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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Gogo Inc.'s First Quarter 2022 Earnings Conference Call. (Operator Instructions)

I would now like to hand the conference over to your speaker today, Mr. William Davis, Vice President of Investor Relations. Sir, please go ahead.

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

Thank you, (inaudible), and good morning, everyone. Welcome to Gogo's First Quarter 2022 Earnings Conference Call. Joining me today to talk about our results are Oakleigh Thorne, Chairman 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 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 the conference call. Those risk factors are described in our earnings release filed this morning and are more fully detailed under the risk factors in our annual report on Form 10-K and 10-Q and other documents we have filed with the SEC.

In addition, please note that the date of this conference call is May 5, 2022. Any forward-looking statements that we make today are based on assumptions as of this date. We undertake no obligation to update these statements as a result of more information or future events.

During the call, we'll present both GAAP and non-GAAP financial measures. We've included a reconciliation and explanation of adjustments and other considerations of our non-GAAP measures to the most comparable GAAP measures in our first quarter earnings release. This call is being broadcast on the Internet and available on the Investor Relations website at ir.gogoair.com. The earnings press release is also available on the website.

After management comments, we'll host a Q&A session with the financial community only.

It is now my great pleasure to turn the call over to Oakleigh.

Oakleigh Thorne - *Gogo Inc. - Chairman & CEO*

Thanks, Will, and thank you all for joining us this morning. The first quarter results we announced today reflect our continued strong momentum as we execute on our strategy, and capitalize on the unprecedented demand for broadband connectivity solutions in business aviation. I'll focus my remarks today on 3 buckets: BA industry demand for connectivity, Gogo's strong first quarter results and our progress in 2 of Gogo's key strategic initiatives. Barry will then walk through the details of our quarterly performance and update our 2022 outlook, and then we'll open up the call to your questions.

In the first quarter, Gogo delivered record top line revenue of nearly $93 million, up 26% year-over-year fueled by strong service and equipment revenue. Our results demonstrate that demand for BA travel and connectivity continues to accelerate. The 3 variables driving that demand are: first, the growth over the last decade is the number of high net worth individuals who can afford to fly privately; second, the COVID pandemic, which led many in that cohort to try private aviation; and third, the acceleration of the digital transformation brought on partly by COVID as demonstrated by growing usage of video intense social and work-related applications like TikTok, Zoom, Office 365 and the like.

These are all trends we believe will continue. In a recent survey, 91% of business jet passengers said they will fly privately either the same or more versus -- in 2022 versus 2021, with 51% of those saying they will actually fly more flights in 2022 than 2021. We also believe the propensity of these flyers to demand in-flight connectivity will continue to grow, driven partly by passenger demographics shifting to younger age groups.

Traditionally, business aircraft passengers skewed more towards baby boomers or older. But in our recent Gogo brand survey, 67% of all respondents identified as members of Gens X, Y and Z. We've seen the impact of these trends play out in usage as data consumed by business aircraft on our network in Q1 grew 50% year-over-year and more than doubled over pre-COVID Q1 2019. We've also seen these trends play out in rate plans as more than twice as many customers upgraded plans as downgraded plans in the quarter, driving an 8% year-over-year increase in Gogo's first quarter ARPU. And we've seen these trends play out in flight counts with flights across our entire fleet, up 33% from Q1 2021 and 29% from pre-COVID Q1 2019. What's more, flights by corporate aircraft, which had lagged fractional and charter fleets and account for about 50% of our fleet surged in Q1, up 23% from Q1 2019 and 47% from Q1 2021, signaling a strong comeback in demand from that very important segment.

This demand for travel is having huge repercussions in the business aviation industry. Some fractional operators have suspended sales in order to meet their service commitments to owners. Used aircraft for sale are at an all-time low at 2% of the U.S. fleet. Many operators have turned to buying jets overseas and bringing them back to the U.S. to bolster supply. Fortunately, for us, almost always, those just require installation of an in-flight connectivity system. And order books at the OEMs continue to grow. On its recent earnings call, Textron, a very significant partner for Gogo announced a $5.1 billion absolute backlog, up 53% from Q1 2021. All of this activity is driving broader Gogo adoption. We ended this Q1 with 6,526 ATG units online, an 11% increase over Q1 2021 and we shipped 246 new advanced units in the quarter, which is seasonally usually a low quarter for us, but not this year. That 246 units shipped number is the highest Q1 in our history. 64% higher than any prior Q1.

As you may recall, we entered this year, projecting 25% growth in advanced unit sales. And on our last call, indicated that we may be able to exceed that number if we could access enough supply to do so. The good news is that our amazing supply chain team has managed to secure more supply and we're now raising our committed deliveries for the year to around 1,300 units, almost 50% over the prior year, with 95% of that demand number already spoken for. Almost all units we ship are tied to a particular customer order from a dealer OEM. So a very high percentage are installed and activated even in an economic downturn. So this increase in unit shipment is a very good harbinger of future growth and high-margin service revenue.

Despite the dire circumstances currently surrounding supply in the telecom industry, our supply chain team has displayed tremendous creativity, deep knowledge of our products and deep knowledge of international logistics. They've leveraged our common componentry strategy and our strong balance sheet to work with our suppliers and our supplier's suppliers and even our supplier's, supplier's suppliers to get to thousands of individual components we need to meet this tremendous surge in demand. The efforts of our supply chain team have not only allowed us to increase our committed deliveries. But they've also built up buffer stock that allows us to meet drop-in orders so that we never miss an opportunity to install a plane. They've also enabled us to pull in the outdate on committed shipments from December to October, again, helping ensure we do not ever miss an installation opportunity on a plane.

