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CIEN - Q4 2014 Ciena Corp Earnings Call

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PRESENTATION

Operator

Welcome to the Ciena Corporation's fiscal fourth quarter and year-end 2014 earnings conference call. My name is Paulette, and I will be your operator for today's call.

At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Please note that this conference is being recorded.

I will now turn the call over to Gregg Lampf, Vice President of Investor Relations. Please go ahead.

Gregg Lampf - *Ciena Corporation - VP of IR*

Thank you, Paulette. Good morning and welcome to Ciena's FY14 fourth quarter and year-end review. With me today is Gary Smith, CEO and President; Jim Moylan, CFO; Steve Alexander, CTO; and Tom Mock, Senior Vice President, Corporate Communications.

This morning's press release is available on National Business Wire and Ciena.com. We'll also post 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 our prepared remarks today, Gary will discuss management's view on the market and Jim will offer some color on our results and provide guidance. We'll then open the call to questions from 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 10-Q filing.

Our 10-K is required to be filed with the SEC by December 31 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 detail 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 - CEO & President*

Thank you, Gregg, and good morning, everyone. As you saw earlier this morning, we posted another record breaking fiscal year at Ciena. In FY14, we made great progress against both our strategic and financial objectives. Most importantly, our progress in FY14 sets us up nicely to continue to grow revenue and increase our profitability in FY15, which we're confident we will do.

We've been designing our business for the last several years based on our expectation of how the market will evolve, and that evolution is coming about. The cloud has hastened the shift towards On Demand networking to the point where the cloud really is the principal driver in network architecture evolution.

The need for On Demand network resources is redefining traditional domains from geographies such as core and metro to a simpler topology that reflects more cloud-centric usage. Connecting users to their data, which we refer to as content to user, and connecting data centers together, which we refer to as content to content. This shift aligns perfectly with our OPN open network architecture which we announced 3 years ago, and which is now facilitating this evolution for our customers.

Going forward, the new architectural model has implications for all kinds of network operators, but especially the two key buyers of networking solutions for the cloud, global Tier 1 service providers and web scale providers, sometimes referred to as Web 2.0. We use the term web scale to describe the community of internet content providers like Amazon, Facebook, Google, and carrier neutral providers of co-location and interconnect functionality for data centers, such as Equinix and DRT.

With regard to service providers, whether they're customers or enterprise, mobile or residential, global Tier 1s are, and will continue to be, the primary owners of the content to user domain. In many cases, global Tier 1s are also providing various types of network resources specifically for the web scale providers. Within the content to content domain, the web scale providers are also critical drivers in this evolving ecosystem, as they are taking a growing role connecting content across data centers.

But most important to Ciena's outlook for 2015 and beyond is that we are uniquely positioned to serve both of these networking domains, and both the service provider and web scale verticals; and our position in each is market leading. Just last month, Infonetics released its Global 2014 Service Provider vendor report in which Ciena was again named the number one optical supplier, as we claimed also the number one spots for packet optical systems, optical transport and switching, and transport SDN and control plane.

Perhaps less understood, however, is our leading position within the web scale market. While we've not named them publicly, Ciena counts as customers leading providers of search, social networking and web services, as well as other emerging network operators, including data center and ethernet exchange operators. In fact, Ovum ranked Ciena number one in global market share for internet content providers and carrier neutral providers. This is based on its data center interconnect market share report which is expected to be released in the coming weeks.

In addition to these direct sales, the web scale community buys enormous amounts of network capacity from Ciena's service provider and submarine customers around the world. When taking this into consideration, this makes our total web scale position even more market leading.

And I think the last point demonstrates why diversification across both these markets is so critical to future success. As the cloud ecosystem develops, the roles of service providers and the web scale community are increasingly interdependent and dynamic. To build the global On Demand environment that the cloud requires, you must be working closely with both global Tier 1 service providers and the major web scale players. Ciena's leading position with both sets of buyers gives us a unique competitive advantage in building out global On Demand network resources for the cloud in 2015 and over the long term.

Clearly, these are critical markets, but they certainly are not the only verticals we are targeting. MSOs, research and education, government and other customer segments also complement our ongoing diversification. MSO revenue, for instance, grew 34% in FY14 year-over-year. And in submarine, we've grown from zero market share just a few years ago to number one in cable upgrades in FY14.

These results demonstrate the benefits of our evolved go-to-market strategy and geographic diversification, and I think provide a long-term foundation from which to continue our international growth. In FY14, international revenues were up 12% versus FY13; and over the course of the year, we developed and significantly expanded our relationship with the largest MSO outside North America, Liberty Global. And FY14 was also our best ever year for our India and Brazilian markets.

Meanwhile, our partnership with Ericsson has already yielded an announced win with Telstra, as well as several other wins yet to be announced, including a Tier 1 provider in Europe. The partnership is now gaining momentum and we continue to expect it will be a key part of our geographic expansion going forward.

When taken together, all of this market progress contributed to our growth in FY14 and has critically helped us build new footprint for future growth and increased customer diversification.

From a portfolio standpoint, FY15 represents a tremendous opportunity to continue to expand our role and our reach, with a broad range of new platforms and solutions either just in market or about to come to market. Our new 8700 Packet Wave further expands our opportunity in metro and data center networking, and we already have nine customers for the platform.

Our recently announced agility matrix and related software solutions position us into the service delivery parts of our customers' business, expanding our solutions for NFV and SDN. We're expanding our lead in optics with full packet integration on 5400, and we'll be delivering new wave logic photonics during the course of the year.

