility just given the environment that we are all operating in, but can you just refresh us on the assumptions that you are baking into your full year projections?

Eyal Harari:

So, our – as we reiterated, we are still confident with our guidance of 35 to 38 million. We are happy to continue and execute our plans and looking on a growth year. We are now in August, so there is still few months to go to complete the year. But we have very good visibility already with the contracts we have, with the engagements we have, which allow us to reaffirm this guidance.

We are very busy these days already to continue and build an increase the pipeline for 2021. As we know, sales opportunity in our space are a long-term processes and we are still in confident on the year, but already busy building next year pipeline.

So, overall, it's a mix of existing customer, expansions within existing customer, and penetrating into new accounts that is mainly targeted into revenue of 2021.

Matt Stotler:

Right. Right. That's helpful. And busy is obviously very good. One question to follow up on the RADCOM ACE announcement, and it's obviously good to see this, you know, this released last week.

You mentioned a number of, you know, kind of early trials ongoing. How should we be thinking about, kind of, time to revenue contribution for these solutions, or for the solution? And, kind of, your expectation for, you know, what a typical trial period might look like, or how to think of about how this kind of rolls into revenue in the back half of this year, and into 2021, would be helpful.

Eyal Harari:

So, we commented all along that the timeline for the 5G assurance solution is likely to be late in 2020 and primarily in 2021. So, this year is mainly about building the engagements, releasing the product that we are very excited to release, and securing our contracts towards 2021. So, our 2020 numbers are still without any upside from the 5G. But things could happen and accelerate also… results.

Exact timing is obviously uncertain. It's things could happen a bit earlier or a bit later. But I would say that the – as analysts predicts, the early adopters will select their solutions in the next six to twelve months, and this is something that we want to take part of.

We have the privilege to be working with some of the most advanced carriers that are investing in 5G, and we want to leverage our experience in virtualization and our ability to deliver those – this exciting technology, to take part of those early adopters' deals. Obviously, from the time we will – we introduce until it goes to the revenue, there is some few more months. So this is why it's likely more to happen in the – to affect and be part of our 2021 revenue

Matt Stotler:

Right. Very helpful. Thank you. Just a couple of quick additional questions from me. Rakuten obviously launched in – their 4G network in April, as you mentioned, expect to launch 5G next month.

Any – so, in terms of what that contract looks like as they move to 5G, is that tail into revenue for you, that customer? Is that – should we expect that to, you know, increase your revenue opportunity with that customer? Or should we expect that to be kind of flattish for the remaining quarters of the year?

Amir Hai:

So, 5G introduced an upside on most of our customers, as this newly launched product is not something that anyone already purchase. So, any new deal for 5G would be an upside on top of the revenues we will get from our accounts. And this is why – moving forward, 5G brings an opportunity, but it's also primarily an opportunity to penetrate to new accounts that are currently evaluating what is – who is the right partner for them to the 5G era.

Matt Stotler:

Right. Got it. And then, last one for me, would just be, any update on AT&T? And you mentioned a, you know, roll out of 5G coverage in the U.S. over this summer is something you talked about in the last quarter, as well.

Just, any update on progress with that customer and any expansion opportunity that you're seeing, going forward?

Eyal Harari:

So, as mentioned, AT&T, like others, without getting into specifics, is busy, and they are definitely very vocal about their 5G plans. And they are part of our target audience for this RADCOM ACE. And I think this is really where our technology advantage would come to play.

We obviously used a lot of the inputs of our existing customers in order to build and design our new 5G solution. And we are exciting to have it launched and start to work with, both, again, new customers and our existing customers moving forward into implementations of these technologies in their network.

I still want to reiterate that while we see operator announce their 5G, and their 5G investment, and some even nationwide, most of them are still in a very early stage in their 5G investment, primarily focused on the radio side. And they are just – I think quarter we saw first announcement of selecting the vendors for their 5G core, which is the main driver for investment in assurance.

So, we are seeing progress, but we need to understand where are we in the timeline. We are now moving through the next step. But there is still time until we would see implementations of service assurance solutions in 5G. It's – as I indicated, it's expected to happen late in 2020, and primarily 2021.

