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Ciena Corporation

Fiscal Second Quarter 2022 Earnings Conference Call

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Gary Smith, *President and Chief Executive Officer*

James Moylan, *Senior Vice President and Chief Financial Officer*

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George Notter, *Jefferies & Co.*

Fahad Najam, *Loop Capital*

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David Vogt, *UBS*

Rod Hall, *Goldman Sachs*

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PRESENTATION

Operator

At this time, I would like to welcome everyone to the Ciena Fiscal Second Quarter 2022 Earnings Conference Call.

After the speakers' remarks there will be a question-and-answer session.

Thank you. Gregg Lampf, Vice President, Investor Relations, you may begin your conference.

Gregg Lampf

Thank you, Rob. Good morning and welcome to Ciena's 2022 Fiscal Second Quarter Results Conference Call.

On the call today is Gary Smith, President and CEO, and Jim Moylan, CFO. Scott McFeely, our Senior Vice President of Global Products and Services is also with us for Q&A.

In addition to this call and the press release, we have posted to the Investor section of our website and accompanying investor presentation that reflects this discussion, as well as certain highlighted items from the quarter. Our comments today speak to our recent Q2 performance, our view on the current demand environment and supply chain conditions, as well as a discussion of our financial outlook. Today's discussion includes certain adjusted or non-GAAP measures of Ciena's results of operations. A detailed reconciliation of these non-GAAP measures to our GAAP results is included in today's press release.

Before turning the call over to Gary, I'll remind you that during this call we'll be making certain forward-looking statements. Such statements, including our quarterly and annual guidance, discussion of market opportunities, and commentary about the impact of COVID-19 and supply chain constraints on our business and results are based on current expectations, forecasts and assumptions regarding the Company and its markets, which include risks and uncertainties that could cause actual results to differ materially from the statements discussed today. These statements should be viewed in the context of the risk factors detailed in our most recent 10-K filing and our upcoming 10-Q filing, which is required to be filed with the SEC by June 8 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.

As always, we'll allow for as much Q&A as possible today, but we do ask that you limit yourselves to one question and one follow up question.

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

Gary Smith

Thanks Gregg and good morning, everyone. This morning we reported largely in line financial results. When considering there's really a strong achievement against a backdrop of an increasingly challenging supply environment. This included revenue of $949 million, reflecting year-over-year growth of 14% as we continued to take share and grow faster than the overall market.

Building off an historic first quarter order flows, our order flow in the second quarter remained very strong with a book to bill ratio well in excess of 1.5. As a result, we continue to grow our backlog. In fact, with continued strength in orders in recent periods, we have seen significant expansion in our backlog since the end of Fiscal 2021. From about $2.2 billion to more than $4 billion exiting Q2.

We are clearly seeing a number of positive demand trends at a secular level that we believe are very durable over the long term. With our leading innovation, scale, customer relationships, and investment capacity, we will continue to capture market share. Ironically, this significant growth in demand for our technology has exacerbated the impact of ongoing global supply chain challenges on our business. In fact, Q2 really presented the most volatile set of supply chain conditions to date, which in fact worsened as we moved through the quarter.

To put it simply, demand continues to significantly exceed supply and availability of supply is the most impactful factor in our performance and rate of revenue growth at this time. Within this context, we continue to execute well in Q2 and navigate these challenges through supply chain mitigation strategies. As a result, we delivered more product in Q2 than we did in the same quarter last year, including some notable highlights that illustrate our innovation leadership and the diversified business that we built.

To start with, non telco revenue in Q2 was approximately 44% or up 15% year-over-year. This included direct web scale revenue of 22%, an increase of 7% year-over-year, primarily for our Wave server platform. Our top 10 customers in the quarter included four web scalers, and we made our first product shipments to a new, large web scale customer in the U.S. We now have the top six global web scale companies as customers of WaveLogic 5 Extreme in different stages in the (inaudible) of deployment.

Overall, in the quarter, we added 16 new customers for WaveLogic 5E, bringing our total to 172. Q2 was a record quarter for shipments of WaveLogic 5E, up 50% year-over-year and more than double that of last quarter. To date, we've shipped more than 35,000 WaveLogic 5E modems to customers globally.

In routing and switching our business is growing, driven by tier one service providers, as well as tier two, three customers for our expanded routing and pond capabilities. Quarterly revenue there was up 27% sequentially and more than 70% year-over-year, including the strong contribution from the recently added Vyatta platform. Finally, platform software and services revenue was up 22% from this time last year.

