03-Jun-2021

Ciena Corp. (CIEN)

Q2 2021 Earnings Call

CORPORATE PARTICIPANTS

Gregg M. Lampf
Vice President-Investor Relations, Ciena Corp.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

Scott A. McFeely
Senior Vice President-Global Products & Services, Ciena Corp.

OTHER PARTICIPANTS

Meta A. Marshall
Analyst, Morgan Stanley & Co. LLC

Paul Silverstein
Analyst, Cowen and Company

Rod Hall
Analyst, Goldman Sachs & Co. LLC

George C. Notter
Analyst, Jefferies LLC

John Marchetti
Analyst, Stifel

Mauricio Munoz
Analyst, Raymond James & Associates, Inc.

Jeffrey Thomas Kvaal
Analyst, Wolfe Research LLC

Amit Daryanani
Analyst, Evercore ISI

Alex Henderson
Analyst, Needham & Co. LLC

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Fahad Najam
Analyst, MKM Partners, LLC

Tim Long
Analyst, Barclays Capital, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, everyone. Thank you for standing by, and welcome to the Ciena Fiscal Q2 2021 Financial Results Conference Call. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions]

I would now like to hand the conference over to your speaker today, Gregg Lampf. Thank you. Please go ahead, sir.

Gregg M. Lampf

Vice President-Investor Relations, Ciena Corp.

Thank you, Casey. Good morning and welcome to Ciena's 2021 fiscal second quarter results conference call. On the call today is Gary Smith, President and CEO; and Jim Moylan, CFO. Scott McFeely, our Senior Vice President of Global Products and Services, is also with us for Q&A.

In addition to this call and the press release, we have posted to the Investors section of our website an accompanying investor presentation that reflects this discussion as well as certain highlighted items in the quarter. Our comments today speak to our fiscal second quarter performance, our view on current market dynamics as well as a discussion of our outlook for the third quarter and fiscal 2021. Today's discussion includes certain adjusted or non-GAAP measures of Ciena's results of operations. A detailed reconciliation of these non-GAAP measures to our GAAP results is included in today's press release.

Before turning the call over to Gary, I'll remind everyone that during this call, we'll be making certain forward-looking statements. Such statements, including our quarterly and annual guidance, discussion of market opportunities, and commentary about the impact of COVID-19 and supply chain constraints are based on current expectations, forecasts and assumptions regarding the company and its markets, which include risks and uncertainties that could cause actual results to differ materially from the statements discussed today. These statements should be viewed in the context of the risk factors detailed in our most recent 10-K filing and in our upcoming 10-Q filing, which is required to be filed with the SEC by June 10. We expect to file by that date.

Ciena assumes no obligation to update the information discussed in this conference call, whether as a result of new information, future events or otherwise. As always, we will allow for as much Q&A as possible today, though, ask you limit yourselves to one question and one follow-up.

With that, I'll turn the call over to Gary.

Gary B. Smith

President, Chief Executive Officer & Director, Ciena Corp.

Thanks, Gregg, and good morning, everyone. This morning, we reported strong performance for our fiscal second quarter, including $834 million in revenue and a particularly strong gross margin that drove a 16% adjusted operating margin and a $0.62 adjusted earnings per share. These results reflect continued strength in the fundamental demand drivers of our business that reflect our distinct competitive set of advantages as well as continued encouraging signs of improvement in the overall market environment.

And I must first once again thank our people for their hard work and fortitude in these challenging times. They continue to drive our business forward and build on our position as the industry leader.

As you may recall from our commentary, as we entered fiscal 2021, and again last quarter, we laid out several key assumptions that form the basis of our outlook for the current year. First, was an improvement of industry and economic conditions overall, which we are starting to see in many parts of the world where the effects of the COVID-19 are somewhat abating, of course, fully recognizing that the current COVID status globally of each region and country varies tremendously.

Secondly, we noted that service providers spend, which has been constrained since the second half of 2020, needed to return to more typical pre-pandemic levels. I am pleased to report that during Q2, we began to see material amelioration of the operational and fiscal caution of key service provider customers around the world. And we believe that this is translating into a more normalized approach to network investments and operations, including more focus on new architecture builds and deployments.

And lastly, really as a result of these two dynamics, we indicated the need for strong order flow and backlog growth, particularly in Q2, if we are to drive a stronger than typical uptick in second half performance in order to meet our outlook for the year. We absolutely achieved that, as orders in Q2 were significantly greater than revenue and backlog grew both sequentially and year-over-year.

So, as we close out the first half of the year, the things we said we needed to happen in the market and our businesses are, in fact, materializing. And this has yielded financial results in line with our expectations and overall business performance that continues outpace the competition.

Based on these dynamics, we continue to be confident in our ability to deliver on the financial guidance we provided for fiscal 2021. In fact, we now believe that we will exceed our profitability target for the year through better than expected gross margins, and Jim will cover that in more detail.

Before I review some of the highlights from the quarter, I'll briefly comment on the shared industry concerns around semiconductor supply chain constraints that are impacting a broad range of technology market sectors. And while we have experienced some lengthening of component lead times, we have in place very strong mitigation strategies for supply chain disruptions as we've proven over many years and most recently through the COVID-19 challenges.

We also benefit from scale and diversification of our supply chain and continued investments in inventory as well as a high degree of vertical integration. As a result, we are well-positioned to navigate this dynamic. And as we sit here today, our perspective is that we can believe we can manage the current supply chain challenges with no material impact to our revenue expectations for fiscal 2021.

Moving to highlights from the quarter, our innovation and diversification continued to strengthen our competitive position. And with respect to innovation, our lead in fifth generation coherent technology with WaveLogic 5 is uncontested. In Q2, we secured 16 new wins for WaveLogic 5 Extreme, bringing our total customer count to 95. And we shipped nearly 5,000 WaveLogic 5e modems in the quarter, bringing our total to date to roughly 11,500 WaveLogic 5e modems shipped to a wide range of customers around the world active in their networks.

