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Ciena Corp. (CIEN)

Q1 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by, and welcome to the Ciena Fiscal Q1 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] Please be advised that today's conference is being recorded. [Operator Instructions]

I would now like to hand the conference over to Mr. Gregg Lampf, Vice President of Investor Relations. Please go ahead.

Gregg M. Lampf

Vice President-Investor Relations, Ciena Corp.

Thank you, Sharon. Good morning and welcome to Ciena's 2021 fiscal first 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 from the quarter. Our comments today speak to our recent performance, our view on current [ph] market (00:01:12) dynamics and [ph] drivers of (00:01:13) business, as well as a discussion of our financial outlook. 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 you 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 on our business and our end results, 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 March 11. 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, so we ask that 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 solid revenue and strong profitability for our fiscal first quarter, including adjusted operating margin of nearly 15%. This quarterly performance once again demonstrates the strength and durability of our business model, which enabled us to perform well in Q1 despite continued challenging conditions due to COVID-19. With these results, our fiscal 2021 is starting off essentially as we'd anticipated, including, as we indicated during our Q3 2020 earnings call in September, that pandemic-related challenges would likely persist for a few quarters.

Specifically, we see continued operational caution and business velocity challenges, and really affecting prioritization by our service provider customers of new architectures and deployments. And more generally, Tier 1 service providers, primarily in North America, remain financially cautious.

However, we are seeing some early encouraging signs of improvement. In fact, orders in Q1 slightly exceeded revenue for the first time since the first half of 2020. These indications are providing us increased confidence in a strong second half performance this year.

Achieving our annual revenue target requires that our performance in the second half of fiscal 2021 be stronger than our typical first half versus second half growth. Obviously, the precise trajectory of this second half improvement is dependent upon the ongoing recovery in industry and economic conditions, specifically enabling continued growing order flow and building backlog as we move through the year. We remain very confident in our competitive position, and we continue to take share, winning more than our fair share of new business around the world.

Turning now to highlights from the first quarter, our WaveLogic technology continues to lead the market, with the only generally available 800-gigabit capable platform in the market. We secured 14 new customers in Q1, bringing our total WaveLogic 5 Extreme customer count to 79. In just over nine months of commercial availability, we have shipped WaveLogic 5e coherent modems to more than 75 customers around the globe, all of whom are actively deploying the technology in their networks. In fact, the adoption rate of WaveLogic 5 Extreme is impressive. Based on available data, it has been faster than the combined ramp of all competitive 600G solutions that are in the market today.

Moving to Packet Networking, we've recently renamed this portfolio Routing and Switching. This change, we think, better aligns to the language used in the industry and by our customers, and also reflects an increased strategic focus on IP technologies in our portfolio. We continue to grow our customer engagements in this area, particularly given the unique advantages we bring with our Adaptive IP solution and ability to address key use cases in areas like 5G, the Internet of Things, and Edge Cloud. In fact, in Q1, we secured our first private 5G network win using our 5164 Router for in-building xHaul aggregation.

Revenue for our Blue Planet Automation Software and Services portfolio increased 10% year-over-year in Q1, and we now count more than 200 customers worldwide. With customer engagements continuing to expand, it is very clear that Blue Planet can disrupt the status quo and deliver a software-driven approach to digital transformation and service management and delivery.

Our fiscal first quarter was also strong with respect to diversification across customer segments and geographies. Of particular note is the strength of our non-telco business, which comprise nearly 40% of revenues in Q1. This was led by our continued market leadership in web-scale. And, in fact, direct web-scale revenue increased 25% year-over-year and represented more than 20% of total revenue in Q1. And at this point, most of our large web-scale customers are now deploying WaveLogic 5 Extreme in addition to prior generations of WaveLogic.

Geographically, EMEA performed well in Q1, increasing 20% year-over-year, and we continue to see encouraging signs of recovery from India. Finally, our subsea business was also strong in the quarter at 9% of revenue and five new wins in the quarter, including the Southern Cross NEXT cable, as well as upgrades on two large international cable systems.

Turning to the broader environment, our fundamental drivers remain strong as demand for connectivity continues and the move towards cloud architectures has, in fact, accelerated. Our strategy is well-aligned to these market dynamics, and we continue to invest in our portfolio to address these key opportunities. The specific dynamics related to COVID-19 have accelerated bandwidth consumption in core networks. And while many customers are running these networks hotter right now, they ultimately will need to be augmented with additional capacity to maintain performance.

And we are extremely well-positioned to meet this demand, given our market leadership in high-performance optical platforms and systems, including pluggables that support the connection of content-to-content and users-to-content, particularly in DCI, submarine, and long-haul and regional networks.

COVID-19 dynamics have also driven our focus on network operator investments and next-generation metro edge and access networks, due to the distributed nature of how connectivity is now being consumed. As this presents an opportunity for addressable market expansion, we are making investments to expand our IP and automation capabilities, as well as our talent area for this particular opportunity.