As a result of this boost in supply, we're now able to raise our revenue guidance from a range of $380 million to $390 million, up to a range of $390 million to $400 million. As I would note, we continue to see signs of even further increased demand later in the year, and we're working on supply to meet that demand. This boost in equipment sales bodes well for our virtuous circle growth strategy. Equipment sales drive future high-margin service revenue which is the primary engine of our ongoing value creation.

The gross margin dialers for this service revenue in turn provide capital that allows us to invest in leveraging the advanced platform to pursue adjacent markets and deliver higher bandwidth solutions which in turn will drive more equipment sales and high-margin service plans and so on and so forth.

On the earnings front, despite this being an investment year, we showed nice growth in Q1. Delivering adjusted EBITDA of $42.8 million, an increase of 26% over Q1 2021, driven by an increase in service revenue and gross profit. Q1 came in better than we expected due to some timing-related issues Barry will talk about later, but also due to higher average equipment selling prices than we anticipated, and scale benefits in manufacturing as we ramp production. At this point, we're not raising our adjusted EBITDA guidance range of $150 million to $160 million, but we now expect to be at the high end of that range. And I would note that our new guidance includes an estimated $5 million of legal fees in Q3 related to our patent litigation with SmartSky networks.

Now let me turn to our strategic initiatives, which are aimed at deepening our competitive moat and driving long-term shareholder value. First, enhancing our ATG network to keep pace with customers on ground connectivity expectations; and second, driving adoption of our flexible future-proof AVANCE platform in our existing customer base among the approximately 70% of the U.S. business aircraft that do not yet have connectivity and ultimately among the 14,000 business aircraft outside the United States.

I'll start with enhancing our ATG network. The first step in that, in the successful execution of this objective is the commercial launch of our Gogo 5G network in the second half of this year. We remain on track, on time and on budget. We've now passed all development risks and are focused on 5G chipset tracking and building towers. We had previously communicated that Gogo's 5G chipset supplier had delayed delivery of that critical component, but they have now almost completed their production build and are on track to deliver that chipset in time for us to hit our current launch schedule.

On the tower front, we've had to manage through many supply chain challenges in Southeast Asia but also remain on track for our scheduled launch. As of this morning, we completed 35 of the 150 tower sites we're going to build and we're picking up the pace. You can watch our progress on a map at our website, www.business.gogoair.com.

Later this summer, once we have our chip and deploy most of our towers, we'll begin end-to-end testing and fine-tuning of the network. From a regulatory standpoint, we're also on track. We recently announced the receipt of our parts manufacturing authorization from the FAA for our [5G NB13] antenna, which enables us to begin installing that equipment on customers' aircraft.

On the commercial side, we're continuing to take orders for 5G, and we're making progress towards getting line-fit with major OEMs, and we're extremely encouraged by the response from existing customers and dealers.

Gogo 5G will be a huge advance for BA and flight connectivity as it will achieve average speeds of approximately 25 megabits per second with peaks up to 75 to 80 megabits per second, faster than any IFC product available for Business Aviation today and at a lower cost than competing geo-satellite solutions. Gogo 5G will enable multiple streaming and video conference applications to be opened at the same time on the same aircraft and deliver a quality home or office like connectivity experience in flight.

That leads me to our second strategic objective, driving advanced penetration. Our AVANCE platform gives us opportunities to improve equipment stickiness, introduce adjacent products and grow into adjacent markets. And for those reasons, growing the AVANCE installed base is core to our strategy. So far, we've been very successful at this and reached an exciting milestone this quarter. Gogo's AVANCE system reached 1 million business aviation flights since launching in August 2017. It's the most successful broadband product launch ever in Business Aviation with just over 2,700 aircrafts online as of the end of Q1, and is installed on more aircraft than our 2 biggest competitors combined.

Today, I want to touch on just one very important feature of AVANCE. It's multi-barrier capability, which gives Gogo the ability to partner with a global LEO provider under a managed services model to build a global broadband offering. Gogo Global Broadband will allow us to first pursue the 14,000 business aircraft outside North America; second, pursue large North American jets that fly global missions and use GEO satellite connectivity outside the U.S. today; and third, drive stickiness in our core North American medium-sized and smaller aircraft segments by offering a unique dual ATG LEO solution. That latter solution will aggregate our ATG capacity with the LEO network satellite capacity in North American market. making our offering very competitive with offerings that rely on LEO capacity alone. For customers that already have AVANCE, the upgrade to add LEO would be simple. They would just install an ESA antenna on top of the plane and run 2 wires inside, 1 for data and 1 for power. And then they would have access to all the functionality AVANCE offers, including our fleet management and entertainment products, along with the LEO offering.

To pursue this tremendous opportunity, Gogo would design and fund development of the airport and hardware required to access the LEO network and then partner with a LEO operator for network access. We expect external development costs would be less than half the investment required for our Gogo 5G network and that, that investment would be spread over approximately 3 years. We also believe that our global broadband initiative or GBB, we call it, will significantly accelerate our revenue and free cash flow after we launch and would generate a very high return on capital relative to our other capital allocation priorities. We are in active discussions with LEO and Antenna Partners. And once we're ready to proceed, we'll provide more details on this very important project.

To wrap up, these 2 key strategic initiatives, ATG network enhancements and AVANCE penetration will dramatically improve the performance of our network for our customers. They'll provide adjacent product opportunities and provide new market opportunities, all of which should build Gogo's competitive advantage and shareholder value in the future.

