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Ciena Corporation

Fiscal Third Quarter 2018 Financial Results Conference Call

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Meta Marshall, *Morgan Stanley*

George Notter, *Jefferies & Company*

Jim Suva, *Citi*

Simon Leopold, *Raymond James*

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PRESENTATION

Operator:

Good morning, my name is Emily and I will be your conference Operator today. At this time, I would like to welcome everyone to the Ciena Fiscal Q3 2018 Financial Results Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question and answer session. If you would like to ask a question during this time, simply press star, then the number one on your telephone keypad. If you would like to withdraw your question, press the pound key. Thank you.

Gregg Lampf, Vice President, Investor Relations, please go ahead.

Gregg M. Lampf:

Thank you, Emily. Good morning, and welcome to Ciena's 2018 Fiscal Third Quarter Review. With me today is Gary Smith, President and CEO, and Jim Moylan, CFO. Scott McFeely, Senior Vice President of Global Products and Services, will join us for the Q&A portion of the call.

This morning's press release is available on National Business Wire and ciena.com. We have also posted to the Investor section of ciena.com an accompanying Investor Presentation that includes certain highlighted items from the quarter. Our comments today include detail on our fiscal third quarter results, our views on the market environment and our outlook for the remainder of the year. We'll then open the call to questions from the sell-side analysts, taking one question per person, with follow-ups as time allows.

Before turning the call over to Gary, I'll remind you that during this call we will be making certain forward-looking statements. Such statements are based on current expectations, forecasts and assumptions regarding the Company that 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 SEC filings. Our 10-Q is required to be filed with the SEC by September 6, and we expect to file by that date. Ciena assumes no obligation to update the information discussed on this call whether as a result of new information, future events, or otherwise.

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.

This call is being recorded and will be available for replay from the Investors section of our website.

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

Gary B. Smith:

Thanks, Greg, and good morning, everyone. Let me start by saying that Q3 was a great quarter, but more importantly, the strong financial performance is a clear validation of our strategy and continued consistency of our execution. Our diversification, global scale and clear technology leadership enable us to take full advantage of robust demand across a broad spectrum of customers and applications. As a result, our third quarter revenue came in very strong, and we continue to deliver faster than market growth and take considerable market share. In fact, orders in the quarter were greater than revenue and we achieved record backlog coming out of Q3. We also delivered a strong adjusted bottom line, with EPS of $0.48, and on that point, I'd like to mention that as we've become more profitable and substantially improved our EPS, we are increasingly focused on EPS as a key performance metric, in addition to top line growth, of our business.

This continued execution and consistent performance increasingly differentiates us from our competitors, many of whom are challenged with weakening financial positions and strategic distractions. I'll also point out that that the distinction between the winners and losers is becoming even more pronounced and we remain the only western company in our space that is both growing and profitable.

Fundamental to our strong performance is the continued diversification of our business, as illustrated in Q3, with 37% of revenue coming from non-telco customers. This diversification is contributing to our growth and, importantly, it better enables us to navigate through industry dynamics that may temporarily adversely affect particular customers, verticals or geographies. Similar to last quarter, in Q3, we saw the benefits of this diversification specifically with webscale customers, international Tier 1 service providers and across the Asia-Pacific region, in general.

Let's start with webscale. This customer set is clearly now a major influencer of network architecture demands. We are extremely well positioned in this key segment and we continue to capitalize on the increasing opportunities we see in this space. In fact, in Q3, three of our top ten revenue accounts were webscale customers, including one that exceeded 10% of total quarterly sales, which was a first for us. Overall, our direct webscale business was up more than 150% year-over-year. This represents a record 20% of quarterly revenue in Q3, and revenue for our DCI platform, Waveserver, which has seen rapid adoption by webscale customers, is $252 million year to date. This compares with $110 million for all of fiscal 2017.

Last quarter, we mentioned that we're working with several international Tier 1 service providers, many of whom are new to Ciena, to help them with their network transformation plans. This dynamic continues to play out, and I'm very pleased to share with you that one of those customers, as an example, is Deutsche Telekom; specifically, in support of its international wholesale business entity. The project includes a European-wide network deployment leveraging our WaveLogic technology. Importantly, this new set of customers are coming to us because they view us as a financially stable partner with global reach and capabilities, and an ability to sustain our innovation leadership over the long term, and we see this opportunity continuing.

Lastly, as you've seen in our results, Asia-Pacific region generally continues to contribute meaningfully to our growth. With the region representing more than half of the world's digital population and estimated to have roughly 1.8 billion smartphone users by 2021, the network infrastructure demand is obviously booming to support this in the region. In Q3, once again this region's performance was led by India, which grew 100% year-over-year, and Japan, which doubled in the same period. Australia was also a strong contributor to our quarterly results.

Overall, our consistent performance further reinforces our resiliency to the ebbs and flows of specific customers and market segments, and we are extremely well positioned to take advantage of generally robust market demand.

With that, I'll turn it over to Jim for some additional detail.

James E. Moylan, Jr.:

Thanks, Gary, and good morning, everyone. Today, we delivered strong quarterly performance, with revenue of $819 million. Notably, we had three 10% customers this quarter. In order of contribution, these were Verizon, AT&T and a major webscale company. In aggregate, these three customers comprised 33% of Q3 revenue. For the past few years, the composition of our top customer list has changed and evolved. We have intentionally, and successfully, diversified our business across customer segments, geographies and products. Our quarterly, and even annual, performance is now less correlated to any one customer or region. Also of note in the quarter, our top 10 revenue customers included three webscalers.