Digital transformation has also grown in importance for our largest customers. From 5G to content delivery to cloud applications, customers are directing CapEx towards automating and streamlining how they deliver new services to reduce operational inefficiency in their back-office operations. Accordingly, we continue to invest in our Blue Planet business to build a market leadership position and deliver a software-driven approach to digital transformation.

With these investments and focus, we believe we are well-positioned to take advantage of the current market opportunities and intersect longer-term trends and transitions. In doing that, we believe that we will continue to drive strong financial performance over the long term.

With that, I'll turn it over to Jim.

James E. Moylan, Jr.

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

Thanks, Gary. Good morning, everyone. We performed, as expected, in Q1, marking a good start to fiscal 2021. Total Q1 revenue was $757 million. Adjusted gross margin in the quarter was again strong at 48%. Adjusted operating expense in the quarter was $253 million, lower than expected, as certain projects and spend shifted out into future quarters.

With respect to profitability measures; in Q1, we delivered adjusted operating margin of 14.6%, adjusted net income of $81.3 million, and adjusted EPS of $0.52. In addition, in Q1, cash used in operations was $7 million, consistent with our first fiscal quarter typically being a seasonally soft quarter for cash. Adjusted EBITDA in Q1 was $134 million.

We ended the quarter with approximately $1.3 billion in cash and investments. Our balance sheet continues to be a differentiator that speaks to our long-term strength and viability, particularly in the current environment. It also offers us the flexibility to continue investing in our business for the long term, as Gary described, while returning capital to stockholders. To that point, as we reinstituted our share buyback plans during the quarter, we repurchased approximately 250,000 shares for $13 million in Q1. And, since the program began, we have repurchased 6.1 million shares for a total of $242 million.

Turning now to our guidance. As Gary mentioned, our business has performed largely as we expected within the current market conditions. And we are seeing the initial encouraging signs we were anticipating by this time. We are benefiting from the unique advantages of our deliberate strategy to drive innovation, diversification and global scale across our business. From our 800-gigabit leadership, to our growing software business, to the agility of our supply chain, we are well-positioned to continue successfully navigating challenging times.

Therefore, we continue to expect to grow our annual revenue in fiscal year 2021 in a range of 0% to 3%. This level of growth is predicated upon the same variables that we talked about last quarter, including continued improvement in economic conditions, as well as spend by service providers returning to more typical levels. Achieving our annual revenue target also requires that our performance in the second half of fiscal 2021 be stronger than our typical first half versus second half growth. And, as Gary touched on earlier, that is dependent upon our continued improvement in order flow, our ability to build backlog through the year, as well as successful supply chain execution against the orders necessary to achieve our second half plan.

With respect to OpEx, as I said earlier, our Q1 OpEx came in much lighter than expected. Certain IT infrastructure and R&D projects we expected in Q1 shifted into future quarters of the fiscal year. While we have not changed our OpEx plan for the year, we are also seeing some pressure on OpEx from the weaker US dollar. As a result of these two factors, we expect our OpEx for the remaining three quarters of the year to average between $280 million and $285 million. With respect to adjusted operating margin for the fiscal year, we continue to expect it to be in a range of 15% to 16%.

Turning to our second quarter 2021 performance, we expect to deliver revenue in a range of $810 million to $840 million, adjusted gross margin in the 45% to 47% range, and adjusted operating expense of approximately $280 million to $285 million.

Before we close out our prepared remarks, I want to take a moment to, again, thank the entire Ciena team for their continued passion and commitment during a challenging period. It is because of our people and their resilience that we continue to perform well and to meet our customers' needs.

I also want to highlight progress on our Digital Inclusion Commitment, which promotes digital inclusion through greater connectivity, access to technology and digital skilling, with a goal of expanding opportunities for 100,000 underserved students in our global communities. We recently launched a number of innovative new programs with customers, including Verizon, Spark New Zealand, and Bharti; and we're excited about other digital inclusion initiatives on the horizon.

In closing, the fundamental demand drivers of our business are strong. We are very confident in our competitive position, and we continue to perform well, delivering strong profitability and returning capital to shareholders. We are encouraged by the initial signs of improvement in market conditions and are increasingly confident in our ability to deliver a strong second half performance this year.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] First question comes from Rod Hall with Goldman Sachs.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Yeah. Hi. Thanks for the question. I wanted to start off with a question on the guidance. Just the fact that the margin guide is down a little bit, maybe you guys could dig into that, help us understand why that's happening. And then I've got a follow-up.

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

A

Yes. Rod, we think that this is sort of good news, because we are starting to see the rollout of some of the deals that we won. So, it's really a little faster on some of the deals that we've had in the hopper for a while but have not been able to roll out for various reasons.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Is there any regional color you could give on that, Jim? Is it India or – what types of projects are you seeing rollout now?

