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EDITED TRANSCRIPT

GOGO - Q1 2018 Gogo Inc Earnings Call

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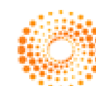

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Gogo Inc. First Quarter 2018 Earnings Conference Call. (Operator Instructions) As a reminder, this conference call may be recorded.

I would now like to turn the conference over to Ms. Alva, Vice President of Investor Relations and Treasurer. Ma'am, you may begin.

Varvara Alva - *Gogo Inc. - VP of IR & Treasurer*

Thank you, and good morning, everyone. Welcome to Gogo's First 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 and are more fully detailed under the caption Risk Factors in our annual report on Form 10-K and other documents we filed with the SEC.

In addition, please note that the date of this conference call is May 4, 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 first 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 our website. After management's remarks, we'll host a Q&A session.

And now it's my great pleasure to turn the call over to Oakleigh.

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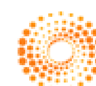

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Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

Good morning, everyone. Welcome to my first Gogo quarterly earnings call. My goal on these calls will be to develop an open relationship with the financial community so that investors can make informed decisions about investing in Gogo. I plan to be candid about our issues but also candid about how we plan to solve those issues and about the huge opportunity I see for this company to create value for its shareholders.

I also want to make it clear, I don't want to tie the company to old numbers or projections. We're rebuilding our plans as part of an integrated business planning process, IBP. And when that's done, we'll have numbers that our management team can own and communicate.

So let me start by discussing the process we're going through to get Gogo back on track, then I'll touch on the quarter and then finish with several examples of how we're attacking my 4 priorities of quality, focus, getting profitable and driving shareholder value.

Since joining the company as CEO 8 weeks ago, I've tried to take a methodical approach to assessing the issues and opportunities we face and to charting a course to fix those issues and realize those opportunities. We spent the first 4 weeks meeting with staff in business reviews, visiting our facilities and meeting with customers and suppliers.

The process of doing that, it became clear to me that we need to meet -- to improve quality and control costs and that to make those things happen, we needed to break down functional silos and reorganize around market-facing business units, their own P&Ls and with end-to-end responsibility for delivering quality product to customers.

With the new executive leadership in place, we're now embarking on the integrated business planning process I mentioned a moment ago, which is intended to put a solid cross-functional plan in place to drive my 4 priorities. Our newly organized team has identified 15 objectives that are aligned with those priorities that we want to accomplish over the next 12 months. I'll touch on some of the 15 objectives a little later in my comments.

The goal of the IBP is to be able to achieve cash flow positive results and control our own destiny. We hope to have the IBP and the reforecast for the rest of 2018 and 2019 completed in the late June time frame.

In parallel, we've launched a longer-term strategic planning process. We see tremendous change coming to our industry over the next few years, which includes consolidation of existing players, the potential entry of larger strategic players and large new sources of capital looking to finance consolidation.

To ensure that those changes create value for our shareholders, we created a strategy in corporate development function as part of our recent reorganization. Our opportunity is to make sure we understand how that game of thrones will play out and ensure that we choose a path that will be rewarding to Gogo's shareholders.

Lastly, we need to think through the financing implications of whatever we do. So we're running a concurrent financial planning process. Before anyone panics over the words Gogo and financing, I want to remind everyone, my family and I own 30% of the equity in this company. So we are highly motivated to act in the best interest of shareholders. Our financial planning will address refinancing our convertible notes due in 2020 and make sure we are adequately capitalized for whichever operational and strategic path we should choose. So let me lay out the financing situation as we see it.

First, if we made no changes to the business right now, we would need some but not a lot of additional capital. However, the goal of the IBP will be to extract enough cash out of our operations to mitigate that need. We'll be able to offer more guidance on that by late June.

That said, if we see attractive opportunities to add buffer capital, we will. The bigger issue, however, are our growth opportunities. Later in my comments, I'll discuss our sales pipeline, which right now is as full as it's ever been. If we end up signing a large number of new NPV positive deals, we may seek growth capital to fund the ramp-up associated with those opportunities.

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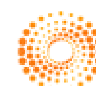

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Let me turn briefly to the quarter. I'll cover the business aspects and leave the heavy lifting around the numbers, the airline-directed model and 606 accounting to Barry.

The quarter truly was the best of times and the worst of times. We had an outstanding quarter in our BA division but a very disappointing quarter in our CA division. In BA, we had record equipment service revenue, driven by the market's enthusiasm for our new AVANCE L5 platform, and we had record earnings and very positive margin expansion.

In Q1, we had more than 100 aircraft flying AVANCE L5, which is a streaming class product aimed at the large business jet market. We shipped another 114 L5 units, and we had a backlog of close to 500 units. We also received FAA approval for and launched and shipped 35 units of our new L3 platform, which is aimed at the smaller business aircraft market.

The AVANCE platform is our fastest-growing and most reliable product launch ever. Besides faster speeds, the main passenger benefits are new information system, such as maps and real-time news, new entertainment options and a built-in cellular modem for on-ground Internet access. The main flight department benefits are remote diagnostics and auto reporting so that flight departments on the ground know about in-flight issues earlier and can take corrective action.

One negative issue has arisen for BA since the end of the quarter, and this will also affect CA. The Department of Commerce recently issued a denial order impacting ZTE, a Chinese company that is a major supplier to Gogo for our Next Gen ATG system and that helped us build and now helps us maintain our original ATG network.

We are hard working -- working hard on assessing the legal, regulatory, supply chain and technology issues presented by this order. This time, we've not been able to determine whether the order applies to our technology or not nor the impact on the timing nor cost of our Next Gen projects.

