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CIEN - Q4 2013 Ciena Corporation Earnings Conference Call

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PRESENTATION

Operator

Welcome to the Ciena Corporation fiscal fourth-quarter 2013 and year-end results conference call. My name is Lorraine, and I will be your operator for today's call.

(Operator Instructions)

Please note that this conference is being recorded.

I would now like to turn the call over to Mr. Gregg Lampf. Mr. Lampf, you may begin.

Gregg Lampf - *Ciena Corporation - VP, IR*

Thank you, Lorraine. Good morning, and welcome to Ciena's fourth-quarter 2013 and fiscal year-end review. With me today is Gary Smith, CEO and President; Jim Moylan, CFO; and Tom Mock, Senior Vice President Corporation Communications.

This morning's press release is available on National Business Wire and ciena.com. We've also posted to the investor section of ciena.com an accompanying investor presentation, including certain highlighted items from this quarter being discussed today, as well as our historical results.

In a separate release this morning, we also announced the pending transfer of the listing of Ciena's common stock from NASDAQ to the New York Stock Exchange. We expect to begin trading on the New York Stock Exchange on December 23 under the current ticker, CIEN. We will continue to trade on NASDAQ until the transfer is complete.

In our prepared remarks today, Gary will discuss management's view on the year and the market. And Jim will offer some color on our results, and provide guidance for Q1. 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 will 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 10-Q filing.

Our 10-K is required to be filed with the SEC by January 2, and 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.

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, available on ciena.com.

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

Gary?

Gary Smith - *Ciena Corporation - President & CEO*

Thank you, Gregg. And good morning, everyone, and thanks for joining us today. This morning we reported a fourth-quarter performance that I believe continues our trend of revenue and orders growth, and caps the outstanding year we've had at Ciena. In fiscal 2013, we continued to take share from our competitors, growing annual revenue 14% year over year, while the overall packet and optical market was actually flat. Orders outpaced revenue for the year, and we closed 2013 with record backlog.

In addition to claiming number-one share across numerous markets throughout the year, we won a clean sweep of the industry's mine share by taking the number-one position virtually across the board in Infonetics' recent customer perception research. And all of those gains contributed to our ability to dramatically improve our adjusted operating margin to 6% for the year, tripling our 2012 results, and continuing our steady improvement in operating margin over the past several years.

So, 2013 clearly was a great year for Ciena. But I believe, more importantly, we think our success over the last year serves as a platform for the next phase of growth and sustained long-term profitability for our Company. And that is in large part because 2013 was a critical year in establishing market preference. And I call it a critical year because, as we've discussed in recent quarters, the industry is in an important period of significant architectural change. And while the roll out of new architectures and technologies will occur over a multi-year period, decisions are being made now as to which partners and suppliers will drive this critical period of change for our industry.

As our performance demonstrates, we are winning that battle for customer preference. Preference for both our architectural vision and our unique approach to customer engagement. From an architectural point of view, for all the reasons we've discussed over the last year, networks are shifting towards a fundamentally different architecture that is based on convergence, openness, programmability and automation, capabilities that we are sharply focused on.

From a customer-engagement perspective, our collaborative approach and our suite of professional services are critical to planning and facilitating network transformation that is tailored for each customer, yet another important differentiator for Ciena. Our architectural vision and collaborative engagement, together with industry-leading innovation, come together as pillars of our proven network specialist approach.

As the industry shifts to an open environment that is simpler, less proprietary and more programmable, we believe customers will continue to favor suppliers who are experts in partnering, and with them to execute network transformation to quickly solve problems and to identify new opportunities, in other words, a network specialist. The market's growing preference for Ciena's comprehensive approach as the network specialist is driving our continued ability to outperform the rest of the market. And because this approach is so central to the complete design points of our Business and our mode of operation, we believe that it is not easily replicated.

Our clear competitive differentiation is also evident in the contrast between our financial performance and that of our peers. 2013 was certainly a strong year for Ciena. But looking back a bit further, our relative performance is even more telling, I think, of our progress. Since we closed the Nortel MEN acquisition in mid-2010, not only has our revenue grown substantially faster than our peer group, we've turned an operating loss into a 6% adjusted operating margin, while our competitors' operating margin on average has remained flat.

As we discussed last quarter, our progress is a direct result of very deliberate strategies we've adopted in our Business, including greater emphasis on packets, software, services and more integrated solutions. Because we've expanded our Business beyond optical, we believe that viewing our performance through the historical optical prism is, in fact, no longer valid. And it's not just Ciena that's evolving. Customers are changing fast. They continue to shift CapEx away from legacy networking, and towards converged next-gen solutions, another change that is benefiting Ciena. And as we've said repeatedly, continued success for Ciena is less about absolute customer CapEx, and more about where those CapEx dollars are actually allocated.

I mentioned a moment ago that we believe our growth, our momentum and our financial progress in the last year will set us up nicely for success in 2014 and beyond. Fundamental demand drivers remain strong. More and more customers are choosing the platform, software, services and partners that offer a path to open, programmable networking. And our approach is resonating. So, we believe that we will continue to expand our role and our reach in the industry, as well as our share of customer CapEx, as we drive and lead this era of architectural change.