We also plan to introduce new technologies in FY15 that will not only provide first to market advantage, but also significant cost reduction benefits. These benefits, along with changes in our product mix, will help us increase gross margins over time. These investments in both our portfolio and go-to-market strategy will help us expand our role and our reach in FY15 and beyond. We're now in a great position to capitalize on those investments.

Simply put, we are diversifying both our customer base and our solutions and expanding our available market. As a result, we expect FY15 to show continued growth in revenue and increased profitability over FY14. I'll now turn the call over to Jim.

Jim Moylan - *Ciena Corporation - CFO*

Thank you, Gary. Good morning, everyone. FY14 was an excellent year for Ciena and, as Gary said, we now have a solid platform for growth and increased profitability in the years ahead, serving all network providers, from Tier 1 Service Providers to web scale players and everyone in between.

That success has translated into another record year for Ciena in FY14, with financial performance that is significantly improved over last year. Our revenue was $2.3 billion, a 10% increase over FY13.

Fy14 was another demonstration of our ability to consistently raise the bar on our performance. Our adjusted gross margin for the year came in at 42.1%, roughly flat with FY13 and in line with our expectations.

We remain committed to controlling the things that are within our control, and our adjusted operating expense for FY14 reflects that commitment. OpEx for the year was $816 million below the target we set and communicated to you at the beginning of the year. As a result of this performance, we saw increased operating leverage in our business in FY14, with adjusted operating margin coming in at 6.5% for the year. Our adjusted operating profit for the year was $148 million, an increase of 28% over FY13.

We ended the year with $777 million in cash and investments. That includes the proceeds from the term loan facility that we closed last summer. During FY14, our business generated $45 million in cash, excluding the proceeds from the term loan.

As expected, our backlog declined in 2014. We ended the year with backlog of $807 million, and orders for the year were slightly lower than revenue. These results are consistent with the changing profile of our customer base to include more packet and web scale buyers, both of whom require rapid fulfillment. Our business optimization efforts to meet those customers' lead time requirements is allowed us to convert orders to revenue more efficiently and also positioned us nicely for future business with these buyers.

Taking a closer look at the quarter, revenue came in at $591 million. International sales accounted for 48% of revenue, which is higher than it has been for several quarters and reflects our increasing diversification globally.

Adjusted gross margin in Q4 was 38%, at the lower end of our guidance range. As you'll recall, last quarter we discussed a number of variables that had the potential to affect our gross margin in the short term.

The combination of these variables and the degree to which they occurred within Q4 did in fact push down our margin performance during the quarter. As we will discuss in guidance, we are confident that this is a short-term phenomenon and that our gross margin will reflect a return to our more typical low to mid-40s range in the first half of 2015.

Adjusted operating expense in the fourth quarter was $204 million. With an adjusted operating profit of $20 million, Q4's adjusted operating margin was 3.4%.

We had a very strong cash quarter. We generated almost $60 million in cash during Q4. This, coupled with higher inventory turns and lower product lead times, demonstrates the benefits of our greater efficiency in balance sheet management.

Finally, as a result of fluctuations in foreign currency exchange rates, we had a net loss in interest and other income of approximately $11 million, net of hedging effects. This was driven mainly by a significant strengthening of the dollar during the quarter, mainly against Latin American currencies.

I'll now turn to guidance. Last year at this time, our improved visibility and confidence in the business allowed us to provide annual guidance for the first time. We remain confident in our market position, with good visibility into 2015, so I'd like to offer some color on our expectations for the year.

From a revenue standpoint, we believe 2015 will be another strong year for Ciena. We expect to grow revenue between 7% and 9% year-over-year in a market that is forecasted to grow 5% to 7%. This gain in share reflects our multi-year trend of outpacing the growth of the market.

Our customer profile is rapidly shifting and we are diversifying. I'd like to be very clear about this. In 2014, our two largest customers on a combined basis represented 26% of revenue, down from 29% in 2013, yet we continued to outgrow the market. While we believe that these customers will remain important for us and will likely be our two largest customers in 2015, we expect the combination of these two will decline as a percentage revenue of revenue again in 2015. And I'll repeat that we expect to grow overall revenue between 7% and 9% year-over-year.

With respect to OpEx, we continue to tightly manage our expense and we will continue to constrain OpEx to a growth rate that is significantly less than our growth in revenue, as we have for several years. In 2015, we expect that the rough quarterly average for adjusted OpEx throughout the fiscal year will be approximately $210 million, likely with some quarter to quarter variation. That would represent only about a 3% increase over our OpEx in 2014. We expect to further increase profitability and we expect to achieve an adjusted operating margin in the range of 8% to 9% FY15.

And finally, we expect a strong year for cash generation for the business, despite significantly higher capital expenditures due to an upgrade of our company-wide ERP system. Though the first couple of quarters will be light, mainly due to seasonal effects, we expect to generate roughly double the cash from our business in 2015 than we did in 2014. That excludes any repayment of the outstanding notes. This performance will further strengthen our balance sheet.

Looking at our fiscal first quarter, we expect revenue in the range of $540 million to $570 million, reflecting the normal seasonal reductions in order volume and customer deployment activity that we typically experience during this quarter. We expect Q1's adjusted gross margin to be up meaningfully from Q4 and in the low 40s percentage range. We expect adjusted operating expense to be approximately $210 million. And finally, due to the cost of hedging, particularly the Brazilian real, we expect a charge in other expense of $4 million for Q1 and Q2.