Our Q3 gross margin was 43.4%, mainly driven by favorable product mix. We reported quarterly adjusted operating expense of $241 million. In addition, in Q3, our Adjusted EBITDA was $132 million, we generated $88 million in cash from operations, and our free cash flow was $70 million. With respect to profitability measures in the third quarter, we delivered adjusted operating margin of 14%, adjusted net income of $74 million and, as Gary mentioned, adjusted EPS of $0.48. We ended the quarter with approximately $985 million in cash and investments.

Moving to capital allocation, during the third quarter, we repurchased approximately 1.4 million shares of common stock at an aggregate value of $36 million, which represented about half of our free cash flow in the quarter.

In addition, we want to update you today on our plans with respect to our 2018 notes which mature in October. Previously, we indicated our intent to settle in cash the $288 million face value of the new 2018 notes upon maturity. Given our current stock price, the market value of these notes will likely exceed their face value at maturity. As a result, we've decided to settle in cash up to $112 million of the market value in excess of the face value of these notes upon maturity. This effectively represents an additional repurchase of shares in that amount.

Taken together, with our ongoing share repurchase activity, these steps are strong indicators of our confidence in the business and our continued commitment to managing dilution and returning capital to stockholders.

I'll now share some additional highlights from the third quarter that illustrate the continued momentum across our business.

Key geographies performed well this quarter and we've seen strong year-over-year growth in nearly every region. In particular, APAC was up nearly 50%, with India once again contributing greater than 10% of global revenue.

I'll also highlight our continued traction in the subsea vertical, which remains a key contributor to our growth and diversification. This segment was up 23% year-over-year, largely driven by webscale company demand. We had several new significant wins in Q3 in the submarine business, including four new logos, and we were selected as the preferred vendor for two large consortia cables.

Finally, with respect to our portfolio, we grew our Networking Platforms business more than 14% year-over-year. In Packet Optical, our WaveLogic coherent modem technology is clearly best-in-breed, as evidenced by our growing market share in the demanding webscale market. As we approach the one-year mark from WaveLogic Ai availability, there is still no significant innovation challenger on 400 gigs to date.

Our Packet Networking business had a strong quarter, with 32% growth quarter-over-quarter, which reflects some early deployments with Verizon.

In Software, we continue to leverage our early leadership position in the network automation domain with Blue Planet. Blue Planet diversifies our customer base and our portfolio, and it also provides an opportunity to expand our gross margin as this business grows over time. This is a nascent market and we are still learning about customer needs in this space, and we are encouraged by the market's reception to our automation capability. We'll be increasing both our efforts and our investments in our Software strategy over the next several months to accelerate the growth of Blue Planet.

Looking ahead to fiscal fourth quarter 2018, we expect to deliver revenue in a range of $845 million to $875 million; we expect to deliver gross margin in the low 40s, and we expect to report operating expense of approximately $255 million; we expect op ex to be slightly higher in Q4, given the 53-week fiscal year, as well as the addition of Packet Design.

In closing, we delivered outstanding performance in Q3, due to solid execution and robust demand across a wide range of customers and applications. We are increasing market share and we the market leader. We are confident in our business model and our ability to achieve our three-year financial targets. We'll look to provide additional commentary on our progress against those targets when we report the full fiscal year 2018 in December, as well as any updates to our projections at that time.

Thank you for your time today. Emily, we will now take questions from the sell-side analysts.

Operator:

Of course, and if you would like to ask a question over the phone, please press star, then the number one on your telephone keypad. We'll pause for just a moment to compile the Q&A roster.

Our first question comes from the line of Paul Silverstein from Cowen & Company. Your line is open.

Paul Silverstein:

Thanks. Gary, I heard the comment about orders exceeding revenue. Can you give us a sense—clearly, visibility is improving, but can you give us some more insight in terms of looking beyond the quarter and beyond this year now, and maybe compare it to 90 days ago and a year ago, what you're seeing?

Gary B. Smith:

I think we see improving visibility, and it's improved steadily throughout the year. I'd describe it as very diverse, both geographically and with the customer set. We talked about Asia-Pacific particularly being strong, but also we're seeing opportunities in Europe with Tier 1s. We're getting visibility to some of these now, these early wins. The backlog going out of Q3 was the largest that we've had, and obviously that's one dimension of visibility, and revenue is clearly another one, but I think all dimensions, being customer engagement, our forecasting, our pipeline, you know, points upwards.

Paul Silverstein:

If I may, just a quick follow-up. We all know the history in terms of two steps forward and one step back, and the limited visibility that characterizes Optical in general, but it does sound like there's been meaningful improvement in that regard; and if I could extend the question to margins, the guidance strikes me as conservative, but that's the question, how much—to what extent are you all being conservative in the outlook on both revenue and margins, not that there's anything wrong with that?

Gary B. Smith:

Let me take the first one, Paul. I think what we've seen over the last few years in Optical is very consistent demand. If you look at our top line revenue performance over the last five to seven years, it has been very consistent. The demand has been consistent and our performance has been consistent. I think this notion of Optical being two forward and one back, I think is based on what happened in 2001, I honestly believe that, and all the analytics that we've done, this is a very broad-based demand characteristic that we're seeing.

