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Calix: Drifting At The Mercy Of Market Tides

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Summary

- Calix's 2Q19 earnings call was followed by a 13% drop in the stock. Guidance was below market expectations.
- Looking past the drama, fundamentals are improving gradually. Just not as fast as management had led the market to believe. Vague and imprecise disclosure makes it hard to dig deeper.
- While potential upside remains 50%-to 100%. the stock will likely drift with the market until at least their October call and possibly into 2020.
- Improved disclosures around the revenue and gross margin trajectory of "Calix 2.0" would be a major positive catalyst. Management, however, seems unwilling to go beyond vague generalities. The call left many questions un-answered.

Calix's (CALX) 2Q19 report was, characteristically, a mismatch between over-hyped expectations and underwhelming guidance. The stock ran up to as high as $7.50 in advance of earnings. CALX dropped 13% to $6.35 (at market close) on the actual results.

As best as I can tell, the CEO had stoked the fires of expectations at a recent investor conference. Taking his cue from the CEO's tone, an analyst published a recent note calling out 3Q as the likely “inflection point” for the stock (I also expected an inflection point recovery after the 1Q19 production problems). New investors bought in on that basis, driving the stock up ahead of results.

Actual 2Q19 results were in line with expectations. 3Q19 guidance did not meet expectations. Calix guided to $110m – $114m revenues in 3Q19 and and $0.02 - $0.08 EPS. Consensus estimates for 3Q19 stood at $121.1m and $0.10.

Looking past the drama, the fundamental outlook does appear to be improving gradually. Just more gradually than management led the market to believe.

There remains a pretty good story to tell in Calix, but management seems unwilling to deliver it in detail. As a result, the specifics of that improvement remain vague behind the veil of Calix's frustratingly opaque approach to disclosure.

Likely To Drift At the Mercy of Market Tides Until At least Mid-October's Report.

My best guess is CALX will drift with the market until we get to the 3Q19 report – probably in mid-October. A decisive turn in the numbers may not come until 2020.

Today's market reaction just takes CALX back to mid-June 2019 levels. With the stock holding above $6 today, the pre-quarter run up and subsequent drop could be seen as just a blip in an improving trend. But there is damage done.

Calix has singed the fingers of yet another crop of recent buyers who might have been convinced to become long-term holders of the company. Questions left un-answered by management on the 2Q19 call (see below) will also make it that much harder to find new buyers. Investors tend to be wary about crediting improvements in advance after a stock has burned them so frequently and recently. In the meantime, that leaves Calix and its current owners at the mercy of market tides.

I continue to hold the stock. I've done enough digging to see through to those improving fundamentals. Per the below, there is still 50%-100% upside on 2020 numbers with more potential in 2021. The question is how long it will take until numbers turn up decisively enough and/or disclosures improve significantly enough for the market to price that in.

Through a Glass Darkly - Fundamentals Seem to Be Improving Behind An Opaque Veil of Weak Disclosure.

The fundamentals do seem to be improving in broad terms. Calix's contract manufacturer has largely resolved the 1Q19 production problems. Gross margins continue trending upwards as their new, software-based products ramp. Verizon (VZ) is confirmed to be a 10% customer in 2019 and will ramp further in 2020. The UK's CityFibre (Private) is earlier in its ramp, but has expanded its build to 14 new cities covering 2 million of its targeted 5 million endpoints. CenturyLink (CTL) has stabilized spending – admittedly at a low level as they assess whether to spin off their consumer division.

The dimmed expectations were ascribed to further weakness at mid-sized telcos Windstream (WIND) and Frontier (FRO). Windstream is in bankruptcy and Frontier is also widely reported to be considering bankruptcy. Per comments made on Calix's 1Q19 calls and subsequent conference presentations, I had (reasonably) thought that Calix management had already factored in a worst case scenario for these customers. Regardless of whether my or management's assumptions were wrong, the actual worst case seems to be another step down. But at only ~7% of 2Q19 revenue, management is right to argue these customers can't do much more damage.