That said, we've been working on some sort of Next Gen air-to-ground products since at least 2010 and have considered many other technology paths and vendors. So if we need to change direction, we can. Though, obviously, that would involve cost and delay. We'll provide more information on the ZTE situation when appropriate.

Now let's turn to the CA division. Obviously, it was a tough quarter in CA-NA, though it was a pretty good quarter in CA-Rest of World. In the future, we may combine results for these 2 segments, as they are now consolidated into 1 management structure.

Headline revenue in CA-NA looks great because of the onetime switch of a customer from the turnkey to the airline-directed business model. But service revenue actually declined, partly due to 606 accounting but also due to the economic effect of the airline-directed switch I mentioned a moment ago.

Barry will get into the accounting issues associated with the switch, but the business issue is that the airline has priced the product in a manner that depressed demand and sessions fell short of our expectations. Hopefully, this issue will get resolved, and we will return to higher take rates of that customer sometime in the next couple of quarters.

I know there's concern out there over whether the airline-directed model is bad for Gogo. Generally, we found that it's good because both we and the airline are incented to drive passenger satisfaction and usage, which in turn drives revenue for our company.

CA-Rest of World revenue was relatively strong with 86% revenue growth over the prior period and growth in both service and equipment revenue. We had 93 installs for CA in the quarter and look to still be on track with our guidance of 550 to 650 installs with roughly half of those in Rest of World, which should leave Rest of World with more than 600 installed aircraft at year-end.

The other big issue in the quarter was the deicing fluid impact on 2Ku. I'll get into this issue in more detail later, but the impact on Q1 was twofold. First, airlines held back on marketing the product, which hurt revenue. And two, we ramped up spending to fix reliability as soon as we could,

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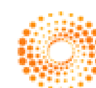

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which hurt costs. We'll see even higher spending in Q2 as our remediation plans ramp up further in that quarter. The costs are primarily around maintenance expense and CapEx for new antenna inventory.

The final big downer for the quarter was the long-awaited deinstall of approximately 550 of our old ATG aircraft in favor of the competitor's satellite product that a major customer has begun with 19 aircraft deinstalled for the quarter. We expect those deinstalls to predominantly occur this year with some to follow next year. Over that period, we'll add more aircraft in our combined CA division than we'll lose. However, the planes coming off have fairly high ARPA, and the new planes, generally newer fleets -- are generally newer fleets, which won't produce high ARPA until they've matured.

So now let me turn to some of the positive events that occurred in the quarter. First, 2Ku is returning to reliable operation. Once it's reliable, there's no question in my mind that it's the best ISP product in the market, and a lot of airlines are figuring that out.

My predecessor, Michael Small, talked about 98/98/15. That's 98% system availability, 98% flight route coverage and 15 megabits per second speeds, and that's still our goal. We're achieving the 98% coverage, and we're achieving average 15 megabits per second speeds globally. But we slipped on the 98% system availability with our deicing problems.

The good news is that we're back to over 96% reliability as of yesterday, and that project's underway that will get us back to 98% reliability by year-end. Now the cynics amongst you will say, "Of course the deicing is better, the weather got warm." Well, actually, we saw a considerable improvement before the weather improved, mostly driven by new software releases.

2Ku is also designed to be future-proof, and airlines are starting to figure that out. It's the only commercially available antenna that can work with the new Ku LE -- LEO constellations should they launch. We also have the capability to adopt a 2Ku installation to the Ka-band, should the Ka-band be more appropriate for our airline customers down the road, saving our customers from potential expensive deinstallation programs in the future.

As a result of this product's superiority, our pipeline is full of high-quality airline opportunities. As we demonstrate to the world that 2Ku is reliable and that we have the deicing problem solved, we can close a lot of deals over the next 18 months.

I just attended the Aircraft Interiors Expo show in Hamburg, Germany, where I met with about a dozen customers and prospects and was amazed by how enthusiastic they were about 2Ku and about Gogo as a company. We also continued to make progress in our [FTC] and service built-in portfolio, adding installs on the A321neo and A380 in April, and we continued to make progress on line-fit at Boeing and Airbus. We had our first line-fit install recently at Bombardier on the C series due for deliveries at Delta later this year.

In the win column, Air Canada and Air Mexico selected 2Ku for in-flight connectivity on more than another 50 additional aircraft, including Air Canada's Bombardier CS300 aircraft, which will also be line-fit. In January of 2018, Gogo integrated SES-15 into our global satellite network. SES-15 is the first hybrid HTS satellite providing Ku-band wide beams and Ku-band spot-beam capacity over North America, Mexico, Central America and the Caribbean.

On the business metrics front, we obviously suffered in the quarter, with ARPA and ARPS both down from all the reasons I've discussed already. However, take rates climbed considerably from 9% in Q1 2017 to 10.8% this year. That's for CA in total. While take rate may not be a very important financial measure, I do consider it an important strategic measure because the more passengers that are engaged with our products, the more important we are strategically to our airline partners.

Now I'd like to turn our attention to how we'll use the integrated business planning process to drive our 4 key priorities: quality, focus, profitability and shareholder value. As a first step, we've identified key issues and areas of opportunity. And as I said, we've set 15 objectives to address those issues and realize those opportunities.

Underneath each of those objectives are, or will be, a set of projects or actions needed to achieve the objective and milestones or KPIs to let us know if we're on track for hitting those objectives. I'm not going to go into all of our objectives and initiatives, but I'd like to give you a taste for what we're up to and how they'll drive my 4 priorities.