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

A

It's really generally. I mean, it's Europe, it's India, it's US. It's around the world.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Thanks for that. And then on my follow-up, I wanted to just ask, competitively, I know that Infinera has talked about a couple of 800-gigabit wins. You guys obviously have a whole lot more. I wonder – are you seeing them in the market with 800-gigabit? Can you just talk a little bit about the 800-gigabit competitive environment as it stands right now?

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

A

Yeah., Rod, good morning. As we said in the press release, we're up to, I think it was at the end of the quarter, 78, 79 customer wins. Since the end of the quarter, that's actually increased. By the way, 18, I think, of those 79 were brand-new logos to Ciena. So, a lot of momentum there.

Last I checked a few weeks ago, that equated to something like 7,500 units shipped to customers. So, as far as I know, we are the only commercially available 800-gigabit solution in the marketplace, and you can see it in those statistics.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

And do you guys think that these are just lab deployments then that these guys are talking about?

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

7,500 units, a lot of labs. All the other competitors, I don't know. You have to ask them. Like, I should – probably that's my only comment on that.

Rod Hall
Analyst, Goldman Sachs & Co. LLC
Q

Okay. All right. Great. Thank you.

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

Thanks, Rod.

Operator: Next question comes from George Notter. Please go ahead.

George C. Notter
Analyst, Jefferies LLC
Q

Hi, guys. Thanks very much. I guess I wanted to ask about the supply chain dynamics. Obviously, it's been more of an issue for many companies, I think, over the last few quarters. Are you guys having issues with supply chain? And is that factored into your guidance for Q2 or the full year? Any kind of color you could give us would be great. Thanks.

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

Yeah. Good morning, George. So, first of all, as I think you already probably know, George is referring to specifically the subset of the supply chain that is related to the semiconductor supply chain and ecosystem. And the dynamics that we're seeing in there is very similar to the dynamics we would have seen in other challenges in not-too-distant past on the supply chain. And whether you look at components that had high concentration in areas that were hit hard by the early days of COVID or not too far before that, capacitors and resistors and pumps and power supplies, etcetera.

And what – for somebody that sits in the sort of system vendor part of the ecosystem like us, what's really important to be able to navigate those challenges as they come up is the design of the supply chain and the dimensions of that, but also the willingness and ability to invest in it. And from our perspective, we were very deliberate in terms of investing in resiliency on a bunch of different dimensions: geographical, multi-component supply strategies, inventory strategies throughout the supply chain including component levels and distribution partner networks, and the confidence in our business and the scale and financial strength to invest in that ecosystem and network. And that served us incredibly well in the past challenges, particularly recently through the COVID challenges. And you didn't see us back off from our service-level agreements to our customers or have to talk about it being a significant headwind to us delivering to our financial plans.

So, to your specific question, with that context, we had no impact in our Q1 results to supply chain execution, and we expect no to little impact in the immediate quarters in the future. If that situation persists for a long period of time, obviously, we're not immune to it. It's a multi-industry challenge. But giving the design, giving our continued investment in it, and giving how it served us in the past, I'm extremely confident that in our segment, we'll be best-in-class in terms of our ability to continue to serve our customers.

George C. Notter
Analyst, Jefferies LLC

Q

Great. Thanks a lot guys.

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

A

Thank you.

Operator: Next question comes from Simon Leopold with Raymond James.

Simon Leopold
Analyst, Raymond James & Associates, Inc.

Q

Thank you very much. Two things. First one is, I just wanted to see if you could help us understand what you're assuming in your outlook as it regards to the Tier 1 international carriers, particularly those in Japan, India, and Germany. And then I've got a follow-up.

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

A

Yeah. And I think it does differ between those. In Japan, the working assumption, from a Ciena point of view, is that continues to be sluggish from our perspective. I think for the remainder of the year, that's our working assumption.

In India, we are seeing increased activity, both in terms of beginning deployments that were held up because of COVID. That's beginning. And also, the award of new business there, primarily, I would say, driven by the desire to replace Huawei. We are seeing that being expedited in India. And we've won a number of those awards. So, we're seeing good activity in India. We're also seeing strength in EMEA service providers.

And to some extent, in North America, what we're seeing is a bit of an amelioration of the caution around operational deployments. As Jim noted, it's a little perverse statistic, but we expect our gross margins to go down slightly because they're beginning to deploy the things that we've won in the last 18 months. So, those are all actually encouraging signs.

And then in Germany, and particularly in Europe, we've had a number of wins that we are beginning to deploy. Again, as I said, that's both with Tier 1 – mainly with Tier 1 service providers. But also in Europe, there's a dynamic around a lot of the wholesale players providing capacity for the web-scale folks as well, including Germany.

Simon Leopold
Analyst, Raymond James & Associates, Inc.

Q

Appreciate that. And then just as a follow-up, you did ramp [ph] versus (00:24:21) North America. I'm assuming you did not have 10% customers in the quarter, but that you expect some improvement in your April quarter from your historic top customers, and maybe the reason for the caution. Is it at all related to spectrum auctions and what they're paying or are there other issues at play here? Thank you.