Before turning it over to Barry, I want to thank the entire Gogo team for their exceptional work and dedication to Gogo and our continued success. I also want to note that like so many across the world, we are horrified by the war in Ukraine and deeply saddened for all those affected, both in the region and beyond. In particular, I'd like to take a few moments to acknowledge and share my deep appreciation and support for 10 Ukrainian software engineers in [Lviv] that worked for Gogo supporting our flight tracking and data pool tools. One of them has left us for the Army and the other 9 have continued to work almost every day since the war began, despite the destruction and brutality all around them. We're inspired by their fortitude and sacrifice and we'll continue to support them and their extended families throughout this crisis.

Now I'll turn it over to Barry. Thank you.

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

Thanks, Oak, and good morning, everyone. In my remarks today, I'll start by walking through Gogo's first quarter financial performance in more detail. Then I'll provide an update on our balance sheet and capital allocation strategy. And I'll finish up with some additional context around the updated 2022 guidance we announced this morning.

During this quarter, we delivered record performance on multiple fronts: record service revenue, record total revenue, record equipment backlog and record adjusted EBITDA. These records are the result of continued solid execution by the Gogo team in a vibrant market as higher-than-expected equipment shipments led to high-margin service revenue growth and increased profitability.

Total revenue of $92.8 million in the first quarter grew 26% year-over-year. This was the highest ever first quarter revenue for the company with strong trends in both service and equipment. We achieved record service revenue of $70.7 million driven by an increase in ATG units online of 11% year-over-year and 2% sequentially. Our track record of continuing growth of ATG units online is evidence of the tremendous white space in a market that is only about 30% penetrated with WiFi connectivity.

Notably, we continue to -- our strong trend of adding new customers with 61% of ATG activations in the quarter coming from new customers. As we have described, penetration of our AVANCE products across our installed base and with new customers is the centerpiece of our strategy. These equipment installations that drive increasing service revenue and provide the other significant customer benefits of the extensible AVANCE platform Oak has highlighted.

In the first quarter, AVANCE units online grew 42% year-over-year to 2,699, an increase of 8% sequentially. Our year-over-year AVANCE unit growth has averaged about 45% over the past 6 quarters, and we continue to expect AVANCE to reach approximately 50% of our total ATG units online by the end of 2022. Importantly, as we grew our ATG units online, the ATG ARPU grew 8% year-over-year to $3,321, demonstrating the increased utilization of our services by our customers. As Oak described, strong growth in passenger data demand is driving upgrades to Gogo's high rate data plans, supporting our continued ARPU growth. The launch of Gogo 5G will further expand our ARPU growth opportunity.

Now turning to equipment revenue. Gogo delivered $22.1 million in equipment revenue, a remarkable 52% increase year-over-year with high demand for our AVANCE L3 and L5 products. We shipped 246 AVANCE units in the first quarter, which was above our internal budget. It was also a record for any first quarter in Gogo's history. As a reminder, equipment shipments are typically back-end loaded during the year and tend to be strongest in the fourth quarter due to a combination of promotional activity and the seasonal dynamics of our customers.

As Oak mentioned, thanks to the outstanding work by our supply chain team coupled with the ability to leverage our strong balance sheet to acquire inventory and capitalize on unprecedented industry demand for our products, we now expect total ATG equipment shipments in 2022 to reach 1,300 units. This is up nearly 50% versus 2021 and is an increase from the budgeted growth of 25% that we communicated on our first quarter call. 95% of these 1,300 chipsets are already secured and committed to customers, which is the foundation for our confidence in the increased 2022 revenue guidance we're providing today.

Turning now to profitability. We delivered strong service margins of 79% in the first quarter, slightly above our budget, driven by high operating leverage from our recurring revenue model. Equipment margins were 35% in the first quarter, a 1.7 percentage point decrease sequentially. We expect lower equipment margins of approximately 30% for the remainder of the year, consistent with our strategic objective of increasing AVANCE penetration. However, this is higher than originally anticipated due to an increase in the average selling price for equipment versus budget, and the benefits of increased scale in our production operations with increased equipment revenue. Our updated expectation for equipment revenue and margin is a key driver of our revised guidance expectations for 2022. Our rising record backlog also derisks our long-term targets as more units installed drive growth of recurring high-margin service revenue, leading to stronger cash flow.

Moving now to operating expenses. First quarter combined engineering, design and development, sales and marketing and general and administrative expenses decreased 10% sequentially to $25.1 million. This reduction was driven primarily by timing of expenses including those related to 5G, which I will discuss more in a moment as well as lower general and administrative and sales and marketing expenses. These factors were partially offset by increased stock-based compensation.

In March of this year, we filed an 8-K to disclose our updated executive employee agreements. The details of which will be filed with our 10-Q today. These agreements will contribute to increased levels of noncash stock-based compensation expense through 2022 as compared to 2021. As we stated previously, 2022 is an investment year, particularly as we ramp expenses for Gogo 5G. While the investment levels will fluctuate quarter-to-quarter, spending for this strategically important project will drive increased operating expenses for the year. We continue to expect our business model to reflect meaningful operating leverage over time, which is demonstrated by our long-term target of adjusted EBITDA margin approaching 50% in 2026.

Now I'll provide some additional detail on our Gogo 5G program and spending profile. We remain on track to deploy our 5G ATG network in the second half of 2022 on time and on budget. Our $5.1 million of 5G spend in the first quarter was lower than expected due to timing and was comprised of $0.3 million in OpEx and $4.8 million in CapEx.

I want to be clear that while the recording of expenses is shifting quarter-to-quarter, the deployment schedule of our project and our overall cost expectations for Gogo 5G are unchanged. We expect our 5G spend with a significant majority in CapEx to ramp meaningfully over the next several quarters as we complete our project and commercially launch our Gogo 5G network in the second half of this year.