Looking at the overall demand environment, the shifts in business and consumer behavior have accelerated positive trends for our business, including cloud adoption, a greater focus on the network edge, which is really greater capacity closer to the customer, and the need of course, for increased automation. These are strong and durable, long term secular drivers for the industry, creating an incredible demand environment for our business going forward. In optical specifically, we are experiencing significant growth in our large install base of customers around the globe, fueled by exploding bandwidth requirements.

Adding to this positive dynamic is continued incremental opportunity to displace Huawei in many countries, particularly in Europe, as well as increasing public investments in network infrastructure. In routing and switching, we continued to secure new design wins around the world, primarily associated with growth in wireless and accelerated cloud adoption, again at the edge of the network. We continued to expand our addressable market in this space as we invest in new technologies and solutions to address additional use cases, such as residential broadband.

In Blue Planet, demand continues for automation that enables differentiated digital services for a fully connected experience. 5G, we believe, will continue to fuel the need for OSS modernization, as new, innovative services require end-to-end service life cycle automation. These demand dynamics are present in our order book today and we expect continued demand to address these network requirements will result in a growing backlog as we move through the second half of the year.

This level of demand far outpaces, frankly our expectations for orders in the year, driving a backlog that reflects strong underlying secular demand. As a result, we have tremendous confidence in our forward growth opportunities. Now, with that said, I want to be extremely clear. In this environment, our revenue is not a function of demand, or even production capacity for that matter. It is purely a matter of component supply availability.

That of course, brings me to supply chain. As we all know, we remain in a very constrained supply environment, particularly with respect to semiconductors and integrated circuits. I think it's important to remember that these particular parts are relevant to multiple industries, from telecom, to consumer electronics, to automotive and others, which only serves to exacerbate this global supply challenge. Of course, we continue to employ a range of supply mitigation strategies that we've previously discussed, including placement of large, advanced purchase commitments for critical components in short supply with extended lead times, and qualifying engineering alternatives to expand our sources of supply. However, as I mentioned earlier, supply chain conditions appreciably worsened as we moved through Q2.

Specifically, we saw a significant increase in both the volume and magnitude of supplier decommits that we weren't able to fully mitigate in two areas that are critical to our business. Firstly, a number of key optical subcomponent suppliers, as they themselves have publicly noted, have been unable to fulfill their supply commitments due to constrained access to semiconductors. Second, we've seen additional supply decommits for a number of integrated circuit suppliers, centered really on low value, commoditized parts that are essential to the operation of our finished products.

This second dynamic has been largely related to the COVID lockdowns in China. While we have, by design, a very low overall supply chain exposure to China, our revenue is being effected given that China is effectively the primary source of many of these low value, commoditized parts that are essential to the production of IC and semis. On both of these issues, there simply aren't enough parts to go around and satisfy demand across a number of industries and market segments.

Just to reiterate, these dynamics do not represent a Ciena specific challenge. Rather, this is an industry wide global challenge. Despite the willingness of network operators to spend, we expect that the length and severity of current supply conditions will impact both overall industry growth rates and of course, our own revenue growth. That said, when our industry begins to see improvements in supply dynamics, our scale, investments, customer relationships and strong balance sheet puts us in the best possible position to service industry demand.

With that, I'll turn over to Jim for more detail on Q2 and to discuss our guidance. Jim.

James Moylan

Thank you, Gary. Good morning, everyone. We delivered Q2 revenue of $949 million, in line with our guidance. Adjusted gross margin in the quarter was 43%, also in line with our guidance, and consistent with our expectation for a revenue mix that includes a larger proportion of lower margin common equipment, but also reflects significantly higher component costs, and also higher logistics expense. We expect these dynamics to continue as we move through the remainder of this year.

Adjusted operating expense in Q2 was $301 million. It is important to point out that while our results were in line with guidance, this achievement was a significant task in the current environment and required outstanding execution across a number of functions inside Ciena.

Moving to profitability measures, we delivered adjusted operating margin of 11.3%, adjusted net income of $76 million, and adjusted EPS of $0.50.

In addition, in Q2, cash from operations was $106 million, free cash flow was $86 million, and Adjusted EBITDA was $129 million. We ended the quarter with approximately $1.6 billion in cash and investments.