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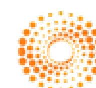

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So let's start with the quality priority. Our first quality priority is, obviously, fixing 2Ku. Last summer, 2Ku was our most successful product launch ever, with greater than 98% service availability. And then came winter, and availability plunged down to the mid 80s.

The major cause was deicing fluid getting into the antenna array's ways in which the antenna discs spin. We've done a thorough analysis of root causes and discovered that while deicing was the biggest issue, there are also some manufacturing issues and software issues at fault.

We also discovered the deicing fluid entered the antenna array down through far more pathways than we originally thought. We fixed the software issues, and we fixed the manufacturing issues. We're in the process of replacing all contaminated antennas by the end of this quarter.

Our goal was to hit 95% availability by June 30. And I want to repeat, this week, we're at 96%. So we're well ahead of plan. In the second half of this year, we're planning to roll out a set of 2Ku modifications that will keep deicing fluid out of the array's ways and get it back to our target of 98% system availability.

The benefits of getting 2Ku operating well again are obvious. First, we'll get uptick and penetration rates in ARPA; and two, prospective airlines will have confidence that the product will work and hopefully sign valuable contracts.

While this improvement in 2Ku performance is nice, the most important learning from this exercise is that you can't just fix problems, you have to fix causes. Our reorganization will help fix causes by putting end-to-end responsibility for quality in one organization. We've also gone back and more clearly defined our new product introduction or NPI process to incorporate manufacturing and quality assurance and maintenance earlier in our product design.

Another big quality issue is around user experience. I'm sure everyone on this call has a frustrating Gogo story, either a hard time connecting to the network or an arduous logon process or just slow performance. As a board member, I used to complain about all those things all the time. And now I get to complain about them as the CEO.

A problem at Gogo was that we measured success by network availability, in other words, how well the network was reaching the airplane, but we failed to measure the user experience once our signal was on board. We're changing all of that and rolling out tools to measure network connection times, portal performance and browsing performance in the cabin so that we can manage on-aircraft maintenance, such as wireless access points, outages, coverage shadows or software glitches on our onboard servers.

As part of this user-experience improvement, we're also rolling out new Gilat modem across the 2Ku fleet, which should significantly improve browse times. We've installed about 500 of those Gilat modems, and we have another 500 to go before year-end. We're also completely rewriting the software that runs our onboard servers to improve the performance of our onboard software.

One last quality area I'll raise today is the frustration we cause airline customers by missing milestones in our airline pre-install and installation programs. The 2 main culprits here are a, immaturity production launches; and b, too many one-off commitments to airlines, crowding our product development pipeline.

I want to start by pointing out that our BA division is certainly best-of-class in our industry when it comes to production operations, and we've begged, borrowed and stolen a number of our quality BA people from BA to fix our CA issues.

I should also point out that we hurt ourselves quite a bit on this front last year by rolling out an imperfect ERP system in the middle of our massive 2Ku ramp-up. The system added many work steps to the basic check-in and out process and contained a lot of inaccurate data, making it very hard for our dedicated teams to locate the thousands of parts that go into a 2Ku chipset.

We have many projects aimed at improving these operations, including fixing the functionality and data of our ERP system, which we are targeting for completion in Q3. We're also moving into a new well-organized warehouse that enhances the production flow of material into and through our kitting facility and out to the customer. Once we have the ERP system fixed and the warehouse complete, we'll be able to implement better supply chain controls that we hope will reduce the amount of airborne inventory sitting in the warehouse.

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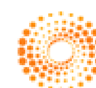

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These operational initiatives should improve our kits-on-dock performance with customers, which should get more aircraft flying sooner and improve revenue. They should cut down on inventory and help drive cash out of working capital. They should cut down on the cost of bad qualities, such as rework, airline penalties and expedited shipping, all of which cost us about $30 million last year. And finally, they should scale easily and affordably if we land a large number of the deals in our pipeline that I discussed earlier.

Now let me turn to the focus priority. Like many young companies, Gogo has pursued many new product opportunities beyond its core product line. Many of these have been driven by sales opportunities with a particular customer rather than as market-driven platform initiatives. The number of one-off products clogged up our product development pipeline and creates quality issues because every time we push production code, we need to manage a lot.

Also, a lot of the activities that we bundle into our basic service offering that perhaps we do not need to offer. So as part of our IBP process, we'll be evaluating all products to make sure they make strategic and economic sense with an eye to developing platforms as opposed to one-off products.

We also need to improve the throughput on our product development. So we're rolling out the scaled agile framework product development methodology, which should help prioritize product development initiatives, reduce development cycle times and reduce our program backlog. This should help control costs because we won't need to ramp up development resources to handle all the projects that are on our plate and enhance revenue as initiatives, such as improved user experience and better in-plane diagnostics, improve availability and penetration.

Now let's turn to the third priority, getting profitable. Our reorganization itself should drive cost savings, as we believe there were redundancies across the 3 separate departments that now make up the Commercial Aviation division. We're working through those savings, and we'll be able to report by our second quarter earnings call.

The [BPI] (sic) [IBP] process will also lead to savings, as our quality and focus projects bring down cost and help boost revenue. A key goal of the IBP is to develop a plan that achieves sustainable free cash flow. If we find at the end of the planning process that it does not, we will iterate until it does.

Finally, let's touch on shareholder value. Earlier in the call, I highlighted the strategic transaction activity in our industry appears to be heating up. Competitors are thinking about consolidation, large strategic players are thinking about how to enter the business through acquisition and PE firms are thinking about how to act as consolidators and take advantage of the huge opportunity IFC offers. It's very important that we position ourselves well in this dance, and that's why we created the new function focused on strategic planning and corporate development.

