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GOGO - Q2 2018 Gogo Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Gogo Inc. Second Quarter 2018 Earnings Conference Call. (Operator Instructions)

As a reminder, this conference call is being recorded.

I would now like to introduce your host for today's conference, Mr. Will Davis, Vice President of Investor Relations. Sir, you may begin.

William G. Davis - *Gogo Inc. - VP of IR*

Thank you, and good morning, everyone. Welcome to Gogo's second quarter earnings conference call.

Joining me today to talk about our results are Oakleigh Thorne, President and CEO; and Barry Rowan, Executive Vice President and CFO.

Before we get started, I would like to take this opportunity to remind you that during the course of this call, we may make forward-looking statements regarding future events and the future financial performance of the company.

We caution you to consider the risk factors that could cause actual results to differ materially from those in the forward-looking statements on this conference call.

These risk factors are described in our earnings press release filed this morning and are more fully detailed under the caption risk factors in our annual report on Form 10-K and 10-Q and other documents we filed with the SEC.

In addition, please note that the date of this conference call is August 8, 2018. Any forward-looking statements that we may make today are based on assumptions as of this date.

We undertake no obligation to update these statements as a result of new information or future events.

During this call, we'll present both GAAP and non-GAAP financial measures.

We included a reconciliation and explanation of adjustments and other considerations of our non-GAAP measures to the most comparable GAAP measure in our second quarter earnings press release.

This call is being broadcast on the Internet and is available on the Investor Relations section of Gogo's website at ir.gogoair.com. The earnings press release is also available on the website.

After management's remarks, we'll host a Q&A session with the financial community only. It's now my great pleasure to turn the call over to Oakleigh.

Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

Thanks, Will. Good morning, everybody, and welcome to Gogo's second quarter 2018 earnings call.

I'd actually like to start by welcoming Will Davis to his first Gogo quarterly earnings call.

Will joined us as VP of Investor Relations in May. He brings nearly 20 years of wireless and communications infrastructure industry experience in Investor Relations, including with Nokia and as an analyst in both the buy side and sell side.

Most recently, Will was the SVP of Marketing and Chief of Staff of the combination of Lumos Networks and Spirit Communications. During his tenure at Lumos, the company's EBITDA multiple doubled and he played an active role in assessing ongoing strategic opportunities including M&A and the potential sale of the company. We're glad to have Will in the Gogo team, let's hope he has the same magic touch here.

So let me get started. We had a strong quarter with all 3 of our business segments coming in ahead of our expectations on almost every metric.

Our consolidated EBITDA performance was especially strong at $19 million versus our expectations of 0 with roughly $4 million of our performance coming from our BA division and $15 million from our CA division.

The BA division outperformance demonstrates the continued strength of that business and was driven by stronger-than-expected revenue and a variety of cost saves.

Of the CA-NA outperformance against expectations, roughly $6.5 million is timing and $8.5 million is a fundamental business improvement, including a $5 million BA service revenue and $3.5 million of cost saves.

The Business Aviation segment had another record quarter. The new AVANCE L5 and L3 systems driving a 67% year-over-year increase in equipment sales, which pertains very strong future high-margin net service revenue growth. And segment earnings hitting an all-time high of $36.7 million, up 46% from the prior year.

We're also pleased with the resiliency of our CA-NA service revenue. If you back out American Airlines, GAAP service revenue for all other airlines was up 14% for the quarter. That 14% CA-NA revenue increase was driven by a 6% increase in average aircraft online, but also a big pop in take rates. When you exclude American Airlines, take rates hit 13%, up 67% from 7.8% prior year, driven by new lower-cost offerings such as airline sponsored free messaging and our T-Mobile offer.

We think the increases in take rates and the consequent 15% jump in revenue across all airlines besides American reaffirms our strategy of leveraging our installed base and our 2Ku bandwidth to drive revenue with multi-tier plans and third-party sponsored usage.

Our 2Ku product is performing very well, achieving greater than 97% availability this June and July.

This in turn is driving significant increases in customer satisfaction and net promoter scores, not only for 2Ku but also for our ATG network as more traffic is being offloaded to the 2Ku system. It should be noted that our 2Ku network actually passed our ATG network and data consumed during the month of June.

We remain focused on positioning Gogo for sustainable value creation and as a long-term investor myself, I look at the underlying growth of the business ex 2 things. One, the large American deinstalls, which we believe are a onetime anomaly and two, post the icing expense, which is hurting both our OpEx and CapEx lines, but really represents an investment and a valuable platform for growth.

Now I'm going to spend a few minutes talking about each of our 3 segments, than about the icing and finally about our progress in Gogo 2020 and then turn it over to Barry to cover the numbers.

One thing we're not going to spend a lot of time talking about today is refinancing our convertible note during March 2020. There are many avenues open to us and in the case of refinancing we're working with urgency and focus to prioritize and execute on the avenues that incurred the least execution risk and as a least dilutive to common shareholders.

When we have more details to share we'll do so.

So let me start with BA. Business Aviation achieved outstanding 28% year-over-year revenue growth consisting of 14% growth in our high-margin service revenue and 67% growth in equipment revenue. This is a portent of good things to come as equipment revenue drives future service revenue.

BA earnings were also strong with segment profit up almost -- up $37 million, 46% year-over-year, driven mostly by revenue growth.

