FTE Networks, Inc.

First Quarter 2018 Financial Results Conference Call

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CORPORATE PARTICIPANTS

Michael Palleschi, *President and Chief Executive Officer*

David Lethem, *Chief Financial Officer*

Gregg Davis, *Vice President, MZ Group North America*

PRESENTATION

Operator:

Greetings, and welcome to the FTE Networks First Quarter 2018 Financial Results Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. If anyone should require Operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Gregg Davis, MZ North America.

Gregg Davis:

Thank you, Operator. Before turning the call over to Management, I'd like to remind listeners that during today's call Management may make forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, which statements are based on current expectations, forecasts and assumptions regarding anticipated levels of future performance. Forward-looking statements involve risks, uncertainties and other factors that could cause actual outcomes and results to differ materially from those discussed today. We refer you to a more detailed discussion of these risks and uncertainties in the Company's filings with the SEC. Any forward-looking statements should be considered in light of these factors. Furthermore, any outlook presented is as of today's date and Management does not undertake any obligation to update these projections in the future, as market conditions may change.

Additionally, our discussion this afternoon may contain certain non-GAAP financial measures. These measures should not be considered replacements for GAAP results. Reconciliation of the non-GAAP measures to GAAP measures are provided in the Company's earnings release, available on the Company's website.

On the call today are Michael Palleschi, FTE Network's President and Chief Executive Officer, and David Lethem, Chief Financial Officer.

With those comments complete, it is my pleasure to turn the call over to Michael Palleschi. Michael, the floor is yours.

Michael Palleschi:

Thank you, Gregg, and welcome to the FTE Networks First Quarter 2018 Earnings Conference Call. Before I discuss the operational highlights and milestones achieved during the first quarter of 2018, I'd like to begin today's call with a brief introduction to the Company, especially for those of you who are new to the story.

As announced in our press release today, we will now be operating in two business segments, the Infrastructure segment and the Technology segment.

The Infrastructure segment is comprised of Benchmark Builders, which provides end-to-end interior design, build and support solutions, and Jus-Com, which provides network infrastructure solutions. Benchmark, which was acquired by the Company in April of 2017, provides general contracting and management services on interior commercial space, predominantly in the New York City market. Benchmark is a tier-1 general contractor with a powerful industry brand and strong presence in the New York market. Meanwhile, Just-Com offers comprehensive telecommunication solutions to its customer base, including many Fortune 100 and Fortune 500 companies in the wireline and wireless telecommunications industry. Together, these two entities offer a wide range of services to a variety of customers.

The Technology segment includes CrossLayer, a managed network services company with an innovative business model for connecting large-scale, state-of-the-art campuses and multi-use developments. It enables owners and developers to directly offer cutting-edge technology solutions via its single, scalable edge compute platform to tenants and guests that differentiates their properties and increases their value. CrossLayer's edge compute platform is a direct connect fiber to wireless network with a software-driven open network operating system that seamlessly integrates network and cloud functions into a highly concentrated footprint, providing the framework for interoperability, customization and scale, to meet the evolving technology advances without costly network infrastructure upgrades. With CrossLayer's single network solution, multiple independent overlapping networks can be eliminated and property managers and building owners can utilize multiple end devices, different vendor solutions, or change communications technologies, while maintaining their investment in end devices.

To summarize, through our two business segments, Technology and Infrastructure, we have a great opportunity to manage the entire in-building ecosystem from design through implementation of data systems and intelligent business solutions.

Our contracts are structured to offer building owners a new value proposition. We build and design one of the most advanced high-speed in-building networks that creates revenue opportunities for the landlord and increases the asset value of the building. Said another way, our managed network services enable building owners to control a state-of-the-art in-building network and leverage it as a business asset.

The focus of CrossLayer is to be the technology solution provider for the building owner and its tenants, delivering greater efficiencies and new ongoing revenue, while exceeding tenant expectations. For the tenant, service is available the same they day they enroll with CrossLayer as the provider, and they experience significantly lower costs, with higher speeds and lower latency. CrossLayer is the in-building network that keeps tenants securely connected to their network regardless of where they're working in the building. Services are comprised of business Internet, business WiFi, campus connect, guest WiFi, business voice and edge cloud services. As an example of a typical contract, it would include approximately $400,000 in annual revenue per building on-net. CrossLayer has gained significant traction in the market, with a promising pipeline of visibility into the projected 30 on-net buildings by year end.