Before opening the line for questions, I'd like to just take a moment to discuss our longer term view of the business. We've made tremendous financial progress over the past few years and particularly in 2014, and we are confident that there is more to come. We believe that we can continue to improve our operating profit and operating margin over time.

We've designed our Company to be the leader in creating capacity On Demand and in turning that capacity into capability On Demand. With our programmable platforms and new application software, we will enable On Demand business models for network owners and operators.

We see balanced, diversified growth in the years ahead, with increased contributions from web scale buyers, our new platforms and software solutions, and our Ericsson partnership. With our early success in a rapidly growing On Demand market, together with our investments in our portfolio and our go-to-market, we believe that we have the platform we need to achieve our strategic and financial goals.

We are committed to increasing our operating profit and operating margin in 2015 and beyond. As such, we will measure our progress and report periodically on key metrics, some of which include revenue mix by vertical and geography, customer wins from our Ericsson partnership, and customer engagements on new products, including the 8700 Packet Wave.

Our markets will continue to change and evolve, and Ciena is positioned for sustained revenue growth, higher profitability and substantially increased operating leverage in the coming years. Paulette, we'll now open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from Kent Schofield from Goldman Sachs.

Kent Schofield - *Goldman Sachs - Analyst*

Great; thank you. First question around the gross-margin dynamic: You alluded to this, but just to make clear, as we look into the gross-margin guidance in the January quarter, is a lot of that driven by the fact that a bulk of the discounting and some of those initial builds happened in October, and that's what's driving the majority of the bounce back in January?

Jim Moylan - *Ciena Corporation - CFO*

Yes, absolutely, Kent. As we've said, it's the case in our Business that in new deals, we often give discounts. And that was certainly the case in two cases, or two situations that we talked about in Q4. That happened in Q4. It's behind us, and we'll march forward.

Kent Schofield - *Goldman Sachs - Analyst*

Great; thank you. And then, on the web-scale side of things, some of your supply chain has discussed some lumpiness, especially around the Web 2.0 customers. Have you seen this, as well?

And then, as a follow-up around R&D expense, in the past we've seen where you had customers that have driven R&D expense for specific projects. Do you see a similar dynamic with some of those Web 2.0 customers?

Gary Smith - *Ciena Corporation - CEO & President*

Kent, we've seen a steadily increasing, I would say sort of broad-based engagement with the web-scale folks, both directly and indirectly. And I guess we benefit from that, both in North America and because of our global exposure to them. So, we haven't seen as much of the lumpiness perhaps, given our broad exposure to it. In fact, I think in Q4, one of our -- our second-largest customer by revenue was actually a web-scale company. And looking at the pipeline going forward, we're seeing opportunities, both directly and indirectly, with those web-scale players. And I include in that also the people like Equinix, et cetera, as well.

So, to your question around specific developments, I think they're very aligned with our OPn architecture, particularly in content to content. And I think there's a good fit there; increasingly more software-controlled. So, I think we're extremely well placed around -- they're going in the same direction as we are.

Jim Moylan - *Ciena Corporation - CFO*

Yes, just to add to this, as we said earlier, we have number-one share in that market that we came -- we developed that over the last couple of years. And you haven't seen any significant change in our R&D expense. We have to develop for all of our customers, and we can do that within our business model.

Gregg Lampf - *Ciena Corporation - VP of IR*

Thank you, Kent.

Operator

Our next question comes from Amitabh Passi from UBS.

Tejas Venkatesh - *UBS - Analyst*

Hi, this is [Tejas] on behalf of Amitabh. Thank you for taking my question.

Could you clarify the dynamic at your largest customer? As a percentage of sales, it was down from almost 22% to 12%. I think you said in your prepared remarks that you expect it to be further down. But on a dollar basis, is this the low point, and could it get worse?

Jim Moylan - *Ciena Corporation - CFO*

Yes, what I said in the script is that the two largest customers on a combined basis declined as a percent of revenue in 2014 as compared to 2013, and we expect that to occur in 2015, as well. We didn't really make a comment about the growth in the revenue. What I would say about both of them is that we have a very strong relationship with both. We've been chosen repeatedly for NextGen architectural solutions. We're very pleased that we're a part of Domain 2.0; that's going to be very important for us as we move through time.

And so, I think they're going to continue to be important for customers for us for the long term. And I expect that we'll grow with them over time. But we have other segments that are growing much faster.

Gary Smith - *Ciena Corporation - CEO & President*

The other point that I would make is that we're doing extremely well with both of those customers, but the rest of our Business, frankly, is growing faster. And I think that's a good balance to the overall Business, that our top two customers will be in the early -- combined, in the early-20%s of our total Business. I think that's a healthy thing for us.

And I think we've taken into account all of the industry dynamics that we see, and we have good visibility with both of those top customers, as you'd expect, certainly for 2015. And we've encompassed that completely in our planning and in our guidance.

Tejas Venkatesh - *UBS - Analyst*

Got it. And what contributed to the services gross-margin strength?

Jim Moylan - *Ciena Corporation - CFO*

As we've said in the past, we have a number of different ways that we serve our customers, from deployment to maintenance to advanced services. And each of those individual products have a different margin profile.

The deployment, because it's the least technically involved, tends to have the lowest margin. And so, you're going to get perturbations in our services gross margin. We must have had a low percentage of deployment in the fourth quarter.

Tejas Venkatesh - *UBS - Analyst*

Got it. Thank you.

Operator

Our next question comes from Mark Sue from RBC Capital Markets.