James E. Moylan, Jr.:

On gross margins, Paul, as we've said many times, in the early stages of big deployments, we're going to enjoy slightly lower margins than average, and as we move through time and we get more mature in the lifecycle of the project, we will get improvement in our gross margins. It so happens that, because we're winning and we're getting great opportunities to win more, we are experiencing margins in the low 40s. We don't view this as a conservative guide. In fact, I think we might be slightly down in Q4 as compared to Q3, but we're going to be in the range of where we've been this year. This is a good positive sign for the future of the business, it's a good news story.

Paul Silverstein:

I appreciate it. Thanks, guys.

Gregg M. Lampf:

Thanks, Paul.

Operator:

Our next question comes from the line of Meta Marshall from Morgan Stanley. Your line is open.

Meta Marshall:

Great, thanks. Maybe just following up on that, I think we had expected slightly lower gross margins in fiscal Q3, so was there perhaps projects that hadn't started to the level that you expected, or just maybe more detail on what led to the gross margin upside in fiscal Q3. Then, second, you mentioned the ability to diversify away from a lot of lumpiness from particular customers, but just, you know, as we head throughout the rest of the year—the cloud customers have been particularly strong through the first fiscal—through fiscal Q3—is there any expectation that they would potentially be weaker heading into the second half of the year? Thanks.

James E. Moylan, Jr.:

Yes, the two drivers of our gross margin, as I said before, are where we are in the lifecycle of projects and product mix, because certain products do, by the very nature of the competitive situation in those products' markets, have slightly better margins than others. We had a pretty good product mix in the quarter and that helped us.

Gary B. Smith:

In terms of the visibility into build-out with folks like the webscale, I think, overall, we're very mindful of the need for diversification, both customer-wise, geographically and in applications, and I think we've built a business to be resilient to that, as we've demonstrated this year. You will get ebbs and flows, but I believe in—if you take the webscale segment, specifically, I still think we're at the early stages of this. I mean, they're trying to get more content out to more people, particularly internationally, which means more connectivity and more data centers, and it shows no signs of abating, when you look at their strategy to basically get more eyeballs, and particularly outside of the U.S. So, I mean, it's going to have ebbs and flows between certain customers, for sure. We've got a broad base of customers now, both within the predominant webscale players, and also the emerging players, as well, that are increasingly looking to connect their data centers. So, as a segment, I think we're very positive around the demand characteristics of this for certainly sort of the near to medium term.

Meta Marshall:

Got it. Thank you, guys.

Gregg M. Lampf:

Thanks, Meta.

Operator:

Our next question comes from the line of George Notter from Jefferies. Your line is open.

George Notter:

Hi, guys. Thanks very much. I was just looking at the year-on-year sales growth, 12%, and not that long ago you guys were talking about growth rates of mid-single-digits in 2018. As I think about that year-on-year growth rate, how much of that growth are you ascribing to market growth versus share capture, is there any sense for what that might look like? Then, also, I noticed that you hired 200 people in the quarter, I think some of those may have come from Packet Design, but that's a really big hiring quarter. I guess I'm wondering where you're making incremental investments right now. Thanks.

Gary B. Smith:

George, let me take the first part of that. Yes, you're right, the 12% is considerably more than we thought when we came into the year, or on our sort of three-year projections, as well. I think that's been driven by the growth areas that we've talked about. Webscale has come in stronger than we thought, Asia-Pacific stronger than we had anticipated, and we're also beginning to see these Tier 1 wins, as well, come into the revenues. So, I think the contribution of those three elements, I think has taken us above.

Interestingly, the market data, I think many of the industry analysts have actually revised down their numbers for the year, and, depending on which analyst you look at, they're in the very single digits. So, this is share gain. We anticipate, by the end of the year, to have gained something like 2% market share globally on the back of this performance.

James E. Moylan, Jr.:

On the people count, George, not quite half of that people gain was due to our acquisition of Packet Design, but we're right on plan, frankly, with our hiring for the year. We're going to spend $400 million in R&D this year and it takes people to do that.

George Notter:

Okay, thank you.

Gregg M. Lampf:

Thanks, George.

Operator:

Our next question comes from the line of Jim Suva from Citi. Your line is open.

Jim Suva:

Thanks very much. The revenue beat this quarter was very material and, based upon your guidance, I think—am I correct by assuming that there was no major pull-in from revenues from your quarter out; and on that strong revenues that you just reported, can you help us understand—I think I heard in your prepared comments a little bit that it was webscale and Tier 1 strength, can you confirm if that was the case, and was it geographic focused at all or more, say, land-based or undersea, or just help us get some color on the clarity of the strength, because it was quite impressive?

James E. Moylan, Jr.:

Yes, as we said, it is mostly Tier 1s and GCNs. Remember, we've said over the past couple of quarters that we're seeing increasing opportunities with Tier 1s, we're winning those, and sometimes they take a bit of time to get to revenue, so that's something that's happening in this quarter, but the other side is WaveLogic Ai is a very attractive piece of technology, particularly to the webscale customers who demand high performance, and we're winning in that space and we're gaining market share. Those are the two big changes from what we expected as we came into the quarter. Now, we did say we had a strong quarter in subsea, we said that that grew 23%, we're sort of 50% market share in that business now. We had a strong quarter in Packet Networking. So, really, across the Company, across geographies and across products, we're winning.

