FTE Networks

FTE Networks, Inc.

Second Quarter 2018 Financial Results Conference Call

August 21, 2018

C O R P O R A T E P A R T I C I P A N T S

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

Michael Palleschi, *President and Chief Executive Officer*

David Lethem, *Chief Financial Officer*

Ted Haberfield, *President, MZ Group - Q&A Moderator*

P R E S E N T A T I O N

Operator:

Greetings, and welcome to the FTE Networks Second Quarter 2018 Financial Results Conference Call. At this time, all participants are in a listen-only mode. 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, Greggory Davis of MZ Group.

Greggory 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 that 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. Reconciliations 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, Greggory, and welcome to the FTE Networks Second Quarter 2018 Earnings Call. We made great progress during the second quarter. The vision we shared at the beginning of the year is coming to fruition and I could not be more pleased with the Company's operational performance to date. This performance is reflected in the strong quarterly revenues, our highest quarter to date of $86.4 million and $7.6 million of Adjusted EBITDA. This quarter also highlights our ability to use cash flow largely generated by our Infrastructure segment to both service our debt and support further investment in our Technology segment, in particular, CrossLayer.

With respect to new business, our year-to-date contract wins remain strong, totaling $302 million, and a backlog of $396 million as of July 31, 2018.

We are reiterating our 2018 guidance of $350 million in revenues, $30 million in Adjusted EBITDA and a goal to bring 30 CrossLayer buildings on net by year end. We define on net as a building with our fiber networking compute to the edge nodes installed where we can extend CrossLayer services.

For those who may be new to the CrossLayer story, CrossLayer is the cornerstone of our Technology segment and bring highly disruptive functionality to an in-building network infrastructure by offering a more efficient, more convenient and more profitable solution for building owners. For decades, the traditional approach was to outsource network connectivity to Tier 1 carriers, leaving building owners and tenants at the mercy of those service providers with new installs, maintenance and troubleshooting. Whereas CrossLayer, building owners can now maintain control of their network and offer tenants highly reliable turnkey connectivity. Building owners are effectively offering what is considered the fourth utility which they can now profit from.

While CrossLayer and our Technology segment offer a great deal of growth potential, our core Infrastructure segment provides the foundation and financial resources necessary to support its expansion. Our reputation in the Infrastructure segment continues to build upon itself, and the frequency of contracts being expanded upon with existing customers is increasing. This is a great trend to see and is a result of our commitment to deliver projects on time and to specifications.

While our backlog can fluctuate substantially from one day to the next based on project timing and contract execution, our ability to win new business continues to ramp up as evidenced by approximately $302 million of new contracts secured this year through the month of July. This puts us on pace to accomplish our year-end objectives while also laying a solid foundation going into 2019.

Additionally, I think it's important to discuss our niche within the infrastructure market and the impact we believe that it has on the economic elasticity of our business. We are fortunate to be able to benefit from expansionary bull markets like the one we are currently in, and also have a defensive nature to our service offerings which should allow us to outperform our peers during periods of contraction.

A significant amount of our business in the Infrastructure segment is interior buildouts which tend to be in high demand as companies grow and downsize. I think it's a critical point to understand that we should have relatively low economic elasticity in our Infrastructure segment and the added benefit of recurring annuity-like revenue streams from our Technology segment as our CrossLayer footprint expands over time.

We will continue utilizing the strong cash flows provided by our Infrastructure segment to optimize the balance sheet. Currently, the $91.6 million amount of total debt we have outstanding, $46.9 million is in the form of favorable low 3% to 5% interest seller notes, with $28.7 million in the form of a senior secured note, and $16 million of short-term notes and capital equipment leases. We believe that cash flow from operations will allow for a continued investment into the Technology segment and payment of the current debt structure.

The short-term notes and capital equipment leases are used for operations and support revenue generation in both Infrastructure and Technology segments. We are constantly evaluating refinance opportunities and will remain opportunistic in our efforts to continue improving upon our balance sheet and capital structure.

Our primary reason we remain so optimistic about CrossLayer and its potential to disrupt the status quo is that the implementation costs for customers are relatively minimal. This translates into sticky, long-term, recurring revenue streams for FTE. Each building on-net with an average size of 300,000 to 400,000 square feet is expected to begin generating revenues shortly after implementation, and ramp up to a peak rate of approximately $400,000. While we do not disclose profit margins associated with CrossLayer, we believe them to be in line with traditional software models where the bulk of the cost is in the early R&D.