I think it's important that investors think about our role in this industry. We're the industry leader in Business Aviation in-flight connectivity, with a 90% market share in broadband-connected aircraft and very healthy free cash flow. And though we may face competition in this space in the future, the BA market is very underpenetrated with only 23% of all BA aircraft carrying a broadband product today.

On the CA side, despite our temporary operating issues, we are also the industry leader, and the airline and the OEMs, we are close to, tell us that despite our issues, we are the best IFC provider in the industry with the best technology.

That's supported by our leading market share in broadband connected airlines and the 2Ku product superiority I discussed earlier. Our shareholder value objective this year is to convince the market of the strategic value of our 2 businesses and to have our stock price reflect that value.

Thank you for your attention, and I'll now turn it over to Barry to do the numbers.

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

Thank you, Oak, and good morning, everyone. Before we get into the numbers, I'd like to highlight 3 items that impacted our financial results this quarter. First, one of our airline partners transitioned to the airline-directed model, which had both an accounting and an economic impact on the financial results.

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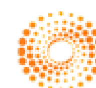

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Second, the adoption of the new revenue recognition standard, ASC 606, has amplified the accounting impact of the airline partner's business model change. Under the airline-directed model, equipment revenue and related costs are recognized at the time of the installation or in this case, at the time of the business model transition.

As a result, we recognized an incremental $45 million in equipment revenue and $26 million in equipment cost, resulting in a $19 million benefit to net income for the quarter. This impact has been excluded from our reported adjusted EBITDA.

As a reminder, these accounting changes are cash flow neutral, and Business Aviation is largely unaffected. We encourage you to review the supplemental tables in our earnings release and first quarter 10-Q for more information on the impact of ASC 606.

The third major impact on our financials this quarter are the 2Ku operational issues Oak described in detail. These are resulting in increased operational costs and lower service revenue. The bulk of the cost will be incurred in the first half of this year.

With this context, let's turn to a review of the numbers. Consolidated revenue for the quarter of $232 million was up 40% from the prior year and increased 13% when excluding the $45 million accounting impact I discussed. Our adjusted EBITDA increased to $12 million, up 11% versus the prior year and excludes $19 million accounting impact associated with that incremental revenue.

Let me now turn to the performance of our business segments starting with Business Aviation, which continues to deliver record financial and operating performance. Total BA revenue reached a record $68.8 million for the quarter, up 22% year-over-year. Service revenue was up 19% to a record $47.7 million, with 11% growth in ATG aircraft online to more than 4,800 planes and a 9% increase in ATG service ARPU to more than $3,000 per month.

BA equipment revenue was $21.2 million for the quarter, up 30% from the prior year, driven by growth in ATG shipments as demand for our new AVANCE platform products continues to be very strong. In the quarter, we announced hitting a record 100 installation of our AVANCE L5 product. Segment profit for the quarter was $32.3 million and the segment profit margin expanded to 47%, also a record.

As BA continues to deliver strong top line growth, the division is also translating a significant portion of that growth into bottom line performance. For the quarter, BA converted 50% of its year-over-year incremental revenue into additional segment profit, and this percentage is expected to continue at or above these levels for the year as a whole. BA continues to outperform in the marketplace and financially.

I'll now turn to our Commercial Aviation segments. Before discussing our financial performance, let me summarize the 4 primary accounting differences between the 2 business models we offer in Commercial Aviation, which we refer to as the turnkey and airline-directed models. With the adoption of ASC 606, these differences become more visible in our financials.

First, under the airline-directed model, we record equipment revenue and cost when installations occur. Second, service revenue is recorded net of revenue share, which results in lower ARPA and the associated cost of service versus a comparable turnkey model. With an increasing number of aircraft operating under the airline-directed model, we updated our definition of ARPA to be net of revenue share to provide better comparability of ARPA results.

Third, airborne equipment purchases are reflected in inventory and cost of goods sold versus cash, CapEx and PP&E under the turnkey model. And finally, under the 606 revenue recognition standard for the airline-directed models, we allocate revenue between service and equipment revenue to reflect the true economics of the contract. This results in lower service revenue since our equipment is typically sold at a discount. However, over the life of the contract, total revenue is the same.

I'll now turn to the operating results for our Commercial Aviation business. CA generated $144 million in total revenue, up 46% from the prior year, reflecting the accounting changes we discussed. Service revenue decreased to $89 million for the quarter, down 9% versus the prior year, which was primarily affected by one of our airline partners' transition to the airline-directed model and the related economic impact. Net annualized CA-NA ARPA was similarly affected and declined to $103,000 for the quarter.

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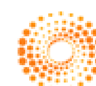

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As a result of this airline partner's transition to the airline-directed model during the quarter, an incremental $45 million was added to equipment revenue. Aircraft online of 2,840 were up 126 from a year ago. Aircraft online was flat sequentially because the incremental 30 installs were offset by deinstalls, a majority of which were from American Airlines.

We continue to upgrade our North American aircraft to 2Ku and completed 50 FLEX conversions. CA-North America segment profit declined by approximately $9 million from the prior year to $1.7 million. As a reminder, the first quarter of 2017 included a $9.4 million ATG Next Gen milestone expense.

Excluding this cost, CA-NA segment profit declined $19 million year-over-year. It was impacted by the increased satellite capacity cost to support the rollout of 2Ku, increased operational cost to improve 2Ku performance and resolve the deicing issues and lower service revenue.

Turning to CA-Rest of World, quarterly revenue increased to $19.2 million, up 86% versus the prior year. Service revenue of $14.2 million was up 52% from the prior year, driven largely by the increase in the number of aircraft online. Service revenue declined $1 million sequentially, primarily due to seasonality.