Also, in Q2, we repurchased approximately 1.5 million shares for $87 million and received 900,000 shares of common stock, pursuant to the final settlement of the accelerated share repurchase program, which we implemented earlier in the year. We continue to expect to repurchase approximately $250 million of shares in Fiscal 2022, in addition to the ASR.

Turning to guidance. Overall, industry supply chain conditions make providing guidance extremely challenging at this time. Conditions were more difficult in Q2 than in previous quarters, mainly because of the higher number of decommits from our supply base, caused both by semiconductor availability and China lockdowns. Demand drivers are very robust but as Gary said, in this environment our revenue is not a function of demand. It is purely a matter of component supply availability.

Also, with the current state of the supply chain and the resulting greater uncertainty, there is a wider range of potential outcomes in the coming quarters than has been the case. As always though, we are providing our best perspective today about our expected performance in Q3 and for the fiscal year. Importantly, this view assumes that our component suppliers deliver on their most recent commitments and that we don't encounter any substantial new decommits that we cannot successfully mitigate.

With that, in Q3 we expect to deliver revenue in a range of $870 million to $930 million. This lower range for expected revenue is entirely driven by conditions in our supply chain. We expect gross margin for Q3 in the low 40s percentage range, which reflects a continuation of the same dynamics that we saw in the second quarter. A higher percentage of revenue from line systems and common equipment, again coupled with greater than expected component costs and higher logistics expense. Finally, we expect OpEx of $305 million to $310 million.

With respect to the full fiscal year, we are adjusting our expectations for exactly the same reasons and with the same assumptions. We now expect to deliver annual revenue growth in Fiscal 2022 in the mid-single digits. Gross margin for the fiscal year we expect to be in the low 40s percentages. Our operating expense will be roughly consistent with an average of $300 million per quarter for the full year, perhaps a little bit higher in Q4, mostly due to compensation expense. Finally, operating margin in the low double digits.

Generally speaking, the growing consensus view in the industry is that supply chain conditions will take at least several more quarters to return to a normalized state. Given the persistence and unpredictability of these challenges to date, we believe that is a reasonable assumption at this time. But it is entirely possible that this timeline will continue to change. It is an incredibly dynamic situation. Furthermore, it is critical to remember that there will not be a light switch moment. That is, a single moment in time when conditions improve and the flow of supply returns to normalized levels. Any recovery, when it begins, will be gradual and will occur over time.

In summary, we're mindful of the variability of outcomes the supply challenges present in the near term but we are prepared to benefit when a meaningful and sustained recovery in supply dynamics occurs. Importantly, we are extremely positive about the durability of the underlying secular drivers, which continue to drive a significant and growing backlog that reflects not only a strong demand environment, but also our continued market leadership.

Combined with our relationships with customers and suppliers, and the mitigation steps we are taking to address current challenges, we are very well positioned for long term growth and success.

With that, we'll now take questions from sell side analysts. Rob?

Operator

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

Paul Silverstein

Thanks for taking the questions. Jim, Gary, can you all discuss what linearity looked like in the quarter, and perhaps even more importantly, what has been—what have bookings looked like over the past four weeks leading up to today? Then I've got—and Jim, related to that, what would guidance be for July and for the October fiscal year, but for the supply chain impacts? How much revenue was impacted? What was the gross margin impact? Thanks.

James Moylan

Yes, with respect to linearity, as has always been the case, we are back end loaded. Typically, it's because of the timing of our orders, but in this case, it has to do with the delivery of components to our contract manufacturers. We've had a very nonlinear flow of orders. They've been strong, really, the entire year and not necessarily in the last month of the quarter, even though it's strong in the last month of the quarter, it's not as back end loaded on the order side. But on the supply side, it has been back end loaded and therefore our revenue has been back end loaded.

Gary Smith

Paul, the other thing I would add in terms of the linearity of orders, as Jim said, it's been pretty consistent. Q2 was over 1.5 ratio to revenue, and we expect to continue to build backlog for the second half of the year as well. We are seeing very consistent demand, which is really driven by just the increase in traffic and the adoption of cloud at both the consumer and enterprise level on a global basis. Initially, there was a little bit of catch up and then there's some forward ordering, but it's not that much. We've only got—in '23, you know, requested we've only got a few hundred million. Most folks would take everything we've got right now. That's why we talk to these very sustainable order flow demand.