The biggest driver of our BA growth is our highly successful AVANCE platform. The AVANCE platform is packaged in 2 configurations, the L5 product which is aimed at the medium to large jet market and the L3 product aimed at the mid- to small jet and turboprop markets.

The L5 and L3 share a common architecture that will enable us to remotely install future product upsells without having to install new equipment.

So far, we shipped 460 L5's of which 256 have been activated and we have another 400 on order.

The L5 is delivering 3x the bandwidth of our traditional ATG product and is available with a streaming data plan or a data place -- data or a browsing data plan with about 35% of customers choosing the streaming plan, which operates well on our current ATG network.

Interestingly, 65% of all L5 orders are new customers indicating that we're achieving higher market penetration with this product.

So far, we shipped a 100 L3's, activated 53 and have another 40 on order. L3 delivers roughly 1.5 to 2x the bandwidth of our traditional ATG product.

The AVANCE platform LRUs are designed to securely host and enable many product extensions and third-party applications. This is especially important in the BA market where aircraft real estate is precious.

Among the connected capabilities, we're already exploding -- exploiting our predictive maintenance tools that will drive customer satisfaction by allowing us and flight departments to identify and fix problems before the customer knows there is a problem.

We have a lot of other product extensions we're developing to drive customer satisfaction with owners, operators, passengers and crew and we look forward to telling you about them in future calls when they are ready to launch.

Another big piece of news at BA is that it appears the cloud has been listed on ZTE, our primary supplier for our 2.4 gig NexGen ATG network.

Both the House of Representatives and Senate have now approved final language for the defense authorization bill, which would allow American companies to do business with ZTE and the president has indicated he will sign that bill.

This is very important as it gives us optionality around whether to deploy NextGen and if so when to deploy NexGen. We're going to start flying the system again and if it looks strong and pass the system testing to ensure our superior service offering now and in the future, the next critical decision will be when we deploy and at what pace?

If we can see competitive pressure, we'll be ready to deploy quickly.

It's important to remember that one of our key advantages is that we already have a nationwide network built on owned spectrum. So customers who install NextGen ATG will be able to get the benefit of our new high-speed network immediately in some regions of the country while falling back to our traditional ATG network in other geographies while we finish building the ATG -- the NextGen network out.

It's important to remember we're the industry leader and have a very strong position in the BA market but that only 23% of all BA aircraft carry a broadband product today, leaving a lot of room for future profitable growth.

It's also important to remember the learnings of the world-class team that built our BA business, many of whom are now bringing their talents and business knowledge (inaudible) and building our CA business.

Now let me turn to CA in North America. As I noted in my opening comments, underlying service sales growth in CA-NA was quite strong when excluding American airlines.

It's important to note that we lost a bid for 550 jets back in early 2016 via an American RFP process aimed at upgrading from our ATG system to a new streaming class satellite system.

Sadly, for us, our marketing and delivery of 2Ku were not ready for prime time and we lost that deal to a competitor.

We view that as an anomaly because at this point virtually all the rest of our CA-NA airline customers have committed their mainline ATG fleets to upgrade to 2Ku.

Equipment revenue was up significantly as we hit 111 installs in the quarter. We also suffered 76 deinstalls of which 71 were from American.

As you may recall, the time we lost the 550 aircraft, we were also awarded 140 2Ku upgrades on American and we installed 67 totally American aircraft with 2Ku in Q2 for a total of 96 2Ku installs.

For planning purposes, we should note that we expect American deinstalls to taper a little in Q3 and then pick up significantly in the fourth quarter, putting significant downward pressure on CA-NA service revenue at that time.

CA-NA segment profit was $7 million for the quarter, down significantly from $16 million in the prior year but considerably better than our expectations.

Operationally, it was a strong quarter. 2Ku system availability rose steadily from 93% in April to 95% in May and averaged 97% for June and July.

And the system availability rose, we saw a dramatic increases in customer satisfaction and net promoter scores as measured by Gogo and by Airline Partners. We installed 2Ku on 89 aircraft across 4 fleets in the quarter including inductions on the Air Canada 777 fleet and Alaska's former Virgin America A321s.

We also launched our first agile development teams in the quarter and are moving most of our software development to the agile methodology.

Importantly, our agile teams have started delivering a series of improvements to our IFC product that will remove friction in the sign-up process, improve page load times and enable third-party services, all designed to drive higher take rates and revenue for Gogo.

Now let me touch on CA, Rest of World briefly.

Remember, when the early stages of development in Rest of World and we are proud of our continued success building scale with service revenue up 15% and equipment revenue up an almost infinite amount as many of our Rest of World contracts come under 606 sale accounting, which was just initiated this year.

Overall, segment loss improved by 20% -- 22% year-over-year and gross margin improved from minus 57% to minus 12%.

In the quarter, we installed 59 Rest of World aircraft with 2Ku. Not all of which have been activated yet and we expect to install more than 250 for the year, leaving us with more than 600 2Ku aircraft in Rest of World at year-end.

Installations included inductions in Air France's 777s, British Airways' A380s, Cathay Pacific's 777s, KLM's A330s, LATAM's A320s and LEVEL A330s.