For background purposes, CrossLayer launched its technology product offerings back in October of 2017. We are extremely pleased with CrossLayer's progress, as the Company now has 11 buildings where the CrossLayer solution is being offered. In addition, this segment has already contributed to FTE's revenues in the period ending March 31, 2018. Going forward, we anticipate CrossLayer to continue to have a positive impact on revenue and margins in the second half of 2018, and beyond. We are highly encouraged by its progress to date and are excited to share the news about our new agreement to provide managed network services portfolio to one of the largest commercial real estate services and investment firms in the world.

Before going into more detail on our performance in the first quarter of 2018, it's important to note that our two business segments are synergistic in terms of the powerful sales channel that the Infrastructure segment provides for the Technology segment, due to its access to more than 200 REITs and Fortune 100 and 500 customer portfolio. Furthermore, the Infrastructure segment also delivers full support services, serving as an installation operations provider for CrossLayer.

Now, let's discuss some operational highlights and milestones from the first quarter of 2018.

As I mentioned on our year end call last month, we started 2018 with some very positive momentum. In the first quarter of 2018, and through May 1, we announced $161 million in new contracts, as well as a backlog of approximately $460 million as of March 31, which we believe underscores the underlying strength of our business. We estimate that a strong portion of the backlog will be converted to revenue during 2018, with the balance anticipated by early 2019.

For the first quarter of 2018, FTE generated revenue of $85.1 million, which largely consisted of contributions from the Infrastructure segment. This represented an 89% increase over the $45 million of revenue generated, on a pro forma basis, during the same period in 2017. The latter period was prior to FTE's acquisition of Benchmark on April 20 of last year. We believe this year-over-year growth highlights the reputation of Benchmark across the industry. Earlier this month, Benchmark was ranked number five among the top general contractors for alteration and renovation projects in New York City by the New York City Department of Buildings. This year's ranking was an improvement over last year's number six position.

Although 2017 showed a 13% decline in construction spending from the prior year, according to the New York Building Congress, 2017 construction spending was still the second highest total in actual dollars in New York City's history. Despite lower construction spending forecasts and a competitive marketplace, Benchmark continued to deliver competitive results. We are encouraged by the New York Building Congress' prediction of record expansion during 2018 and 2019, and believe Benchmark is well positioned for continued growth, and is now equipped with CrossLayer as a foundation of advanced technology service offering.

We are excited to have announced in February that CrossLayer was awarded a contract to build a gigabit fiber network across a 35-acre development at Industry City, a historic shipping and warehouse complex located on the Brooklyn/New York waterfront. CrossLayer will equip Industry City's multiple buildings and campus with carrier-like functionality. This will provide its tenants, many of whom are in the media, design, creative arts, production and technology sectors, essentially, an ultra-fast, highly secured data network with unlimited connections, that Industry City will own, with CrossLayer managing the network from sign-up to service. We look forward to implementing the Industry City project and sharing our progress with you.

Speaking of progress, as mentioned earlier, we've been named as the technology provider for one of the largest commercial real estate services and investment firms in the world. This significant achievement, we are honored to be among a few key service providers that will partner with the firm to provide advanced technology services to building owners and their tenants. It speaks volumes about the value of our CrossLayer solution. This is a significant achievement and further supports the upward growth momentum of CrossLayer.

Over the long term, we believe FTE will be able to drive higher margins from the Technology segment, but also from reoccurring elements across the business that keep our customer acquisition costs down, while providing a high degree of revenue visibility. For example, CrossLayer revenue is recurring by nature, as tenants pay for network access on a monthly basis. In addition, we estimate a high percentage of the Infrastructure segment revenue from tier-1 customers, recurring customers and existing master service agreements, driven by established relationships. So, we believe that the stickiness of the business model we are building should position the Company for sustained growth, profitability and shareholder value.

I also want to make a few additional observations about our Q1 revenue.

Benchmark's revenue is related to project cycle timing, with less revenue realized in the beginning stages of a project. The revenue tends to increase over the life of the project, but sometimes trailing off in the latter part. In general, we recognize more revenues in the second half of a project.

In the first quarter of 2018, we experienced a trough in the cycle, mainly because of several large projects that we expected to finish in the quarter were completed in Q4 of 2017. This led to the strong fourth quarter results to end 2017.