Mark Sue - *RBC Capital Markets - Analyst*

Thank you; good morning. Gary, I want to understand the dynamics in the declining orders. I do recognize the [systemic diversification] and the broadness there. Do web customers -- do their orders go to backlog or are they mostly turns? And also, for Ericsson, for example, does that go to the backlog or is it just drop-shipped?

And then, Jim, a question on price discounts: Price discounts to one customer can often attract the attention of others. It sounds like you're pretty confident that that's behind us. How do you feel in terms of price discounting being contained, for example, and that no subsequent discount and no change in behavior is expanded beyond your couple of customers?

Gary Smith - *Ciena Corporation - CEO & President*

Let me take the first one, Mark. I think what we're seeing is the demands of the different customer sets, but also I think there's an element that cuts across this. And I think the point is that Ciena now has much greater exposure to service creation and service enablement. And I think what we're seeing is a definite shift in our Business of two elements.

One is the mix of customers, generally web scale, enterprise, the diversification into those areas; they require faster deliveries and increased velocity. We recognized this going into the year. We made changes to our inventory management and our supply chain and our ability to reflect that. So, you've seen greater velocity in there. And that's also resulted in the improved cash position, as it flushed out in Q4.

I would also say that the service-creation element, both with the large Tier 1s, web scale and others, is such that it's a success-based spend; therefore, the delivery times required are much faster. And that's also reflected in the dynamics that we're seeing from the backlog, et cetera. So, typically, to give you a real example, we are delivering a lot of those requirements on service creation within three to four weeks; and even less, in some cases.

Jim Moylan - *Ciena Corporation - CFO*

On the gross-margin piece, Mark, what I'd say about that is that, as we said, when we talked about Q4, we had a couple of different things that were going to affect Q4, and they would be relatively short term in nature. And when we look into Q1 and for the rest of 2015, that is proving to be true.

We have a history of sometimes having lower gross margins. In fact, in 2012 we had a quarter or two where we had margins below 40%. That was, again, related to particular projects when we were in an attacking mode. And we did improve our gross margins after that. So, we feel confident, based on what our backlog looks like, what our customer behavior is, that we can get our margins back into the low- to mid-40%s this year.

The other thing that we do constantly is we focus very hard on reducing the cost of our products. That's something that we've done, I think, in an industry-leading way; and that enables us to get our margins back to that low- to mid-40%s.

Mark Sue - *RBC Capital Markets - Analyst*

That's helpful, Jim.

Any way to quantify for investors the work that you're doing for taking the cost of goods lower on an annual basis? I know you've been doing this for many years now, so just how we should think about that?

Jim Moylan - *Ciena Corporation - CFO*

I guess that we've said generally that you see a 10% to 12% decline in pricing and our costs over time, and we've seen that consistently; some years it's higher, and some years it's lower. And our success in driving cost reductions greater than price erosion in the market has been good. I think we've done very well with that.

Gary Smith - *Ciena Corporation - CEO & President*

Sorry, Mark. (multiple speakers) The other thing that I would add is: I think we're in a very different position structurally than we were even a couple of years ago, in that if you think about it from a supply-chain point of view, we're vertically integrated in the key elements that we want to be in.

And secondly, given our diversification of product sets, increasingly more packet- and more software-orientated, we've got the ability, I think, to improve margins there, as we change our solutions. And as Jim said, on the front end of the Business, it's a much more diversified customer base, which, again, gives us the ability to drive margins over time.

Gregg Lampf - *Ciena Corporation - VP of IR*

Thanks, Mark.

Mark Sue - *RBC Capital Markets - Analyst*

That's helpful; thank you.

Gary Smith - *Ciena Corporation - CEO & President*

Thanks, Mark.

Operator

Our next question comes from Dmitry Netis from William Blair.

Dmitry Netis - *William Blair & Company - Analyst*

Yes, thank you, gentlemen, for taking my question. Wanted to go back to the margin issue, actually specific to this quarter. Could you give us a breakdown of different elements that went into this mix? I think you talked about AT&T discounting, you talked about federal and international deals. How much of each of those elements represented in the margin mix, and how much overflow actually do you expect in Q1 related to the AT&T?

Jim Moylan - *Ciena Corporation - CFO*

Dmitry, we haven't quantified the individual effects of the two elements, being the AT&T Domain 2.0 discount, and the international projects. They both hit in the quarter. They were both significant and meaningful. And although there will be some continuation into Q1, we're confident that we're going to get into the low-40%s in Q1. The effect of both of those two will be substantially less than it was in Q4.

Dmitry Netis - *William Blair & Company - Analyst*

Okay, thank you. And then the second question, if I may, again, going to the backlog, I think Mark asked this question, but wanted to get some visibility. I think the backlog, you said, was $807 million, if I captured that correctly. And then, I think you said orders were slightly lower than revenue. Could you compare and contrast what it was in the prior quarter, maybe six months ago, just to give us sort of a reference point?

Gary Smith - *Ciena Corporation - CEO & President*

I think the reference point is, overall for the year -- and we predicted this, based on the -- the point I'd make is the structural change to our Business and our customer base, down about $150 million to $200 million. We thought that was, as we turned the year, higher than we would have liked it to be, quite frankly. We wanted to turn some of that to revenue, number one, addressing some of the required delivery intervals.

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So, we've worked very hard at beginning of the year to implement changes to our supply chain to reflect the changes in our customer base, principally, as I said, Dmitry, about driven by the service creation. We're much closer now to the creation of services and enablement, and less on pure infrastructure. Therefore, the delivery time scales are that much greater. And I'm pleased with what we've been able to do during the course of the year, and I think that's reflected in our ability to be able to grow the Business significantly, and operate with a lower backlog.