James Moylan

To your specific question about what our guide would have been, it's a number that is almost beyond the pale, Paul, because we've got backlog of over $4 billion. As Gary said, only a few hundred million of that is true 2023 demand. All the rest of it is asked for by the customers in this year. Our revenue for this year would have been extremely high if we were able to get the components to manufacture it.

Now, I don't think people should take that as the, if you just run the numbers in and figure out what our revenue could be this year, you shouldn't take that as our run rate. This is a catch up. It's the fact that they're all trying to get ahead of everybody else with their orders, but it does speak to the strength of demand and what we think is very durable demand.

Paul Silverstein

Jim, just to be clear, you all, I don't think you provided the backlog number last quarter. It was $2.17 billion coming out of October. What was the backlog increase in April? Just to be perfectly clear and with respect to my question about linearity in order strength, the forward indicators you're looking at, order growth, and all the other leading indicators that speak to future demand, there has been no attenuation, at least—I mean, obviously there's been some concern, widespread concern about a macro slow down translating into slow economic activity for virtually everybody, yourself included. You're arguing that's not what's going on. This is purely supply driven. But again, my question to you is, looking at demand trends, looking at all the different forward indicators, you're not seeing any attenuation in strength?

Gary Smith

No, we're not Paul. I mean, and you know, the rough, rounded numbers we came out of the year at over $2 billion. We came out of last quarter with over $3 billion. We came out of this quarter with over $4 billion, and you know, everything that we're seeing in forecasts with our customers tells us that it might not continue at that pace but we're going to continue to grow backlog with the order flow.

The other thing I'd say about macroeconomics, you know, whilst no industry is immune from that, I do think that cloud adoption has proven to be incredibly resilient in the ups and downs of various economic moves. I think it's sort of fundamental, you know, to how the world works now around getting greater bandwidth closer to the customer. We're not seeing any signs of that letting up at all. In fact, the opposite.

If you look at web scale, they're planning to build more and more datacenters, again closer to the customers around the world and we are obviously in partnership with them about their long-term planning. We're not seeing any slow down on that whatsoever.

Paul Silverstein

My follow up, just to be clear, you can't see it in the numbers because of the supply chain situation but the strength you're referencing, that was broad based geographically across five markets, across…

Gary Smith

Yes.

James Moylan

Yes, absolutely, verticals, regions, products. Particular strength on our routing and switching business, which as you know, that's a focus for us.

Paul Silverstein

I appreciate it. Thanks guys.

James Moylan

Thanks Paul.

Gary Smith

Thanks Paul.

Operator

Your next question comes from the line of Amit Daryanani from Evercore ISI. Your line is open.

Amit Daryanani

Yes, good morning. Thanks for taking my question. I have a few as well. Are you seeing, also maybe, simplistic, I think, (inaudible) the backlog has ramped up from $2.2 billion to $4 billion in the last four quarters, over the last year? How should we think about how much of this is really just demand is stronger and it's a massive build up of backlog versus customers that are placing longer duration orders, maybe because they want to get supply. But (inaudible) way of thinking about yes, the backlog is ran up, how much of that is due to duration going extended by your customers versus all the supply chain issues you've talked about?

Gary Smith

Okay, yes. That's a good question, Amit. Let me give you sort of a datapoint here that I think will help with that. I think you've got a confluence of sort of three things going on. You've got a little bit of cash up. That certainly was the case sort of probably 12 months ago, where carriers were very conservative during COVID, both from an operational perspective and from a fiscal perspective. They were playing a bit of catch up. That's largely flowed out.

Then we are seeing a little bit of certain customers looking to get security of supply and they're giving us more visibility longer into the cycle. That's absolutely happening. But you know, an interesting data point around is it real traffic that they're trying to buy for and address or is it just security of supply chain?

Of the $4 billion plus, in hardware we've only got a few hundred million that is requested for '23. All the rest of it is requested for '22. Now, that's not going to happen, clearly, for all the reasons that we've just talked about, but it does give you, I think, a great insight into the fact that there's not that much forward ordering in that backlog. This is real demand that folks want.

James Moylan

Just another clarifying couple of points here. Our backlog is definitely a double-edged sword here. It's great to have the demand. It's great that the orders are placed on us as compared to our competitors, but part of the reason that we have such a big backlog is because our lead times are longer than we'd like them to be and we're not making our customers delighted, as we like to do.