Lastly, while quarter-to-quarter results may be a bit lumpy, we have excellent visibility into the next 12 months and are confident that we will meet our full year guidance. As an additional reminder, we anticipate the majority of our 2018 revenue forecast will be related to the Infrastructure segment, as we anticipate that initial CrossLayer contracts, including Industry City, will begin to shortly impact our financials late in 2018.

With that, I'll now turn the call over to David Lethem, our CFO, who will review our financial results for the first quarter of 2018.

David Lethem:

Thank you, Michael, and good afternoon, everyone. I will now provide you with a summary of our financial results for the quarter ended March 31, 2018. For the more detailed results, please refer to the Company's earnings release we issued this morning, along with our quarterly report on Form 10-Q filed with the SEC.

For the quarter ended March 31, 2018, revenues totaled $85.1 million, compared with $45 million, on a pro forma basis, for the same period in 2017. The increase was driven largely by the acquisition of Benchmark, which closed early in the second quarter of 2017.

In the first quarter of 2018, cost of sales was $73.7 million, representing a gross margin of 13.5%. This compares with the pro forma cost of sales of $35 million and a pro forma gross margin of 22.2% in the same period of 2017. Excluding the amortization of intangibles, the gross margin would have been 15.2% for the first quarter of 2018. Gross margin showed a small improvement over Q4's 13%, which was largely attributable to project mix. We expect margins to begin to better reflect the contribution from CrossLayer in the fourth quarter as new contracts currently in backlog are executed.

Selling, general and administrative expenses for the first quarter of 2018 were $4.2 million, compared to a pro forma $2.9 million in the corresponding 2017 period. The increase in expenses was largely attributable to increases in amortization expense of just under $1 million as a result of the acquisition of Benchmark Builders.

Total operating expenses for the first quarter of 2018 were $11.3 million, representing an increase of $2.1 million over pro forma operating expenses of $9.2 million in the same period in 2017. The increase in expenses is primarily, again, attributable to higher non-cash compensation expense and increased amortization expense of the intangible assets associated with the Benchmark acquisition.

Operating income was approximately $200,000 in the first quarter of 2018, which included approximately $200,000 in one-time expenses, compared to the prior quarter pro forma operating profit of $800,000, which included approximately $200,000 in one-time expenses.

Other expenses increased to $9.7 million from other expenses, on a pro forma basis, of $4 million for the same period in 2017. The increase was primarily attributable to costs such as the amortization of deferred financing costs and debt discounts, as well as other financing costs associated with the acquisition of Benchmark Builders.

On a GAAP basis, we generated a net loss of $10.2 million for the first quarter of 2018, compared to a pro forma net loss of $3.1 million for the same period in 2017. On an adjusted basis, which we believe is more indicative of the economic value of the business, adjusted net income was $3.5 million, or $0.56 per share, for the first quarter of 2018, compared with an adjusted net loss of $100,000, or $0.10 per share, for the same period in 2017, on a pro forma basis.

Adjusted EBITDA was approximately $7.4 million for the three months ended March 31, 2018. This compares with pro forma Adjusted EBITDA of $1.1 million for the prior year period.

As of March 31, 2018, the combined backlog totaled approximately $460 million.

Cash used by operations was $5.3 million for the first quarter of 2018, which was primarily driven by an increase in accounts receivable. As of March 31, FTE had $9.6 million in cash and working capital of $12.5 million.

Based on our results year to date, at this time we are reiterating our financial guidance for 2018, which we issued in conjunction with our 2017 full year results. First, FTE expects revenue of approximately $350 million for the full year. We expect this to be primarily driven by the Infrastructure segment and anticipate initial CrossLayer revenue to transition from backlog to revenue in the second half of this year. We also expect Adjusted EBITDA of $30 million for the year, operating income of $15 million for the year, and buildings on-net of 30.

I'd now like to return the call back over to Michael.

Michael Palleschi:

Thanks, David. So, in summary, we believe we're off to a strong start to the year, as evidenced by the $160 million in announced new contracts as of May 1, 2018, and healthy backlog that reflects the market's acceptance of FTE's product and service suite. We are obviously excited about the progress that our Technology segment is making, led by CrossLayer, and believe that the recent agreement with one of the largest commercial real estate services and investment firms in the world further magnifies the value proposition offered by our solution. We remain confident in the multi-prong and multi-year growth opportunity that lies before us and our ability to leverage our complementary business units to realize improved operating efficiencies, enhanced margins, and to build sustainable and growing profitability, thereby maximizing shareholder value.