Net annualized CA-ROW ARPA of $159,000 declined versus the prior year and sequentially. This reflects the dilution from new airline partners aircraft coming online during Q1 2018, which initially generate lower net annualized ARPA. The new aircraft from new airline partners represented 43% of aircraft online in Q1 2018. We continue to expect total CA-ROW ARPA to decline during 2018 as the mix of aircraft from newly launched airlines increases throughout the year.

Equipment revenue of $4.9 million was up $4 million year-over-year and $3.4 million sequentially. Aircraft online increased to 414, as we installed 23 incremental 2Ku aircraft for the quarter. We continue to expect approximately 300 2Ku aircraft to come online during 2018 with roughly 2/3 of these installations in the second half of the year and with most of these installs under the airline-directed model. Rest of World segment loss to the quarter was $22.6 million, representing a 15% improvement year-over-year and a 9% improvement sequentially, driven by revenue growth from the addition of new aircraft.

We'll now turn to a discussion of CapEx. Consolidated CapEx -- cash CapEx of $57 million was $2 million lower than the prior year. Cash CapEx increased sequentially, driven by increased airborne equipment purchases as we built inventory during the quarter. We ended the quarter with $300 million in cash equivalents and short-term investments, reflecting a cash burn of $109 million for the quarter.

Much of this higher cash burn was related to the timing of regularly scheduled cash payments for interest and bonus expenses. It also reflects the timing of payments for airborne equipment crossing over the last 2 quarters, as we reported a higher cash balance than anticipated at the end of the year, which we discussed on our fourth quarter call.

Excluding our cash interest payment of $50 million, which occurs every first and third quarter, our unlevered cash burn was approximately $60 million for the quarter and averaged $32 million per quarter over the Q4 and Q1 quarters.

Before I turn to the outlook for 2018, let me touch on the balance sheet. With the increase in number of installations under the airline-directed model, we reclassified a portion of our airborne fixed assets from PP&E to inventory. As detailed in the 10-Q to be filed shortly after this call, our inventory balance increased by $127 million while PP&E declined by $156 million as of March 31, 2018, with much of the difference being recognized as cost of goods sold on the income statement.

Our consolidated inventory balance now includes inventory for both Business Aviation and Commercial Aviation customers. Going forward, we will allocate our Commercial Aviation equipment purchases to inventory and PP&E based on projected installations under the airline-directed and turnkey models, respectively.

Let's now turn to our outlook for the balance of 2018. We expect consolidated revenue -- segment revenue and 2Ku aircraft installations to be unchanged from prior guidance. Specifically, we continue to expect an increase in 2Ku aircraft online of 550 to 650, of which approximately 300

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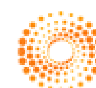

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are expected to be in CA-ROW; and total 2Ku aircraft online as of December 31, 2018 of 1,100 to 1,200. We expect these installations to be weighted more heavily toward the second half of the year.

We expect total revenue of $865 million to $935 million; BA revenue of $285 million to $295 million; CA-NA revenue of $445 million to $485 million; and CA-ROW revenue of $125 million to $165 million. Equipment revenue as a percentage of CA-NA revenue and CA-ROW revenue is expected to be higher than prior guidance due primarily to the 606 accounting impact.

Adjusted EBITDA is expected to be below the previously provided range of $75 million to $100 million due to increased cost and lost revenue related to the 2Ku implementation challenges we cited. Based on the timing of these expenses, we expect adjusted EBITDA to be extremely low in the second quarter and to then ramp significantly in the second half of the year similar to last year.

As Oak described, the integrated business planning process will result in us taking concrete actions to improve our cost structure and to lay the foundation for future revenue growth.

Gross capital expenditures of $150 million to $170 million and cash CapEx of $110 million to $130 million are unchanged from prior guidance. As we're currently undergoing the integrated business planning process, we plan to provide updated guidance no later than on our Q2 2018 earnings call. Until that process is completed, we are withdrawing our free cash flow guidance.

Operator, we're now ready for our first question.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Philip Cusick of JPMorgan.

Philip A. Cusick - *JP Morgan Chase & Co, Research Division - MD and Senior Analyst*

I guess, first, let's go back to cash. Oak, you opened up a lot of doors with this. First, if we think about the business as it is right now, should we -- we can assume that you will -- you're planning to get this to a cash-neutral, as you said before, act like this is all the cash we're ever going to have type of model?

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

Correct.

Philip A. Cusick - *JP Morgan Chase & Co, Research Division - MD and Senior Analyst*

And does that assume that you don't sign any more airlines? Or is that sort of a slow pace of additional signings from here?

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

If we sign a lot of new airlines, the -- first of all, we've been trying to actually restructure our deals to be more cash flow-neutral, especially in the early years, so we could manage things that way. If we can sign a lot of airlines though, we feel like we could raise more capital if we needed to because we'd have a successful business model to take to The Street. So when we talk about a cash flow-neutral model, it incorporates both those things: first of all, getting cost out of the business; and second of all, taking on future contracts that we can afford.

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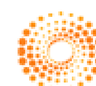

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Philip A. Cusick - *JP Morgan Chase & Co, Research Division - MD and Senior Analyst*

And I would expect that given the leverage on the business already and probably weaker EBITDA than we had expected, any cash raise would probably be on the equity side rather than the debt side?

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

Well, Phil, we would look at both those alternatives. We -- we'll be looking at refinancing the converts, for example. So under the right set of circumstances, there could be cash added to the balance sheet through those kinds of debt-oriented transactions. But I think it's also fair to say that particularly, as we look at the growth opportunities that there would be an opportunity to raise growth capital to be able to fund those. And I think the prospective investors would see a good return on that, as with the current shareholders.