With those comments, I'll turn the call on over to Jim.

Jim Moylan - *Ciena Corporation - CFO*

Thanks, Gary. Good morning, everyone. I'll cover the highlights of the annual and quarterly results we published earlier today. I'll speak only to non-GAAP results. So, please refer to this morning's press release, which is on our website, for reconciliations to our GAAP results.

First let's look at our performance for the full FY13. The market's preference for Ciena propelled market share gains and industry-leading revenue growth in 2013, leading to our strong financial performance for the year. And it has provided excellent momentum heading into 2014.

For the year, revenue was up 14% over fiscal 2012 to $2.1 billion, while our year-end backlog grew 12% to over $1 billion. We continue to make good progress toward our financial targets, with adjusted operating margin improving significantly to 6% for the full year. And we took action to further improve our balance sheet, and pay down debt. We ended the year with cash and investments totaling $487 million.

We continue to believe that the adoption of our solutions approach, and the increasing diversification of our Business, are good measures of our ongoing progress, as the industry shifts toward more converged, more open and more programmable networking. We made strides in both adoption and diversification in 2013.

Strong adoption of Ciena's solutions was evidenced by our packet networking revenue growing by 73% over 2012, with particular strength in North America. And switching revenue ramped considerably as we closed out the year. In fact, more than three-quarters of our revenue growth in 2013 was driven by packet-switching software or services revenue, all of which are elements of Ciena's architectural and engagement approach. As expected, the earliest adopters have largely been in North America.

We also made good progress on the ongoing diversification of our Business, especially in our newer geographies and vertical markets. Tier 1 wins in Brazil and India will drive future growth for those regions. We are seeing success with content service providers and other non-carrier customers.

And I'm pleased to announce that we entered into a new global relationship with Vodafone, for which we began taking revenue in fiscal 2013. We do expect to expand our footprint with that strategic customer in 2014 and beyond.

Turning to Q4 specifically, our performance in the quarter was a key contributor to the overall financial progress we made to the year. We had another very strong quarter for orders, which were again greater than revenue. Revenue grew to $583 million in Q4, representing an 8% sequential increase, and a 25% increase over Q4 a year ago. Revenue actually came in a bit higher than our guidance range, primarily due to faster-than-expected deployments on one of the large international network builds that we referred to last quarter.

Q4 adjusted gross margin came in at the lower end of our target range at 40.8%, reflecting customer and product mix. Adjusted operating expense in the fourth quarter was $210 million. Higher-than-expected OpEx was the result of strong order flow, which led to increased performance-based variable compensation. We also saw in Q4 some of the R&D expense that was deferred from previous quarters, as we talked about during our last conference call.

With an adjusted operating profit of $28 million, Q4's adjusted operating margin was 5%. As we said earlier, the market preference for Ciena that we firmly established in 2013 serves as a great platform for future growth and operating leverage. As a result of the progress we've made, especially in the form of customer wins and increased backlog, we have improved visibility in our Business today.

So, before I turn to guidance for Q1, I'd like to offer some color on our expectations for the coming year. We expect fiscal 2014 to be another strong revenue year for Ciena. We believe that we will continue to take share, and grow faster than the overall market.

We do expect an increase in operating expense for 2014. We see opportunities to continue to expand our role and reach in the industry. And therefore, we will continue to invest across our Business, including product development, go-to-market resources and business re-engineering.

We believe that the rough quarterly average for OpEx throughout the fiscal year will be approximately $205 million, with some quarterly variation. At the same time, however, we expect that OpEx will grow at a rate that is lower than our revenue growth rate. And we are committed to continuing to drive operating leverage in this manner, just as we have for the last several years.

And with our improved visibility, we now are in a position to discuss our anticipated adjusted operating margin for the full fiscal year. Specifically, for fiscal 2014 we expect to achieve the low end of our current target range of 7% to 10% for adjusted operating margin.

As you know, and as you've seen, our quarterly financial results can fluctuate. And we've often said that we believe that looking at our performance over time provides a more accurate view of the strengths in our Business. So, while progress in each of our quarterly financial metrics won't always be linear quarter to quarter, we are confident that 2014 as a whole will be another solid year for Ciena, one that will show continued improvement in operating profit margin.

I'll now turn to guidance for the fiscal first quarter of 2014. Absent any significant change in exchange rates, our guidance is as follows. For fiscal Q1, a quarter in which we typically experience seasonal reductions in order volume and customer-deployment activity, we expect revenue to be in the range of $515 million to $545 million. We expect Q1 adjusted gross margin to be in the low-40%s, but higher than Q4 of 2013. We expect Q1's adjusted OpEx to be approximately $205 million.

With regard to other income and expense in the first quarter, we project an expense of approximately $11 million related to the interest on our convertible notes. We expect our tax obligation for Q1 will continue to be related solely to foreign taxes. And as for share count, we estimate Q1's basic share count at approximately 104 million total shares. Diluted share count will vary depending upon your assumptions about our profitability.

That concludes our prepared remarks. Lorraine, we'll now open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Mark Sue, RBC Capital Markets.