We also remain on track with our WaveLogic 5 Nano pluggables and expect to have GA product in time to intersect with customer demand, which will likely begin later this year. We have product in customer labs today with the solution performing extremely well, including best-in-class power performance, perhaps the single most important metric for a differentiated pluggable.

I mentioned last quarter, our increased strategic focus on IP technologies in our Routing and Switching portfolio and our growing customer engagements in this area, specifically around our Adaptive IP solution and ability to address key use cases in areas like 5G, Internet of Things, and Edge Cloud.

Our momentum for this portfolio continued in Q2 with roughly a dozen new wins ranging from global Tier 1 service providers to MSOs and enterprises. Q2 was also very strong again for Blue Planet, with the largest order quarter to date and four new portfolio wins with major service providers.

Turning to customer segment and regional performance in the quarter, our overall non-telco business continues to be strong, comprising 43% of revenue in Q2. Direct web-scale contributed 24% of quarterly revenue as these customers have once again started building and expanding data centers. We continue to retain a very strong leadership position in this segment as our relationships with these key customers become increasingly broader and more strategic. And I think the introduction of our WaveLogic 5 pluggables further enables us to address a wide range of our web-scale customers' needs.

Activity with our Tier 1 service provider customers, especially in North America, is increasing, as they can no longer put off adding capacity to their network, and they are now better able to navigate logistical COVID-related challenges.

EMEA also performed well in the quarter, with revenues increasing 10% year-over-year as service providers in the region invest to address their own traffic growth needs as well as to support increasing traffic flows and bandwidth requirements of the web-scale players.

And finally, on India, with the recent wave of COVID across the country, we've expanded support and resources for our local team, and we continue to be incredibly impressed by their resilience and optimism amidst a very challenging situation.

With respect to the business in India, this new wave of the pandemic is obviously slowing the expected recovery. However, revenue from the country for Ciena still grew sequentially and year-over-year. And I would also say that wins and order activity continue to be strong with the impact to date largely related to deployment schedules. We continue to expect India to grow year-over-year in fiscal 2021 with any near-term challenges mitigated by our general geographic diversification.

Overall, there remains strong underlying secular demand for bandwidth and automation that drives our business. Our strong performance in Q2 is a reflection of that demand, and it gives us greater visibility as we sit here today.

These results, together with encouraging signals in the market environment and the continued execution of our strategy, gives us confidence in a strong second half and our ability to achieve our financial targets as we move through the year. Jim?

James E. Moylan, Jr.

Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

Thanks, Gary. Good morning, everyone. We performed well in Q2 with revenue in the quarter totaling $834 million. Adjusted gross margin in the quarter was again strong at 49.2%, driven by a favorable customer and product mix, including strong software contribution and a high concentration of capacity adds versus new builds. Adjusted operating expense in the quarter was $279 million.

With respect to profitability measures, in Q2, we delivered adjusted operating margin of 16%, adjusted net income of $98 million. It's worth noting that GAAP net income in Q2 was higher than non-GAAP as a result of $40 million we received from the Canadian Emergency Wage Subsidy during the quarter. This figure flows through our GAAP P&L at each line where wages are incurred, primarily in OpEx. We have excluded this effect in getting to our adjusted numbers.

And finally, on profitability, we reported net income of $0.62 per share. In addition, cash from operations was $225 million in Q2. Free cash flow was $194 million. Adjusted EBITDA was $156 million. We ended the quarter with approximately $1.4 billion in cash and investments.

Also in Q2, we repurchased approximately 483,000 shares for $26 million. We continue to expect to repurchase approximately $150 million of shares in fiscal 2021.

Turning now to our guidance, as Gary mentioned, encouraging signals in market conditions, and improvements in customer spending as well as our strong first half performance give us confidence in our ability to deliver on our fiscal year 2021 targets. Specifically, we continue to expect to grow our annual revenue in fiscal year 2021 in a range of zero to 3%.

As we've said previously, as conditions improve and revenue begins to reflect a more typical mix of existing and new business, we do expect gross margins to moderate somewhat. However, we do expect a somewhat higher gross margin in the second half than previously, as we expect that our favorable mix of strong software contribution and – we expect that that will continue.

Additionally, we expect OpEx for the second half to be higher than we generated in the first half. OpEx for the first half was a bit lower than the average quarterly OpEx call for the year. So there is some movement of OpEx from first half to second half. Also, the weak dollar continues to put pressure on our OpEx.

With this guidance, combined with our adjusted gross margin results in the first half, we now expect adjusted operating margin for the fiscal year to be in a range of 16% to 17%, 100 basis points higher than previously anticipated.

For Q3 specifically, we expect to deliver revenue in a range $950 million to $980 million, adjusted gross margin in the 46% to 47% range, and adjusted operating expense of approximately $285 million to $290 million.

In closing, we delivered a great performance in Q2. Second quarter order flow indicates a return to spending by our service provider customers, and gives us great visibility into the rest of this year. We are confident in our ability to deliver a strong second half and significant profitability for fiscal year 2021.

Before moving to Q&A, I want to once again thank the entire Ciena team for their continued focus and dedication during a very difficult period. In particular, our team in India has demonstrated tremendous resilience in recent weeks in the face of another COVID-19 wave.

Also, our employees have also been incredibly active in their communities, safely gathering with each other as well as with our customers to give back through a wide range of service activities. We are extremely proud of the Ciena team.

With that, Casey, we'll now take questions from the sell-side analysts.

Gregg M. Lampf

Vice President-Investor Relations, Ciena Corp.