To reiterate our expectations for Gogo 5G operating expenses in 2022, we have budgeted an increase of approximately $13 million versus 2021, which includes external development and deployment costs as well as additional 5G-related investments in marketing, production operations and network costs. Of course, this spin dampens Gogo's adjusted EBITDA growth rate for 2022 from what it would have been without this increased investment.

On the CapEx side, we expect over 90% of our total 5G investment to be completed by the end of 2022. After Gogo 5G is launched, we forecast very attractive adjusted EBITDA to free cash flow conversion rates in 2023 and beyond, driving our expectations of a significant ramp in free cash flow beginning in 2023. Moving on to the bottom line. Gogo's adjusted EBITDA increased 26% year-over-year to $42.8 million, primarily driven by a 19% increase in service revenue.

Gogo delivered net income of $22.2 million in the first quarter, translating to $0.20 in basic earnings per share and $0.18 in diluted earnings per share. We expect to incur noncash income tax expense in future quarters as we did this quarter as we continue to generate positive pretax income. We also expect to see additional reversals for portions of our remaining valuation allowance within the next 12 to 18 months. Importantly, based on our substantial NOL position, we do not expect to pay meaningful cash taxes for an extended period of time, that we may pay a modest amount by the end of our planning horizon. We expect net income in future quarters to reflect an increase in stock-based compensation expense due to the executive employment agreements I mentioned earlier and the annual grants issued to all employees. Incidentally, we believe our employee equity program is a meaningful contributor to our very high retention rates relative to peers. This is especially important as we face a surge in customer demand in this constrained labor market.

Now turning to free cash flow. We generated $8.8 million in free cash flow during the quarter. Our first quarter free cash flow declined from the prior year period due to a change in the timing of our interest payments following our refinancing last year as well as higher CapEx and the use of net working capital driven by a change in accounts receivable and increased inventory purchases due to increased demand.

On a sequential basis, this $8.8 million in free cash flow was down from $25.7 million in the fourth quarter of 2021, primarily due to $8.9 million in employee bonus payments made in the first quarter and the change in accounts receivable. Despite 2022 being a heavy investment year, we are increasing our free cash flow guidance for 2022.

Now I'll turn to a brief discussion of Gogo's balance sheet. Gogo is in a very strong liquidity position as we ended the quarter with $152.8 million of cash on hand, and our $100 million revolver remains undrawn. As of the end of the first quarter, we had approximately $822.4 million in outstanding debt. This includes the $719.6 million Term Loan B and approximately $102.8 million in outstanding convertible notes, which are maturing on the 15th of this month, unless earlier converted. As we have discussed, we will settle any conversions prior to maturity in stock.

Let me provide a quick reminder of the timing and impact of this process. Given our current stock price relative to the $6 conversion price, we expect all holders of the remaining convertible notes to elect to convert. Holders must notify Gogo by May 12 to convert their notes. This process is expected to add approximately 17 million shares, which will bring us to a total of about 134 million shares outstanding.

The equitization will reduce Gogo's net leverage ratio to below 4x based on adjusted EBITDA for the 12 months ended March 31, 2022, putting us in the range of our targeted capital structure, which I will discuss in a moment. The maturity of our convertible notes also further simplifies our capital structure. After concluding the step on a comprehensive refinancing plan, our interest expense will have been reduced by $78 million annually from $111 million before our April 2021 refinancing to approximately $33 million going forward. This $33 million excludes the impact of changes in LIBOR rates, inflows from our hedging contract and potential voluntary debt repayments.

As a result of a remarkable operational and financial progress, Gogo's balance sheet is now a competitive strength. It provides significant strategic and financial flexibility as evidenced by the actions we've been able to take to manage our supply chain and will help propel the long-term growth of our bottom line.

As we've shared on previous calls, we are pursuing a balanced capital allocation strategy focused on 4 primary actions in the following order of priority: the first priority is launching Gogo 5G in the second half of this year, on time and on budget.

The second priority is reducing our financial leverage, on this point, we stated on our last call that our balance sheet objectives included targeting a net leverage ratio of less than 4x while maintaining minimum available liquidity of $125 million, with the majority in cash, but also considering our revolver capacity. As I mentioned a moment ago, we expect to achieve our targeted leverage ratio during the second quarter.

The third prong of our capital allocation strategy is to make strategic value-creating investments in our business, including the LEO-based global broadband opportunity we're evaluating and which Oak discussed in some detail.

And finally, our fourth priority is returning capital to shareholders. As you can see, we are progressing well through the first 3 of these priorities. We will continue to assess returning capital to shareholders in the right way and at the right time.

Let me add one final housekeeping point to this discussion of our capital structure related to the shelf registration statement that Gogo filed this morning. I noted last quarter that when GTCR exchanged its convertible notes for common stock in April of 2021 received customary demand and piggyback registration rates. This shelf was filed pursuant to that registration rights agreement. The Thorne family and certain members of our Board have also registered chairs under the shelf pursuant to piggyback registration rights issued back in 2009.

Now, I'll turn to our increased 2022 full year financial guidance that we announced this morning. We now expect to ship approximately 1,300 ATG equipment units in 2022, up nearly 50% from 2021 and a meaningful improvement from our prior guidance for shipments of approximately $1,100. Gogo now expects to deliver the full year 2022 revenue in the range of $390 million to $400 million compared to our previous guidance range of $380 million to $395 million. We also expect to achieve full year adjusted EBITDA at the high end of our previously announced $150 million to $160 million range, reflecting the planned increase in our 5G investment this year and also factoring in $5 million for estimated legal expenses related to the SmartSky patent litigation.