Mark Sue - *RBC Capital Markets - Analyst*

Gentlemen, my first thoughts on just trying to get a sense of the order trends, because the revenue beat, I understand, because of the one customer. Just trying to see how you're looking at the trend in orders as we move into the new calendar year considering the conservative revenue guidance. Just maybe the trajectory of order trends would be helpful. Thank you.

Jim Moylan - *Ciena Corporation - CFO*

Let me start with that, Mark. And I think Gary will want to comment, as well. We've had a very strong year for orders. We grew our backlog, as we said, to over $1 billion. We expect that we'll continue to show that kind of strong orders in 2014. The level of engagement that we've seen with our customers has never been stronger. We've pointed to and talked about some significant tier 1 wins as we've come through 2013. We expect that those tier 1 wins will result in good order flows. And, as we've talked about, many of these are international. Many of the wins that we've made over, say, 2012 were in North America. And 2013 was a year where we saw good progress internationally. So, we expect good orders for next year.

Gary Smith - *Ciena Corporation - President & CEO*

Mark, the only thing I'd add is I think we're seeing growing momentum around this shift from essentially legacy networks into next-gen. As Jim said in his comments, we've seen that start in North America but we're now seeing that gather momentum outside, as well.

Mark Sue - *RBC Capital Markets - Analyst*

Okay. So, no concern that things will slow down any time as we start the new year?

Jim Moylan - *Ciena Corporation - CFO*

Q1, as we've always said, is a quarter that has holidays and has the first month of the new year. So, it wouldn't surprise me if we did see a bit of lowered orders in Q1 as compared to the last two quarters of 2013. But overall as we look out for the year we expect a strong year.

Gary Smith - *Ciena Corporation - President & CEO*

And I would say, Mark, to maybe what you're getting at there, we're seeing no softness in activity at all. The activity has increased. We're just seeing little seasonal -- because we straddle, really, the end of people's fiscal years where they essentially freeze the network from deployment. And it really steps over two budget cycles. So it's always been a challenging quarter. But even if you look to the midpoint of our guidance I think it's still 15% up from revenues year on year.

Mark Sue - *RBC Capital Markets - Analyst*

Got it. And gentlemen, just a question on OpEx. The concern from investors is the revenues don't always translate to the bottom line. I understand the variable compensation for the salesforce. But is there some thought of adjusting the compensation so it's not just on orders and bookings but also potentially to profit contributions for the Firm as a whole?

Jim Moylan - *Ciena Corporation - CFO*

We do have a mixture of the basis of our sales compensation. We pay on both orders and margin. That's a change that we made a couple years ago. So that I don't think we're going to continue to make any big changes in our comp plan. We do think that it drives the right behavior from our sales force. The fact that our OpEx was higher in Q4 was pretty much the fact that we had a very strong end of the year push from the sales force. And we're glad to see it and we think it's going to result in the kind of revenue that we expect for 2014. One thing I'd say about OpEx is that when you look back over the past few years, we've done, I think, a very good job of holding our OpEx down while investing in those areas that we need to invest in.

We see continued opportunities. We've got some -- we've talked about adoption and diversification and we see more opportunity for that. And we will invest to get those new opportunities. And that's our expectation. We're going to spend in our R&D and as our go to market. And, as well, we are going to continue to invest in our back office to get more efficient. So I feel like we've done a good job. You can expect that we'll continue to do a good job. I think the one thing investors should focus on is operating leverage. And as we've said, we expect to continue to improve our operating leverage over time.

Mark Sue - *RBC Capital Markets - Analyst*

Thank you, gentlemen.

Operator

Simon Leopold, Raymond James.

Georgios Kyriakopoulos - *Raymond James - Analyst*

This is Georgios Kyriakopoulos for Simon. Looking at your geographical mix, international grew nicely this quarter but domestic was down around 4%. And we've seen that revenue from your top two domestic customers was down almost 10% compared to last quarter. Can you discuss the dynamics behind the decline and also prospects from these two clients in 2014? And how much of a factor were they behind the soft guidance for the January quarter? Thank you.

Gary Smith - *Ciena Corporation - President & CEO*

Georgios, I think you're going to see fluctuations between international and domestic. I think we had our strongest ever revenues from international for a lot of the newbuilds that we secured. Domestically, we feel very positive around what's happening in North America, as well. We're getting further penetration into the major carriers into different applications to them. You are going to see some fluctuations for them, I think. We're expecting a very strong 2014 from the major carriers in North America and we have good visibility to that, as well.

And I think, to Q1, I'd reiterate, the midpoint of the guidance for Q1 is actually, I think, above 15%. I think it's closer to 17% above what we did last year. And that takes into account North America, obviously, and international. I expect a very strong showing from the major carriers in North America this year.

Georgios Kyriakopoulos - *Raymond James - Analyst*

Basically, again, as I mentioned, the major carriers down 10% compared to last quarter. They will decline further next quarter based on your guidance. So just wanting to see how you see them trend in 2014.

Gary Smith - *Ciena Corporation - President & CEO*

You are going to see fluctuations. All of the major carriers are customers of Ciena in North America, and large customers. I expect them to expand in most of the major carriers this year. So we will do more business -- said simply, we will do more business with them in 2014 than we did with them in 2013.

Georgios Kyriakopoulos - *Raymond James - Analyst*

Thanks.