With that, Operator, we are now ready to open the call to questions.

Gregg Davis:

Great, thank you. We'll be taking approximately nine questions from the investment community. We have several questions to go through. These questions were submitted today in response to an issued press release, as well as the 10-Q that was filed earlier today.

First and foremost, this question is to Mike, "Mike, what are FTE's plans on becoming more of a national growth story, rather than a regional, such as New York City?"

Michael Palleschi:

Currently, our technology and legacy infrastructure businesses operate nationally. Our goal in 2018 is to target strategic markets that we can successfully grow the Benchmark Builders business. Ultimately, we'd like to put our flag in the ground in seven to ten markets and continue to deliver the highest quality service to our customers. Luckily, most of our existing customers are nationally based already, so planned expansion should be rather easy. The main driving factors will be the ability to continue to deliver the same quality of services we do today and profitability. Currently, we're targeting all the NFL cities and expanding from there.

Gregg Davis:

Thank you. “Can you provide more clarity on the CrossLayer revenue model?”

Michael Palleschi:

Sure. At this stage, due to potential competitive interference, we haven’t released a revenue model. We believe that the type of contracts and services that we are offering are new and evolving, while being very disruptive in nature. However, as detailed in our prepared remarks, we anticipate a reasonably sized building to generate approximately $400,000 per year in revenue.

Gregg Davis:

Excellent. “How many buildings does CrossLayer have online currently?”

Michael Palleschi:

Currently, there are 11 buildings where we can offer services of the CrossLayer solution. We’re reiterating the guidance of 30 buildings by the end of the year.

Gregg Davis:

Thank you. “Any detail on the commercial real estate partner that you can provide?”

Michael Palleschi:

Sure. So, this partner, Benchmark has been doing business with them for the last nine years, CrossLayer has been working with them on this engagement for the last five to six months, and our agreement was actually signed about two months ago. We’re already recognizing positive results from the engagement and we’re looking forward to them making the public announcement in the very near future.

One thing to note is that, while we’re focused on leveraging both the Benchmark business and this relationship, our Sales Team is actively building out a solid pipeline of internally-sourced projects. It’s important to remember that the projects require CrossLayer to manage the infrastructure of an entire building, so it’s very complex, but we will continue to provide updates as they become available.

Gregg Davis:

Thank you, and “Where are you in scaling up CrossLayer?”

Michael Palleschi:

Currently, CrossLayer is scaling up, we’re growing significantly. We’ll be continuing to add headcount into the end of 2018, as the buildings on-net continue to grow.

Gregg Davis:

Thank you, Mike. The remaining questions will be geared for David. “David, given that there’s a cap on interest deduction resulting from tax cuts last year, does this impact FTE’s strategy of managing debt on its balance sheet?”

David Lethem:

At this time, it really doesn't. Look, the Company's focused on reviewing all opportunities to eliminate debt all together, or at least reduce the amount of debt and their associated carrying costs, whether that be interest expense or the other liability associated carrying costs, so we're not—that's not a priority right now.

Gregg Davis:

Thank you. "How much will gross margins improve with the addition of CrossLayer clients and what are FTE's plans to improve margins?"

David Lethem:

It goes pretty linear, as you well know. CrossLayer is the highest margin division of FTE Networks and as that revenue growths, as Mike and I talked about this afternoon, obviously it'll have a positive impact on our overall margin. Today, we're not really providing formal gross margin guidance, but as CrossLayer revenues become more impactful, we obviously would expect margin expansion.

Gregg Davis:

As a related question, "How is the legacy higher margin business planning to increase revenue to lift the lower margin Benchmark business?"

David Lethem:

Well, look, both entities are self-sustainable and their growth is profitable. Just-Com is continuing to build on its solid—continuing to grow through its existing MSA agreements, which, as we all know, is a higher gross margin than Benchmark. So, as Just-Com continues to grow on its backlog of MSAs under contract, that's going to lift the lower margin Benchmark business, along with the CrossLayer business that we discussed in the earlier question.

Gregg Davis:

Excellent, and lastly, "What is this line item—"I believe we already tackled that earlier, so that's it. That concludes our prepared questions. Thank you to the investor community for submitting your questions on time. I'll go ahead and give it back to Management for any closing remarks, and then the Operator will close us out.

Michael Palleschi:

Thank you for joining and we look forward to talking to you in another 90 days.

Operator:

This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.