Scott A. McFeely:

Jim, it's Scott McFeely. The AI technology that our Jim spoke about is also very applicable to the submarine space and a very big part of the reason why we're continuing to win and continuing to show number one market share there.

Jim Suva:

Great, and then as my follow-up, can you briefly mention, or give us some insights about your market share gains, what's really driving that? Is it execution, is it world-class product, is it ability to react in a very quick manner? There's lots of things that could lead to share gain, but could you help us understand what you think are the key factors that are driving your market share gains? Thank you.

Gary B. Smith:

Jim, I think, at the highest level, it's this virtuous combination of absolute leading technology and the roadmap of that technology, and Scott can talk to that, and the combination of the fact that we've got the largest Optical salesforce in the world, and we've geared up for global scale very meaningfully over many years. So, the combination of those two things are we have the best customer relationships in the world, we have more of those customer relationships than anybody else, and reach, and so you combine the two and you just get the virtuous velocity of leadership, and that's why we're taking market share so dramatically over the last few years, because the business is completely designed to go and do that, and the combination of the two.

Scott A. McFeely:

Yes, and I think, from a portfolio perspective and differentiation, I think the breadth of our portfolio, right from access through to the core, and being able to deliver, I'll just say, a roadmap for the lowest cost-per-bit in the industry for the applications that matter, where the growths are, combined with the other dimensions of our adaptive network strategy around the programmable infrastructure and the automation software that goes with it, is a story that's resonating with a number of customers. I've been at this for a long time and I'd say every time you have an engagement with a significant Tier 1, and even the webscale folks, which surprises some people, they're not only buying into what's on the shelf, they're buying into your ability to continue to drive that story and drive that innovation. Now, more than ever, people are starting to question the ability of some folks in the industry to follow through on that, and the financial strength that we have to be able to continue to invest in innovation is actually starting to become a major differentiator.

Jim Suva:

Thank you, and congratulations to you and your team.

Gary B. Smith:

Thanks, Jim.

Operator:

Our next question comes from the line of Simon Leopold from Raymond James. Your line is open.

Simon Leopold:

Great, thanks. I just wanted to see, reflecting on this quarter and the strong beat, if you could just identify what were the biggest elements that surprised you versus your expectations when you offered the guidance. Then, in terms of trending, you haven't talked that much today about the Packet Networking segment, which looks like a good grower in the long-term outlook. I'm assuming that that particular business is not driven by webscale, it's more around maybe cable TV and wireless. Maybe if you could offer a little bit of color on how you see that particular product group trending. Thank you.

Gary B. Smith:

Simon, let me take the first part of that. I think, you know, there's always a lot of moving parts into the quarter. I think the thing that did better than we anticipated, if you want to keep it as simple as that, I think webscale demand was stronger than we thought. You've got the Tier 1s came in a little bit stronger than we thought, some of these initial new wins that we've got. Then, thirdly, just Asia-Pacific, as a general region, Japan was stronger than we thought. So, there was no one big thing, really, that blew it out, it was really a combination, which I think talks to the diversity of the dynamics that we have in our business.

Scott, do you want to talk about the Packet?

Scott A. McFeely:

Yes, the Packet Networking, our strength historically has been on access and aggregation, focused on Ethernet business services and wireless backhaul. We've worked very diligently over the last couple of seasons to diversify that geographically and to also marry it, I'll say, with our Optical portfolio, so that we can provide a more holistic end-to-end solution, and we're benefiting, I think, from our efforts to diversify geographically and we're starting to see the benefits of that sort of whole portfolio piece.

The other thing that, from just a market dynamic perspective—you're quite right, by the way, the dominant deployment scenarios are folks that have access networks, so they're the MSO cable folks or they're the service providers, typically, with a wireless property. Both of those segments are looking at enhancing their end user experience, and for us that means fiber densification, and that means more opportunity for Packet access, and we're benefiting from that, as well.

Simon Leopold:

Great, and one quick clarification. Gary, you mentioned Japan. This is something you've talked about in the past. Has that market inflected for you or is this still on the come?

Gary B. Smith:

I think we've got more in front of us here, I really do. I think there's been a significant change in the last sort of 12 months or so in terms of the need, really, to get a vendor that has got global scale for them, that they're comfortable can sustain the innovation that Scott talked about, and I think we're beginning to see the momentum of that now. We've had a number of wins of big Tier 1 players that have not been customers before and they're now beginning to ramp up.

Simon Leopold:

Great. Thank you.

Gregg M. Lampf:

Thanks, Simon.

Operator:

Our next question comes from the line of Rod Hall from Goldman Sachs. Your line is open.

Rod Hall:

Yes, hi, guys, and thanks for the question. I guess I wanted to ask a little bit about the 400 gig competition and just see whether—you know, right now you're saying that you're well ahead of the field and you guys kind leapfrogged the competition with WaveLogic Ai, I wonder what you see on the competitive front there as you look forward; and I'm kind of curious on DCI, whether you've learned as you've gained more footprint that there's more to it than just the chip. I mean, obviously, you're gaining a lot of traction on the chip, but are there other things about your platform that you think are resonating with customers and that might give you more stickiness there even if competition comes. Then, I've got a follow-up question, as well.