Before we start the Q&A, we are aware of some webcast technical difficulties for those who have tried to access through the webcast as well. Please reregister and you should have access. Casey, we're ready for questions.

QUESTION AND ANSWER SECTION

Operator: Certainly. Thank you. [Operator Instructions] Also, once again, in the interest of time, please limit yourself to one question and one follow-up. Thank you. Your first question here comes from Meta Marshall from Morgan Stanley. Please go ahead. Your line is now open.

Meta A. Marshall

Analyst, Morgan Stanley & Co. LLC

Q

Great. Thanks. I appreciate the question. Maybe just on, in terms of, one, what you're seeing as far as the ramp-up, kind of the 800-gig product versus maybe the 400-gig and how that's trending versus your expectation? And then just on the – the pacing of the Tier 1s certainly sound better, but I guess just in terms of is it orders, is it new projects, just maybe some more context for what you're seeing on the Tier 1s in North America that leaves you encouraged? Thanks.

Scott A. McFeely

Senior Vice President-Global Products & Services, Ciena Corp.

A

Yeah. Thanks, Meta. It's Scott. I'll take the first one on the 800-gig. So, just to repeat the sort of ramp numbers that we talked about or Gary talked about to date, and we're just a little shy of the year, I guess, into commercial shipments, we've got about 11,500 total units of our WaveLogic 5 Extreme shipped, 5,000 in the last quarter. So you can see that that's absolutely accelerating. And if I sort of compare it to previous generation that you referred to as a 400-gig of, call it, WaveLogic AI, from a RAN perspective, that's an accelerated pace of ramp from the previous generation. And it's across all customer segment as well, I should point out.

Gary B. Smith

President, Chief Executive Officer & Director, Ciena Corp.

A

And Meta, on the – this is Gary, on the Tier 1s, and I'm generalizing sort of globally here, but I think the main issue that we've seen with them in the second half of 2020 and the first half of 2021 was just really described it as an operational caution, both operationally and fiscally on the networks. They ran it hot. And I think we are seeing encouraging signs of that ameliorating, both in terms of their operational plans. And I think it's manifesting right now in terms of a bit of catch-up around capacity, which was helpful to our margin in Q2, but we're also getting good indications of the new business deploying in the second half. And I think they're getting a little more comfortable from a fiscal point of view as well in terms of their budget spend. So that definite improvement in the second half across the board in most service providers around the world.

Meta A. Marshall

Analyst, Morgan Stanley & Co. LLC

Q

Great. Thanks.

Gregg M. Lampf
Vice President-Investor Relations, Ciena Corp.

A

Thank you, Meta.

Operator: Your next question comes from the line of Paul Silverstein from Cowen. Please go ahead. Your line is now open.

Paul Silverstein
Analyst, Cowen and Company

Q

Thanks, guys. I appreciate the question. Gary, on the competitive landscape, one, with respect to traditional competitors, in particular, Infinera and Nokia, both of whom are talking a very good game. And then more broadly, I know you did a whole seminar on [ph] ZR as Infinera (19:46) in terms of downplaying the threat. But can you update us in terms of what you're seeing real-time with respect to customers' plan deployments in terms of empirical data that would speak to that threat?

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Well, I think the best set of empirical data is the numbers that Scott just went through in terms of our shipments of real customer. We've got 95 customers now for WaveLogic 5e, and I mean, real customers where we're actually deploying. So pretty much most of the primary landing slots on 800-gig are already taken with the head-start that we've had. And I think that's the best set of metrics kind of talks to itself, frankly.

Scott A. McFeely
Senior Vice President-Global Products & Services, Ciena Corp.

A

And Paul, to your second point on the ZR dynamics in the marketplace, I mean, you referenced an Investor Chalk Talk that we did probably about a month ago. So for those on the call that hadn't had an opportunity to see that, we spent quite a bit of time giving you our perspective and belief system of the application space and how various different flavors of coherent technology play in those application space. So that's accessible on our IR events page. So I'd encourage you to go look at that if you're interested in more details.

I would summarize it as this, Paul, the first early moving application, I think, for this technology will be in the campus metro data center interconnect. We've talked in the past around the timing and the market size of that. Our perspective hasn't changed on that. I think you'll start to see some early deployments this year – later this year, and moving to more significant deployments in 2022. As you know, our technology that addresses that is our WaveLogic 5 Nano. We've said we were targeting mid-year for GA. We're on track for that. We're extremely pleased with the optical performance that we're seeing on that, and we get more and more confident that we have best-in-class not only optical performance but best-in-class power numbers, and that product and technology is now actively in certification in a number of customer labs around the world.

Paul Silverstein
Analyst, Cowen and Company

Q

Guys, you can't share with us what your backlog is on the WaveLogic 5 modems (sic) [WaveLogic 5e modems] relative to those 95 customers, can you?

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

No.

Paul Silverstein
Analyst, Cowen and Company

Q

That's all right.

Scott A. McFeely
Senior Vice President-Global Products & Services, Ciena Corp.

A

The numbers – I'll say, though, that, Paul, the numbers that we quoted in terms of port numbers, those are shipped. That's not backlog. That's shipped. Yeah.

Paul Silverstein
Analyst, Cowen and Company

Q

Understood, understood. All right. Thank you.

Gregg M. Lampf
Vice President-Investor Relations, Ciena Corp.

A

Thanks, Paul.

Operator: Your next question comes from the line of Rod Hall from Goldman Sachs. Please go ahead. Your line is now open.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Yeah, good morning. Thanks for the question. I guess I wanted to focus in on the software line that is substantially higher than what we were forecasting. And you guys have grown that now year-over-year. It's accelerating on not easy comps last year, admittedly off a low level, but still the growth's pretty high. And yet, it seems to me that you're indicating, Jim, the gross margin drops off next quarter.