Rest of World is important to us because some of our key airline partners fly international routes that require global coverage. However, it's important that we scale up to cover the fixed cost of our global satellite network and manage this segment of our business to profitability as soon as possible.

Now let me turn to deicing, which mostly affects CA-NA but also CA, Rest of World to some extent.

We've been very actively working with our airline partners and solutions to the deicing issues, ever since last winter. This started with a series of software upgrades in April that significantly improved our system availability.

In Q2, we replaced all 2Ku antennas that showed consistent signs of degradation coming out of last winter.

In order to avoid future degradation, we're taking a belt and suspenders approach by identifying as many further solutions as possible, running them through effectiveness, quality and safety tests and then deploying as many solutions as practical.

By way of background, it's important to understand that for safety reasons, in the aviation business, it takes a lot of time to design, build, get regulatory approval for and then install a piece of hardware on an aircraft.

Some of the solutions we've identified will begin installation later this month and we expect them to be complete by winter. We believe these will add even more significant safeguards against the effective deicing and what we've done to date.

Some other solutions are more complex and will require us to rotate updated antenna stock out to airlines to be installed over night. Those uninstalls will begin in September and they could well drag through the winter.

We have yet other solutions that are in testing, they could further reduce the risk of fluid getting into the antennas in case our earlier solutions are not effective. We need to assess the effectiveness of our earlier solutions and complete testing before we know if and when we would install those solutions.

We believe that we have identified as many solutions as possible to definitely address this issue and are working collaboratively with our airline partners to tailor installation of these solutions to each of them based on where they fly.

We expect the bulk of the cost associated with these solutions to hit this year and some costs to lapse into next year.

But the exact cost is hard to know until we see the effectiveness of early solutions and until we have a plan with each airline.

Despite its early teasing pains, we consider our investment in solving the deicing issues on 2Ku to be a minimal investment for our longer-term differentiated solution for both the airlines and Gogo, as it enables us to deliver a better user experience and a monetized higher take rates than our competitors products.

Let's not forget 2Ku's advantages. First, it's twice as (inaudible) efficient as traditional gimbal antennas, which enables us to deliver more bandwidth for less money. Second, it relies on the 2 -- on the Ku satellite echo system, which is far more open, has better coverage and has more redundancy than the Ka echo system.

And third, it has relatively cheap upgrade path to LEO compatibility, which would enable our airline partners to take advantage of cheaper and lower latency LEO constellations such as OneWeb when they launch in the future.

Now I'll give a quick update on Gogo 2020.

As you'll recall, we announced Gogo 2020 a month ago. To planned overhaul our go-to-market strategy, improve quality, implement mature business processes, ensure proper capital allocation and realize efficiencies over the next 10 quarters.

We expect the plan to reduce our CA operating spend excluding Satcom expenses by 20% by the end of 2020 and drive significant operational improvements.

In order to facilitate conservative cash planning, we assume very low revenue growth and use our current contracts to project future Satcom costs.

Even with these conservative assumptions, the plan showed significant benefits including significant growth in annual adjusted EBITDA through 2022, a materially reduced CapEx burden, large reductions in our OpEx cost structure and significant improvements in free cash flow.

With those conservative projections, we identified a need to raise some additional capital, however, we outlined 3 levers we're working on to try and improve our cash projections.

First, revenue growth, driven by user experience improvements and third-party payer programs.

Second, renegotiating certain contracts to reduce subsidies on equipment, and third, revising our Satcom plan to take advantage of the downward trajectory of Satcom pricing.

Our agile teams have already started delivering U.S. improvements including simplifying captcha, improving Remember Me credentialing and improving our implementation of captive portal.

We've also entered into negotiations with several airline partners about reducing the subsidies in our current contracts in exchange for better terms on service revenue in the future.

And we're in conversations with several satellite companies consuming future Satcom pricing and availability.

So far, all of these conversations seem promising though there can be no guarantee of success.

We'll update you on future calls when appropriate.

Quickly, I'll talk about strategic conversations. As we've discussed in prior calls strategic conversations in our industry are heating up, competitors are thinking about consolidation, our strategic players are thinking about how to enter the business and private equity firms are thinking about how to act as consolidators and take advantage of the huge IFC opportunities.

In our case, those opportunities come up either in the context of being a platform for future industry consolidation or as a centerpiece to connected aircraft strategies.

Despite all of our issues, it's important to remember that we are the IFC market leader in both BA and CA, that we have the leading products in both markets. In the case of our BA business, we have very strong cash flow and that we have considerable unique experience delivering solutions at the junction of the mobile telecom, satellite and avionics industries.

It's probably no surprise that the Gogo's received a number of strategic inquiries from financial and strategic players in the last few months and as we said on our last call, our board has considered those inquiries and asked management to assess them. We don't have an update to provide on those matters today rather than to say management is assessing various opportunities as requested by our board.

With that, I'll hand it over to Barry to cover the numbers.

Barry L. Rowan - *Gogo Inc. - CFO & Executive VP*

Thank you, and good morning, everyone. As Oak noted, our commercial aviation division delivered solid results this quarter and our business aviation division surpassed our expectations with overall revenue of $74.2 million, up 28% from a year ago.

Some other key metrics worth noting are Gogo's consolidated revenue reached $227 million, up 32% year-over-year.