Oddly missing from the discussion was the roughly $10m - $20m of product orders that were delayed by the first half's production problems. Those were expected to come back into the second half. They were (I believe) the reason for the sharp increase reflected in consensus revenue expectations (going up 20% from $100m in 2Q19 to $120m in 3Q19).

One way or another, Calix ended up carrying excessively high expectations into the quarter and has been marked down for it. The associated drama overshadowed a gradually improving outlook.

2020 Revenues Probably $500-$550m. EPS Range Uselessly Wide at $0.30c to $0.75.

I don't have the new consensus estimates yet. Going into the quarter, they were for $493m 2020 revenue and 52c EPS. But I would take those estimates only as a starting point for your own analysis. Sell-side analysts don't generally stay up late fine-tuning their models on a $400 million market cap company with anemic trading volumes and a volatile history.

I think $500m to $550m is probably achievable for 2020 revenues. At 1x to 1.2x EV/sales (reasonable multiples for this sector) that solves for a $10-$12 stock.

It is hard to come up with a P/E multiple valuation because of uncertainty around 2020 EPS. I could drive a truck through my model's EPS estimate range of $0.30 to $0.75. At the 17.5x S&P500 P/E multiple, that solves for a $5 to $13 target price range. So wide as to signify nothing.

The EPS variance stems from the vagueness surrounding Calix's future gross margins. We know they are "improving" but we have no insight into the trajectory and end point of that trend line. With gross margin in particular, investors are mostly at the mercy of management's disclosures and guidance.

My gut tells me to go with the higher end of Calix's margins and thus EPS range. That would yield a price target in the $11 to $15 range. But, per the below, I am growing weary of relying on my gut vs clearer guidance from Calix management.

The above points to a deeper problem. As a current investor and close observer of the market space, I can dig in to model the outlines of a more software/subscription based, higher-margin, growing company inside Calix. Incremental new investors in $400m market cap companies, however, generally can't and don't spend that sort of time.

Google (GOOG) Can Get Away With Opaque Disclosures. Calix Can't.

Large cap companies such as Google (GOOG) can generally get away with more opaque disclosure and vague generalities on their calls. Why? Because investors *have* to take a position on them one way or the other. They are too big to ignore.

$400m market companies like Calix don't command the same attention. Especially if they sell complex technology in a specialized industry sub-segment. Potential new investors, confronted with a complicated, opaque, vague outlook, can (and do) simply choose to invest their time and capital more profitably elsewhere.

This investor indifference is evidenced in several ways: The preponderance of computer-model-driven investors in the Top-20 holders list. The remainder of non-programatic holders including so many deep value investors (whose simple presence tells you the stock is deeply out of favor and presumably mis-priced). CALX's desultory 225k average daily trading volumes. Extreme volatility around quarterly results. There are precious few buyers or sellers to stand on the other side of a trade if someone wants to move any sort of real volume in or out of the stock.

At some future date, the numbers will win out. The market will duly price them in. A more forthcoming approach to disclosure would bring that date forward by several quarters. It is mystifying and frustrating that Calix management (and its Board) doesn't seem to grasp that truth.

Calix produced a 7 page investor letter on July 23. They held a 36 minute call on July 24. Yet they failed to answer some very simple questions that would seem central to analyzing and understanding the stock. I present them below. Their call transcript is here.

Questions Left Un-Answered on the Call.

Calix 1.0 to 2.0 Transition/Trajectory: Calix management it pitching a "Calix 1.0 to Calix 2.0" transition to a higher gross margin, more software-based, more profitable business model. But they have given no detail. What is a reasonable range of margin expectations for Calix 2.0 at maturity? How long to get there? How big are Calix 2.0 products and service as a percent of total revenues today? When will it become a majority of Calix's revenues? The only comment given on the call was a highly un-specific "*our [new] platforms are growing very rapidly, but still off of, let's say, minority numbers. Our traditional and supporting products or our legacy products are still the large majority of the business.*"