Dmitry Netis - *William Blair & Company - Analyst*

Great, thank you very much.

Gregg Lampf - *Ciena Corporation - VP of IR*

Operator, next question, please. Thank you.

Operator

And our next question comes from Paul Silverstein from Cowen and Company.

Paul Silverstein - *Cowen and Company - Analyst*

Thank you. First off, Jim, can you give us the customer counts on 100 gig and optical switching, as well as the 4100?

Jim Moylan - *Ciena Corporation - CFO*

I would ask Tom to do that, Paul.

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

Yes, Paul, for the quarter, we ended up with -- we shipped during the quarter to 72 customers on 100G. Let me just pull up my numbers here for the summary. So, overall, we had 199 customers today on -- on total 40 and 100G; total of 146 on 100G, total of 143 on 40G. And that represents 12 new customers for 100G in the quarter, and one new customer for 40G in the quarter.

One of the things that also is related to that is we also did a significant amount of business in switching as part of that transport. That's continuing to be an important part of that segment for us.

Paul Silverstein - *Cowen and Company - Analyst*

And, Tom, I'm sorry, the 72 number was for what?

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

The 72 was for how many we shipped to in this quarter, in Q4.

Paul Silverstein - *Cowen and Company - Analyst*

Got it. And the optical switch count was what?

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

The optical switch count was 40 customers for 5400 today. And that's showing that we basically have now essentially achieved the same number of customers that we achieved over the 10-year lifecycle of Core Director. (multiple speakers) Go ahead, Paul.

Paul Silverstein - *Cowen and Company - Analyst*

A couple quick questions, if I may. Jim, I apologize, going back to AT&T, but my simple question is: Given the commentary from last quarter -- and I recognize you're limited in what you can say -- but given the commentary from last quarter, as you look forward, how much have you been impacted by AT&T's revised CapEx guidance, to the extent you could share that with us? To what extent do you expect the snapback that you discussed last quarter, in terms relative to the meaningful discount you gave in the October quarter, and in the, I guess to some extent, the discount you're giving in January? What, beyond that phenomena, especially with respect to the CapEx trends? And then, I've got one other quick question. Sorry. (multiple speakers)

Jim Moylan - *Ciena Corporation - CFO*

Say, Paul, on AT&T, the way we described the effect in Q4 is that it represents a pretty significant sort of concentration of discounts into Q4. We have a price list going forward. We've absolutely baked that price list into our internal planning and into our public guidance. And so, the guidance that we've given reflects everything that we know about AT&T.

I'd also say that they're an important customer to us. We have a very large sales team which interfaces with them on a daily basis. We're very close to what they are going to do in this coming year. And so, based on what they've told us, we have baked everything that we know about that customer into our guidance, including what we know about what they've said.

And we know that they have a lot of effects that pressures on their business model; all of our customers do. But we believe that we've factored all of that into the guidance that we've given. As we said, our two largest customers combined will go down as a percent of revenue in 2015. But we'll make that up through a bunch of other customers, including some new customers that we have.

Paul Silverstein - *Cowen and Company - Analyst*

All right. Guys, basic math, if I did the math correctly, your comments about FY15 would imply, if I took the midpoint, 8.5% growth -- the 8.5% operating margin -- that would imply that you're looking at gross margin somewhere in the range of 42.5%. My question to you is: The 34% OpEx-to-revenue ratio implied by that guidance, and the 42.5% gross margin implied by the guidance, what's the risks and what's the opportunity relative to those numbers? 34% is lower than you've ever done on an annual basis, in terms of OpEx to revenue. And again, what's the risk and opportunity in both numbers?

Jim Moylan - *Ciena Corporation - CFO*

I'll answer the easiest part first, Paul. We're planning our OpEx for the year. And we have consistently, over the past four or five years, hit our OpEx plan. Yes, we've had quarterly variation in our OpEx. But on an annual basis, we've hit our plan. So, I don't -- of course, there's some risk on that, but not a lot of risk on that.

With respect to all the other numbers that you have quoted, we've given a range for each of these numbers. And my feeling is that we've given a range which encompasses the highest probability of events that are going to occur. Not all of these events are within our control. So, of course, there's a possibility of variation. But we feel good about it, and we've done pretty much, over the past several years, what we said we were going to do.

Paul Silverstein - *Cowen and Company - Analyst*

(multiple speakers) Thank you.

Gregg Lampf - *Ciena Corporation - VP of IR*

Thanks, Paul.

Operator

And our next question comes from Ehud Gelblum from Citigroup.

Ehud Gelblum - *Citigroup - Analyst*

Hey, guys. Appreciate it; thank you. So, a couple questions: First of all, want to talk a little bit about international. How did -- obviously, your international mix went up a little bit by subtraction with AT&T going down. But it sounded like international itself was doing decently. Can you give us an update on Vodafone and how that business has flowed out?

And then you talked about the Tier 1 win in Europe through Ericsson that you haven't announced yet. Does that fall into 2015 numbers, or is that something as part of your 7% to 9% that you're anticipating for next year, or is that something that goes afterwards into 2016? And then I've got some other questions, too. Thanks.

Gary Smith - *Ciena Corporation - CEO & President*

I think on the international overall, our revenues for the year were up about 12%. I think maybe 50% of our revenues in Q4 came from outside the US. So, we're seeing good opportunities of expansion there.

And specifically in Europe -- you mentioned Vodafone. We've got a strong base there now. We talked about Liberty Global, as well, which is the largest cable company outside of North America. We're expanding that relationship -- [Kelly Esenera]. So, Europe, for us, I think, over the course of the next 18 months to two years, we're seeing some positive opportunities for us.