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

The honest answer is, it's difficult to truly discern, Simon, but I think it's a combination of those things. The amount of capital required for that, just the general caution of the COVID environment financially and operationally, but we are seeing a little thawing out of that, there are some signs to that. Now, that needs to continue for us to achieve our plan in the second half, but we are expecting a much better second half. And part of that is, Tier 1 service providers in North America beginning to deploy some of their plans, frankly. I'd express it like that. Another way of saying this is, generally across our business, we expect Q1 to be the low point for the year, obviously.

Simon Leopold
Analyst, Raymond James & Associates, Inc.
Q

Thank you.

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

And I would also add that it would not be surprising if we ended up the year with 1% or possibly...

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

10%.

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

...10% customers, because we do expect to come back in big Tier 1 service providers.

Simon Leopold
Analyst, Raymond James & Associates, Inc.
Q

Thank you.

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

Thanks, Simon.

Operator: Next question comes from Meta Marshall with Morgan Stanley.

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

Okay. Great. Thanks. I just wanted to spend a second on the hyperscale customers. Given that you're at early days of those deployments, is there any better visibility just because they're just trying to get their hands on kind of new generation of product? And then just maybe second question, you've noted the private LTE product. Just – are you partnering with anybody on those deployments? Thanks.

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

Yeah. Meta, just on the web-scale, generally, obviously, we've got number one market share. We've got a massive install base with the web-scale players. And all of the four major players are now customers. I think, as we said, at the end of last year, the fourth one, we've now secured. So, we've got the large market share there. You can see the strength of Q1. It was 20% directly of our business and a considerable amount indirectly through other carriers around the world. They're all now deploying WaveLogic 5 Extreme in addition to the prior generations of WaveLogic, and we think we're extremely well-positioned to grow with that market.

Tough for us to really increase market share there given the size of our share, but we're very confident of growing with that market, which we think will be in the mid-single-digits in 2021. I think there were some challenges, I think, certainly last year and bleeding into this year in terms of their ability to deploy data centers and build around the world. They're very focused, I think, on ramping that up as best they can. And so we do expect to see some growth this year with the web-scale folks.

Scott, do you want to take that?

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

A

Yeah, Meta. And just sort of maybe added color on that one, when we talk about the web-scale customers and the big ones and all of them, I think, [ph] and/or almost all (00:27:52), we're certainly in multiple applications. So, think of submarine core networks, their metro deployments, and even managed services to them through the service providers.

So, to Gary's point, they're deploying multiple generations of technology as – they may turn on new generations in one of the applications. There are a couple to get started. So, that's why you see us with a large installed base and multiple generations of technology in there.

To your question on the xHaul win in that particular one, that was an open xHaul. So, that was a direct sale by us to the customer. There was obviously some work on integration and interoperability, but that was a direct sale by us.

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

Q

Great. Thanks.

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

A

Thanks, Meta. Thank you.

Operator: Next question comes from Paul Silverstein with Cowen.

Paul Silverstein
Analyst, Cowen and Company

Q

Thanks. Guys, the Street's been worrying about the impact of pluggables, [ph] 0 and 0+ (00:28:55) for a while. Any insight you can share on your thoughts, more specifically on what you're seeing? Obviously, that's been pushed back somewhat, but it's coming. And, Jim, what are you seeing in terms of the pricing environment? [ph] It's all arrived (00:29:07) with Nokia. What I would think would moderate is Huawei is obviously in desperate shape. Are you seeing any improvement in pricing?

Scott A. McFeely

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

A

Hey. Morning, Paul. Let me try the pluggables XR question first. So, what we said last time was, we expect to see some early deployments of that application and that technology later in 2021, which was quite a push later in time from what people probably would have perceived it was going to be 12 months or so ago. Our perspective hasn't changed on that. So, I think potentially some early get-started deployments, but really material deployments starting in 2021.

For our play in there, we're basing our product offer off of our WaveLogic 5 Nano technology. And again, no change from what we said last time there. We expect to have generally available product in the first half of 2021, and the program is executing well on that path.

And I'll ask maybe – pass it to Jim on the pricing environment.

James E. Moylan, Jr.

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

A

Thanks, Scott. Paul, we're not really seeing any appreciable change in the pricing environment as of yet. Now, we've seen announcements by Nokia that they're changing their segments. They're going to look at the profitability of each of their segments. And we think that's a positive sign, but it's really too early for that to be sort of in the market yet. No real change.

Paul Silverstein

Analyst, Cowen and Company

Q

Hey, Scott, with respect to your comments, putting aside timeline, in terms of magnitude of the impact, magnitude of prospective threat, again, any insight you can share on what you're hearing from customers, both web-scale and traditional communication [ph] or responders (00:30:59)?