Matt Stotler:

Got it. Very helpful. Thanks again for taking my questions.

Amir Hai:

Sure.

Operator:

If there are any additional questions, please press star-one. If you wish to cancel your request, please press star-two. Please stand by while we poll for more questions. [pause]

The next question is from Abba Horowitz of OSP. Please go ahead.

Abba Horowitz:

Hi. Very nice quarter. Thank you. I was wondering about the cash. How much of the cash increase for the quarter came from free cash flow? And how much came from, I guess, government grant, if any?

Amir Hai:

Most of the cash increase was due to the free cash flow.

Abba Horowitz:

Okay. Wonderful. I was wondering, Eyal, if you could characterize, over the next six to twelve months, what size of potential book of business for RADCOM is there? As you see – as you said in the call that, you see at the end of 2020, that they're going to start to open up in terms of 5G.

I am wondering, what does this mean in terms of, versus what you have now? What does that mean for RADCOM? And are there expectations that you would penetrate a certain percent of that market over the next six to twelve months?

Eyal Harari:

So, I think that RADCOM as of today is still has a lot of potential of growth within the market. We are looking on the telecom industry and there are very few to none selections of 5G assurance providers worldwide. So, the market opportunity is ahead of us. But as we know, telecom industries and selection process and new technology adoption takes time ,and it's not something that everything will happen over the next few quarters. It's a journey that we are – we started a year ago, in terms of 5G, and we are expecting to continue in the next few years to come.

I believe that we have great opportunity both with our existing customers, and with potential new customers. The rate of adoption is really dependent on the selection process of the different operators and it's very hard to predict.

But the advantage of RADCOM is that every new win and every new expansion could be a very significant upside on our revenue numbers. So, it's still something that we are monitoring and anticipating, and once we get closer to end of 2020, we are expecting to have better visibility into 2021, and we will share our guidance then.

Abba Horowitz:

Is there a way for you to – can you tell us how many deals, potential deals, are in the pipeline today versus a quarter ago? Are you seeing that build right now? Or is it too early to see a build?

Eyal Harari:

I – it's not information that we are sharing, but I would just say that we are seeing good indications overall on 5G market maturing up, both coming from the announcement of the operators and the feedbacks we are getting from the customer and from the market about where they are and about our technology. So, overall, we are seeing positive progress towards the plan, and it's aligned with what we expected to happen when we planned 2020.

It's very positive in light of the COVID-19, which we know in some industries and some companies are reporting slowdown. We don't see any slowdown, which is very, very good indication. And I think the overall, most important part is that, the journey to 5G continues.

The virtualization and cloud-native is a consensus. This is exactly where we excel, this is where we invested all of our technology. And we believe we are well positioned now to address this market.

Abba Horowitz:

And – okay, thank you. Final question. Anybody who's launching 5G, must they have a solution similar to the RADCOM, or RADCOM solution itself, in order for that 5G network to be launched? Must they have something like RADCOM in place?

Eyal Harari:

So – yeah, yeah. So, if you launch your radio, if you launch your 5G, as I mentioned, if you invest, most operators start with investing only on the radio side, and they still use their 4G network core in order to support this new radio connection.

This is the stage we are as an industry. But once they move to the next stage of 5G, after the initial launch, and want to grow more strategically with that, they need to upgrade their network core. In this stage, most of the carriers, a very big, vast majority of the carrier will select a solution of service assurance in order to assure that they get visibility.

Otherwise, they are transparent to what's going in their network and it will be very hard to support the launch – very hard to maintain the customer experience. This is why, as I mentioned, this market opportunity is still ahead of us.

Abba Horowitz:

Okay. So it's not a matter of if, but rather when, really, because at some point, they will have to transition to something like a RADCOM system?

Eyal Harari:

Exactly.

Abba Horowitz:

Okay. Thanks very much. And thank you for the quarter.

Eyal Harari:

Thank you.

Operator:

[pause] There are no further questions at this time. This concludes RADCOM Ltd.'s second quarter 2020 results conference call.

Thank you for your participation. You may go ahead and disconnect.

[End of conference call]