Outside of Europe, we're just about to turn up India's largest 4G network. In fact, it's the first 4G network. We've talked about expansion in Brazil, which is going very well. Specifically to Ericsson, we've announced Telstra. We've got a new Tier 1, as well, in Europe and others; and that pipeline's growing.

So, I think the work that we've done over the last few years, and really investing in go-to-market and investing, frankly, in the start-up of some of these large networks, I think will yield the benefits of this diversification over the next couple of years.

Ehud Gelblum - *Citigroup - Analyst*

Right. Does that Tier 1 in Europe that you just mentioned, does that fall into 2015 as part of your 7% to 9%?

Gary Smith - *Ciena Corporation - CEO & President*

Yes, I believe we will take revenue in 2015 for that win.

Ehud Gelblum - *Citigroup - Analyst*

That's helpful. Doing some of the same math that Paul did before, the gross margin comes out to implied for next year as 42%, 43% to get into that range. That's basically flat with this year -- you did 42% -- conceptually speaking, could have been a little bit higher if Q4 hadn't been as low as it was. So, essentially, looking at two years of 42%, 43% gross margin. Is that the ongoing gross margin going forward, one, Jim?

And then two, you just made some comments on OpEx. But if we go -- I'm looking three to five years out -- are we looking at this gross margin three to five years out, and are we looking at the same OpEx growth, 3%, 4% or so. So, both gross margin and OpEx, as you look out multiple years.

Gary Smith - *Ciena Corporation - CEO & President*

Ehud, let me take the first part of that, in terms of margin. And I understand the math around the guidance. I would say that is not our long-term goal. Our long-term goals is certainly into the mid-40%s consistently. We've had quarters where we -- I mean, Q3 of last year, we hit 44%. And we said at the time, we don't think it's sustainable because of the mix, but we've proven that we can do that.

As we increasingly diversify the Business with more software, more packets, closer to service creation, and into SDN and NFV -- so, our agility announcement earlier on this month -- those are the things that are going to drive gross-margin expansion into the mid-40%s. And we think, over the next few years, we will absolutely achieve that, and as that flows through to the financials.

So, I'd just really encourage folks to think about: This is not business as usual. This is business as usual, plus the shift into this new opportunity that the cloud is driving and the solutions that we're putting out there.

Jim?

Jim Moylan - *Ciena Corporation - CFO*

And on OpEx, we're not going to give a specific number on OpEx growth for the next several years. But I think if you look over the past four years, what we've shown is that we can grow revenue faster than our OpEx, and we will continue to do that. We are absolutely committed to growing our operating profit and increasing our operating margin, and we've done it now for four years in a row. I see no reason why we won't continue to do it going forward.

Ehud Gelblum - *Citigroup - Analyst*

Yes, you guys have been very good at that.

One last thing: We talked about that web-scale guidance seems to be a very big part of the story now. Can you give us a sense as to how large they are as a percent? I think I may have asked you this last quarter, too. And I think last quarter the answer was somewhere around 5% or so, if I remember correctly. How large are they? And did you mention that your number-two customer was a web-scale guy; I can't put those two comments together.

Gary Smith - *Ciena Corporation - CEO & President*

Yes, we did. In fact, in Web Scale 2.0, the second-largest customer in Q4 was a Web Scale 2.0 customer. That actually would be top 10 for the year, as well. So, we're seeing steady growth -- (multiple speakers)

Ehud Gelblum - *Citigroup - Analyst*

How large is the category?

Gary Smith - *Ciena Corporation - CEO & President*

That category -- well, we have number-one market share in that space, as just announced by Ovum, and -- (multiple speakers)

Ehud Gelblum - *Citigroup - Analyst*

But as a percent of your revenue?

Gary Smith - *Ciena Corporation - CEO & President*

As a percentage of our revenue, directly it's about 5% to 10% of our total revenue. And that's just taking into account the direct relationship that we have with them.

The other point that I would stress, Ehud, is we have a lot of other engagements directly and partnering with them into service providers around the world where we also take business. I've not included that in that statistic.

Ehud Gelblum - *Citigroup - Analyst*

So, you have a number-two guy that's presumably 5%, 6% of revenue, I'm guessing. And so, the majority of your Web 2.0 revenue, this 5% to 10%, is this one guy?

Gary Smith - *Ciena Corporation - CEO & President*

No, that's just a snapshot at one quarter. We directly -- we have direct relationships with a number of these web-scale players. And it ebbs and flows by the quarter, but it's an increasing amount of capacity.

And in fact, I'll give you another statistic which might help you. About a third of our 100-gig port shipments in Q4 were deployed by Web 2.0 providers, or web-scale players.

Ehud Gelblum - *Citigroup - Analyst*

Okay, that's very helpful. Thank you.

Gary Smith - *Ciena Corporation - CEO & President*

Thanks, Ehud.

Operator

Our next question comes from Brian Modoff from Deutsche Bank.

Brian Modoff - *Deutsche Bank - Analyst*

Yes, guys, just following along Ehud's question there. So, last three quarters, non-telco were 20%, then 25%, then 30% of your revenues. What were they in this quarter as a percent of your revenues?

And then second question is around Verizon. They've got 100-gig buildout planned in the back half of the year from metro. How do you feel positioned about that project? Thank you.

Gary Smith - *Ciena Corporation - CEO & President*

So, the first answer, it was about, Q4, approximately 30% of non-telco revenue, if you will, in Q4.