Overall service revenue grew 3% from 2Q '17 driven primarily by strength in our BA and CA-ROW segments.

This growth would've been 14% excluding effective American Airlines.

Our adjusted EBITDA increased 90% from the prior period to $18.9 million, which is primarily attributable to record results in our BA segment.

EBITDA for the quarter was better than expected due to higher-than-anticipated net service revenue and the timing of reduction -- and reduction of operating expenses in CA and continuing over performance by BA.

We believe our performance this quarter points to the true earnings power and strength of our underlying business, provides reason for confidence that once the deicing costs are behind us, the major deinstallation program is complete and we execute our Gogo 2020 action plans, we'll be poised to accelerate our service revenue growth and generate positive returns for shareholders.

Now let's dig more deeply into the numbers.

On a consolidated basis, higher equipment revenue generated nearly 90% of our overall revenue growth for the quarter. The adoption of ASC 606 for equipment shipments was a primary contributor as were the strong equipment sales in Business Aviation.

The adoption of ASC 606 lowered service revenue by $4.5 million in the second quarter and increased equipment revenue by $31.4 million.

Further details could be found on our 10-Q to be filed later today.

Beginning in the first quarter of next year, the comparability issues driven by the implementation of ASC 606 will be largely eliminated.

In CA-NA, total revenue grew 19% from 2Q '17 to $119.7 million with equipment revenue driving the increase.

Equipment revenue reached $23.9 million, up $21.6 million from the second quarter of 2017, again, reflecting the adoption of ASC 606.

Service revenue in CA-NA declined 3% to $95.7 million from the prior year period. However, excluding American Airlines, our service revenue would have grown by 14% from the prior year period.

This performance of the underlying business supports our expectations of accelerating CA-NA service revenue as we head into 2020.

CA-NA net ARPA in the second quarter was $113,000, essentially flat with Q2 '17. Again, excluding American Airlines ARPA would have been higher by over 10% versus the prior year.

CA-NA ended the quarter with 2,809 aircraft online, up 18 aircraft from the prior year and down 31 sequentially.

Gross margins on CA-NA, service revenue increased to 52% sequentially, largely driven by higher service revenue.

We also made solid progress on the cost side of the business and we expect that these trends will continue into 2019 and beyond.

We are focusing on achieving our target of reducing CA operating spend excluding Satcom expense by nearly 20% over the next 10 quarters with most of those reductions coming from CA-NA.

Let's now turn our attention to CA-ROW. Revenue reached $33.6 million, up from $14.1 million in the prior year period. This increase was driven largely by a $21.6 million increase in equipment revenue reflecting the impact of ASC 606.

CA-ROW service revenue increased 15% from 2Q '17 to $15.2 million as aircraft online increased from 318 to 459.

Due to the impact of newer fleet installations, we experienced the anticipated dilution in ROW net ARPA as it declined from $203,000 to $147,000.

While the addition of new fleets negatively affects ARPA, we are continuing to see the benefits of scale as our net loss improved by 22% versus the prior year period to $24.5 million.

This improvement was driven by a combination of higher utilization of our global satellite capacities and lower operating expenses.

Turning now to Business Aviation, service revenue grew 14% from the prior year period, driven by a 10% increase in ATG and its online, and a 5% increase in average monthly service revenue for ATG unit online.

Total BA aircraft online surpassed 10,000 in the second quarter, ending the quarter with 10,124.

BA equipment revenue grew 67% year-over-year to $26 million in 2Q.

We did benefit from the recognition of sign and fly in 2Q to the $2.7 million, but the primary drivers for our continued growth are straightforward.

Strong growth in aircraft online combined with higher monthly service revenue per aircraft.

As Oak described, we saw strong sales momentum in our advanced product line in 2Q and we expect that strength to continue.

Second quarter adjusted EBITDA in BA reached $36.7 million, up a very strong 46% versus 2Q '17.

We also achieved a high watermark for BA segment margin of 49%.

Congratulations to Sergio and the rest of his team for another fine quarter.

We believe the strong performance positions us well to achieve the long-term financial objectives we have set for our Business Aviation division.

We expect to see compounded annual revenue growth of more than 10% and sustained adjusted EBITDA margins in the mid-40% range for BA over the next several years.

I will now summarize our cash position, capital expenditures and outlook.

Our cash burn in the quarter improved substantially to $38 million from $107 million sequentially aided by higher EBITDA, lower CAPEX and the timing of our interest payments.

We ended the quarter with approximately $264 million in cash equivalents and short-term investments.

As we noted on our call on July 13, we expect that our cash burn declined significantly in each of the next 2 years, by over $100 million in 2019 versus 2018 and by another $100 million in 2020.

In the second quarter, our gross CapEx and cash CapEx fell sequentially to $53 million and 43 -- $46 million respectively.

And we expect that these trends will continue for the balance of the year and into 2019.

This is largely due to our expectation of more airlines shifting to the airline directed model.

In addition, as I communicated in connection with rolling out Gogo 2020, we are focused on reducing or even eliminating equipment subsidies in future airline deals and are in discussions regarding subsidies with some of our current airline partners.

Now let me touch on our guidance. We are reaffirming our 2018 financial guidance including total revenue in a range of $865 million to $935 million, an increase in 2Ku aircraft online at the low-end of the range of $550 million to $650 million, consolidated CapEx in a range of $150 million to $170 million and cash CapEx in a range of $110 million to $130 million.