The development of CrossLayer has been a substantial undertaking with approximately $9 million invested to date, combined with the decades of technical implementation expertise to bring it to market. We now have customer buildings on-net that are validating our technology and the value proposition that comes with it.

A great example of how CrossLayer was designed to perform in a real-world setting can be seen by one of our early deployments at Industry City in Brooklyn, New York. Industry City is one of the largest connected campuses in the country and consists of 16 total buildings, 11 of which are now utilizing CrossLayer services to bring business Internet, tenant and guest WiFi and business over voice-over IP services to end users. The addition of CrossLayer services have been central to the efforts to modernize building infrastructure and provide next-generation Internet, telecom and WiFi.

Overall, we believe we are in a great position with our Infrastructure segment firing on all cylinders and generating strong cash flows to support our continued roll-out of CrossLayer. Not only is the Infrastructure segment providing the necessary financial resources but also the operational backbone and logistical support necessary to help stimulate adoption.

Over time, we believe CrossLayer growth will drive higher margins and recurring revenue streams into the revenue mix. In the interim, we could expect the strong performance of our Infrastructure segment to continue as we leverage the operational reputation we have built.

With that, I now turn the call over to David Lethem, our CFO, who will review our financial results for the second 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 June 30, 2018. For the more detailed results, please refer to the Company's earnings release along with our quarterly report on Form 10-Q filed with the Securities and Exchange Commission.

For the quarter ended June 30, 2018, revenue totaled $86.4 million compared with $52.9 million on a pro forma basis for the same period in 2017. This increase was driven largely by the acquisition of Benchmark which closed early in the second quarter of 2017.

In the second quarter of 2018, cost of sales was $72.4 million, representing a gross margin of 16.2%. This compares with the pro forma cost of sales of $44.3 million and a pro forma gross margin of 16.3% in the same period in 2017. Excluding the amortization of intangibles, the gross margin would have been 17.9% for the second quarter of 2018. Gross margin showed good improvement over Q1's 13.5%, which was largely attributable to the project mix.

Selling, general and administrative expenses for the second quarter of 2018 were $5.1 million compared to a pro forma of $3.5 million in the corresponding 2017 period. The increase in expenses was largely attributable to an increase in amortization expense as a result of the acquisition of Benchmark.

Total operating expenses for the second quarter of 2018 were $13.6 million, representing an increase of $3 million over pro forma operating expenses of $10.6 million in the same period in 2017. The increase in expenses again is primarily attributable to higher non-cash compensation expense and increased SG&A expenses.

Operating income was approximately $0.3 million in the second quarter of 2018, which included approximately $3.4 million in one-time expenses compared to the prior quarter pro forma operating profit of $1.3 million, which included approximately $1.8 million in one-time expenses.

Other expenses increased to $14 million from other expenses on a pro forma basis of $2.7 million for the same period in 2017. Again, the increase is primarily attributable to costs such as the amortization of deferred financing costs, debt discounts and other noncash financing costs.

On a GAAP basis, we generated a net loss of $13.5 million for the second quarter of 2018 compared to a net loss of $5.1 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 loss was $1.6 million or $0.22 per share for the second quarter of 2018, compared with an adjusted net profit of $0.1 million or $0.0004 per share for the same period in 2017 on a pro forma basis.

Adjusted EBITDA was approximately $7.6 million for the three months ended June 30, 2018. This compares with pro forma Adjusted EBITDA of $2.3 million for the prior year period.

As of June 30, 2018, the combined backlog totaled approximately $322 million, and as of July 31, 2018, $396 million.

As of June 30, FTE had $12.9 million in cash, an increase of $3.3 million from March 31, 2018.

In terms of our debt as of June 30, 2018, we had approximately $46.9 million in related party seller notes, $16 million in notes payable consisting of equipment leases obligation and other notes, and $28.7 million of senior notes payable. The related party seller notes bear interest between 3% to 5%, so we're in a strong position in terms of debt service with over half of our total debt represented by low-cost related parties. Principal payments are due on the seller notes beginning in Q4 of 2018 through 2020. We believe that cash flow from operations will allow continued investments into the Technology segment and payment of the current debt structure.