Philip A. Cusick - *JP Morgan Chase & Co, Research Division - MD and Senior Analyst*

And then, Oak, you didn't talk much about the Next Gen ATG product. Is there any rethinking of the strategy and timing going on there as well?

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

Well, I talked quite a bit about the ZTE issue. And until we understand how we're going to resolve the ZTE issue, we can't really project what the impact is on the Next Gen project. So current course of speed was to have that commercially available by the end of this year. But given the Commerce Department order, we're trying to sort out the impact of that. We were literally in the midst of taking delivery of antennas to install right now. So it caught us pretty much mid-stride.

Philip A. Cusick - *JP Morgan Chase & Co, Research Division - MD and Senior Analyst*

Got it. And then last one if I can, the change in pricing at the airline that went to airline-directed, were they motivated to try and reduce demand? Or are they just trying to experiment with elasticity?

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

I think they were trying to mark up our price to make sure that they were a making profit at every price point, and that's not the best way to stimulate demand. So we're working with them to try and revise that.

Operator

Our next question comes from Simon Flannery of Morgan Stanley.

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

This is Landon Park on for Simon. I guess, it sounds like EBITDA is expected to essentially bottom in 2Q. But was the $109 million in cash burn for 1Q, is that expected to be the peak number as we look forward to interest payments and higher installs in 3Q?

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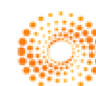

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Barry L. Rowan - *Gogo Inc. - CFO & Executive VP*

So to the first part of your question is that yes, we do expect EBITDA to bottom in Q2 and recover substantially from Q2 into the second half of the year. Regarding the cash burn during the quarter, we would also expect that to be the highest during the year by a meaningful margin. The reason for that is, as I explained, there was the timing of some of the interest -- or, excuse me, some of the payments for the airborne inventory purchases, and it was also during the quarter.

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

Okay. And will EBITDA remain positive in the second quarter?

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

Yes. I wouldn't provide additional clarity about that because there are -- certainly, the bulk of the expenses associated with the process of getting 2Ku well are going to be incurred in the second quarter. So I think I would just say that we expect it to be very significantly affected during that quarter. But I think the other part of this that's important is that the -- those expenses associated with that are larger -- the onetime expenses associated with that, getting that -- the 2Ku up and running and back to the performance levels that it needs to be as opposed to structural issues in the overall business.

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

And can you give us the size of, I guess, the main expense buckets associated with that and how large they are in each quarter? And then I guess one last question just on BA in terms of the margins, it sounds like you're expecting it to remain in this 45%-plus level moving forward.

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

So let's start with BA. We achieved record segment margin. And as I talked about, there was a very substantial conversion of the incremental revenue to the bottom line. So 47% is particularly high, but I think we would expect it to be higher than the number that it averaged last year, which was 41%. So we again see the operating leverage from BA continuing throughout the year. With regard to the primary expense buckets related to the issues associated with the deicing, there are several of them. First, as Oak described, we are replacing antennas. So there's an incremental cost of antenna purchases. There's also the cost of additional airline touches and the work associated with that and the maintenance personnel. So those are some of the primary buckets that we see. And also it's important to recognize the revenue impact of this, in that the airlines are not going to be motivated to market aggressively until they see the 2Ku system performing at the level that we all expect. And it's at that point that they can be more aggressive in marketing and drive the revenues as we planned.

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

Thanks for that color. Can you give us any sense of the actual size of those -- the actual expense buckets that are running through the EBITDA?

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

So we expect in total that those -- the expenses, that they aren't going to be in excess of $25 million for the year.

Operator

Our next question comes from Lance Vitanza of Cowen and Company.

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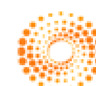

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Lance William Vitanza - *Cowen and Company, LLC, Research Division - MD & Cross-Cap Structure Analyst*

I wanted to start on the Commercial Aviation side. So should we be thinking about this as a delay in the EBITDA ramp? Or will the slope of the ramp necessarily be lower from here on out as well given the new sort of financial constraints and just the passage of time and sort of opportunity cost and so forth?

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

Lance, look, I don't think we want to get into future projections until we get through our integrated business planning process. We're hoping to get that done by late June and either talk about it on our second quarter call or have a special call to call about -- to talk about it. So we'll give more concrete guidance at that time.

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

I would just say conceptually, Lance, that the fundamentals have not changed. Again, by -- we fully expect with the installation of additional aircraft, [we should] you see a strong backlog and a very strong pipeline that, that's going to be the key driver and -- of the increased EBITDA. I think what's happened is that as a result of what we described on this call, it delays the knee of that curve until those airline comes online -- come online, and we could see the kind of operating leverage that we fully expect from the increased growth as well as a reduced cost structure.

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

Yes. I'm just trying to get a sense for whether or not you can get back to sort of the targets that we have been thinking about before the issues happened, not looking for exact guidance, but that's helpful. So let me just switch to the new -- to the Business Aviation side. New competition coming in. I think, Oakleigh, I think you had mentioned a reference to that and the 23% of the jets in Business Aviation that have WiFi so therefore, the big opportunity. The planes, though, that don't have the -- the 77% of the business jets that aren't currently installed, what percentage of those would you say really are good candidates to ultimately have WiFi? I mean, aren't a lot of those planes sub-$1 million and therefore, unlikely to ever wind up with WiFi? Or could you give us a little bit more specifics on really how do -- we should be thinking about that opportunity set?

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

We think about 70% of that market's really addressable with one level of product or another. That's why we have different levels. We have L5 for the bigger planes, L3 for the lower -- smaller planes.