So I've got, I guess, two questions. One is big picture for Gary, and that is what do you see happening there? Can you – do you have an intention to give us some kind of targets on where that revenue line could go, because, obviously, it's a huge margin driver and I think a pretty positive sign for you?

And then, Jim, next quarter, what are you implying to us when you give us the lower margin guidance? Are you saying that that revenue drops off next quarter? Can you kind of tell us what you think is happening with that software line in the fiscal Q3? Thanks.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Sure. So let me take the first part of that. And I broadly say, I'd split the sort of – we've got a lot of embedded software, which we also get value to, but the piece that we pulled out and report on are really this network layer, the automation of the network layer. And then secondly, we've also got Blue Planet, which is really around the service layer. And I think what we're seeing is increased focus on automation in both of those areas, very encouraged by what we're seeing. I think Blue Planet has tremendous amount of momentum. And as we have in the past looked – given some long-term targets for that. Obviously, when COVID came, it kind of all got disrupted. But as we come out of the year, when things begin to stabilize, I would expect for us to articulate some longer term goals for Blue Planet. And we'll talk a little bit more about that. As it continues to grow, it'll probably exceed both orders and revenue for this year that we set. And also, on the network side of things, on the automation piece, we've got a lot more applications being rolled out certainly as we turn the year, and I think that will help drive the overall gross margin and software adoption. Jim?

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

Yes, Gary. On gross margin, Rod, remember that we've said all year that because of the mix of new projects in our revenue stream being lower in the first half than it is in the second half, we expected margins to come down from Q – I'm sorry, half one to half two. And that's the way the world has sort of modeled their consensus numbers.

What we're seeing though is a very good mix, including software, but also just generally product and customer mix, and we expect that mix to continue in the second half. So, yes, we do expect gross margins will come in a little bit as we move into the second half, but we also expect that gross margins in the second half are going to be up, sort of 100 basis points from where we had expected them to be. We're now calling margins in the second half to average 46% to 47%, which is what we call for Q3.

And yes, we'll have a good software mix, but remember, when we enter new projects, typically, we experience lower gross margins. And that's going to be a higher percentage of our revenue than it has been in the first half. Overall, we're very pleased with our gross margin performance.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

So, Jim, is it fair to say then on that that it's not a software mix necessarily reduction thing going on in Q3?

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

No.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

It's much more to do with new projects [ph] spin up and that (26:26) dragging the margins back down as we would expect it to.

A

[ph] Size of lead time (26:30).

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

Totally, that's totally right. We don't expect kind of software to come in.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Yeah. And a lot of it, Rod, is just the relative size. I think we'll continue to do well on software. But as a standalone piece, it's still relatively small to the rest of the business. And that's why we pull it out separately for people to see the progress.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Okay. All right, great. Thanks, guys.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Thanks, Rod.

Operator: Your next question comes from the line of George Notter from Jefferies. Please go ahead. Your line is now open.

George C. Notter
Analyst, Jefferies LLC

Q

Hi guys. Thanks very much. I guess I wanted to ask about the Huawei market share capture opportunity. Obviously, it's been an ongoing narrative, I think, for some time. At some point, I – you guess that there'd be some forcing function as Huawei runs out of inventory on the component side. But tell us what you're seeing in the marketplace regarding Huawei right now? Thank you.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

George, I would say that the dynamic hasn't really changed with one probably notable exception. I think the main area is – the main region to date has been Europe, where you're seeing a slow migration or a reduction in dependency upon Huawei, largely being run initially out of the RAN business where they're seeing it first and then getting to the core infrastructure.

So that's taking time and that's a dynamic that I think is well understood and talked about. And it's definitely a tailwind for us over a period of time. I do think one notable change, as I think about this year, has been India, which I think is going much more aggressively to reduce their dependency. And we have seen not yet deployed, mainly because of some of the challenges in the – with COVID in India, but we've seen a lot of activity around the major carriers there, wishing to decrease their dependency on Huawei, gone out to RFP. We've won more than our fair share of those deals. And they are being, I think, probably more aggressive than we're seeing in other parts of the world. So that would be the sort of exception I would call out. But that's not yet on the scorecard because it hasn't been deployed, but definitely planning to reduce their dependency.

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

The Huawei dynamic is positive for us for the long-term, but we have always been cautionary about how fast it happens, because in Europe, it's just going to take a while for them to replace – well, I shouldn't say replace, I should say move away from Huawei. They're not going to rip and replace in Europe. That's not going to happen. But as new infrastructure projects begin to come into play, then it's going to be difficult for Huawei to win, and I think that helps us.

George C. Notter
Analyst, Jefferies LLC

Q

Okay. Thank you.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Thanks, George.

Operator: Your next question comes from the line of John Marchetti from Stifel. Please go ahead. Your line is now open.

John Marchetti
Analyst, Stifel

Q

Thanks very much. Gary, I wonder if you could just spend an additional minute on the India market. Maybe just talk about how maybe the last two or three months have gone, and maybe compare it to what you saw last year where the company was – or the country rather was really frozen in a tough lockdown? And if that's starting to ease at all as you're looking into 3Q and into – even further into the second half of the year?

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Yeah. I think it's had a couple of – prior to the COVID piece, I think it had this sort of situation, just to remind everybody, as you say, John, it had these challenges around, A, had a very big build out and was digesting that; second of all, the economy and then some regulatory issues. So, it's been a challenging two or three years on that side for India, but the underlying dynamics and demand, I think, are strong. We were just starting to see that move again when, of course, COVID hit. They had a very big lockdown and very little got deployed. We began to see activity, I would say, at the beginning of this year and we won some new deals then, and they were beginning to be deployed. And then, of course, what's happened in the last few months has really slowed all of that down.

We would say from the experience that we're seeing currently is it seems to be stabilizing, and in fact, improving, I would say that from talking with our team in India, generally. Still got a long way to go, but I think it sounds like the – they're heading in the right direction.