The fact is that when we get new orders, which we've had a ton of this year, most of them are being scheduled out into the latter part of this year, in some cases into 2023. Like Gary said, it's not really 2023 demand but that's when we can deliver it. It's, as we say, it's a double-edged sword but glad we have the orders. But we'd like to delight our customers.

Amit Daryanani

Fair enough and that's really helpful. I guess, just my follow up would be in the past when you've had a revenue, you know, challenge or headwind, gross margin have typically done really well. It's been a mix of new projects versus existing ones. Is this (inaudible) seen the revenue headwind, but we aren't seeing a gross margin offset or tailwind, so maybe just talk about why aren't we seeing that tailwind as the margins historically lower revenues has meant better gross margins for the company. Why is that not happening this time around?

Gary Smith

Amit, I'll take the first part of that and then maybe Jim or Scott can talk to the actual sort of increase in cost. The first part of it is really mix. Amit, what we're seeing is remember, we've won a lot of new global strategic carriers and web scale build outs that we're now deploying. A lot of that is really think commons and line systems, which tends to be lower margin. Just the general mix on the business, given the size of it, even though routing and switching is doing well, and software is doing well, it really, the large part of the mix is around those line systems right now.

Now, it bodes extremely well for the future because then we can put in cards and modems which tend to be a higher gross margin. You've got a different mix, really based on the demand that we're seeing. A lot of it is new builds that were both with new customers and with existing folks.

James Moylan

Yes and just to put some numbers on it, Amit, remember the last time we talked about what we believed to be our long-term gross margin or run rate gross margin, I should say, is around mid-40%s. We said 44% to 46%. I'm going to shorthand it at 45%. When we went into COVID, there was a smaller percentage of new builds because of the difficulty of getting supplies and people out to locations, and so we had a higher percentage of capacity adds, which are higher in gross margin, so we enjoyed that.

But we said as we ended this year that we thought that our gross margin this year was going to be 43% to 46% overall because we did expect a higher proportion of new builds and commons and photons, which are inherently lower margin. That was our expectation coming into this year. Now, what's happened is we are seeing that. But we're also seeing significantly higher premiums that we're paying to get parts. We're trying our best to supply our customers, even if it costs us money and gross margin, which it is, and also higher logistics costs.

The rough math for the effect on this year's gross margin of those two latter points, meaning premiums and logistics costs is roughly 400 basis points. You can think of it that way. You can do math and get to where you think our gross margin might be without these. We are reasonably confident that we're going to get back to those mid 40%s at least, as we come out of this supply chain situation, but we can't give you a prediction as to when it's going to occur.

Gregg Lampf

Thanks Amit. Appreciate the question.

Amit Daryanani

Thank you.

Operator

Your next question comes from the line of Tim Long from Barclay's. Your line is open.

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

George Notter

Hi guys. Thanks very much. I guess I wanted to ask about purchase commitments. I think you said in the monolog that one of your mitigating initiatives was to ramp up purchase commitments. Can you tell us what that purchase commitment number was? I think if I recall correctly when you printed the 10-K, that number was about $430 million. Just curious if that number is up.

James Moylan

Yes, that's up quite significantly, George. It's up to about $1.8 billion today. We've essentially laid out to our supply chain at least the next 18 months of what we see as demand. If they deliver on that, we're going to do very well.

George Notter

Got it. Okay, and then the other thing I wanted to ask about was your inventories started to inflect I think just a couple of quarters ago. Look, obviously this supply chain environment has been around for a couple of years and so purchase commitments are just inflecting now. Inventories are just inflecting in the last quarter or two. I guess I'm wondering if like this is more an execution issue at Ciena, or do you think by in large you guys have executed as well as anybody else?

Gary Smith

Look, let me take the first part of that, George and maybe Scott can talk to the inventory a little more precisely. I mean, listen, I think that to date we've navigated it extremely well. I mean, you look at the performance. We shipped more in the second half than we did in the first—in the first half than we did in the previous year. Revenues are up 14% in the quarter, so I think the numbers talk to themselves, particularly when compared to the competition.

We're a much larger install base. We're a much larger business with larger market share but we're still growing the business and shipping more. It's not where we want to be or where we could be if we had supply, so I think generally, we're navigating through better than anybody else. But it's not, you know, it isn't where we want to be from a, as Jim said, from a customer satisfaction point of view.