Scott A. McFeely

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

A

No. So, if I look at – the short answer is no. A little bit of color on it. If I look at the ZR application, in particular, as it applies to potential DCI, metro and campus, we have said in the past that in the fullness of time, that might be a total market opportunity of $500 million on an annual basis. Our perspective on that hasn't changed. By the way, that's – you articulated it as a threat. I think it's also an opportunity because there are some non-coherent technologies that serve that market today. So, that moving into coherent is an opportunity for those that leaving coherent. And I would say the same thing on the service provider side, it has an opportunity on the access side, not necessarily ZR, but other pluggable technologies becoming coherent is an opportunity.

Paul Silverstein

Analyst, Cowen and Company

Q

Appreciate it. Thank you.

Gregg M. Lampf

Vice President-Investor Relations, Ciena Corp.

A

Thanks, Paul.

Operator: Next question comes from John Marchetti with Stifel.

John Marchetti
Analyst, Stifel Financial Corp.

Q

Thanks very much. Gary, I was just wondering with the renaming of the Packet Networking business and seeing some of the focus now on the edge of the network, just with some of the investments you're talking about making there, can you talk about, particularly in Europe, where that's been a focus? What you're seeing as you're looking through the rest of this year and maybe a little further out? And if you feel like you need some significant additional efforts there in that portfolio, and maybe even the possibility of some M&A focus there?

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

A

Let me try, and then Gary can add some color. So, first of all, what we believe is the winning hand in that part of the network is a combination of what we've called Adaptive IP, sort of the next generation. I think of it as a thin IP not necessarily burdened by the applications or protocols of the router that was built for the Internet 15-plus years ago; combined with the convergence of best-in-class optics, an intelligent photonic layer, and the software automation tools that go along with that convergence in order to be able to operationalize that in the network.

We think that is the architecture of the future, and it's a long game. And we've been investing on that for a period of time now, and you're starting to see the products come to fruition from those investments, both in our Routing and Software – or sorry, our Routing and Switching portfolio, but also in our software assets. Blue Planet, yes, but also in our domain controllers, MCP.

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

A

So, John, just to reemphasize that, this is not sort of – obviously, as Scott said, sort of an epiphany to us. So, I think we've been talking around this kind of convergence actually probably for decades in the industry. But I really do think that opportunity is presenting itself as the metro edge particularly evolves.

And we've been investing heavily. I think, basically, we've doubled the amount of technical talent that we've had on this area in the last couple of years; and also invested heavily on the go-to-market side. We think we're very well-placed. We have an architecture that we think delivers a much more simplified and operationally better economic solution. We think it's very compelling. We think we have all the elements to that to be successful. Obviously, wouldn't rule out additional scale and technology in that space, of course. But right now, we think we have a good path with the architecture and the investments that we've made.

John Marchetti
Analyst, Stifel Financial Corp.

Q

Thanks very much.

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

A

Sure.

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

A

Thanks, John.

Operator: Next question comes from Tal Liani with Bank of America.

Tal Liani
Analyst, BofA Securities, Inc.

Q

Hi, guys. I have two questions. First of all, probably I'm going to ask you for the next 25 years is if you can give us an update on Huawei share replacement share gain. And the second one, both of you cautioned us enough about second half guidance, that I want to ask about the specifics of your guidance. Meaning, what are the projects with what type of customers – maybe not customer names, but types of customers and types of projects that need to materialize in order for you to hit your second half guidance? What is assumed – categorically, what is assumed in the guidance?

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

A

Okay. Let me take the first part of that, then I'll hand off to Jim. So, the question you're going to ask me for the next 25 years, same kind of answer, I think. I think I described the major opportunity with Huawei is really in Europe. And that's, again, to your point, about 25 years. It's probably not that long. But we're in the infrastructure business. This takes time, both time for decisions, time to operationalize, and to get all the back office done. And that is a multiyear program.

Whilst this has had a lot of focus for all the reasons that we know in the last sort of 18 months to 2 years, we saw signs of this before. Basically, just – and I would describe it more around reducing dependency. Such a large market share in Europe in all facets of infrastructure. And I think the carriers began to realize that, frankly, about three years ago. When you look at some of the wins we've had with Deutsche Telekom, with Vodafone, etcetera, those wins, I think, were centered a long time ago in this dynamic. I expect that to continue.

I would also comment with this on the EMEA side. Whilst we've seen that, and that opportunity is very much a tailwind for us, I think their priority right now is on the RAM side, because I think that's the one that's got the particular geopolitical focus. But – and that's why I think this will be a multiyear element. And we are winning more than our fair share of that.

I would – as I mentioned sort of earlier, India, I think, is moving faster in all dimensions of that change-out, I think, because of the relationships between the two countries. And we are seeing that being expedited and beginning to be awarded and will begin to roll out. And that reflects, to your second point, Tal, some of the assumptions around our second half uptick. Basically, I think we're very confident that the second half is going to be a significant uptick to the first. There are certain assumptions to meet that target. They've obviously got to continue. And one is, India continues to recover, and I think we're pretty confident around that.

Second element overall, I would say, is that the Tier 1 service providers, most notably in North America, begin to deploy some of their plans that they've cautiously not deployed; and we are beginning to see that. So, I would say, combination of service provider Tier 1s in North America, Europe continues as it is, and that we see this uptick in India.