The capitalized investment in CrossLayer was approximately $2.5 million in the first half of 2018 and approximately $9 million since inception. Going forward, we anticipate ongoing R&D budget of approximately $4 million annually in support of CrossLayer. We also anticipate sufficient cash flow from operations to fully fund this investment.

That concludes my prepared financial commentary. Operator, please proceed to the Q&A portion of the call.

Operator:

Mr. Ted Haberfield, President of MZ Group will now facilitate the Q&A. Mr. Haberfield, please proceed with the first question.

Ted Haberfield:

Thank you, Operator. We received approximately six questions, all of which have some sub-questions and comments to it. The first question is: There seems to be a significant increase in debt financing cost over the reporting period. Can you please apprise us on what the plans are to restructure the debt to help the Company with better cash flow?

David Lethem:

Sure. As mentioned in our prepared remarks, we believe that cash from operations, primarily generated by our Infrastructure segment, is strong enough to support current and future debt obligations. That said, we are exploring refinancing alternatives to address a portion of our existing debt that we would like to restructure.

Ted Haberfield:

Thank you. The second line of questioning is: I have noticed margin compression in the last quarter. I had thought as we move forward with the CrossLayer technology we would begin to see higher margins. This does not seem to be bearing out in the latest results.

David Lethem:

Depending on the lifecycle and the dollar value of Benchmark contracts, margins do fluctuate from period to period. We do believe, however, that as revenue contributions from the Technology segment increase, there will be a positive impact on margins.

Ted Haberfield:

Thank you. The third line is: How does the overall demand picture look? Have request for proposals increased through the quarter or are potential bids diminishing?

Michael Palleschi:

Ted, I'll take that. On the Infrastructure segment, we have the same amount of projects projected in the second half of the year that we had the first half of the year. Additionally, the CrossLayer business has more than doubled its pipeline from Q2—in Q2 from Q1.

Ted Haberfield:

Line four: Aside from backlog of $322 million, what leaves you confident that you'll approach $350 million this year? How much of that backlog is expected to convert to sales this year, and how does that backlog break down relative to Benchmark and CrossLayer?

David Lethem:

Okay, thanks. Look, just for clarification, as of July 31, 2018, our backlog was $396 million, which actually represents just how quickly backlog can increase or decrease depending on the timing of the contracts. Our backlog consists of projects in progress that have previously been contracted. A large percentage of the backlog is associated, as we said, with the Infrastructure segment.

Ted Haberfield:

Thank you. Line five is: There's little discussion on the legacy telecom construction business. What's the status there and how much of the $86.4 million did it contribute?

David Lethem:

Sure. The legacy telecom construction business remained strong and continues to report an increase in contract wins, as we've announced over the last several months. We do not, however, break out individual subsidiary revenues in our segment reporting.

Ted Haberfield:

That now concludes the Q&A section. I will now turn it back over to Mr. Palleschi for closing remarks.

Michael Palleschi:

Thanks, Ted. In summary, we had a great first half 2018, and this is a trend we expect to continue. Our strategic vision was to build a dynamic technologically advanced company that offered both strong cash flows and tremendous growth potential. We've made a great deal of progress doing exactly that.

Before we close, I'd like to briefly reiterate a few key takeaways from the call today. Number one: The Company is confirming guidance of $350 million of revenue, $30 million of Adjusted EBITDA and 30 CrossLayer buildings on-net by year end.

Number two: Strong cash flow from operations will allow the Company to service both principal and interest on our debt while supporting continued R&D associated with CrossLayer.

Number three: CrossLayer buildings on-net are performing to spec and we anticipate bringing additional buildings on-net in the very near term.

Number four: Regarding balance sheet, we will continue to optimize the balance sheet opportunistically over time as strong cash flows from operation provide increased flexibility.

Lastly, number five: Our year-to-date new contract wins continue at a very brisk pace totaling $302 million as of July 2018.

Before I wrap up, I wanted to thank our team for their hard work and dedication, continued support and thank all of you very much for taking the time to dial today. I truly appreciate it.

Operator, that concludes our call.

Operator:

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