Composition of the Customer Base That is Actually Growing? Calix did (finally) disclose that CenturyLink, Windstream, and Frontier are down from over ¾ of revenues to "less than ¼." CenturyLink was 17% of 2Q19 revenues, leaving bankrupt WindStream and struggling Frontier at around 7% combined. So we know who is shrinking. But we know very little about who is growing. Calix gives no detail on the composition of the other 76%+ of its revenues. We know that Verizon and CityFibre are relatively big and growing fast, but we don't know how big or how fast. We are are wholly in the dark on the rest of their customer base. This is particularly frustrating as one of Calix's great strengths *should* be its relatively wide customer base among rural telcos, cable companies, electric cooperatives, and new over builders. That diversity could be perceived as a strength if we had some numbers to back it up. The only detail given on the call was "*Headwinds from our publicly traded ILEC customers will continue through the third quarter and into the fourth quarter. We are confident that these headwinds will no longer be a meaningful factor in the business entering 2020. It is worth noting that not many years ago, this narrow category of customers represented more than 3/4 of our business. Today, that same set of customers delivers less than 1/4 of our business. The flip side of this story is the robust nature of the future Calix business model. We continue to add new customers at a rate greater than 100 per year. That is remarkable. And as the headwinds from our legacy business subside, this new business will continue to shine."*

Outlook for Verizon and CityFibre? Engagement With Other Potential Marquee Customers? Calix management did provide a significantly more detailed update on marquee customers Verizon and CityFibre (see quote below). It is not clear if they will continue to deliver that much-needed context. Moreover, they continue to provide no insight into engagement with other large potential customers. It is never advisable to count chickens before they are hatched. But it would help to have some rough color on how many eggs are left in the nest that *might* hatch.

Cash Flow Outlook? As a rule of thumb, telcos like to see about one quarter's worth of cash (or more) on their supplier's books as a cushion in the event of a downturn. For Calix, this would amount to about $100-$150m. Net cash at present is about $10m. Calix does seem likely to turn cash positive in 3Q19. It appears to have the continuing support of its lender Silicon Valley Bank (the source of the $25m revolving debt shown on the balance sheet). Calix also has roughly $15-$20m of excess inventory that should convert to cash as its contract manufacturer recovers from its 1H19 production problems. But it doesn't appear that Calix will be comfortably liquid until well into 2021. Will they be able to finance growth in the meantime? When will shareholders see a cash return on their invested capital?

Internal Management Changes to Address Persistent Forecasting Errors and Operational Failures. In the past three years, Calix has experienced two major operational failures – poorly negotiated, negative margin services contracts that dragged down results for all of 2017 and the more recent disruptive manufacturing shift out of China in 2018-2019. Calix has also persistently failed to set and communicate realistic forecasts and guidance to investors – as evidenced by the jagged path of the stock price.

It would seem to behoove the company to 1). Make structural management changes to improve execution going forward. 2). Discuss and disclose those changes so investors might have more confidence in that future execution. As it stands, it is not clear if Calix management even sees a need for structural improvement.

A Binary Bet That Remains Un-Resolved.

Calix is currently trading at 0.6x to 0.7x presumed $500m - $550m 2020 revenues. CALX could and arguably should trade closer to the sector's more normal valuation range of 1x to 1.2x. Per the above, a 2020 P/E multiple is hard to derive given the wide range of earnings Calix could potentially deliver. But a P/E valuation could potentially support an $11 to $15 stock price.

The discounted valuation tells us investors have low confidence in Calix's ability to deliver. Calix does have a track record of weak execution. Calix also has a thin cash cushion ($10m net cash in 2Q19 plus their $30m revolving credit facility). If Calix mis-executes or hits a negative macro shock, the company could face existential risk. All the above explains the discounted valuation.

Eventually, Calix likely delivers a long enough string of improved results to overcome the skepticism embedded in the stock price. I had hoped that today's call would start the engines and get the stock on its way.

As it stands, CALX will likely drift unpowered at least until they release 3Q19 results in mid October. Judging from its recent track record, it may well keep drifting further into 2020 – particularly absent improved disclosures.

I consider this a high risk, binary bet. I do own the stock. A more uncertain market outlook has left me more concerned about holding a “drifting” asset with an uncertain date for when it might move under its own power once more. Your personal situation and objectives must be the starting point for any investment decision you might make.

Disclosure: I am/we are long CALX. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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