Scott A. McFeely:

That's all right, it's Scott. From a 400 gig perspective, I still believe we're the only commercially deployable 400 gig solution in the marketplace now, and I think that's going to continue for a little bit. No question there will be competition that comes. We're not going to make a product announcement on this call, but you rest assured, with the $400 million of R&D we're spending, we've got some more things coming down the pipe, as well.

In terms of your second question, yes, actually, it's a very good point. I think people focus on the Optics, line side Optics and sort of the cost-per-bit, but one of the attributes of the webscale folks is they run a relatively lean operation and really depend on, I'll say, an IT kind of approach to operating the network, which comes with a lot of automation, though the programmability of the network supporting the right application programming interfaces and having the software infrastructure to go around that certainly adds to the stickiness, and as you get ingrained in that, I think it starts to become a bit of a barrier to entry.

Rod Hall:

Okay, and then—thanks for that, Scott, and I wanted to follow up on—I know the margin question has been asked over and over again, but I wanted to follow up on this and just kind of ask. I think, historically, you guys have said that DCI and India, and things like that, are kind of at corporate average margins, and these are some of the things that are driving this mix surprised, and the better margins, so I'm curious whether that's the holds, or are you seeing better margins in some of these specific deal or product categories than maybe we would have anticipated you would be seeing over time?

James E. Moylan, Jr.:

Well, the biggest contributor to the slightly higher gross margins that we had this quarter was Packet, which has slightly higher margins than our Optical business, but if you look across our business, there's really not a lot of difference in the gross margins that we get across customer segments or geographies. What really matters, other than products, is where we are in the lifecycle of deployment, and as we said, early-stage deployments are going to be costly, we're going to have start-up costs, we might give credits, whatever, and then we move through time and we get better in gross margin as we move to upselling and improving the mix with individual customers. So, that's just a natural recurring phenomena that happens over time. In any given quarter, the mix of early lifecycle deployments, as compared to later lifecycle projects, is going to be a driver of our gross margin, and although some of that is visible, we get surprises, things don't happen as we expected, but, on balance, things are happen more positively for us than we expected.

Rod Hall:

That's great, thanks, Jim. I appreciate it, guys.

Gregg M. Lampf:

Thanks, Rod.

Operator:

Our next question comes from the line of Michael Genovese from MKM Partners. Your line is open.

Michael Genovese:

Great, thanks a lot, and congratulations, guys, on the good execution. You've talked about a lot of positive things on here. One thing I may have missed, that I didn't hear a lot of talk about, was the expectation to return gross margins back to the mid-40s and the timing of that, so could you give us an update on that, please?

James E. Moylan, Jr.:

Yes, if I'm not mistaken, Mike, it sounds as though you're looking for some guidance on gross margins beyond fourth quarter and we're not going to provide that. I will say that we're seeing lots of opportunity to win and we'll update you on our gross margin progression at the end of fourth quarter.

Michael Genovese:

Okay, but when you talk about your three- to five-year targets, can you just remind us what the gross margins are in the three- to five-year targets—or sorry, the three-year targets?

James E. Moylan, Jr.:

Yes, I actually don't know that we provided guidance on gross margin. What we said was we expected to achieve a 15% operating margin by 2020. That's what we said.

Michael Genovese:

Okay, and then one more, my follow-up—

James E. Moylan, Jr.:

What we said was our revenue growth rate was going to be 5% to 7%. You know that if we hit our guidance in fourth quarter, we'll be above that range for this year, and so we're going to have to look at our three-year targets and talk about that again when we talk in December. The other thing that's going to be updated is our view on EPS.

Michael Genovese:

Okay. Actually, my follow-up is related to that. To clarify, on the three-year targets, if the three-year targets are for two more years, if you were rolling them forward to be the next three years, is the 5% to 7% was for three more years or basically for two more years at this point?

James E. Moylan, Jr.:

We gave three-year guidance at the beginning of this year, so we talked about the three-year period '18, '19 and '20, and we'll look at all of those things as we come to the end of this year and we'll consider giving new three-year guidance. I don't know that we will, I'm just saying that we will certainly talk about our progress against our targets that we set, we'll update any that we feel need to be updated.

Michael Genovese:

Great. All right, thank you.

Gregg M. Lampf:

Thanks, Mike.

Operator:

Our next question comes from the line of Tejas Venkatesh from UBS. Your line is open.

Tejas Venkatesh:

Thank you. I was hoping you could comment on how far away we are from an inflection in the Blue Planet business. You talked about it a little bit in the prepared remarks, but I think you had a very strong bookings quarter in the prior quarter, so just curious how that's going and how far away we are from an inflection.

Gary B. Smith:

You saw the acquisition of Packet Design, and the context of that is—as you know, we were early entrants into this with Blue Planet. We've done a lot of learning over the last two to three years. It's still a nascent space. What we've tested this year is really some of those learnings and we're very encouraged by what we're seeing. We've got good momentum. As you said, the bookings were very encouraging, and we should be able to come into the year next year with a backlog for 2019. But, importantly, I think we've identified the roadmap that we want to put together for those capabilities, and as we come out of the year, we'll talk a little more about that roadmap. We're putting the pieces together predominantly organically, but there probably has been some—there has been inorganic, and I wouldn't rule out a little inorganic acquisitions going forward to fill out the roadmap that we've identified. We've got a very clear direction on where we want to go with Blue Planet now and that's going to be a key part of our automation story going forward, and probably, as we turn the year, we'll give a little more visibility into our thinking here.