Web-scale, I think they've got pretty good visibility to that. I think they're going to have a good year. You saw – you heard my comments around mid-single-digit growth in web-scale, and we will grow at least with the market there.

Jim, any other comments on the specifics for...

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

A

Yes. When – the first thing I'd say is that we've now gone through one quarter of the year, and things are developing as we expected. We feel very confident about the second half of the year. But what we didn't want to impart to anybody is that every – all of the spending is at the levels that they need to be at in order to get to our numbers for the year. That was why we repeated the variables that we put out at the beginning of the year, and it's still the case.

With respect to how we get to those, we do a lot of forecasting, and it's all bottoms-up from our sales force. And so that set of numbers we're talking to comes from sales force indications of what customers are saying they're going to spend for the rest of the year. As Gary said, it's Tier 1 service providers around the world.

But I'd also say this. As I said before, our backlog is still not where it needs to be to get to those numbers. It will be, we think, as our orders start coming in at stronger rates. But we just wanted everyone to know that things have to continue as they have started to begin.

Tal Liani
Analyst, BofA Securities, Inc.

Q

So, Jim, I have just a follow-up. If the carriers get frequencies in December – that's 100-gigabit in December – and they deploy radios, assuming they're going to deploy the equipment – that's what Ericsson is saying. They're going to start before the time, not after they're getting the frequencies. Where is your portion of the network in terms of timing? Meaning, is it before you put radios or is it after you put radios? Do you prepare the backbone optical before or after in all your routers' portfolio? So, can you just give us kind of the understanding of a typical deployment where you are – timing-wise, where you are in the process?

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

A

Tal, the answer to your question is yes to all of the above, and I'm not being cute there. I mean – and I think about it in some of the real-world examples we've had of that. We've had carriers that build out in advance of that spectrum. Because they're building out converged metro, particularly, they're very mindful around putting capacity and the ability to go support that when they put it out there. We've got others that are very hand-to-mouth with their perspectives around getting capacity into that spectrum as they deploy. And so you've got all shades around that. Obviously, there's a correlation, and it's good news for us, basically. The more they deploy out there, the more speed – the faster they're going to require fiber-fed capabilities.

So, generally, it's a big positive. But we are seeing signs – what – it's not – I would say it's not particularly, from our perspective, spectrum led at this stage. They had a number of plans to build out that got slowed down, but we're now seeing them – and these are wins that we've had, design wins that we have, that they're now beginning to deploy. Now, there's some correlation to spectrum coming on and then leveraging that investment, but it's not as simple as a direct line into all of that.

Tal Liani
Analyst, BofA Securities, Inc.

Q

Got it. Thank you.

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

A

Thanks Tal.

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

A

Thanks Tal.

Operator: Next question comes from Alex Henderson with Needham.

Alex Henderson
Analyst, Needham & Co. LLC

Q

Thank you very much. I was hoping you could talk a little bit about an issue around the timing of – and the cadence of inventory purchases. Obviously, there's some constraints around some supplies. But on the other side of the coin, your inventory increased sequentially quite a bit. And I was wondering if you're planning on bringing the inventory down or whether you see the constraints that you're struggling with persisting, and therefore anticipating continuing to build inventory? Can you just talk about the direction of that?

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

A

Yeah. Good morning, Alex. So, really primarily two things driving the inventory dynamics that you pointed out. One is, it goes back to the second half of the year ramp that we talked about. We have significant bigger second half than first half, and we are working for success and sort of priming the pump, if you like to be able to deliver to the customers on that ramp. So, that's number one. And that is, by far, the bigger of the two dynamics.

The second one is, I'll just say, our own security of supply. So, I talked about having the confidence in our business and having the ability to invest in that supply chain. That's what you're seeing happen there in terms of the security of supply. And it's not just the most recent [ph] semiconductor (00:43:52) piece, but it's also the activities that we've done to protect ourselves from the COVID dynamics that we've talked about in the past.

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

A

We do expect that our [ph] terms (00:44:01) will improve...

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

A

Yes.

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

A

...as we move through the year.

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

A

Yeah.

Alex Henderson
Analyst, Needham & Co. LLC

Q

Is it a function of more chassis and less line card, and therefore because of the footprint build? And then the second question I wanted to ask really was around the mix of – on the revenue guide sequentially. It looks to me like you probably would have a recovery in service sequentially, and therefore the majority of the pressure in the quarter is really on the product side. Can you talk a little bit about the cadence between those two as we go into the April quarter? Thanks.

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

A

On the first question, the mix dynamic isn't really what's driving it at all. It's more just prepping the pump for a big uptick in the second half and the security supply dynamics I've talked about.

On the second one, Gary, you...

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

A

Yeah. Alex, I think as I think about the rest of the year – I'd make my commentary around the rest of the year. And I think the overall trend that we're seeing is the deployment essentially starting of the wins that we've had over the last year or even 18 months. And as Jim said, that will weigh on our gross margins, which is kind of a good news, I think, perversely in that that will get deployed and will – our gross margins have improved overall in our baseline, as we've said, but this fluctuation has really been about not deploying the new business, which we're now seeing.