Operator

Kent Schofield, Goldman Sachs.

Kent Schofield - *Goldman Sachs - Analyst*

To follow-up on the earlier question around OpEx, as I look at sales and marketing spend in FY11, since FY11, and I look at product revenue growth, sales and marketing spend has modestly outstripped the actual product revenue growth. So, as we think about the mid $200 millions going forward, are there any changes in terms of how we think about that OpEx going forward relative to that product revenue growth line?

Jim Moylan - *Ciena Corporation - CFO*

What I'd say is, we've always said that we would have to continue to add sales resources and sales and marketing expense as we grew our top line. And we've seen that over the past several years. As we look out into the future, though, overall our OpEx, I think, will trend down this year. So, my guess is that you'll see some movement down on that over the next few years on sales comp because we haven't shown the kind of leverage that we thought on that line. I think we will going forward. By the way we look at our sales comp very closely and compare it to others in the industry, and we think that we're very much in line with market practice.

Kent Schofield - *Goldman Sachs - Analyst*

Is there any dynamic with a little bit more international pickup going forward? Does that have an impact that we should be thinking about?

Jim Moylan - *Ciena Corporation - CFO*

I think you've probably already seen whatever impact is there because we have expanded our people, our sales force, internationally. And you're seeing that in the order flow in 2013.

Kent Schofield - *Goldman Sachs - Analyst*

Thank you.

Operator

Vijay Bhagavath, Deutsche Bank.

Vijay Bhagavath - *Deutsche Bank - Analyst*

The question for you is, on your 100-gig product cycle heading into the new year, if you can give us some qualitative color? Here in the US, Europe and rest of world, obviously your 100-gig opportunity water falling through the years.

Tom Mock - *Ciena Corporation - SVP, Corporate Communications*

Hi, Vijay, it's Tom. We see 100G as continuing to be a strong growth area for us. Our converged packet optical segment was up a good bit over last year. We've added additional customers in the fourth quarter and we expect to continue that trend over the course of the year. We're seeing the trend towards 100 gig continue. If we look at Q4 and really across all of 2013 between one-half and two-thirds of our revenue has come from coherent, primarily 40-and 100-gig type applications. And that's up a good bit from 2012. So we expect that to continue. As far as our 6500 product line goes, we expect that we're going to finish on that this year close to $1 billion in revenue, and we expect that to increase next year.

Vijay Bhagavath - *Deutsche Bank - Analyst*

Thank you again.

Operator

Zach Amsel, Evercore.

Mark McKechnie - *Evercore Partners - Analyst*

Actually it's Mark McKechnie calling. I wanted to ask you, on the gross margins, you're talking low 40%s for next quarter but you said they're going to be up. I want to dig into that a bit more. One is, how confident you are that they'd be up. And if you can give us any sense -- I know it's hard to predict -- but on the magnitude. Are we talking (technical difficulty) or up 200 bps? Maybe you can talk a little bit about the puts and takes. And how you see that gross margin trending through the year. You talked about OpEx but talk about the movement on the gross margin throughout the year. Thanks.

Jim Moylan - *Ciena Corporation - CFO*

Okay, Mark, sure. As we've always said, predicting near-term gross margin can be challenging because there are so many things that move in and out of our gross margin in terms of customers and mix and specific products. So, what we can say is that, because we do have a big backlog, we do feel positive about the underlying dynamics as we move through time on gross margin. As we look into Q1, in particular, we know that only a portion of the revenue that we expect to see in Q1 is not already in our backlog. So we have reasonable confidence that -- we have good confidence that it's going to be up, but I couldn't tell you how many bps it's going to be up. I can just tell you that based on what we expect to deliver and recognize in revenue in Q1, it will be up.

As far as the year, that's going to be a function of new wins, how fast they get to revenue, and how that compares to our overall growth. And our backlog, we feel great about the fact that we have such a big backlog. But clearly we don't have a year's worth of backlog here. Things are going to change in our mix. And so we feel, though, that the combination of our backlog, the customer engagements we now have, our success around the globe is going to lead to a good revenue year that will show operating leverage. But how we get there -- we can get there by revenue growth or we can get there by margin expansion. It's going to be some combination of those two things.

Tom Mock - *Ciena Corporation - SVP, Corporate Communications*

One thing I'd add to Jim's comments, Mark, is we've also seen our mix evolve over time and we expect to see that continue. If you look at it Q4 this year versus Q4 last year, the capacity we've shipped on the packet space is up twice what it was, and packet revenue is up 73% year on year. So, those things I think show that the dynamics are headed in the right direction.

Gary Smith - *Ciena Corporation - President & CEO*

Mark, this is Gary. If you look at it year on year, as well, we expanded 2% basically, 190 bps year on year this year. So we showed progress in the right direction.

Mark McKechnie - *Evercore Partners - Analyst*

Okay. That's super helpful on all fronts. If you have another second, you talked about Vodafone in your prepared remarks. And I know you announced the win over there in New Zealand but it sounded like you've got a services agreement. Can you expand a little bit on what's going on with Vodafone and maybe share with us what products and any geographies that --?