In addition to raising our guidance for both revenue and adjusted EBITDA, we raised the low end of our previously guided range for free cash flow in 2022 by $10 million and now expect it to be in the range of $35 million to $45 million. Our free cash flow expectations reflect capital expenditures of approximately $65 million, with approximately $50 million of the CapEx spend tied to Gogo 5G. Our 5-year targets remain unchanged.

As a reminder, the 2022 guidance and long-term targets are derived from our baseline 2022 forecast and long-term plan, which include planned investments in Gogo 5G, but do not include potential strategic investments currently under consideration, including the global broadband initiative. As our outlook demonstrates, our momentum is building, which we believe positions us for an even brighter future, stemming from the strong tailwinds in the attractive business aviation industry, our leading market position our quality product and service platform and the strength of our balance sheet.

Before we open up the call to questions, I'll just echo Oak's heartfelt thanks to the entire Gogo team. Your relentless dedication and hard work inspire us as you continue to deliver industry-leading service and impactful innovation for our customers and value for our shareholders.

Thank you. Operator, this concludes our prepared remarks, and I'm now ready for our first question.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We have our first question from the line of Lance Vitanza with Cowen.

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

Congratulations on the great quarter. Where to begin, I guess, on the unit shipments -- the air-to-ground unit shipments, 1,300 for the full year, if I -- I'm looking at the press -- it looks like that suggests pretty substantial acceleration from the pace in Q1. And I'm just wondering, certainly ahead of the number that we had been modeling. What -- can you talk a little bit about what gives you the confidence that you can get to that 1,300 number? I mean how much of that is sort of contractually in backlog? How much of that is just sort of your sense on where the business is going? And then I have one follow-up question, if I could.

Oakleigh Thorne - *Gogo Inc. - Chairman & CEO*

Yes, Lance, the real governor on our unit shipments this year is supply, not demand. The demand is tremendous. So the real confidence comes now in that we've secured all the componentry we need to hit a 1,300 number. And that is all well in place and in hand. On the demand side, 95% of those -- of that number is -- got a name on it in terms of where it's going and what it's being installed in. So we're almost already sold out of the increased 200 units at it that way. And frankly, I think we see signals that there could be a lot more demand later in the year than even in the 1,300 number. So we're seeing now and working hard now to see if we can secure more supply.

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

Okay. And then my follow-up is really actually on the LEO global broadband strategy. There's been an increasing amount of conversation on these earnings calls around this. So it certainly feels like things are happening more quickly than perhaps we had expected. Is that the case? Or is this still something that you see potentially rolling out -- I guess, what is the time frame that we should be thinking about in terms of making an announcement of finding partners. And then also more importantly, when you think you could be someday in service with the global broadband product? Is that still sort of towards the end of the decade? Or is that the middle of the decade? How do we think about that?

Oakleigh Thorne - *Gogo Inc. - Chairman & CEO*

Yes, we're in active conversations with potential partners, as I said in my comments. And we'll provide more detail when we have those partnerships nailed down and we're ready to talk about our plans. I would -- in terms of timing, it will take probably 2 years or so to develop the equipment that we'll be putting on the aircraft. And so that's sort of one critical path. And then the other critical path is LEO network is actually being completed that can service us. So -- and that's also probably about 2 years. So I'd use that in of your mind as to being when the earliest we could have a product out. And we're going to move as quickly as we can. We view this as very important. It's a competitive response to potential other LEO providers trying to come into our market or other people partnering with our market and coming in, and we don't want to be a laggard at that. We'd like to be the leader.

And frankly, these constellations are still in progress in terms of being launched. So that's the governing factor as well. So I would say, mid-decade on, we expect these to accelerate our growth, both on the top line and bottom line, and that most of the financial benefit of this will be from '25 -- 2025 or '26 -- '25-ish on.

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

So really just to sort of the current long-term plan is kind of wrapping up.

Oakleigh Thorne - *Gogo Inc. - Chairman & CEO*

Yes.

Operator

Our next question is from the line of Landon Park with Morgan Stanley.

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

Just following up on the backlog question. I'm wondering if you can provide any more details in terms of what type of L3 versus L5? And maybe what types of aircraft you're seeing the demand come through from in terms of aircraft size and stuff like that?

And then just a second question. could you touch on the FCC funding that you applied for earlier this year and how you're thinking about the potential to receive significant funds?

Oakleigh Thorne - *Gogo Inc. - Chairman & CEO*

Yes, sure. In terms of the L3, L5 mix, I don't have that at my fingertips. But L3 has grown as a percentage of our AVANCE sales this year. But I'll leave it to Barry in a moment, maybe he'll provide the L3, L5 breakdown. In terms of the aircraft side, we're having -- we're seeing growth in all segments. As you know, we've had considerable success getting down into the general aviation market this year with [Cirrus]. And we have a lot of activity in that space. And then across the light, medium and large jets, we've seen growth in every segment. So there's been no real skew there.

In terms of the SEC, government subsidies are designed to get you to do things that you wouldn't view as economically viable on your own. And we would be removing the ZTE equipment over a much longer time frame. If it weren't for the availability of a subsidy like this. Depending on what we receive, we'll decide whether it's enough to alter our behavior or not. And if it is, we'll accelerate the removal, which is what the government wants us to do. So I'm going to leave it at that for now. We'll see what happens. I think the FCC announced that -- decisions in June on this. There's a lot more demand for these dollars than they anticipated. So very hard to tell right now exactly where all that will land.