Tejas Venkatesh:

Thank you, and as a follow-up, how are you thinking about revenue from AT&T and Verizon through the rest of the calendar year?

James E. Moylan, Jr.:

Yes, as we've always said, those are important customers and we expect that they're going to remain big customers for the long term. We've also said consistently that the combination of those two customers, over time, will decline as a percentage of our revenue, because we are growing in a lot of other spaces. It's really hard to comment on what's going to happen with any individual customer in any given quarter, but I would say we do expect a stronger performance from AT&T in Q4.

Gregg M. Lampf:

Thank you, Tejas.

Tejas Venkatesh:

Thank you.

Operator:

Our next question comes from the line of James Kisner from Loop Capital Markets. Your line is open.

James Kisner:

Thank you very much for taking my question. I just want to follow up on that last question a little bit more and clarify your comments. You guys, I think, have said in the past that Verizon and AT&T would be flat to down for the year. I just want to clarify, has that expectation changed or not? Thank you.

James E. Moylan, Jr.:

No, it hasn't changed at all.

James Kisner:

Okay, and then just as a follow-up, on Packet Networking, I think, if my math is right here, if you guys are going to hit your kind of 68% growth rate target for that business, you'd have to generate, I think, $150 million in this coming quarter. Is that your expectation or you'll be below the low end of what you expect for the long-term growth rate for Packet Networking? Thank you.

Scott A. McFeely:

The target, James, actually, that you quoted, I'll just remind you it's a three-year target. This business, as we said, we're working to diversify it, from a customer and geography perspective. We think we'll see ebbs and flows as we go through the three-year target, but we're very comfortable in terms of achieving that three-year target.

James Kisner:

Great, thank you.

Gregg M. Lampf:

Thanks, James.

Operator:

Our next question comes from the line of Vijay Bhagavath from Deutsche Bank. Your line is open.

Vijay Bhagavath:

Yes, thanks. Hey, good morning, Gary, Jim. I have two questions, if I may. The first is on webscale and it's great to hear 20% of revenue. My question is how do you see competition both on pricing and also on speeds and feeds as we head into next year with this 400 gig product cycle coming up in the cloud with switching and routing; and then the second part of the question is on Fiber Deep, fiber densification, and how is Ciena positioned in that opportunity? Thanks.

Scott A. McFeely:

Yes, Vijay, it's Scott. I'm going to take a crack at the two of them. On the webscale piece, the competition—it's been an attractive market space for everybody in our segment, so the competition has been there forever and we'll continue to see it going forward. I think the important attributes of what will decide who will win market share here is who's going to drive the best coherent Optics roadmap and who actually has the programmable infrastructure that they're looking for. I'm not saying we're alone in the field in terms of the competition, but I like our hand that we have. I think we've demonstrated in the past that we're able to drive both of those dimensions pretty well, and you can expect there's lots of focus in terms of continuing to lead in both of those dimensions.

On the Fiber Deep piece, for where we play in the network on Fiber Deep, which is sort of from the fiber node into the network, if you like, it's a great opportunity, more fiber, more bandwidth plays to what we do. If I look at the technology combination that's there, it's Packet capabilities and it's Optical transport, both of which we have a good set of capabilities there. We have won some of the early deployments with some of the first movers on that, but much of that build-out is still quite in front of us and is probably more of 2020 event than it is a ’19 event.

Vijay Bhagavath:

Okay, thank you.

Gregg M. Lampf:

Thank you, Vijay.

Operator:

Our next question comes from the line of Dimitry Netis from William Blair. Your line is open.

Dimitry Netis:

Okay, thanks, guys. Nice results, nice guidance. A couple questions. As you look at your 10% customer, you have three of them coming in at 33%, I think is what you said. Are those the usual suspects, you know, AT&T, Verizon, India customer, and then, are there any customers close to that 10% mark, maybe Japan or ICT?

Gary B. Smith:

That’s a good question. You’ve got—of those two, I think Verizon was, interestingly, the largest this quarter, and then the other two were AT&T and a webscale player. That’s the first time we’ve had a webscale player get into that 10% bracket, particularly considering the growth that the Company’s been on. The makeup of the sort of 10% players, you’ve got a number of other customers, including—you mentioned one of the Indian players—very close. There are other customers that are just under that percentage. In fact, we’ve got more and more of those customers in the high single-digits pushing into the 10% range.

Dimitry Netis:

Perfect, and is Japan coming—one of the Japanese operators, is that (inaudible)?

Gary B. Smith:

It isn’t yet, but I wouldn’t be shocked to see that over the course of the next 18 months.

Dimitry Netis:

Excellent, okay. Then, Jim, you also mentioned that you would expect AT&T to be up in the fourth quarter, and that’s probably after quite a sluggish first half, as evidenced by their guidance, by AT&T’s cap ex numbers, as we progress through this year. On Verizon’s earnings call, they emphasized fiber projects accelerating, so small cell densification ahead of their 5G deployment. So, does that mean that you would see acceleration, as well, at Verizon as we head into fourth quarter, based on that commentary?