Gary Smith - *Ciena Corporation - President & CEO*

Sure. We've announced one or two from an international perspective, obviously, a couple of the countries that we've been with for a little while. But we did actually secure a global strategic partnership agreement with Vodafone in the second part of the year. And that, I think, gives us the opportunity with their expansion plans to help them around their Project Spring. And so it's a much broader relationship now than it was before. I'd describe it as historically it's been small and somewhat tactical based on the individual operating entities.

This agreement is with Vodafone Group. And it is for a global supply partnership across the next generation of architectures that they're rolling out. So, I do believe, over the course of 2014 and beyond, that they will become increasingly a larger customer for Ciena. And in terms of the platform that is converged packet, it includes switching and all of the associated software with that, and also obviously the long-haul capability, as well. And I think that will expand over time.

Mark McKechnie - *Evercore Partners - Analyst*

Thank you.

Operator

Ehud Gelblum, Citi Research.

Stan Kovler - *Citi Research - Analyst*

It's Stan Kovler calling in for Ehud. My question is just about continuation of the OpEx conversation. It seems, based on the guidance that you're giving for the full year, implied guidance, especially in the second half of the year, would actually come down sharply. And if the math is right it could be somewhere below trend even where the first half of fiscal 2013 was. So I just wanted to confirm that we should be thinking about it that way, where OpEx stays in that $205 million range for the first half of the year and drops sharply.

And, again, if you could just provide some color whether that's more on the R&D side that you're going to get the savings, or more on the sales and marketing. Because presumably if the opportunities you have in front of you get bigger, then maybe you can help us understand how that sales and marketing component declines. And just to better understand Vodafone, which is the other part of my question, how the dynamics there are in terms of your gross margin comparison with the international business and the US business. If you can help us with those two margin-related questions.

Jim Moylan - *Ciena Corporation - CFO*

I believe that was more than one question. (laughter). I'm not sure. But I tell you what. I'll speak to the OpEx point. You might have misunderstood what I said or maybe I wasn't clear. What I said was, or what I tried to say was, we believe that for the full year our OpEx is going to average about $205 million a quarter. There will be quarterly variations. Now, it just so happens that Q1 will be, we think, roughly $205 million. But we're going to have some quarterly variations as we move through the year. So, anyway, I just want to clarify that point. The increase is mostly on the product development side, given that we have some really exciting opportunities to continue to expand that we're going to try to take advantage of. So that's what's driving the increase that we're seeing this year. Gary, do you want to --?

Gary Smith - *Ciena Corporation - President & CEO*

Yes, why don't I take the international. Broadly speaking -- I wouldn't obviously talk about a specific customer -- broadly speaking, if you look at international versus North America, generally speaking the margin is slightly lower than North America. That being said, it's very application dependent. And as we are broadening out the portfolio, particularly internationally with packet software, and the convergence particularly, I expect that delta to move around a little. And again very application-dependent with the international expansion.

Jim Moylan - *Ciena Corporation - CFO*

The other thing about the international business is we're in the early stages and we're laying out less than fully loaded networks. And, as we've always said, we have the razor/razor blade phenomenon and we're going to see that as we move through time.

Stan Kovler - *Citi Research - Analyst*

Thanks very much.

Operator

Mike Genovese, MKM Partners.

Mike Genovese - *MKM Partners - Analyst*

My question is more about gross margins. Just given all the puts and takes in gross margins, and given the outlook for the first quarter, do you expect, can gross margins be flat to up for the year? Do you think we could see gross margins getting better in the second half of the fiscal year? Or how do you think gross margins will look on a year-over-year basis?

Jim Moylan - *Ciena Corporation - CFO*

We're not prepared to answer the question specifically about gross margins for 2014 because, as we said, it's going to be challenging to project them, given that we expect to continue to aggressively take share, internationally in particular. And so it's just hard for us to predict what gross margins will be this year. The underlying dynamics in our business, though, over time we think can still get us to the mid-40s that we've been talking about. Now, what has to happen for that is that, number one, the percentage of the new wins that show up in our revenue in both 2013 and 2014 needs to decline as a percent of the total. That doesn't mean that we're not going to continue to win new business. It means that as our revenue grows, the percent that the new international wins represent is going to decline. So that's one thing.

The other thing is that we've shown great progress this year on the packet side. And in Q4, in particular, we had a very strong switching quarter. And we have to increase our mix toward those solution sets that drive stickiness with customers and are toward our architectural approach, and that will over time build margin. So, long term still mid-40%s we think is achievable.

Operator

Rod Hall, JPMorgan.

Ashwin Kesireddy - *JPMorgan - Analyst*

This is Ashwin on behalf of Rod. Got one question on your fiscal 2014 outlook. It will be really interesting to get your view on what market growth could be next year. Also, Gary, going back to one of the comments you made that you are seeing no softness in activity at all, what gives you the confidence? Is it more your salespeople coming back to you and saying everything is good? Or is it a combination of you talking to customers as well as feedback from the salespeople? Also, I want to understand the linearity in the quarter,.