I would say that our view on the second half is, obviously, we've kind of derisked that view in the second half, given what we were seeing. And so – but I still think that India will be up for Ciena year-on-year. It won't be as high as we had anticipated, but I think the order activity and RFP activity continues to be strong as they do their plans, and we're winning more than our fair share of that. So one's hopeful as we turn the year that we'll see a good step function in India, albeit a delayed one from the second half.

John Marchetti
Analyst, Stifel

Q

Got it. And then just maybe shifting gears to overall order growth, you talked about that being up significantly higher than revenue. I'm just curious if you can comment at all about whether that's more heavily weighted towards Tier 1s. You obviously had a very good sequential quarter in web-scale. Just as we're looking into that second half, is it a function of those networks that you talked about running hotter, you're starting to see that ease out and those orders now are coming in for second half deployments? Is it a function of now having time to evaluate 800-gig and doing those deployments? Just curious if you can give us any color there on some of that order growth that you saw. Thank you.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Yeah. No, I would say generally, it's across the board. We're seeing it – I think the dynamic is obviously very different as you go to each of web-scale players. But I would say, generally, they have been constrained in their ability to roll out and connect new data centers. Just like the carriers have been constrained in terms of their ability to deploy, first of all, both logistically, but more laterally out of caution and run their networks hot. So a slightly different dynamic, obviously, between the two, but we're generally seeing most of them now. And I would describe it, to some extent, as being catch-up on the capacity build-outs, which I think has been largely – they've been running it hotter the last sort of nine months or so. And I think that's what we're seeing is I describe it as sort of catch-up and then a return to a more normalized approach to the development of their networks.

So, as Jim sort of talked about, a lot of the new business that we've won, we actually think will end up now deploying in the second half, which what we've kind of hoped and expected. So that's good news, coupled with this catch-up. And I think we were expecting a big step function in our second half. And I think we're now much more – we've got real confidence around that in terms of what the activity that we're seeing and the backlog that we've got as well.

So, I would say, really, John, it's across the board. It's Tier 1s in North America, Tier 1s in Europe. We talked about India. I would say Japan is still a challenge for us. That's more specific to us because of what's going on with Docomo and NTT. But generally across the board, we're seeing a catch-up on capacity, and we're seeing increased leaning in on the deployment of new architectures and new builds.

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

COVID affected everyone [ph] to an extent (34:31) really across the board in terms of customers, but it had a much more severe effect on the service providers than it did on the web-scale. So we did expect and hoped for a big improvement in service providers spend as we came into our second quarter, and we have seen that. But I would say, as Gary said, this is across the board. I think that everyone is seeing the need for network. The network is more important than it ever has been, and we expect that trend to continue for us.

Gregg M. Lampf
Vice President-Investor Relations, Ciena Corp.

A

Thanks, John.

John Marchetti
Analyst, Stifel

Q

Thank you.

Operator: Your next question comes from the line of Simon Leopold from Raymond James. Please go ahead. Your line is now open.

Mauricio Munoz
Analyst, Raymond James & Associates, Inc.

Q

Thank you for taking my question. This is Mauricio in for Simon. Just wanted to go back to the question on the European opportunity on the back of the Huawei backlash. Maybe you could talk about what you're seeing in terms of the pricing dynamics, as some of the Huawei footprint starts to gradually become available and competitors look to gain a piece of that footprint? And then I have a follow-up.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Mauricio, I would say this dynamic has been going on for a while. I don't see any particular change in the pricing dynamics. I would say, as Jim talked about earlier, I think the main priority of the Europeans is to derisk themselves around their RAN business. And that's where they're focusing their attention and dollars right now.

Underlying to that, as they look at changing their network infrastructure and transport architecture, they are looking to decrease their dependency on Huawei. And so those are the entry points, if you will, and that takes time, both in terms of evaluation, the decision and the actual deployment. And it's a big deal for these carriers because they're all integrated into their back-office, their systems, their support, and that doesn't happen quickly.

And this has been going on for a couple of years. We've won a number of those and we're now kind of deploying. And that is sort of an ongoing tailwind for us, but we're not seeing any particular change in the dynamics there. It obviously benefits us and other competitors that are not Huawei, but it's a very long term play. And really, I would stress again, it's the RAN vendors that are really being a significant probably uptick in the shorter term from it.

Scott A. McFeely
Senior Vice President-Global Products & Services, Ciena Corp.

A

Yeah. And in any time there's been major piece of infrastructure that's competitively contested, it's always a very competitive in tough pricing environment. And that hasn't changed. And the fact that the trigger happens to be a move away from Huawei, I don't think it's going to change that either.

Mauricio Munoz
Analyst, Raymond James & Associates, Inc.

Q

Thanks. And then for my follow-up question, Jim, this is the second consecutive quarter that we're seeing a sequential increase and actually another record high on Ciena inventory levels. So I'm just wondering if this concentration is related to getting to ready for the sort of demand that you're anticipating in the second half of the year, or perhaps it's a combination of that as well as an effort to build some inventory buffer that will help you navigate the supply chain limitations we're seeing in the industry. So, maybe if you could offer some color around that? And how we should think about inventory for the remainder of the year? Thank you.

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

Yeah. I'll start and Scott can continue. It's all of the above, frankly. We do expect and our guidance would lead you to think that we're going to have a big uptick in the second half, and we had to build inventory for that. The other thing though is that, with supply chain, we have always been very proactive in terms of making sure that we had good inventory levels as we moved into shortages in some areas. This year is no exception. We've also had some MDs of certain products and we had to get last time buy.

So it's all of those things combined. We do think that inventory levels will come down over time. We'll have to watch and see what happens as a result of this semi issue and whether there might be last time buys associated with that as we move through the year. But over time, we do expect our turns to get back to something approaching or more normal levels.