James E. Moylan, Jr.:

Again, it's difficult to say how these customers progress, because they're in different stages of their projects. Verizon will be strong for us in Q4. I don't know if it's going to be higher or lower in Q4, but it will be strong.

Dimitry Netis:

Do you think 5G is driving that yet?

Gary B. Smith:

I think we are seeing some of that in in the converged Metro deployments that they're rolling out, and the Packet, we're just beginning on the Packet side with them. So, we feel pretty bullish around Verizon for the next, certainly, couple of years, I think we've got reasonable visibility to that, and I think this converged Metro deployment, the consideration of it is around their 5G, though it's difficult to see exactly how much of that is 5G, but it's definitely in their capacity considerations when they're thinking of these roll-outs.

Gregg M. Lampf:

Thanks, Dimitry.

Dimitry Netis:

Great. One last question on the Software side, if I may. It came in a little bit light on a year-over-year basis. You said you were increasing investments in Blue Planet. Can you walk us through what you plan on doing there specifically and how could this ramp up from here?

Gary B. Smith:

I think this quarter, in terms of the revenue, it was slightly down. I think that's just the normal sort of ebbs and flows. Orders have been strong, engagement is very strong, and the pipeline is increasing. So, I think we're getting increasingly confident around the methodology of our engagement with the market and also refining our offering around that, Packet Design, with the key elements around fulfilling some of that roadmap. There are other elements that we're working on. I think, probably, as we turn the year, Dimitry, we'd give a little more visibility into those, they're not quite at a degree of maturity yet, but I think as we get into '19, we'll talk a little more around our plans for Blue Planet and a roadmap, both in terms of capabilities and what we think that might mean from a financial point of view.

Dimitry Netis:

I appreciate it. Thank you.

Gary B. Smith:

Thank you, Dimitry.

Operator:

Our next question coms from the line of Catharine Trebnick from Dougherty. Your line is open.

Catharine Trebnick:

Thank you. Great quarter, guys. Can you explain—all of a sudden, the last year, you've been doing very well in Japan. Can you describe some of the dynamics in that market, where you've been able to break into that market? Thank you.

Scott A. McFeely:

The biggest single thing is that the domestic Japanese market has been served by Japanese companies, and several of those companies, just like several companies in the West, have lost market share or having trouble investing enough in order to keep their innovation at world-class, and I think operators in Japan have noted that, they want to make sure that they get the best available technology. That's the big driver and that's why we're doing well in Japan.

Catharine Trebnick:

All right.

Gregg M. Lampf:

Thanks, Catharine.

Operator:

Our next question comes from the line of Samik Chatterjee from JP Morgan. Your line is open.

Joe Cardoso:

Hi, this is Joe Cardoso on behalf of Samik. Just one question for me, and I just wanted to dive into the subsea business. You guys are seeing great growth there and I'm just curious. Some of the other industry participants in the subsea business have highlighted project delays and I'm just curious why you guys haven't seen those; and then just a second part on that, how sustainable do you think that business is, because it's well known for being very cyclical, so I just want to see if this cycle is any different from prior cycles? That's it.

Gary B. Smith:

I think the difference, Joe, is really that we're positioned with both the upgrade cycle and we've also got the new builds, as well, so we see very diverse sources of demand. I think that it is going through a new build cycle. The upgrade cycle, we basically have elongated, because our technology was able to take old cables and to change the economic dynamics of them, from a capacity point of view, but you are seeing, actually, now new cables going in. I would also say that, and Jim talked about it, we won two consortia cables this last quarter alone. We're also seeing increasingly this is driven by webscale, they're putting in their own cables. They're also key drivers of capacity on other cables. I think the overall demand for capacity is not particularly cyclical, it's up and to the right, as you'd expect. So, I think we're well placed in both the upgrade market and in terms of the new builds. Basically, we think we've come over the 50% market share threshold this year in submarine.

Scott A. McFeely:

Yes, I think a couple of items I'd point out. If you look back in the rearview mirror, say, five years ago, the bandwidth on those cables was dominated, actually, by voice traffic, and today it's actually exposed and the biggest dominant driver of the bandwidth is actually the webscale folks, and we're talking about a significant increase in bandwidth demand, and that's going to, I think, continue for the future. What is happening, as Gary said, is we're seeing a shift from the upgrade market to the new cable market, being led by the webscale folks.

The other thing I'd say, just relative to your comment of some people seeing delays, that may happen on an individual project basis, and if you're a company serving a relatively limited number of cables, you may be susceptible to those delays, but we're on pretty much every major cable on the globe and, back to the diversification of the business, we're less susceptible in any individual quarter to one project delay.

Joe Cardoso:

All right. Thanks, guys.

Gregg M. Lampf:

Thanks, Joe.

Operator:

Our next question comes from the line of Alex Henderson from Needham. Your line is open.

Alex Henderson:

Great, thank you very much. Guys, it seems to me that the current environment is probably the most dynamically changing environment we've seen in a long time. With the acquisition of Coriant by Infinera and knocking out what is clearly the price leader in the marketplace, the most aggressive pricer, plus, obviously, a radical change in Japan where Fujitsu's been pushed out of the U.S. gradually and now has lost position, and the kingpin of Japan, i.e., NTT, it seems pretty clear that there's a major shift going on here in terms of market share as a result of these things. When you look at those dynamics, can you talk a little bit about the rate of change in that? I mean, obviously, getting into Japan, it starts off with smaller projects and then gradually will raise its position, and how fast do you think the roll-off of Fujitsu and Hitachi and other Japanese players, you know, what's the slope of that over time? It seems pretty clear that that's a huge positive dynamic for you.