Brian Modoff - *Deutsche Bank - Analyst*

So, essentially flat from the last quarter as a percent of revenue?

Gary Smith - *Ciena Corporation - CEO & President*

It was a little bit higher than that. It was probably in the early-30%s. I think it was about 32%, 33%. So, it was up a little bit in Q4.

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

In fact, if we look overall, Brian, at our 100G port shipments, like Gary was talking about with the web-scale guys a moment ago, about half of those went to non-traditional telcos in the quarter, or non-traditional telco customers.

Brian Modoff - *Deutsche Bank - Analyst*

Okay.

Gary Smith - *Ciena Corporation - CEO & President*

In terms of Verizon, obviously don't want to talk too much around specific customer. And we think we're well positioned. But obviously, that won't -- even if successful, that won't contribute to 2015 revenues.

Brian Modoff - *Deutsche Bank - Analyst*

Okay. Thank you.

Gary Smith - *Ciena Corporation - CEO & President*

Thank you.

Gregg Lampf - *Ciena Corporation - VP of IR*

Thank you.

Operator

Our next question comes from Jeff Kvaal from Northland.

Jeff Kvaal - *Northland Securities - Analyst*

Thank you, gentlemen. I have a couple. I think one is: Could you talk a little bit about the dynamics of the gross margin recovering before the revenues start recovering? Typically, we see those things marching in somewhat lock step.

And then secondly -- Jim, maybe this one is for you -- you've mentioned towards the end of your prepared remarks that you're expecting significant leverage over time. I would imagine that is on top of the 7% to 9% operating margin that you told us about for 2015. If there's anything more that you could share there, I'd appreciate it.

Gary Smith - *Ciena Corporation - CEO & President*

Jeff, why don't I take the first part of it. The gross-margin function is purely around this sort of mix and the disproportionate impact that we had in Q4. We're kind of back to normal services being resumed, is another way of putting it. And we don't need volumes to do that. It's all about mix.

Our revenues are up on this time last year, but Q1 is always a challenging quarter from a revenue point of view, because of our particular fiscal year where we -- which encompasses the end of the calendar year and the beginning of the next calendar year. It's always challenging, from a telco point of view. But notwithstanding that, we're seeing strong pipeline and demand, and we're also predicting to be up on Q1 last year.

Jim?

Jim Moylan - *Ciena Corporation - CFO*

And on the longer-term picture, Jeff, we didn't give a number beyond 2015. We think 8% to 9% is a strong improvement from 2014. That's where we expect to be.

We put out a few years ago that our target was 10% to 12%, and we still think that we can get there. I think we're going to have to get a little bit of help on gross margin to get to that range, which we expect to happen over the next few years.

Jeff Kvaal - *Northland Securities - Analyst*

Great. And then, maybe just one last to slip in is: People have been asking about web scale. What mix of the 8700 customers are web scale versus traditional telcos versus MSOs? That might help.

Gary Smith - *Ciena Corporation - CEO & President*

I think we've only just released the platform, so it's very early days. And we've seen a mix on that. We've seen cable companies to it. We've seen a couple of Web 2.0 directly into it. If I look at the engagement, though, it's certainly across the board. I mean, it really is a packet.

Steve, do you want to -- ?

Steve Alexander - *Ciena Corporation - CTO*

Sure. The 8700 really anticipates the transition to the edge of the network going from gig E speeds up to 10 gig E speeds and above. And that applies to the web scale; it applies to the Tier 1s. It's a platform that's intended to play into a very diverse set of markets and, again, really relies on additional capacity showing up from the edge of the network right through to the core.

Jeff Kvaal - *Northland Securities - Analyst*

Thank you, gentlemen.

Jim Moylan - *Ciena Corporation - CFO*

Thanks, Jeff.

Operator

Our next question comes from Rod Hall from JPMorgan.

Rod Hall - *JPMorgan - Analyst*

Yes, hi, guys. Thanks. I just had a couple of questions related to the 2015 revenue guidance, and also maybe the new products. So, the 7% to 9% revenue growth that you guys are talking about, within that, what proportion of that revenue do you think is going to be web scale next year, if you're 5% or maybe a little higher this year? Exiting this year, what do you think 2015 looks like as a proportion of web scale?

And then, you talked, I think, Gary, in your comments, you said that you guys are reducing cost on products. I assume there's some new products in the pipeline next year that are far lower in cost to produce for you guys, that keep those gross margins where you expect them to be. I wonder -- I'm sure you shared that road map with the web-scale guys. I think that's probably a product you're deploying at AT&T, as well.

Can you talk a little bit about what the reaction to that has been from the web-scale guys? Do you think that those kinds of products, whatever they are, end up giving you a lot more traction with web scale? And then, I've got maybe one more question. Thanks.

Jim Moylan - *Ciena Corporation - CFO*

Yes. On the growth rate, we're not going to give a specific number for them next year, because things are going to move around. But they have been our most rapidly growing segment. And if you look at our internal plan, they will be our most rapidly growing vertical in 2015. They're still, overall, on a direct sale basis, less than 10% of the market. So, although we're gaining share, we're number-one market share in that space, we don't expect to see them getting to a big double-digit number in the near term.

But I'd also say a couple -- well, the other things, the other pieces that will grow for us are Ericsson, the new platforms, including the 8700, international, and particularly the metro. Those are the places where we'll be growing. Also submarine -- we'll be growing there.