In terms of the mix between services and product, generally speaking, the services for installation are lower margin, which go with the investment in the product side, early day. You could express it to chassis and cards, but it's getting a little fuzzier than that, but lower margin at the start of it. And some of that is increased installation services as well, which we expect to see through the year. But that's all contained within our guidance on the gross margins.

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

A

Only other thing I'd say, Alex, is when you look at our services revenue, a very big chunk, over 50%, is maintenance. And so the deployment is not a big number. For many of our customers, we don't do deployment. It's the submarine customers, it's many of our non-US customers, and including in Europe. So, it's – the sequence is not [ph] tariff foretelling (00:46:42), except deployment is going to come in at lower gross margins than maintenance on most of our products as well.

Alex Henderson
Analyst, Needham & Co. LLC

Q

Thank you.

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

A

Thanks, Alex.

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

A

Thanks, Alex.

Operator: Next question comes from Amit Daryanani with Evercore.

Amit Daryanani
Analyst, Evercore Group LLC

Q

Thank you for taking my question. Maybe just questions really on the web-scale business, which did really well this quarter. It was up 20%. I'd love to understand, how do you feel the web-scale business today for fiscal 2021 in the context of the aggregate growth being 0% to 3%? And then secondly, what do you [ph] mean (00:47:20) for the competitive environment here today, especially with the Cisco-Acacia case deal formally done? How does that sort of alter the environment for Ciena?

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

A

Hi, Amit. In terms of web-scale, yeah, we had a very good quarter, and we expect to have a good year overall on web-scale. I think they've had some challenges deploying and standing up data centers around the world in the velocity that they generally would have liked during the last 12 or 18 months. So, based on the plans that we're seeing right now, we would expect growth in the mid-single digits in that space for the year.

We've got a very high market share there. Probably not going to grow that share, but we're certainly going to maintain it. We've got all of them now taking WaveLogic 5 Extreme in addition to their prior generations. And we're engaged in a lot of the planning around the expansions, both in all of their applications in terms of submarine, DCI connectivity, and in their metros as well. So, very, very strong engagement on the web-scale, and we think they're going to have a good year.

I think there's even the potential for some of them to be a top 10 customer during the year. That's a possibility, one or two of them. We'll see how that goes. But I think, generally, we expect a good year in web-scale.

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

A

And then with respect to the second question about Cisco and Acacia, I'd remind everybody that we've been competing against Cisco in various parts of the network, really, for a long, long time; and they have been using Acacia technology for a while. So, this is not a change in and of itself. I would say that the excitement in our space is the fact that all of the architectural turmoil that's going on in the metro and in the edge and all of those things are opportunities for us. And we think that, as Scott said earlier – I'm sure he'll want to add something to this – we think that we have a winning hand in there with the best optics in the business and increasing IP capabilities.

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

A

Yeah. The other thing I would add, Jim, is as these architectures play out in our customers' network, another important [ph] to mention, I mean (00:49:40), is actually going to be the software capabilities to operationalize this, and we think – we've been investing for a while, both organically and inorganically on that path, and that's going to be a really important part of the winning hand, as you said.

Amit Daryanani
Analyst, Evercore Group LLC

Q

Thank you, [ph] guys, for all the (00:50:00) clarity.

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

A

Thanks Amit.

Operator: Next question comes from Samik Chatterjee with JPMorgan. Samik, your line is open. Next question comes from Jim Suva with Citi Research.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you very much, Gary and Jim, and I'll ask both my questions at the same time. The first question is, when you alluded to or specifically called out the OpEx kind of some push-out, sometimes that happens because R&D for some of your key customers, they've asked you to change some of the specs on it, or sometimes it's just internally at the company like Ciena, maybe you're deploying an ERP upgrade or system upgrade, and you just decided to do it later or with COVID. Can you help us understand about why the OpEx got pushed out? Was it customer-driven or was it more Ciena driven?

And then my second question is, you definitely laid out the risks of the second half ramp. When you look at the orders, bookings, and discussions with customers, is it aligning to that ramp looking pretty probable or is it aligning to that ramp having incremental risks that you kind of identified today? Thank you.

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

A

Hey, Jim, I'll deal with the OpEx question, and then Gary, I think, will deal with the second half. With respect to our OpEx, there were no customer push-outs or really any intentional push-out by us. Our OpEx does have projects in it. And the timing of those projects and the timing at which we can complete them and record them just moves around a little bit. And so I don't think you should read anything into that shift-out, except that it is shifted out and we are going to spend that money. As I said, we haven't changed our OpEx plan for the year. We will spend the exact amount of time and hours and money, except that – sorry, for the full year – except that we will be a little higher because of the weakness of the US dollar.

Gary?