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

And Landon, just to provide some specificity on your question around the backlog. In general terms, we expect the split between L5 and L3 to be about 50-50 for all of 2022 with perhaps a slight skew to a little bit more of L5, but think about it in terms of roughly 50-50.

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

And should we still be expecting overall equipment margin to compress year-over-year? Or are you guys in that (inaudible).

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

As I mentioned, we do expect equipment margin to be in the 30% range for the balance of this year. That is higher than we had previously expected as we're seeing that we do as the average selling prices are not coming down and we're not required to do as much discounting as we might have projected. But as I mentioned, this is very much in line with our strategy to drive AVANCE penetration. So we're happy to see those equipment margins even be at that level, which, of course, is still additive to our unit economics, but really gets the AVANCE penetration and unit installations up there.

Operator

Our next question is from Ric Prentiss with Raymond James.

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

A couple of follow-on questions. I appreciate the time today. Follow-up on one Lance's question. Obviously, I appreciate the color on the ad LEO program possibility. I think if you mentioned externally developed could be about half the 5G investment. Help us -- remind us about what that total 5G investment is just so we can get a ballpark of what the half of the 5G investment would be. And when it says externally developed, what would you imagine your cost as far as splitting it roughly between OpEx versus CapEx then?

Oakleigh Thorne - *Gogo Inc. - Chairman & CEO*

Yes. So we've always said that 5G external costs would be about $100 million. Barry can correct me if I got that wrong, but I believe about $100 million. So I think that's the guidepost you can use. We have -- and external is both cost of equipment, R&D and other things. So that's what we're guiding to here. The rest of it is, frankly, just baked into our internal costs are already just baked into our guidance. It's just using our resources that are already in OpEx and CapEx for the guidance we've provided in the past for the 5-year plan.

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

And Ric, a little bit of color on the split. As you know, 5G is substantially weighted to CapEx on the order of 2/3 of that $100 million of CapEx for the global broadband product being less than the half of that total $100 million number, the lion's share of that will be in OpEx. So it's going to be a much more development centered project, we don't have to deploy towers and those kinds of things, obviously. So the CapEx spend is much lower.

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

Yes. So to be more OpEx trigger, but you're only spending half that level. When you think about potential partners on the (inaudible) side and the antenna side, I know you don't want to get into specifics, but how do you -- what do you consider important success factors as far as picking partners, a lot of LEO constellations out there, some launch, some not launch? But what do you think are the important factors as you consider partners as far as what they would bring to the table?

Oakleigh Thorne - *Gogo Inc. - Chairman & CEO*

Yes. Well, obviously, in terms of the LEOs, it would be the probability of them being launched is a very important one. So that's foremost in our minds on that. And in terms of the rest of our partners, I probably don't want to get into that in too much detail. But obviously, we're looking for people that have the expertise to what build what we want them to build to our design and the time frame that we want it delivered. So.

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

Okay. And then just one kind of housekeeping one. You both mentioned the litigation fees. I think it's $5 million this year. You include that in your EBITDA. Any thoughts on -- other than just calling out like excluding it, I know there's some accounting rules out there, but why I think some other firms would pull that out also when they report.

Oakleigh Thorne - *Gogo Inc. - Chairman & CEO*

Well, I did ask the question, Ric, but I think we came to the conclusion that we've had legal fees associated with litigation in the past. We've had the shareholder lawsuit, we've had various patent lawsuits. And we've never pulled that out in the past of EBITDA. So we thought that pulling it out now would be inconsistent with that and that inconsistency was inappropriate.

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

We did want to provide the number though, Rick, because certainly, as you look at this, you can pull the number out from the recurring EBITDA number, obviously. So we thought it's helpful for TheStreet to be able to know what that number was.

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

Exactly. Final one for me, appreciate the time. Obviously, inflation is in the news. As you think about interest rates effect on your numbers and labor costs and inflation costs. How should we think about how the current financial markets are affecting your operations and your view going forward?

Oakleigh Thorne - *Gogo Inc. - Chairman & CEO*

Barry, why don't you take the question on our operations, and then I can talk about the market a little bit.

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

Yes. Regarding inflation, Ric, we kind of think about it in 3 parts. It is built into our forecast, by the way, and planned for in our guidance. But the first is for increases in wages and we have budgeted for larger increases in the past than in the past based on what we're seeing overall. The second piece is on component cost increases. We do have long-term contracted purchase orders that lock in future pricing and materials. So component costs in aggregate will rise gradually over time, we do see some increases on the component-by-component basis, but we'd expect that to increase over time.

Importantly, the cost of equipment is only about 20% of our total OpEx spend. So we're less vulnerable there. And then the third area is related to our cost of service. And we actually see a meaningful portion of that cost structure like backhaul, not subject to inflation. And in fact, our overall ATG cost per megabyte in unit terms are expected to stay flat or decline over the 5-year planning horizon. So we feel like we have comprehended inflation into our forecast, but it's something we monitor very carefully.

Oakleigh Thorne - *Gogo Inc. - Chairman & CEO*

Yes. And then taking that just a step further and thinking about potential recession and high interest rates and all that and how that could affect our market. It's interesting when you look at the market. We've performed very well through the '08, '09 financial recession and through COVID, obviously. And '08, '09, the business aviation industry went through a huge downdraft. It was -- it went from over 1,000 aircraft deliveries a year to 500. And it stayed very low for a number of years. But our demand sort of seemly unaffected. We continued to sell very well through that period. We -- of course, we launched right before that period. So it was a pretty new market, but we were able to drive significant service revenue growth through that period.