Tom Mock - *Ciena Corporation - SVP, Corporate Communications*

Let me start with the market piece first. For 2014 we expect the markets we participate in, the packet and optical markets, to grow in the low- to mid-single digits. Again, we think the phenomenon you're going to see is that there's going to be strength in areas like WDM that will be offset by weakness in areas like legacy SONET/SDH. If we look at this year, the picture was actually a bit worse. The market was basically flat. But, again, the dynamic was that strong growth in things like WDM and packet were offset by declines in legacy areas like SONET and SDH. So, in terms of market growth we expect 2014 to be a bit better than 2013 but still low- to mid-single digits overall.

Gary Smith - *Ciena Corporation - President & CEO*

If I take our perspective around and our confidence around our activity, it comes from a broad spectrum of things, as you'd expect. It's clearly orders. That's the ultimate piece and we continue to grow our backlog at an excellent order flow in Q4. We also look at things, obviously, like the sales pipeline activity. We look at the general engagement, the amount of activity that we have across the various theaters, and also the amount of contract awards. We might have not got the orders yet but the amount of engagements that we're with. We look at all of those dynamics and across the spectrum and we're seeing very positive dynamics there. And obviously we spend a lot of time with the executives of the major carriers around the world. And I feel very positive around the feedback and activity that I'm seeing.

I think as we look back on the year, really this was the year that we really pivoted from the legacy networks into these next-generation converged networks. And I think you're seeing that in the disparity of performance amongst companies that are more associated with the legacy piece and those that are more associated with the next gen. Led by North America, but as I said I think we're now seeing that in various International markets, as well. So the answer to your question is, across a broad spectrum of engagements with the customers, I think we see a lot of very positive movement.

Tom Mock - *Ciena Corporation - SVP, Corporate Communications*

I would say while we think the market's going to grow in the low- to mid-single digits, we think we're going to grow faster than that. Because, as Gary pointed out, we're exposed to the segments that actually are growing faster and we're less exposed to the segments that are actually declining.

Ashwin Kesireddy - *JPMorgan - Analyst*

Okay. And can you comment on the linearity?

Jim Moylan - *Ciena Corporation - CFO*

The only thing we can say there is -- well, first of all, in first quarter, it is a quarter in which activity tends to decline across our major customers. It's two holiday months and then we have the first month of the year when budgets are being set. We've seen for the last couple of years a reduction from Q4 going into Q1 in revenue. And we expect to see that again, as our guidance would indicate, and orders. So that weakness in no way reflects any general weakness in the market. It's purely seasonal.

As far as linearity going through the year, all we can say there is that we have a business in which we do tend to recognize revenue in fairly large amounts related to big projects or big networks being completed and lit up. And so we do expect quarterly fluctuation as we move through the year. That's why we've always said you should think about us over time, think about us in six-month periods or annual periods. And if you do that, you see the kind of improved performance that I think you're going to continue to see from us.

Ashwin Kesireddy - *JPMorgan - Analyst*

Thanks.

Operator

Scott Thompson, FBR.

Scott Thompson - *FBR Capital Markets & Co. - Analyst*

A two-parter, if I could. First of all, can you comment a little bit on the pricing environment? We're hearing that pricing pressure may be ramping up out there. Are you seeing anything like that?

Gary Smith - *Ciena Corporation - President & CEO*

Scott, this is Gary. I'd describe the pricing environment as no different than I've seen for a while. The overall dynamics of it I would describe it as no real change. I think particularly as the engagement gets to be more cross the next-gen convergence, I think we feel confident of driving our value proposition very strongly through that.

Scott Thompson - *FBR Capital Markets & Co. - Analyst*

Okay. And second part, your OpEx. Again, I know we've made this quite clear, but it came in at $211 million. We guided to the high $190 millions. We've guided 2014 to the mid $205 million or so. Can we assume that this quarter was a little bit seasonally high compared to where these numbers may come in next year? Or is it really just tied to complete order growth outperformance?

Jim Moylan - *Ciena Corporation - CFO*

When you say -- you're talking about Q4 being high, when you asked the question?

Scott Thompson - *FBR Capital Markets & Co. - Analyst*

Yes.

Jim Moylan - *Ciena Corporation - CFO*

Q4 had two elements in it. The biggest single element was the fact that we had a very strong orders quarter, and stronger than we expected. And salespeople hit their accelerators at a more rapid rate than we expected. And so that was the bulk of the increase from the guide that we gave. The guide that we gave did take into account the fact that we did expect some R&D expense that was deferred in earlier quarters to come into Q4. But the $210 million or so, or $211 million, was largely the result of a very strong fourth quarter order flow.

But I just want to make sure that everybody understands that we're going to see quarterly fluctuations in our OpEx. We've talked about the fact that in many of our OpEx areas, particularly R&D but also IT and real estate, we have project-based expenditures. And projects are going to be completed, and expense is going to be recognized, as we complete those projects or spend for the things that we have to have in R&D, like prototypes. So, there will be quarterly fluctuations. It's a bit of a coincidence that Q1 is what we expect for the average of the year. But we're going to see fluctuation as we move through 2014.

Scott Thompson - *FBR Capital Markets & Co. - Analyst*

Okay. So, if they hit the accelerator, if the sales guys hit the accelerators in the fourth quarter that would mean it could come back a little bit. The reason I'm making a point of this, because if the OpEx line would have been in line with your guide, you would have had a meet or maybe even a slight beat on the EPS line.