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

A

Yeah. On the forecast for the second half, I'd say sort of contextually this. We've been running our business for the last few years going into each quarter with quite a large backlog, quite a large relative backlog each quarter. And so our ability to forecast over the last few years has been pretty accurate. And a large part of that is, you've got the backlog and you've got the pretty accurate forecast of when things are going to happen. I think with COVID, that has been disrupted for the reasons that we've talked about. And I think we're in the process, we think, of building that back up again. And so it is a little more challenging for us, which we've expressed last year and as we came into this year.

But as Jim also said, things are beginning to roll out as we'd anticipated. When you think about it at a high level, there's more capacity demands going into these networks. They're running the networks hotter. We've had a period of time where there's been a general caution around not wanting to operationalize any additional capacity or changes to architecture. And also, some caution around financial spend. No one's taking their budgets down, no one's stopped projects, but they're not spending at the velocity that they'd kind of planned. And that's the period that we're – I think we're beginning to come out of, but that adds to the uncertainty. But so far so good in terms of what we're seeing for the year. I think we're very confident about predicting a substantial [ph] little (00:54:05) uptick in the second half of the year.

Our ability to be completely precise about that is really dependent on that momentum continuing and us building up our orders and backlog. We have a very sophisticated forecast process that's well-tested. And it combines, as you'd imagine, backlog, detailed order forecasting by customers, many of which are long-term partners of ours and we have very good visibility into. And the project plans of things like submarine and some of these new metro architectures, so that all gets taken into account to it.

But I think why we're sort of focusing this is really because we're not operating with a large amount of backlog that we're normally used to. But we're seeing the activity pick up, and we've been very explicit, I think, around the assumptions that we think are the headwinds and the tailwinds for us to hit our plan. And I don't think there are many companies actually giving guidance for the full year, but we think that we've got some visibility that we can share that with you, hence our guidance.

Jim Suva
Analyst, Citigroup Global Markets, Inc.
Q

Thank you so much for the details and the clarifications. Thank you.

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

Thank you.

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

Thank you.

Operator: Next question comes from Fahad Najam with MKM.

Fahad Najam
Analyst, MKM Partners
Q

Thank you. Good morning. My first question for Jim. Jim, if I look at your last three-year trends, your overall full year operating margin tends to be, on average, 3 percentage points higher than your first quarter reported operating margin. Do you expect that trend to continue this year? If not, why not? And do you expect that trend moreover to continue over the next three years? If not, why not? And then I have a follow-up for Gary or Scott.

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

Thanks, Fahad. Here's what I'd say. It is absolutely true that our Q1 operating margin tends to be the lowest operating margin for the year. That is mainly because the Q1 revenue has tended to be lower than that of other revenues. And our OpEx has generally been sort of flattish through the year. I know there's some movement, and there is. But that's the basic reason. OpEx as a percent of revenue in Q1 has tended to be a bigger number than the other quarters.

As we move through the year, first of all, I'd say that we do expect for the year to average 15% to 16%. So, we think that we will show higher operating margins in the later quarters. But I'd also say that sort of offsetting that point is that, as we've said, we expect that gross margin will move down from high 40s to the mid-40s as we move through the year. And so if you just run the math on that, I don't think that we're going to do 3% better for the year. I think we're going to do 15% to 16% for the year.

Fahad Najam
Analyst, MKM Partners

Q

Thank you. For Gary or Scott, I think you guys alluded to the fact that you are increasingly investing in your IP routing or IP stack capabilities. But do you think – or are you comfortable that you have sufficient capabilities today to address the majority of the edge and 5G use cases? Or do you think you need more heavy lifting to kind of get to that majority of the opportunities that are out there?

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

A

Yeah. I'll take that, Fahad. First of all, the focus of the investment, as you said, was on the metro and the edge. The use cases that we're pursuing, I would say, is combined aggregation networks: 5G, IoT, enterprise connectivity use cases. If we were building to a legacy architecture, we would certainly have a steeper hill to climb in terms of capability sets. But we're actually building to what we believe, and our customers are telling us, is the architecture of the future which is, as you go back, a thinner layer of IP where a lot of the application capabilities are no longer embedded in a router. They're getting disaggregated onto general compute capabilities. And that really becomes a, again, back to the winning hand, adaptive IP layer, world's best optics, a programmable photonic layer, and the software automation systems to allow you to drive that converged architecture. That's the lowest cost per bit, that's the most flexible network for our customers, and that's what it's going to win in the future.

With that definition, we're feeling pretty good about our capability set. Gary's comments earlier, if there was an opportunity to do something inorganically that added to scale, we would look at that, but we're pretty comfortable on the capability sets we have today. And you can see that in the product portfolio that we've released in the last six to nine months on that part of the portfolio.

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

Thanks, Fahad. With that, we will close the call, and we thank everybody for joining us today. We look forward to seeing everyone on the Road virtually over the next few weeks and hopefully in person, and not too long. Everyone, stay well and thank you again.

Operator: This concludes today's conference call. You may now disconnect.