And then in COVID, we did have a downturn in equipment orders in the second quarter of '20. But for the year, I mean, our service revenue was only down 4%. So pretty resilient in that recession as well. So as we look forward and we think about the impact of a recession, we could see a slowdown in with our red hot equipment sales at this point, but we see none of that so far. But we would expect our service revenue to be largely unaffected by it. And I think past history sort of bears that out.

Operator

Our next question is from the line of Scott Searle with ROTH Capital.

Scott Wallace Searle - *ROTH Capital Partners, LLC, Research Division - MD & Senior Research Analyst*

Oak, Barry, great job on the quarter, particularly on the operational front. It's probably premature. But given your visibility to 2022 at this point, and we'll exit the year at still less than 1/3 penetrated into the BA market. What are the early thoughts for 2023? Is the initial expectation that we see another 1,300 ATG units going out the door? Is there some moderation on that front? How are you thinking about it?

Oakleigh Thorne - *Gogo Inc. - Chairman & CEO*

Yes. Well, I think -- we'll update '23 in the second quarter call, probably. We haven't really explored all that through. I mean in our long-term model that stands now, Barry, what is it, we have about 11% unit growth each year. Is that what's projected in there?

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

Yes. Of the 15% growth, that's right. It's -- the units -- yes, the aircraft online are in that 11%, 12% range and the balance from an increase in ARPU.

Oakleigh Thorne - *Gogo Inc. - Chairman & CEO*

Okay, right. So that's what's baked in there so far. We are taking orders already for '23. And so we have a pretty sizable chunk of orders actually going out into '23. So, so far, the harbingers are good. And of course, we expect to have a pretty big lift in service revenue from the increased units we're selling this year, which would be above what we projected in the long-term model. So we'll have more on that like I said in -- on our second quarter call after we've done our reforecast for '23.

Scott Wallace Searle - *ROTH Capital Partners, LLC, Research Division - MD & Senior Research Analyst*

Very good. And if I could, maybe looking at 5G, it's nice to see that everything remains on track from a technology development network standpoint for second half launch.

I wonder if you could give us some insight into the interest level of 5G. And what you think the penetration adoption upgrade cycle would be? And give us some color in terms of cost for upgrade with existing AVANCE systems and timing for aircraft to be upgraded.

And I guess as part of that, you've been talking about of 4% to 5%, I think, ARPU increase over the next several years. Yes, we've been running at 8%, I think, the last couple of quarters, and that's even pre-5G. So how does 5G impact that ARPU skew as well?

Oakleigh Thorne - *Gogo Inc. - Chairman & CEO*

Yes. The way we think about 5G is that we expect to start some meaningful shipments in 2023 with the announcement by the end of this year. It is a relatively slow ramp as people upgrade and over time. So it's going to ramp during the planning horizon. And just to give you some context, Scott, the AVANCE product line is the most successful launch in business connectivity aviation history really. And it's at about 25% after 4 years or so. So that was the fastest ramp. So I think you wouldn't necessarily see it quite that fast. But -- so it will take some time to build. But importantly, it also drives the ARPU.

So we have meaningfully higher ARPU expectations for 5G, and that's what's partly driving that lift in ARPU expectations. So I would say that for the first few orders that we're seeing from 5G that, that is an affirmation of the customers' interest and pay more for 5G because of the performance that it's expected to deliver. So the early signs are positive relative to what we have put in the model.

Operator

Our next question is from the line of Louie DiPalma with William Blair.

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

Barry and Will. Barry, congratulations on your eventual retirement.

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

Thank you, Louie. I'm not done yet, and it's going to be in great hands with Jesse. So you still have to put up with me for a while.

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

Indeed, I have a question. It seems that the extinguishment of the convertible debt is imminent. So what share count should analysts be using for Gogo?

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

So it will be about 134 million shares after those 17 million shares convert.

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

Sounds good. And in terms of capital allocation, you discussed leverage. Are -- is a stock buyback and/or a potential dividend? Are those still being considered after you reach your leverage target?

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

Yes. We're very systematic, and we think quite disciplined about the way we're approaching capital allocation. And as we said for a number of quarters now, we're -- we think about this in the sequential priorities of getting 5G Gen, getting the leverage where it needs to be, investing in ways that's going to enhance the value of the business like with Gogo -- global broadband, and then returning capital to shareholders.

So we have made very good progress in the first 3 of those, 5G on track still to be finished, obviously, but on time and on budget. Financial leverage will come below that 4x this quarter. And then as Oak described in some detail, we are very seriously evaluating this global broadband investment, which takes the level of investment that we described. So we are actively pursuing capital -- an analysis of returning capital to shareholders, but it's in that context. So as we look out to the capital generation capability of the business, it certainly is there over the next several years. So it's something that we'll be mindful of and know that it's an important factor for the shareholders.

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

Great. And final one for Oak. Oak, how fast is the 5G network in initial trials with the 35 cell sites that have been completed? And does the carrier aggregation/channel bonding works that combines the your 850 megahertz signal with the, I think, the 2.4 gigahertz signal? And with that backdrop, like is -- like a LEO a broadband product even necessary over continental U.S. if the 5G network works as advertised.

Oakleigh Thorne - *Gogo Inc. - Chairman & CEO*

Well, I guess, first of all, we think it's a strategic imperative to continuously improve the quality of the network to remain competitive. So the idea that you could aggregate 5G with LEO in the same router and distribute it through the aircraft, we think is a great positive about GBB and solidifying our customer base in the U.S. and continue to grow, it and makes it extremely competitive in the U.S. market with any potential LEO provider coming in and trying to compete with us.