Scott A. McFeely A
Senior Vice President-Global Products & Services, Ciena Corp.

Jim, you covered [ph] in fact (39:08) the question. The question kind of was bang on in terms of the dynamics, is really primarily to – we talked in the past of our supply chain resilience and the strategy that we built in, not only how we architect it but how we invest to service our customers. And I'm convinced our customers reward us for that by the way. So that's one driver of it. And it's certainly served us extremely well as we're staring at the semi challenges of the industry.

The second piece is, as we've noted a couple of times in the call here is, we built a plan and an expectation that we're going to have a substantially bigger second half than first half, and we bet on success. So we're getting ready for that second half.

Gregg M. Lampf A
Vice President-Investor Relations, Ciena Corp.

Thanks, Mauricio.

Operator: Your next question comes from the line of Jeff Kvaal from Wolfe Research. Please go ahead. Your line is now open.

Jeffrey Thomas Kvaal Q
Analyst, Wolfe Research LLC

Yes. Thanks very much. And I've got a question for you, Jim. And let me ask it the most direct way, but I can ask it another way if you'd prefer. And that is, the margin structure that you've given us for the second half is really – I mean, it's noticeably better than where you've been historically. Do you think that that is sort of a new baseline for Ciena or do you think that, over time, you'll get back to the mid-40s range in the out year?

James E. Moylan, Jr. A
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

Well, here's what I'd say about that, Jeff. We have been experiencing very good gross margins. We have – we've taken a lot of cost out of our product, and we have great technology. All of that has contributed to our improvement in gross margins. We have called up our gross margins a few times over the past year or so, but it's a very dynamic environment in which we find ourselves now. The dynamic that we've said that new projects will cause margins to get back more toward the mid-40s is still there. We're just not, because of our underlying performance in gross margin, expecting it to be as significant as we expected for the second half of this year. As we move through time, we'll address this issue of gross margin more fully, but we do like our performance so far.

Jeffrey Thomas Kvaal Q
Analyst, Wolfe Research LLC

Okay. So new wins turning back on is part of the guidance of the second of the fiscal year then?

James E. Moylan, Jr. A
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

Absolutely, yes.

Jeffrey Thomas Kvaal
Analyst, Wolfe Research LLC

Q

Okay, okay. Great, great, great. And then, let me follow that up by asking, is it possible that one day that you'll get back to talking about that 6% to 8% long-term sales growth?

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

We're going to revisit the issue of long-term guidance as we turn the year. We've been through an incredibly dynamic period in our market with all sorts of behavioral changes on the part of our customers and with good reason, of course. And that caused us to suspend our three-year guide. Although I would say this, remember, we just – we did talk about the future as we began this year. We said that we still expected the market to grow in the low to mid-single digits overall, and we expected to take share in that context. We just didn't continue that thought to give a number in terms of our revenue growth. I won't say that we're going to as we come into the first part of next year, but it certainly what we're thinking about as we sit here today.

Jeffrey Thomas Kvaal
Analyst, Wolfe Research LLC

Q

Okay. Thank you very much.

Operator: Your next question comes from the line of Amit Daryanani from Evercore ISI. Please go ahead. Your line is now open.

Amit Daryanani
Analyst, Evercore ISI

Q

Good morning and thanks for taking my questions. I guess the first one I have was on the web-scale business. I was hoping if you could just maybe touch on what's happening over there. I think the business was down on a year-over-year basis it was up sequentially. I'd love understand kind of what's happening in web-scale. And then as you think about the back half narrative, how do you think the web-scale business performs versus the back half guide that you provided?

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Amit, I would say that you see general ebbs and flows to the web-scale players. And obviously, they all have very different business models and we talk about them generically. I would say a couple of things to it. One, we continue to perform very well with them. They've also been constrained around their connectivity and ability to deploy new data centers and connect them. I think that is getting better. And the fact that year-to-date, we're at about 4% up, as we get to the half year, is about what we thought. And we think we'll see growth for the year in about the mid sort of single digits and we will absolutely – tough for us to take even more share than we already have, but we're absolutely confident of maintaining the share that we've got. And we do think that the second half will improve on the first half in terms of revenues. Absolutely, we'll see an uptick along with the rest of our business on that.

So, I think we're pretty optimistic around that space. They seem to be getting back into the swing of being able to build out these data centers around the world. And I would say that's a key point. It is around the world where we're partnering with them. It's not just in North America. And that has been particularly constrained for them outside of the US for obvious reasons, and that seems to be getting better. So, we're pretty optimistic about the second half for us, Amit.

Amit Daryanani
Analyst, Evercore ISI

Q

Right, perfect. And then if I could just kind of hear you talk a bit more about free cash flow expectations of back half of the year. Q2 I think was exceptionally strong. So I don't know if you'd call out if it was one off there. But how do we think about H2 free cash flow, because historically that's been the stronger half of free cash flow. Is that the same that happens this time despite the ramps that you're expecting?

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

I would expect that we'll have better free cash flow in the second half than we had in the first half, although I would say that we had a particularly strong Q2. But we're going to – we've said in the past, and I don't think we've guided to this recently, but in the past, we've said that our free cash flow is going to be 60% or some 70% of our EBIT. And that's the kind of number that we kind of expect.

Amit Daryanani
Analyst, Evercore ISI

Q

Perfect. Thank you.

Gregg M. Lampf
Vice President-Investor Relations, Ciena Corp.

A

Thanks, Amit.

Operator: Your next question comes from the line of Alex Henderson from Needham & Co. Please go ahead. Your line is now open.