So, what I'd emphasize, though, with respect to web scale is that, although direct sales are important, and we have top share, they buy a lot of capacity from our traditional customers. In order to serve that market, you need to be in both places. And we've actually done extremely well. Our solutions actually are being spec'd, in some cases, by web-scale customers for use in our service providers. So, it's really great progress there. We're going to grow most rapidly with them going forward.

Steve Alexander - *Ciena Corporation - CTO*

Sure. And with regards to the new products and such -- and I'll cue off of some of the comments that Jim just made -- I think it's important to appreciate, as the cloud and the web continues to expand, it absolutely impacts what we would call the content-to-content space, which I think frequently is what you've termed the web scale. But it also impacts the user-to-content space, which is very much a place where Tier 1 service providers play and offer service connections.

Just as an example, if you are watching high-definition streaming video, the content-to-content piece you would typically think as being in the web scale, but your connection from your phone, your house, your device to that content, that user-to-content piece is, in most cases, provided by a carrier. So, in order to address web scale, it is critically important to be providing capacity solutions all the way out to the edge of the network, as well as interconnecting data centers in the content-to-content space. And the way that we have designed our portfolio under the open, OPn, architecture is intended to do just that.

So, the products that we're bringing to market will continue to enhance capacity; so, higher capacity, more programmability, software-defined capabilities, as well as a very rich suite of network function virtualization products, which again moves the service providers as well as the web-scale folks from having to ship physical boxes to establish a service, to being able to distribute software to do the exact same thing, establish a service and offer additional value connections.

So, we're quite confident, the way that we have designed the portfolio, it's going to meet the needs of web scale, whether it is the user-to-content piece, again, often provided from a carrier, Tier 1 service provider, or from the content-to-content piece, which, today, I think is what you're typically thinking as being the Web 2.0, or what we would call web-scale folks. You really have to be in both to address the market.

Gregg Lampf - *Ciena Corporation - VP of IR*

Thanks, Rod. We're going to take one last person for questions.

Operator

And our last question comes from Alex Henderson from Needham & Company.

Alex Henderson - *Needham & Company - Analyst*

I'm getting the closer role two times in a row. And I'd like to ask the same basic question I asked last time, except this time with a little bit different spin on it. So, last time we talked about the AT&T transaction, you'd implied that you were taking a bunch of upfront pain in order to get further revenue generation from them as a result of winning new contract areas, such as the metro core, the cloud to cloud, and the other pieces of the puzzle that you weren't really participating in as much in the past, particularly the long-haul backbone. And it looks like you fell off quite sharply relative to what we would have expected here, and you're suggesting that overall your AT&T and Verizon businesses are going to go down.

So, I guess what I'm asking here is: To what extent did you actually increase your revenues by giving them this big discount? Have you, in fact, built a substantial bigger business with AT&T as a result of winning those additional two to three segments of their end market? Is that a 2015 event, or is that something that really takes all the way out into 2016 before it metastasizes? I'm trying to figure out, why did you give away such a big discount, if your business with AT&T seems to be not doing much?

Gary Smith - *Ciena Corporation - CEO & President*

Alex, I certainly wouldn't describe our business with AT&T as not doing much. They're a substantial customer, and they will be going forward. I think it's inappropriate for us to get into a lot of specific detail around that.

But let me give you a view, I think where -- I understand the issues around the economics, but I think the real opportunity and the whole driver of Domain 2.0 was to provide better economics, but really change the architecture to be an SDN-type, NFV-type architecture, which aligns completely with our OPn, open, vision. And we're excited by the opportunity for a major carrier to adopt that kind of architecture. And we want to make sure that we're aligned around that, and I really think we are.

So, we think we've got great opportunities within AT&T and this architecture that they're driving. That's a multi-year program. We're well positioned in multiple parts of their network. And over the course of the next one to five years, we actually think we can grow our Business there, because we're now into different parts of the business. And as we get to more software orientation around service creation, the revenues might not be as great over time, but the gross margin opportunity will, because it's predominantly software.

Steve, do you have any other architectural -- ?

Steve Alexander - *Ciena Corporation - CTO*

Well, so, I think, as Gary noted, right, I think it's critically important to remember the Domain 2.0 program was a vision -- an architectural vision for them to migrate away from the standard way people built networks for the last couple decades, SONET/SDH rings on top of rings, and all the rest. They have a clear vision. They want to move towards a software-defined infrastructure. To Gary's point, it aligns very well with what we've done with open, OPn, and that gives us a chance to play in a much broader, much more diversified manner inside of that opportunity.

We expect that the open architecture will be featured in a lot of what we do going forward. Many customers have moved towards a more SDN-based architecture, and are expecting to be able to reduce costs of operating the network from SDN, as well as through the network function virtualization that also features now with agility matrix.

So, again, we believe we're very well positioned for the architectures of the future. And, yes, there was a price of admission to get there. And this is all about the future.

Jim Moylan - *Ciena Corporation - CFO*

Just to be clear, Alex, just so no one misunderstands our comments. What we said was that our two top customers will decline as a percent of revenue in 2015, as they have for the last couple of years.

It's not intended to imply that they're not going to be important customers for us. We think -- we suspect that those two customers will be our two biggest customers, and that we will grow with them over time. But it's a statement of diversification. And we think that's a good thing. So, that's what the comment was. It was combined. We didn't make a comment about either one of them individually, just to be clear.

Alex Henderson - *Needham & Company - Analyst*

Great. Thank you very much.

Gary Smith - *Ciena Corporation - CEO & President*

Thank you, Alex.

Gregg Lampf - *Ciena Corporation - VP of IR*

We will conclude the call. Thank you very much for taking the time. We look forward to connecting with everybody shortly.