So we view that as very important. In terms of the rest of your question, I mean our -- you have to recognize that in terms of our testing, with 1 tower, we could see that the 850 and 2.4 work. So that's been verified and that's not an issue. On those other towers, they haven't been lit up yet. So we'll know how all that gets tested a little bit later.

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

Sounds good. And you just mentioned do we using a potential LEO product with your ATG network. Would that require like substantially more like hardware on the plane?

Oakleigh Thorne - *Gogo Inc. - Chairman & CEO*

No, no. That's built into AVANCE. I mean the benefit of AVANCE is it's got a very unique multi-barrier capabilities, it barriers being networks. So we could handle multiple networks going into the same box and then being blended into 1 user experience. As opposed to today, where you might have two networks, ATG and a GEO satellite, but you have one on and the other one is not turned on. With the Gogo multi-barrier in AVANCE, both can be turned on and both you can essentially add the capacity of the 2 of them, and that's the capacity of the aircraft. So if we're delivering 50 megabits per second with ATG and another 100 megabits per second with the LEO product. There's 150 megabits per second coming to the aircraft.

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

Right. So it'd be additive.

Oakleigh Thorne - *Gogo Inc. - Chairman & CEO*

Yes.

Operator

Our last question comes from the line of Anthony Klarman with Deutsche Bank.

Anthony Francis Klarman - *Deutsche Bank AG, Research Division - MD and Global Head of High Yield Research*

Really just 2 follow-ups. First, on the potential for the global LEO broadband partnership. Just to sanity check that, I guess, I'm assuming that there's no spend on a potential partnership agreement like that, that's included in the long-term financial targets. So theoretically, to the extent you were to sign an agreement that commercialized at some point during the planning horizon. There might be some incremental spend associated with that. But then theoretically, I guess, there's also no inclusion of revenue from that in the 15% CAGR that you put out for '21 through '26.

Oakleigh Thorne - *Gogo Inc. - Chairman & CEO*

Yes, right. First of all, yes, there's -- global broadband is not in our baseline numbers that are the foundation of the long-term guidance we've given. They're what we call an overlay. So we'll share more detail on that overlay if and when we announce the project. So that's number one.

Number two, the business model with the LEO provider is a managed service model. So we would be paying by the drink essentially for usage. So there's no real cost there prior to having revenue to pay for it.

Anthony Francis Klarman - *Deutsche Bank AG, Research Division - MD and Global Head of High Yield Research*

Got it. I guess I was thinking more along the R&D and equipment or CPE lines, but I guess even that is more of a back-ended when the constellation is launched and ready-to-go type investment?

Oakleigh Thorne - *Gogo Inc. - Chairman & CEO*

No, no. That -- yes, we're going to be creating the -- and developing -- sorry, the equipment that goes on the aircraft, which is essentially an ESA electronically steerable antenna and a couple of wires that run down into the aircraft to the AVANCE box that's in the aircraft. So there's not a whole lot of new equipment to develop other than that. But that's something we will fund. And that would happen in advance of going revenue. Yes, that would be the initial investment that I talked about over 3 years.

Anthony Francis Klarman - *Deutsche Bank AG, Research Division - MD and Global Head of High Yield Research*

Understood. That's clear. So if I think about the free cash flow guidance in the long-term targets, which you have at $125 million and $23 million getting to over $200 million by '25, Essentially, that's all coming from underlying base business EBITDA growth. Essentially, CapEx is relatively flattish once you get past 5G. So really, all of that increment is coming from the base business and growing EBITDA over that 2-year period.

Oakleigh Thorne - *Gogo Inc. - Chairman & CEO*

Yes, that's right. That's absolutely right. So we think just to be a little transparent. The service revenue will be more than in that guidance. And so that will help free cash flow some. We may have a little bit of slippage of some 5G spend into next year that might hurt free cash flow, though just by timing of invoices. But -- so we'll see how that all shakes out. I mean the investment in our global broadband product would be obviously, negative to free cash flow, but it may not be -- it may not -- we don't know if it's going to change that guidance or not yet. We'll let you know when we're done with the '23 projections.

Anthony Francis Klarman - *Deutsche Bank AG, Research Division - MD and Global Head of High Yield Research*

Understood. And then, Barry, on the adjusted EBITDA with the litigation expense, just to check to make sure I understand that what you were saying in response to another question. I think in the 10-K, you had not yet reserved anything against SmartSky. So is this an actual accrual against a future potential litigation expense? Or is it actual cash expense that you expect to go out the door? I guess you're using the term more of expense than an accrual. So I just want to check whether it was cash or an accrual against a future potential outcome.

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

Yes, the way we think about that, Anthony, is that that's the amount that we have earmarked to defend this suit through the preliminary injection period. So that is net of the EBITDA. So the way to think about that is that EBITDA range of $150 million to $160 million. And now we're saying we're coming at the high end of that range, and that is accommodating that $5 million expected spend in the high end of the range guidance.

Anthony Francis Klarman - *Deutsche Bank AG, Research Division - MD and Global Head of High Yield Research*

Yes. Understood. But you're -- I think you're also answering my question of it is actual cash expense because it's including the cost of defense in the suit and some of the other cash expenses as opposed to an accrual for a potential future liability?

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

Yes. Once we get -- once we proceed through the suit, this represents the cash outflow for defending ourselves in that suit.

Operator

Thank you. We don't have any further questions at this time. Presenters, please continue.

Oakleigh Thorne - *Gogo Inc. - Chairman & CEO*

Well, thank you, everyone, for joining our first quarter earnings call, and we will look forward to speaking with you next quarter. Thank you.

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

Thank you.

Operator

This concludes today's conference call. Thank you for participating. You may now disconnect.