Alex Henderson
Analyst, Needham & Co. LLC

Q

Thank you very much. So you've addressed the issue associated with Huawei, but I was wondering if you were to look at the broader environment, whether there's been any change in pricing, one, as a result of Huawei receding from the market; two, because of Nokia is saying that they're going to try to drive to profitability. And three, to the extent that you have such an advantage with the 800-gig, is that causing better pricing environment for Ciena as a whole? Can you talk a little bit about what's going on in the pricing realm?

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Yeah, Alex, it's Gary. I don't think it's really changed. The Huawei dynamic has been around for a long time, so no real change to that. I think where we're getting increased margin, I think, is a reflection on the scale of the business, the technology that we have and the vertical integration that we have and the innovation that we're bringing into the market, and that's helping drive our gross margin. I think the pricing environment generally has not changed. We haven't seen any appreciable change in behavior from any of the main competitors.

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

It's a competitive market, Alex. And as Scott said, whenever there's been an opportunity for market share gains as a result of something like a Huawei or anything else, it is a competitive battle to get that market share. And we're going to expect to see that as we move through the next couple of years trying to get Huawei's market share.

Scott A. McFeely
Senior Vice President-Global Products & Services, Ciena Corp.

A

One way – you ask that question related to 800-gig pricing, Alex, one way I would think about it. In most of the competitive engagements, it comes down to a total cost of ownership conversation. And within that, it's what's the cost per bit, not necessarily explicitly what's the cost per an 800 gig capable, but what's the cost per bit that you're trying to achieve. What the 800-gig WaveLogic 5 technology allows us to do is to participate in that market pricing, but at a much more competitive cost basis. And that has actually partially a – a partial factor in our margin dynamic as well.

Alex Henderson
Analyst, Needham & Co. LLC

Q

Great, thanks for that answer. The second question I had for you is, you addressed the component supply constraints and basically saying that it was not impacting your outlook for the back half of the year. It wasn't constraining your expectations. But I wanted to ask a little bit more subtle question of whether that actually might negatively impact your ability to exceed the forecast. Is that a governor on the growth rate within the band in the back half as a result of the inability to produce more, if you had orders in excess of what you thought going into the period?

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

What I'd say is that we expect to be able to meet our current call for the second half based on our current view of the supply chain conditions. Lead times have lengthened. And so to achieve a significant upside to the numbers that we've called would be difficult. I wouldn't say it's impossible, but I would say it would be difficult.

Alex Henderson
Analyst, Needham & Co. LLC

Q

That's very helpful. Thank you very much.

Gregg M. Lampf
Vice President-Investor Relations, Ciena Corp.

A

Thanks, Alex.

Operator: Your next question comes from Samik Chatterjee from JPMorgan. Please go ahead. Your line is now open.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Hi. Thanks for taking the question. I have a couple. Just wanted to start off with seeing if I can get a bit more visibility on what you're seeing with the North American Tier 1 service provider customers. Clearly, you indicated you're seeing either strong orders or revenues from them. But how much of this is attributable to you think like return to normal levels of spending relative to – or relative to just spending more tied to some of their wireless equipment deployments that are going to happen in the back half here relative to C-band, and having to invest to support that wireless equipment deployment? Just trying to get any insights you have of what is the driver here and their returning to a higher level of spending. And I have a follow-up, please.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Yeah, Samik, I think largely, it's to do with them playing catch-up on their capacity. I think – and fully understandable when the sort of COVID piece hit, they were very focused on just achieving endpoints security, i.e. services to our homes basically. And they didn't want any disruption on the network operationally and they were very cautious around doing anything on the network, and so they ran it hot.

I think what we're seeing is more a function of a bit of a catch-up of that and then a return to a more normalized approach of the development of their network, i.e. their new architectures, new business, new deployments. So I think you've got a combination of those two things going on. And I think there might be a little bit around RAN priority earlier on last year, et cetera. But I think it's more about this dynamic of caution on the network, operational caution, and also fiscal caution. I think people are generally in the economy feeling a lot more confident now and that includes the carriers. And I think you're seeing that in some of the various comments around generally in CapEx.

So, I think it's more to do with those dynamics than it is prioritizing RAN versus transport, et cetera, because the RAN won't work without the transport. So, they're pretty closely aligned really.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Got it. Got it. And a quick follow-up, I know in the press release, you mentioned you have one 10% customer, which is accounting for 15% I think. We saw a move – sequential move up significantly on DCI, but just wanted to get some color. I know you can't – probably won't name it, but was it a service provider or was it a more of a DCI web-scale customer?

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

We'll tell you it's AT&T. It's the biggest customer that we've had just historically and continues to be a very strong customer for us.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Great, thank you. Thanks for taking the questions.

Gregg M. Lampf
Vice President-Investor Relations, Ciena Corp.

A

Thank you.

Operator: Your next question comes from the line of Fahad Najam from MKM Partners. Please go ahead. Your line is now open.

Fahad Najam
Analyst, MKM Partners, LLC

Q

Thank you for taking my question. I wanted to revisit Jeff's question, but I'll ask it a more nuanced way. If you look at the broader macro environment, it probably is the best time I could recall for the comm equipment sector in my memory. And I've been in this business for 20-plus years. You have 5G build-outs. You have – yesterday, we heard Facebook talk about 75% year-over-year growth in their network consumption. We've got stimuluses coming from Biden administration's infrastructure bill of $100 billion on top of the $20 billion for [ph] R Dov (53:47), various stimulus spending plans from various governments across the globe as they try to recover from the global pandemic. And you're still targeting about a zero to 3% year-over-year growth out for the second half and not kind of giving up more forward-looking outlook, on top of the fact that you already have the market leading 800-gig, your largest [ph] competitor Huawei in a case. (54:12) So, why hold back on giving us a more forward-looking outlook? What are you concerned about?