Finally, adjusted EBITDA of $35 million to $45 million.

We see 2018 EBITDA likely reaching a low point over the next 2 quarters with some uncertainty in the potential outcomes associated with the implementation of the range of deicing solutions Oak described.

Given our expectations for continued cost reductions from our Gogo 2020 cash management plan, the completion of the major deinstallations and expectations for higher take rates on 2Ku aircraft, we believe we're well positioned for strong EBITDA growth in 2019 and beyond.

Now let's turn to another important topic addressing our balance sheet.

Now that our IBP process completed, we're executing the Gogo 2020 plan and focusing increased attention on addressing our capital structure, including assessing strategic options that may be available to us, which could also shore up our balance sheet.

We continue to actively work on a number of actions that further reduce our cash needs and address the converts due in March of 2020.

Addressing this maturity is a key priority for us and working with urgency on a number of potential solutions.

We have indicated that we plan to refinance our converts no later than when they become current in March 2020 and it's our intention to complete this refinancing well ahead of that date.

We look forward to updating you with further details as these plans are implemented.

Additionally, as a good housekeeping measure and to lay the groundwork, should we need an additional cash cushion, we filed a universal shelf registration statement on form S-3 this morning. Once effective, it will provide us with the ability to publicly sell securities such as debt, convertible debt and/or common stock.

Such public sales may be in addition to private financing solutions.

Additionally, certain large shareholders in Gogo have expressed an interest in being a part of a larger solution.

I'll now turn the call back to Oakleigh.

Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

Thanks, Barry, appreciate it. I'd like to finish by thanking our employees for their hard work during the -- these challenging times. Gogo is really fortunate to have an extremely talented and hard-working team and I am proud to be part of that team.

On a personal note, I speak for the management team and I say that we're not going to let strategic options distract us. We're focused on building a great company, capable of delivering reliable value creation to our customers, employees and owners whether that's in a public context or as part of some larger entity.

Thank you for joining our call today. Barry, Will and I are now available for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Louie Dipalma with William Blair.

Louie Dipalma - *William Blair & Company L.L.C., Research Division - Analyst*

Third-party payer activity seems to be picking up. I think that was reflected in the 14% year-over-year service revenue increase for the CA division. Along those lines, I was wondering if the T-Mobile partnership has a specific end date? And if it does, are you in discussions with the other wireless carriers for them to potentially subsidize the service?

Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

Yes, T-Mobile is on an annual renewal, so it does have an end date, the budget -- it's got part of their budgeting every year. And yes, we are in discussions with all the wireless companies. T-Mobile relationship is going well, and we're trying to -- as I said in my comments, a lot of our software development now is going to create tools and recording for third-party payers to make us a good distribution channel for them. So we're very focused on that and we see a lot of opportunity there.

Louie Dipalma - *William Blair & Company L.L.C., Research Division - Analyst*

Okay. And you mentioned that you're in a lot of strategic discussions and I was wondering if any of these strategic discussions have advanced to the point that it would prevent insiders from purchasing stock?

Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

Louis, we're not allowed to comment on anything vis-à-vis the status of strategic conversations.

Louie Dipalma - *William Blair & Company L.L.C., Research Division - Analyst*

Okay. But are you allowed to purchase stock?

Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

That's a roundabout way of asking the same question. Well done, Louie, but I'm not going to take that bait.

Louie Dipalma - *William Blair & Company L.L.C., Research Division - Analyst*

Okay. And my final question, has the deicing issues delayed your progress with line-fit with Airbus?

Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

I don't think they have. No. We had -- as you all know, we had this asset airline directive, which has delayed, as our service bulletin on the A330s and A340s but we expect that to be clear (inaudible) October or so. And to get on with installation of those in the aftermarket using service bulletins. But that's the only issue affecting us with an OEM right now.

Louie Dipalma - *William Blair & Company L.L.C., Research Division - Analyst*

And in general, is the timing for certain airframes to be licensed on Airbus still for next year?

Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

Yes, next year-end and the year after. It goes airframe by airframe and you've got to get through each program. So we're fighting our way through. I think we're doing well with Airbus. We have a good relationship with them, but it just takes time and it's very hard to predict exactly when you're going to get it.

Operator

And our next question comes from Simon Flannery with Morgan Stanley.

Landon Hoffman Park - *Morgan Stanley, Research Division - Research Associate*

This is Landon Park on for Simon. Just starting on the EBITDA guidance, can you help us understand what the cadence is going to look like in the second half? And is it going to be distributed between Q3 and Q4? Or how low should we expect results to be in Q3 on the 2Ku issues?

Barry L. Rowan - *Gogo Inc. - CFO & Executive VP*

Yes, Landon, it's Barry. As I'm sure you've heard from the call and based on the guidance that it's largely dependent on how the deicing remediation costs come in and there's, as Oak outlined, a range of potential solutions there. So -- but I think it's also fair to say that given the guidance range unchanged at $35 million to $45 million and the EBITDA for the first half of the year at about $31 million that we expect that to be meaningfully impacted, particularly by the deicing remediation costs in the second half of the year. And exactly, how that plays out between third and fourth quarter is I think difficult to call depending on the timing and nature of those solutions to be implemented.