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

Got you. And last one from me is just if you make no changes, you had mentioned that there would be some incremental capital required. Can you talk a little bit about exactly how should we be thinking about it? I mean, is that 0 to $50 million? What is sort of a little bit to you or not much to you? How should we be thinking about that? And then of course, I think you already talked a little bit about where you expect it to come from. Growth capital to me means in incremental equity. But am I reading that the right way? Or is there some other sort of avenue that you might be able to address?

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

First of all, Lance, as a large shareholder, every piece of capital looks big to me. I think that I try to bound this by saying not a lot would be required if we just kept it at current course and speed. I'm not going to put a lot more around that, to be honest. It's something that I don't think would be

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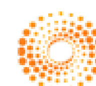

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that hard to raise. In terms of growth capital, it really depends on the size of the opportunity. And so I'd like to reserve judgment until we get to our integrated business planning process to [really down] that, all right?

Operator

Our next question comes from Paul Penney of Northland Capital.

Paul Richard Penney - *Northland Capital Markets, Research Division - MD& Senior Research Analyst*

On the ARPA, it declined, both Rest of World and domestically. You mentioned about '18. So looking forward in the environment without the American deinstalls and with more and more airline-directed models, do you expect that -- a reversion back to positive growth trajectory? And are you going to still keep with your guidance of doubling of ARPA by 2021?

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

So first of all, ex those things, I think we would see a return to ARPA growth, Paul. Absolutely. And then second of all, like I said at the beginning of the call, I want this management team to build our own numbers. And when we're done building our own numbers, we'll communicate those. So we're not going to stick to what was communicated by prior management teams.

Paul Richard Penney - *Northland Capital Markets, Research Division - MD& Senior Research Analyst*

It sounds great. I appreciate your honesty there. And going back to ZTE, in terms of -- you mentioned it's definitely a potential snag for the Next Gen ATG. But what about for the business unit upgrade system that's going on currently? Does it affect your BA unit at all?

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

Yes, I didn't quite follow you. About what, the L3 or L5 product lines? Is that what you're asking?

Paul Richard Penney - *Northland Capital Markets, Research Division - MD& Senior Research Analyst*

Correct. On the BA unit, how does it affect your BA unit, the ZTE supply issues?

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

It doesn't. We have alternative suppliers in our supply chain there.

Paul Richard Penney - *Northland Capital Markets, Research Division - MD& Senior Research Analyst*

Okay, great. And then lastly, you mentioned that you're looking to renegotiate some contracts, some existing contracts. How does that work, in general? Like if you have existing contracts and you're looking to redo it and make it more favorable for you upfront, is that -- how does that happen? Maybe you can just give us more color on how that will transpire.

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

Paul, I don't remember saying that. So where are you picking the quote up from?

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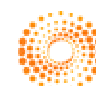

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Varvara Alva - *Gogo Inc. - VP of IR & Treasurer*

It's with the new contracts.

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

Oh, on new contracts?

Paul Richard Penney - *Northland Capital Markets, Research Division - MD& Senior Research Analyst*

Correct. You said you're going to take a harder look at contracts in terms of how you price them. And just maybe give us more color on how you're looking to change your former contracts to what you're -- how you're doing them today with airlines.

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

Paul, I want to be really clear. I'm not talking about changing any former contracts, okay? So if that's the question, the answer is we're not doing that. Second of all, in terms of how we're going to structure future contracts, that's going to be part of our business planning process, and we'll talk about that when we have more clarity. Are you talking about airline contracts? Are you talking about suppliers, Paul? I'm a little unclear.

Paul Richard Penney - *Northland Capital Markets, Research Division - MD& Senior Research Analyst*

Airline contracts for connected planes.

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

Yes. Okay. I think I've answered that.

Operator

Our next question comes from Louie Dipalma of William Blair.

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

With the airline-directed model, based upon the way your existing contracts are structured, if airlines shift towards a free model in the future, is that going to be positive for ARPA relative to the former turnkey model?

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

Yes. Some of our most successful contracts are where the airlines offers to treat its passengers. You have to remember, we get paid by the session or sometimes by the megabit. So the more usage, the better for us.

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

Great. And Oakleigh, you made reference to consolidation, third-party capital and business development. Are you currently exploring anything partnership-related as part of the formal review that you expect to conclude for the second quarter or earlier?

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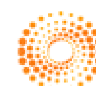

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Oakleigh B. Thorne - *Gogo Inc. - President, CEO & Director*

Actually, the short-term business planning initiative does not really get into big strategic issues. It's all about getting the business operating well and take cost out of the business. Longer-term strategic planning process will take longer to figure out. Now every lawyer in the room will make sure that I tell you that we would never comment on whether we are in the process or not in the process or the stage of a process or whether we've been approached, et cetera, et cetera. I will say this, which is that our board has a duty to do what's best for shareholders, and as a large shareholder, I'm going to make sure that they do that. And so as we watch this, what we call, the game of thrones play out over the next couple of years, we're very committed to charting a course that creates shareholder value for our shareholders. So I think that's about all I can say on it right now, Louie.

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

Okay. And is there any update on your progress with different supplemental-type certificates, specifically with the Boeing 787 with British Airways and Air Canada? And is there also -- do you reiterate your intention to announce an Airbus line-fit win in the first half of this year?

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

Louie, I don't want to get over my skis on anything. So we're plugging away on the 787s at Boeing, and we're making good progress there. We're making good progress with Airbus. Our relationship with the OEMs has really improved dramatically, and we feel very positive about it. But I'm not going to get into specifics right now on a specific aircraft or OEMs.