Jim Moylan - *Ciena Corporation - CFO*

Yes. Absolutely.

Scott Thompson - *FBR Capital Markets & Co. - Analyst*

So, seasonality is important here.

Jim Moylan - *Ciena Corporation - CFO*

You're absolutely correct about that, yes. Without the big sales comp -- and, by the way, we expected some because we always have a good strong fourth quarter orders, but it was stronger than we thought it was going to be. And I think that's good going forward. It so happens that we saw that expense this quarter.

Gary Smith - *Ciena Corporation - President & CEO*

And then, Scott, the other thing that I would add, just to be clear, as well, is that obviously we're into a new year and those sales targets get reset to a higher number to address that dynamic going forward, as well.

Scott Thompson - *FBR Capital Markets & Co. - Analyst*

Okay. Thanks, guys.

Operator

Alex Henderson, Needham.

Alex Henderson - *Needham & Company - Analyst*

Could you just give us the exact what the book-to-bill was in the quarter? I don't think I heard that.

Jim Moylan - *Ciena Corporation - CFO*

No, that's not a number that we disclose. We do talk about, and we've done this for several quarters, the relative relationship between orders and revenue. And it outpaced it for the quarter.

Alex Henderson - *Needham & Company - Analyst*

Okay. And then could you give us the percent coherent that was line card versus chassis in the quarter?

Tom Mock - *Ciena Corporation - SVP, Corporate Communications*

We typically don't give that number specifically, Alex. Since we are still in early stages with a lot of our deployments, we are seeing a higher percentage generally of common equipment than we do of line cards. And that particular effect was in place in the fourth quarter.

Alex Henderson - *Needham & Company - Analyst*

Did it improve at all as a percentage, or no?

Tom Mock - *Ciena Corporation - SVP, Corporate Communications*

No.

Alex Henderson - *Needham & Company - Analyst*

Okay. And then just going back to the international mix, one more question on that. Obviously Cisco made a lot of comments about emerging market weakness. You guys don't really break out between the various international markets. Can you talk a little bit about whether there was any divergence between established international markets and emerging international markets, whether that was a factor in the quarter at all?

Gary Smith - *Ciena Corporation - President & CEO*

I think what we're seeing overall is, in fact -- back to my point around these next-generation networks and adoption, we're actually seeing strong -- if you look at the international markets, we're seeing stronger adoption amongst what you'd call the emerging markets than we are the more traditional markets. For example, compare Continental Europe versus Brazil, India, Middle East, and Russia, we're seeing faster adoption from those countries than we are the more established Western PTT type markets. So, we're actually seeing a different dynamic, I think. And that's not unusual given that we're a very focused player. But we're actually seeing and encouraged by markets like Brazil and India and Russia and the Middle East, where a lot of those markets have the ability to put out a greenfield network. And they don't have some of the legacy challenges that some of the more established markets have. So, we're actually encouraged by what we saw in 2013 and the level of engagement and opportunity in 2014, as well, Alex.

Alex Henderson - *Needham & Company - Analyst*

So, no variance in the numbers? No variance or perturbation to the numbers based on macro swings in those geographies during the last quarter that you could see that was visible.

Gary Smith - *Ciena Corporation - President & CEO*

I think the last quarter is too small a measure, to be honest. But I think if we look at just the last year, markets like Brazil, like India, like the Middle East, like Russia are forming a greater part of our international business. I would say that. And I would see that going forward, yes.

Alex Henderson - *Needham & Company - Analyst*

Great. Thank you.

Jim Moylan - *Ciena Corporation - CFO*

Just to make sure that everybody understands, this razor/razor blades phenomenon that we talk about a lot, it's not just restricted to the transport side. It's both in the transport and the switching side. Just want everybody to understand that point.

Operator

George Notter, Jefferies & Co.

George Notter - *Jefferies & Company - Analyst*

I wanted to ask about dual sourcing. Are you seeing any more incidents of dual sourcing among your customers now that 100 gig is becoming more mature, you've got more vendors in the marketplace? And then, also, is the nature of that dual sourcing changing at all? Historically, I think when it's happened, it's happened where the operators have been dividing up vendors geographically. You said earlier, of course, your business is a razor and blades business. I know there is one instance in North America where a large carrier customer is actually putting two vendors on each route in order to have those vendors bid for the line card upgrades, which is obviously where the profitability is. So, I'm asking, anything new you're seeing in terms of sourcing and the nature of that dual sourcing that's out there? Thanks.

Gary Smith - *Ciena Corporation - President & CEO*

George, I would answer I think we're seeing a very different industry than we've seen through the optical prism of the historical market. Meaning, we're really in a different market. It's a converged market, for the most part, of most of the next-gen architectures. Are there some point-to-point links of long-haul around that, that would still apply? Absolutely, even in these next-gen architectures. But largely we're seeing a very different engagement model with the carriers around the world. I think it's personified, to a large part, one of the most public incidents of that is obviously AT&T with their domain program. But we're seeing that in other carriers, as well, both in North America and outside. So they view this as more of a longer-term partnership. It's more than just cost per bit over per mile. There's a lot more around the architecture than that. And I think you're seeing a narrowing of the vendor base. And I think you're seeing that very clearly.