Landon Hoffman Park - *Morgan Stanley, Research Division - Research Associate*

Okay, that makes sense. And just another question on your commentary around the American deinstalls. So I guess you were calling out a 17% Delta in the growth rate, correct? Between the impact of the American deinstalls.

Barry L. Rowan - *Gogo Inc. - CFO & Executive VP*

Landon, which region you are talking about. Which is -- yes, so -- yes, it's 3% decline versus a 14% improvement, if that's you were referring to. Yes, so that's 17% differential.

Landon Hoffman Park - *Morgan Stanley, Research Division - Research Associate*

And that's -- so I'm just trying to understand. So I think there's been 90 installs through the first half of the year. So that's only about 3% of the fleet. Can you -- is the ARPA on those planes just much more substantial than on the remaining fleet?

Barry L. Rowan - *Gogo Inc. - CFO & Executive VP*

It's a combination of several factors, Landon. So when we talk about that we exclude American in total. So there are several factors that contribute to that, one is the deinstalls, the second is the impact of 606 accounting, which of course effected that also. And then also the change in business terms with American Airlines that was made in conjunction with them going to the airline directed model. So we think it's most appropriate just to take American Airlines out and then look at it on an apples-to-apples basis.

Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

That change (inaudible) seen, in the contract negotiations that took under -- ticed under some (inaudible) back in 2016.

Landon Hoffman Park - *Morgan Stanley, Research Division - Research Associate*

Okay, great, that's very helpful. And then, just 2 last quick ones. Could you give us an update on the status of any renegotiations on any of the pledged 2Ku aircraft? And can you also give us any details on that recent Intelsat 37e contract that was signed?

Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

The Intelsat contract is just part of our ongoing Satcom expenses, nothing extraordinary there. And we renew and make satellite purchases several times a quarter in different regions of the world. The -- in terms of our discussions with airlines, we have discussions going with all the airlines that are in major installation programs or about to have installation programs start about trying to reduce subsidy and return -- in return for better terms on future service revenue and all those are taking place. None of them have stopped installing, so that's an encouraging sign and they haven't thrown us out of the office, so that's an encouraging sign. And we'll have more updates on that in future calls.

Operator

And our next question comes from Ric Prentiss with Raymond James.

Richard Hamilton Prentiss - *Raymond James & Associates, Inc., Research Division - Head of Telecommunication Services Equity Research*

A couple of questions. You've mentioned a couple of times that you're thinking more movement to the airline directed model. How should we think about that flowing through the financial guidance? And then, also, on the take rate, I think you mentioned ex-American, the take rate was 13%. Should we start thinking more and more about gross passenger opportunities and take rates and average revenue per sessions or how are you guys modeling internally what metrics are you watching?

Barry L. Rowan - *Gogo Inc. - CFO & Executive VP*

Yes, first, Rick, on your first question about the move to AD and how that affects our guidance. So that is reflected in our guidance. So as you know, it's done under 606 and the assumption of more airlines moving to the airline directed model. So as you may recall, at the end of last year, on the order of 90%, we're under the currency model and that will move to closer to 50% of the airlines by the end of this year. So that is comprehended in our guidance. In terms of how we build up the model, we realized that we probably did -- do a better job of simplifying and clarifying those metrics to help the street with that, Will, as I got that on his plate to continue to work with us on that. So -- but the way we look at it is we do look at the opportunity in terms of passengers. We look at the relationship between take rate and what the average of new precession does income. And the reason for that is with, as 2Ku comes out and we are no longer banned with constraint they we were historically, that we expect to see higher tax rate but also we expect it as we offer a range of services that the ARPS will come down, for example, you don't get paid as much for a session with a third-party wireless carrier, for example, it is just doing texting that as you do for a full session. So I think what will happen is that, and the way we model it, is how the -- and we'll see higher take rates offset by a ray -- a lower ARPS as based on a range of customer solutions.

Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

And cost per session coming down because a lot of these programs are surf limited and the amount of data you substantially have. So I mean airline directed works for us when it's done on the right terms. The American case, it wasn't done in the right terms, so it hurt us there. But some of our very most successful airline relationships are airline directed. And so to us we're kind of neutral whether somebody is turnkey or airline directed.

Richard Hamilton Prentiss - *Raymond James & Associates, Inc., Research Division - Head of Telecommunication Services Equity Research*

Okay. And obviously, the take rate 13% ex-American airlines. I think if I remember back on the July 13 call, you had some fairly conservative assumptions on what take rates would do. Any update to your thoughts on where those might head then?

Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

Well, that's one of the 3 levers we have to improve on the plan that Wall Street loves so much a month ago, and is to drive revenue. And so our focus on user experience, our focus on third-party payers, are all designed to improve take rates, obviously at lower ARPS, but the net is to have higher revenue. And so we think that growth rate will drive more revenue. So the answer to your question is simply we'll come out with better guidance around future average revenue per session, when we get a little more clarity around where these take rates are going and what the ARPS is and what the deals are that we're doing with third-party payers and airlines to travel.