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

All the things that you mentioning with respect to the conditions in our markets are true. But nothing ever moves quite as fast as we might expect it to sometimes, and there are constraints – there are natural constraints on the service providers' ability to spend quickly. It's a great time to be in the networking business, and we're the best, at least, at the optical layer. And so we're going to benefit for a long period of time from all the trends that you talked about.

I just think that as we look into the second half of the year, that's what we expect. And we did mention that the supply chain is going to make it difficult for us to exceed these numbers. And we'll talk about as we enter the next year, what we think about the next several years. I'm not promising we'll give numbers, but I will say that we will talk about it. We like where we are as a company.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

The other thing I'd just add to that, Fahad, by way of sort of context is, depending on your sort of numbers, but rough out onto the guidance, consensus, whatever, you're talking about a massive uptick in the second half. You're talking about a 16% increase in the second half versus the first half or in order of magnitude around that, which is a significant uptick from where we'd normally be. And I think we're all dealing with a period of great – great turmoil around the COVID for the last couple of years.

I would also say the other thing is, I don't know many companies that actually gave annual guidance for this year, which we gave, clearly predicated on a set of assumptions, which fortunately seem to be playing out. But as Jim said, there's also some headwinds to this thing. We've got some supply constraints. We're not immune to that. We'd navigate through better than anybody else in the industry, but we're not immune to it. We have – India is not going to be as strong as we thought. We'd derisk that.

So, there's lots of sort of puts and takes on a global basis. But I totally agree with the underlying secular demand is super positive. And as we saw prior to COVID, it was extremely strong. And I'm very confident that we will return to that kind of an environment once we get through this.

Fahad Najam
Analyst, MKM Partners, LLC

Q

Appreciate it. I have a follow-up on your Routing and Switching. You had a major win with Openreach in the UK. How big can this product line be? It seems like you're increasingly winning a far greater share of wins than is appreciated by the investment community. So just help us understand what's – where – in which segments of use cases are you winning? Are you beginning to actually kind of take share away from the Juniper's and even potentially Cisco's, and Arista's of the world? Can you just help us a little bit understand what's happening in the Routing and Switching?

Scott A. McFeely
Senior Vice President-Global Products & Services, Ciena Corp.
A

Yeah. So, from a numbers perspective, I mean, I'd revert back to Jim's comment is we're going to take a look at giving you a longer-term perspective on how we think that portfolio will grow as we get into the end of the year. I will say this, though, the growth rates are going to exceed the overall Ciena average growth rates. We've invested very substantially, and it's not just a recent phenomenon for the last couple of years in terms of increasing the addressable market of that portfolio, particularly in terms of its IP capability, its next-generation IP OS capability. And that opens up new market opportunities for us around the metro and edge deployments, which as you know are undergoing a lot of significant architecture changes that is opportunity for non-incumbents. So we're pretty bullish about the opportunities there. It'll show up in applications around the edge, wireless xHaul, cell site routers, connectivity from users to content in various different places. And Openreach was one example of that.

Gregg M. Lampf
Vice President-Investor Relations, Ciena Corp.
A

[ph] That's the objective. (58:39)

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.
A

Thank you for that.

Operator: Your next question comes from the line of Tim Long from Barclays. Please go ahead. Your line is now open.

Tim Long
Analyst, Barclays Capital, Inc.
Q

Thank you. Two quick ones, if I could. First, Gary, you talked about the US Tier 1s looking pretty strong. I think someone mentioned government stimulus and rural broadband. Can you just give us your perspective on how you think that will impact Ciena over the next few years as the smaller and more regional telcos get potentially more funding and more optical reach into the networks? And then second, if you could just give us an update on the subsea segment? I think it's a little bit smaller business, but seems to be there's some good dynamics there as well. Thank you.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.
A

Yeah, Tim. On the rural piece, really talks to this thing that, I think, a number of the questions sort of got to the strong sort of underlying secular demand. I think really, it's all about getting greater bandwidth closer to the customer, be it 5G, Internet of Things, a lot of rural broadband initiatives. Obviously, the one that we're focused on is, and talking about, is the US, but you've got those in different parts of the world, too. You've got them in multiple countries. I think people are recognizing, particularly during COVID that the – any inequalities that exist need to be addressed in the various countries population. And you've seen a number of those initiatives kick off.

I'd just caution that it is – well, first of all, it's government at the end of the day. Second of all is infrastructure. And these things always take a little bit of time to work their way through. But as we come out of the year and look to the next few years, this is a very positive underlying dynamic basically, we couple that with 5G and just basically, as we view it, getting high-speed closer to the customer, which is really about fiber.

So we feel very positive around those dynamics. Similarly, kind of subsea, you look at things like web-scale, and as they look to expand into various countries, they're – basically the largest owners, I think, now of subsea capacity in the world are the web-scale players. It's no longer the PTT carrier consortia that control all of those cables, which was the case 10 years ago. And I think that's a very positive dynamic for the future overall, and that that subsea market, as you look at higher speeds of connectivity out to the terrestrial networks, we're seeing a continued momentum and the need for new cables, basically. And I think you're seeing a bit of a cycle going from adding capacity to existing cables. You're still going to see that, but I think we're into a big cycle of new cable build-outs. And there'll be a bit of a lag effect to us on that because you've got to get the cable in first and then we'll come on top of it. But I think that's pretty positive over the next few years.

Tim Long
Analyst, Barclays Capital, Inc.

Q

Okay. Thank you.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Thanks, Tim.

Gregg M. Lampf
Vice President-Investor Relations, Ciena Corp.

And thanks, everyone, for joining us. We do apologize for the webcast challenges. We will accelerate the availability of the transcript, make available the information for the replay and archive. So please keep an eye on that on our website. We look forward to catching up with everybody over the next few days and at our conferences next week. Thanks, everyone. Have a good day.

Operator: And this concludes today's conference call. Thank you for participating. You may now disconnect.