Gary B. Smith:

Generally, I think we feel very positive around the structure of the industry, you know, improving considerably, I think, over the last few years. I think the key elements for success for us are around global scale and being present in all of these markets, and picking the right markets, as well, at the right time, and putting infrastructure and investments in there. These are long-term bets that we've placed. We've been in Japan over 25 years and we have a lot of resources on the ground, built a lot of relationships over that time. Similarly, places like India, the reason we're doing well, we placed that bet very early on. We've been there over 15 years, we have close to 1,500 people on the ground in India. It's about the combination of technology leadership, which we clearly have, and the largest global salesforce in Optical, and so we're able to take advantage of those dynamics.

In terms of Japan specifically, listen, I'm very bullish on Japan, but things always take longer than you think, and I think we've got a good, long runway there and we're incredibly well positioned with them, I'm very positive about it, but I think it will take time. It's just one of the bets on the table.

Alex Henderson:

If I could just follow-up—

James E. Moylan, Jr.:

In addition to industry structure by consolidation of companies, market share is consolidating, and the winners are getting bigger and the smaller companies are losing share. So, you're really losing in a good direction with respect to consolidation of the industry. As Gary said, all this takes time, but we feel great. We think that the dynamics of the industry are moving toward us.

Alex Henderson:

If I could just follow up with one more question. The Company has a history—or the industry has a history of large players doing large programs and then digesting for a couple of quarters. Typically, the January, February—or the January quarter is a very seasonably soft quarter. You've had a couple of major builds here—in fact, a number of them, whether it's India or in the U.S. around Metro. Should we be careful with our thinking about the lumpiness that that implies and the possibility is there could be a little bit more softness on the other side of that?

Gary B. Smith:

I would say generally, on the industry, I think this perception around big cycles is actually incorrect. There's been very consistent, robust demand for Optical capacity over many years now, and I think that will continue. What you're, I think, talking to is really the seasonality element and you're talking about sort of Q1. Obviously, we're not going to get into—well, we haven't finished this year yet, before we start talking about next year, but I would say, you know, generally speaking, always, Q1 is our lower quarter, because you've got the end of the fiscal year, beginning of the next, and I don't see any reason for that to change, but I think the context of this is consistent, robust demand.

James E. Moylan, Jr.:

You are right, Alex, this is a project-driven business, but the key to showing the kind of consistent execution that we've shown is diversification, and that's across geographies, it's across customer segments, it's across products, and we have demonstrated that, so we expect to continue to deliver consistent performance.

Gregg M. Lampf:

Thanks, Alex.

Alex Henderson:

Thank you.

Operator:

Our last question comes from the long of Tim Savageaux from Northland Securities. Your line is open.

Tim Savageaux:

Good morning, and congrats on the strong quarter. I have a question focused on, I guess, APAC in general and India in particular, and really, kind of similar nature to some of the other questions on the cloud and other markets. You've seen some very strong growth here. I think, in your India revenue this year, by the time it all wraps up, might have tripled over the past couple of years. So, as you look forward there, I wonder if you have any commentary on continued growth, sustainability, market share in the India region and what your expectations are. We've heard about that market, you know, either driving growth or being a potential opportunity for a range of players, kind of large and small. I wonder if you can comment on your thoughts on your overall position in India and to what degree that position is concentrated with various carriers. Thanks.

Gary B. Smith:

Yes, India's got a lot of attention recently. I'd say a couple of things specific to us that are more sort of generic around the market. We've been there for a long time, so we've been on the ground there for over 15 years in a very big way. Let me say I think the dynamics, at the highest level, are that it's the fastest growing Internet usage in the world, you've got broadband penetration still less than 30%, so we've got all this in front of us. I think just the demographics and the population gravity of India, I think will sustain demand for certainly the next few years as these build-outs go. Now, they're going to have ebbs and flows, there's no doubt about that, but I think what we've tried to do is position ourselves. We're in all of the major players in India. We're also with the government in various manifestations, and the DOD. We're also into some regional carriers. We're also in all of the webscale players in India, as well, and they clearly view that as a strategic market, there's no question about that. So, I think we've done everything to diversify our customer base in India, we're very bullish about the sustainability of demand, but we know that there's going to be some ebbs and flows in that, and that's how we've structured our investment there and our anticipation over the next two years. We've got a lot of other areas in Asia-Pacific, as well—Japan is one we just talked about—that will offset any potential ebbs and flows, but we don't see any curtailing of this dynamic in the short term.

Tim Savageaux:

Thanks very much, and congrats once again.

Gregg M. Lampf:

Thanks, Tim.

Operator:

There are no further questions at this time. I will turn the call back over to Gregg Lampf for final remarks.

Gregg M. Lampf:

Thanks, Emily. Thanks, everyone, for your time today. We'll be on the road for the next few weeks and look forward to seeing everybody out on the road. Have a good day.

Operator:

This concludes today's conference call, you may now disconnect.