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

Okay. And lastly for Barry. In the past, you guys have been very confident about the operating leverage associated with bandwidth pricing and the declines in future bandwidth pricing -- being positive for the Rest of the World margin. Can you reiterate at a high level your view of the company's operating leverage for the Rest of the World business?

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

Yes. The fundamentals there are several. So one is it really starts with more aircraft online, which, as you know, is the primary driver of that. I think the second source of operating -- the source of the operating leverage on the expense side is that we've made a major investment in the satellite capacity to provide worldwide coverage. So that means that as we add more planes and add more revenue, the cost of delivering that service does not grow at all proportionally. So as we had talked about, for example, over the prior year period, the effective cost per bandwidth had dropped by about 80% over that period of time, and that's the kind of leverage you see when you have more planes flying over that geography. So I think it's a combination of more planes that leverage on the satellite system. And then over time, as the planes get more seasoned and the ARPA grows with that seasoning, that will add to the overall revenue picture.

Operator

Our next question comes from Andrew Spinola of Wells Fargo.

Andrew Carl Spinola - *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

I just had 1 question. On the cost of service in Q1 in Commercial North America, the step-up from Q4, which I guess is a little over $9 million, how much of that is additional satellite expenses or less deferred airborne lease incentive? Could you just kind of break that down for us?

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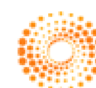

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Barry L. Rowan - *Gogo Inc. - CFO & Executive VP*

So there's a meaningful increase in the satcom expenses from the quarter like we had talked about on the order of $5 million. So that's a big part of it. And the airborne lease activity actually went down during the period. So as we said on the last call, we are investing during this year to provide that satcom capacity in North America, and that amount was about $25 million for the year as a whole.

Andrew Carl Spinola - *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

So then if it was $5 million in the first quarter, I guess should we just expect a modest increase kind of sequentially going forward through this year? Or how should we think about cost of service in NA?

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

I think our satcom costs are actually coming in lower than we anticipated. Pricing keeps coming down, and we've been able to get some better deals as the year has progressed here. So we'll probably end up spending a little bit less on satcom expense than we've originally planned.

Operator

Our next question comes from Robert Gutman of Guggenheim Partners.

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

So is it -- should we read into the 2Ku deicing issue and the ZTE issue, is it possible that it delays the line-fit approval process because Boeing seems to be very focused on perfection in the supply chain? Secondly, when you talk about being more selective or disciplined on future deals, what are some of the levers there? And lastly, on the airline-direct model, is it -- the impact of customer overpricing was less revenue to you. Is it -- are these contracts really purely consumption-based on a per session or per month basis? Or is there a fixed charge element to it also?

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

So let's go back over to your questions. Question one was...

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

Deicing and ZTE, does that delay the line-fit product progress -- process?

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

ZTE, no. It doesn't cause any lines to delay. First of all, the -- Next Gen is really not a line-fit issue. It's not in Commercial Aviation until it's in the RJ market. So that's a long way off. In terms of the mainline fleets, we basically fixed 2Ku at this point. It'd be fully fixed well before it would be on line-fit anyhow. And it hasn't affected the speed of our line-fit progress at all. Okay. So second question was around giving away our negotiating strategy on future contracts. And I don't think I'm going to give away our negotiating strategy on future contracts. So the third question was what again?

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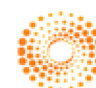

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Robert Ari Gutman - *Guggenheim Securities, LLC, Research Division - Senior Analyst*

On the airline-directed model, you were impacted this quarter because you said the airline overpriced. So it reduced revenue to you on a per session or per megabit basis. But how exposed are you to their -- with the balance of their control versus your stability?

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

Yes. So in the airline-directed model, they have pricing control. And in this particular case and because it's a large case, the way it was priced has not optimized demand. Generally, it has done a good -- hasn't had a very positive impact on demand. So if you believe that airlines want to anger their customers and decrease penetration of IFC, then we'd be in a lot of risk. I personally think that airlines want to improve customer satisfaction and want to have high-quality in-flight connectivity and want to have more penetration, at least that's what they all tell us. So generally, I think that aligns their interest with ours, which is driving usage or sessions. Typically, we are getting paid by sessions. In some cases, we may get paid by megabits. The deals do vary a lot depending on how the airline wants to structure them.

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

Is there a minimum associated with that, like a monthly minimum, (inaudible)? Anything like that in some of these contracts?

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

I don't want to get into all of the nefarious details of different contracts because there's a lot of them. And I might -- out of 22 contracts, I might get a clause wrong. So -- but generally, the way to think about it is that volume and usage are good for us.

Operator

And I'm showing no further questions in queue at this time. I would like to turn the conference back over to Oakleigh Thorne, the company's CEO, for closing remarks.

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

Thank you very much, everybody, for attending our call today. I guess I'd like to finish up with a couple of comments.

First of all, yes, we are having our issues right now, but I really believe the future is bright for this company. Passengers want connectivity. Airlines want to provide it. Providing connectivity at 36,000 feet and 600 miles per hour is a really hard thing to do, and we are really good at it. And in fact, I would say that we are the best at it. So as long as you believe that connectivity is going to grow, you've got to believe that Gogo is going to have a positive future.

I talked a lot today about our plan. We have -- once our plan's complete, we intend to become more active on the Investor Relations front. And in that context, I look forward to continuing our dialogue, sharing our plans and ultimately, sharing our results.

Have a good day. Thank you.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program. You may now disconnect. Everyone have a great day.

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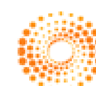

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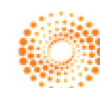

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