Barry L. Rowan - *Gogo Inc. - CFO & Executive VP*

And just to put a final point on your comment, Rick, as you pointed out that we had 13% take rates this quarter without American, as we said on the call last time that the assumption that was in our model out at the end of the planning horizons points to -- is 12.6%. So you can see why we feel like those assumptions were conservative and it really was done to, if that's was described as a cash management baseline scenario rather than what we've consider to be a forecast.

Richard Hamilton Prentiss - *Raymond James & Associates, Inc., Research Division - Head of Telecommunication Services Equity Research*

Exactly. And final one from me. The G&A costs were noticeably lower in 2Q than where they have been previously. Is that some benefit of the programs that you're putting in place? Or any -- or should we think about that as an anomaly. What should we think about that G&A line on a go forward basis?

Barry L. Rowan - *Gogo Inc. - CFO & Executive VP*

Yes, we definitely see the overall cost structure coming down as you know about it, almost 20% over the next 10 quarters or so and that will come across the whole operating cost structure. It's heavily in the technology and the operations side of the house as we work our way through the programs getting STCs in place, for example, or getting -- going through the software development that we're doing. We're reducing sales and marketing as we look at the opportunity to be able to do that. So anyway, yes, it's an approximately $75 million reduction in that combined set of expenses during that period of time. So it'll start in the second half of this year. There is a -- and the order of $15 million benefit from the Gogo 2020 plan that starts this year and then increases in 2019.

Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

Yes, to answer that question directly though, there was a couple of million of saves in Q2 around sales and marketing and things like that, that were part of the IBP plan. There was also some steps in Q2 that's part of the plan that may have all set that, but...

Operator

And our next question comes from Philip Cusick with JPMorgan.

Sebastiano Carmine Petti - *JP Morgan Chase & Co, Research Division - Analyst*

This is Sebastiano on for Phil. Just a more industry level, just what are the pace of RFP conversations, I guess, across the industry? And have you seen a demonstrable change in the level of conversations in light of some of the deicing 2Ku woes at Gogo?

Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

No. I said on the first quarter call, we'd never seen as many deals as we were seeing at that time. And actually, all those deals continue and we're in the process of trying to win some of them. We haven't lost any. We have tried to move all of our bids, if you will, closer to the Gogo 2020 model in terms of being revenue neutral or maybe even profitable in the early stages as opposed to highly subsidized. But airlines I think are being more deliberative, they -- obviously, 2Ku looks great to them. They -- there are concerns about us financially and about our competitors as well. And so airlines are taking their time making decisions. That's for sure.

Sebastiano Carmine Petti - *JP Morgan Chase & Co, Research Division - Analyst*

Great. And then, just following up, you made the comment, I think in your prepared remarks, about just, ZTE seems to be progressing but you've got to take a step back on whether or not to proceed with that NextGen ATG program? And what are the some of the different options that you're considering or potential alternatives? Just give us any color on that would be great.

Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

Yes. Well, when I came in here one of the things I wanted to do, was part of the Gogo 2020 plan, was add discipline around our business processes and that includes our new product in reduction process. So like any product, it has to go through our gating process -- our NTI gating process. So where -- we have upcoming evaluations that it needs to get approved, especially an investment like this which we spent quite a bit of money on it already in R&D but we've got obviously network deployment in front of us which is a pretty big CapEx expense. So before we proceed with that, it's got to get through our gating program and that includes 1 test around efficiency and effectiveness and whether it's going to work. And 2.4 is on my spectrum and there's still questions we have about the noise floor in that spectrum and how effective this network will be now and in the future. So it's got to pass that hurdle as part of 1 gate and it has to pass commercial hurdles as well. And then, if it passes all those things we'll approve it, and we'll go ahead and build it. There are other alternatives if that does not pass the gate that we have started evaluating and those include hybrid ATG and satellite systems and trying to find some license spectrum somewhere. So there are number of other alternatives for getting a, to what I would, call high speed streaming class product to the regional jet and large BA market. But we shouldn't start speculating on those now as we're still evaluating NexGen ATG.

Sebastiano Carmine Petti - *JP Morgan Chase & Co, Research Division - Analyst*

And then, just quickly follow up on that. Does your cash burn and CapEx kind of commentary regard -- long-term with the Gogo 2020 plan? Does that still contemplate some level of network built related to NextGen ATG? That's still in the numbers or not necessarily at this point.

Barry L. Rowan - *Gogo Inc. - CFO & Executive VP*

Yes, there is investment in those numbers for the follow-on network with ATG. So that is in there and exactly what form it takes, you would term it as look outlined but there is money in the plan to accommodate that.

Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

Yes. When we talked about it in the last call, we described that as our LTE upgrade plan. So there is chunk of dollars set aside for ATG.

Operator

And our next question comes from Lance Vitanza with Cowen.

Lance William Vitanza - *Cowen and Company, LLC, Research Division - MD & Cross-Cap Structure Analyst*

I wanted to start back on take rates and capacity. And as someone pointed out, you're already kind of beyond ex-American, you're beyond what you sort of laid for 2022. And I understand that, that wasn't guidance per se, but my contention is that if the product capacity is there that take rates are going to be 3x what you guys are seeing now and so my question is, when we get to 2022, are you going to be able to offer the same kind of quality product to satisfy that kind of demand? Or is the bound going to be, there's just not enough capacity to the plan even in 2Ku to kind of enable those types of take rates?

Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

Yes, there's going to be capacity. I mean we've designed 2Kus to be able to go up at this point, our next bottleneck is around 400 megabits per second and that -- what you need to get there is just provide more satellite capacity, basically. And if you talk to the satellite companies they're all going to be putting up a lot more capacity over the next couple of years and they view this as one of their growth markets. So we think based on our conversation, the Satcom companies is going to be plan a full bandwidth. It's going to be getting cheaper and cheaper all the time and the 2Kus well positioned to deliver that bandwidth.

Lance William Vitanza - *Cowen and Company, LLC, Research Division - MD & Cross-Cap Structure Analyst*

Okay. So next on the EBITA in the quarter, I think I heard you say early on that there was a favorable $6.5 million kind of timing related item embedded in that $19 million of EBITDA. So I guess should we think in terms of $12.5 million of kind of normalized EBITDA? Is that sort of the right way to think about the quarter?

Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

Yes. Yes. That's right. I think the timing...

Lance William Vitanza - *Cowen and Company, LLC, Research Division - MD & Cross-Cap Structure Analyst*

I mean and...

Barry L. Rowan - *Gogo Inc. - CFO & Executive VP*

Just to go over it a little more, just to kind of reinforce what Oakleigh mentioned on the call. So the $19 million versus the expectation of basically near 0. About $4 million of that was from standard BA performance, $15 million of that was from CA and there was about $6.5 million that was timing related. So -- and the others were ongoing or call it permanent differences. So yes, based on that quarter, if you take the timing out that would be the -- that's probably the appropriate adjustment for that.

Lance William Vitanza - *Cowen and Company, LLC, Research Division - MD & Cross-Cap Structure Analyst*

And again, the $12.5 million is still well ahead of your internal expectations I would imagine?

Barry L. Rowan - *Gogo Inc. - CFO & Executive VP*

Yes. It was. It was. As we said on that previous call, we expected it to be extremely low in the second quarter. So it exceeded our expectations for the second quarter.

Lance William Vitanza - *Cowen and Company, LLC, Research Division - MD & Cross-Cap Structure Analyst*

Great. And then just lastly for me. Back on ZTE, can you give us a sense for when we might actually expect the legislation to be enacted and signed into law? And just so that we can kind of mark our calendars and continue to follow that?

Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

You have to ask the President because it's now on his desk. And I think...

Lance William Vitanza - *Cowen and Company, LLC, Research Division - MD & Cross-Cap Structure Analyst*

Yes. It's been voted. It's signed. It's been voted and it's sitting on the President's desk. Okay.

Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

Yes, and it's been approved. Just the process, so you -- to be totally clear. The Senate, Defense Authorization Bill, had ZTE language in it, House Authorization Bill did not. Those 2 things go to conference committee. Conference committee approves language, it allows ZTE to do business with American companies, but ZTE cannot sell to the American government. That's what the language said. And that bill has gone back to both the House and Senate and been approved and now sits on the President's desk. And the bill has everything that the President wanted in it. So I think he -- and he said he's going to sign it.

Lance William Vitanza - *Cowen and Company, LLC, Research Division - MD & Cross-Cap Structure Analyst*

So this should be imminent then.

Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

Yes. When he gets back from vacation.

Operator

And our next question comes from Robert Gutman with Guggenheim.

Robert Ari Gutman - *Guggenheim Securities, LLC, Research Division - Senior Analyst*

So does the $113,000 ARPA reported in North America reflect turnkey revenue share? Or is this an adjusted number? Another way, does it tie to actual revenue going forward? Secondly, how much extraordinary cost or DIC cost was in NA in the second quarter? And lastly, if you could give us some commentary, looking forward on CapEx, because you've noted materially lower CapEx? Is there any way to sort of provide some parameters or way to think about that longer term?

Barry L. Rowan - *Gogo Inc. - CFO & Executive VP*

Sure, Rob. So on your first question about ARPA, that is net ARPA. So that excludes the rev share. So I would -- that's a -- we believe a more accurate way to report it now because it takes out the effect of whether an airline is on the airline directed model or turnkey. So that's net. With regard to deicing costs. We have -- we've incurred about $16 million in expenses in the first half of the year related to that. That $10 million is the expense line, about $6 million in CapEx. So -- and there was about $7.5 million of that in the second quarter. So that's the direct answer to your question.

Robert Ari Gutman - *Guggenheim Securities, LLC, Research Division - Senior Analyst*

And CapEx longer-term? Cash CapEx?

Barry L. Rowan - *Gogo Inc. - CFO & Executive VP*

Yes, CapEx longer-term, I mean I -- we do see it coming down, and like, pretty meaningfully and that's a big driver of improvement in the free cash flow. So as we've talked about expect free cash flow to improve by over $100 million year-over-year for each of the next 2 years. So as we work our way through the airline installation programs, for example, that's a driver of that and also we're using subsidies on that as an example.

William G. Davis - *Gogo Inc. - VP of IR*

Okay. Thank you, everybody. We have completed our our hour-long conference call. Thank you for joining the 2008 -- second quarter 2018 Gogo conference call. I'm reachable during the course of today and tomorrow for follow up questions. And thank you, and have a nice day.

Operator

Ladies and gentlemen, this does conclude your program for today, and you may now disconnect. Everyone, have a great day.