Now, does that mean that all these major carriers are just going to choose one vendor partner per place? Probably not. Just as a business de-risk, you'd have a couple of partners. But it used to be four or five players in each space. It's not that anymore. It's one, maybe two key players that they would have as partners. We are seeing that dynamic repeated in tier 1 after tier 1 around the world. So I think it's a very different dynamic, to your point, George, than we've seen historically.

George Notter - *Jefferies & Company - Analyst*

Got it. Thank you.

Operator

Dmitry Netis, William Blair.

Dmitry Netis - *William Blair & Company - Analyst*

Three questions packed into one, if that's okay. One is really a clarification. I wanted to understand the split between the 6500 and the packet optical switching. And if I understood what Tom had said, you're approaching about $1 billion on the 6500. If I'm doing the math right, that's $285 million this past quarter. That we'll get you to about $1 billion run rate, which would mean that the packet optical switching is in the $65 million range. Can you guys verify that these numbers sound okay?

Jim Moylan - *Ciena Corporation - CFO*

That's in the range. Yes, that's about right.

Dmitry Netis - *William Blair & Company - Analyst*

Okay, great. And then going forward then, what should the growth rates look like on each of those categories? Do you still expect packet optical switching to outpace the growth of 6500? And then if you take that into your North American customers I would be interested to see how you're thinking about the growth of 2014 as far as the product mix. If you could discuss the long-haul 6500 opportunity versus switching versus maybe some of the metro opportunities that you may see emerging, and give us a sense of how you're thinking about that product split with the major customers in North America.

And the final question is just to touch on China. I was hoping, I don't know if you do play there or if there's an opportunity to play there. There is a major LTE build that is happening there. Will you be able to, once those wrap up, complete and there's a need to densify the backbone, whether that's an opportunity for you?

Gregg Lampf - *Ciena Corporation - VP, IR*

Thanks, Dmitry. We're running up to end the call. We'll start answering the questions, then we'll end it there.

Jim Moylan - *Ciena Corporation - CFO*

Let me start, Dmitry. With respect to the relative growth rates, my feeling about our product lines, other than what we call optical transport, which is our traditional products, we expect growth across our product lines. They are all next gen. They are all a part of our converged architecture. And so we expect growth in all of them. We do believe that the rollout of the OTN functionality is going to increase. We're still pretty early days in that. And so it would not surprise me if over time, over the next few years, that we see a bigger growth rate in our pure switching business than in our

6500 business. But I'd also say that, because we are converging our products, and we have switching embedded in transport products, we have transport embedded in our switching products, it's, frankly, going to get harder and harder to measure the functionality, the actual percent of our revenue, which is in switching and which is in transport, and which is in packet, for that matter. But, generally speaking, we do expect switching functionality revenue to grow over time, as well as packet.

Tom Mock - *Ciena Corporation - SVP, Corporate Communications*

Yes. Historically you've typically seen more of a trend where the capacity gets deployed first and then the ability to manage the capacity comes in later. As those two elements begin to happen in the same network element, you're beginning to see those two types of things get deployed in networks simultaneously. As Jim said, I think we do expect to see good growth in our switching business moving forward. But don't forget that we also do switching as part of our transport products. And one of our key advantages is the fact that we have a large standalone switching platform that can interoperate with switching platforms, smaller switching platforms that are integrated as part of our transport fabric.

Gary Smith - *Ciena Corporation - President & CEO*

And, just lastly, on the China question, we don't actually play in China for reasons that we don't think that's an open and attractive market for us. We also don't have any manufacturing in China either. So, sorry, I can't help you on the dynamics around that market.

Dmitry Netis - *William Blair & Company - Analyst*

Okay. And then just Verizon and AT&T, Gary, how are you thinking as far as 2014 when you make your projections for next year? What does the product mix look like?

Gary Smith - *Ciena Corporation - President & CEO*

Dmitry, let me just answer that very briefly. I've said I wouldn't talk about them specifically but I've said we feel very positive around the North American market and the major carriers. And, frankly, you're looking at the full portfolio there in terms of packet, software, long-haul, metro, all of the converged platforms with most of the major carriers in North America.

Jim Moylan - *Ciena Corporation - CFO*

I just want to make one comment. There been a couple questions about mix and what we expect for mix and gross margin, all those kinds of things. And I hope you can tell from the way we talk about our business that we feel very good about our business, that we do think our mix is going to get richer through time, and that we think that we will see, over time, a movement to our target gross margins and improved operating leverage. As we look into 2014 in particular, we feel really good that we're going to show operating leverage this year, that our operating profit margin will increase. And, as we said, we think we are going to hit the low end of our 7% to 10% current target.

Gregg Lampf - *Ciena Corporation - VP, IR*

Thanks, Jim. And thanks, everybody for joining us today. Don't forget to join us this coming Monday, December 16 when we host at 3:00 PM Eastern a IR chalk talk on the evolving roles of software and openness in network architecture. Everyone, have a happy and safe holiday season.

Operator

Thank you. And thank you, ladies and gentlemen. This concludes today's conference. Thank you for participating. You may now disconnect.