Scott McFeely

George, just to speak a little bit to the inventory position, a couple of dynamics there that are all built in conscious decisions, and it really relates back to Jim's comment of we're not pleased with the way we're servicing our customers. We are making investments in component inventory where we can get our hands on it in preparation for the last remaining items that come in, in order for us to turn it into finished goods so that we can do that very quickly for our customers when they become available.

We've also complemented that with manufacturing capacity expansion. So again, we can turn components into finished goods as fast as possible for our customers, so it's a conscious decision. If you look inside that inventory number, you'll see more of it has shifted actually to the component level versus the finished goods level as well and you can see that dynamic happening.

James Moylan

Just to the point of purchase commitments, George, if you read the statement in how we describe it, we talk about noncancellable purchase commitments. If you think about—and there are certain procedures that we have to go through in order to cancel. But our actual total purchase commitments, even a year ago were much higher than the $400 million that we disclosed because we considered that a lot of it was cancellable.

Today, given the demand situation, we sort of viewed that essentially all, perhaps not all, essentially all of our forward purchase commitments as noncancellable because we're not going to cancel them. We need the stuff. If you could see inside that logic, you would have a different view of what our purchase commitment, our total purchase commitments were even a year ago. They would have been a lot higher.

Gary Smith

The other thing I'd add to that, George, is that I'll just remind everybody, that's raw component cost. There's no transformation on that. That doesn't include the inventory that we've got on spec. If you add all of that lot together, you know, we basically have provided commitments out to our supply chain for key elements for the next 18 months.

George Notter

As I think about the kind of manufacturing side of this, I know for example going back to OFC, we were talking to some of your customers. I know lead times were more than a year. Where are lead times now and do you think there's some potential for you guys to lose share now that we're hitting again, longer and longer lead times and it's frustrating for customers?

Scott McFeely

Yes, lead times, George, are 100% a function of the component availability. It's not a function of our manufacturing capacity. I want to point that out and the numbers you sort of quoted as kind of in the range of where we're sitting today from the lead time perspective. I mean, the curve on that, again, goes back to when the ability of the component supply industry starts to show better performance. Do you want to talk to the durability of the demand and the orders?

Gary Smith

Yes, I mean, I think in terms of the competitive environment, our market share, let's look at a couple of data points here. Our market share in the first half we think increased 1% during all of this.

James Moylan

And that's revenue. That's not.

Gary Smith

That's absolute revenue. Yes, that's not shipments. I mean, we shipped actually more than that but that's excluding China. We grew 1%. The other two datapoints is our revenue grew more than the competition in the first half, so we're shipping more and we're a much bigger company than a lot of those folks in optical share.

Then the other testament to it is the order flow. I don't think anybody is seeing the kind of order validation from the customers, knowing what our lead times are and we're still increasing our backlog. We've been very transparent with our customers but remember, our products are highly differentiated. We have by far the best technology and relationships with these customers. I think global scale and balance sheet and those relationships are absolutely critical to coming through this with a winning hand. That's what we're focused on.

James Moylan

Just as importantly, all of our competitors are looking at the same supply chain conditions that we are. It's unlikely that anybody is looking at wildly different lead times than what we're able to provide.

George Notter

Thank you.

Gary Smith

Thanks George.

Operator

Your next question comes from the line of Fahad Najam from Loop Capital. Your line is open. Again, your next question comes from Fahad Najam from Loop Capital. Your line is open.

Fahad Najam

Good morning. Gary, if I look at your backlog commentary and the qualification you provided and across your competitors, the cynical New Yorker in me says, you know, the (inaudible) market hasn't been growing this fast. Broadband speeds in my home haven't really changed much in the last, since the COVID pandemic started. Where is all of the current demand coming from? Or, is it just a pure function of customers double ordering, not solo ordering but double ordering in order to secure more supplies? What do you say to that?

Gary Smith

I say to that we're not seeing that. You know, there may be some minimal amount of that, but you know, given the fact that this is not commodity stuff, you can't swap and change around it and the relationships we have with our customers, I think that is not a dynamic that we're seeing. What's driving this is real bandwidth growth.

When you think about what's happened during the pandemic, people are using more bandwidth, but carriers weren't spending, and this market was kind of flat for about two years. We expected an uptick, which we began to see, you know, about 18 months ago. I think the demand from the customers has continued to increase from the consumers of this, both the consumers and the enterprise space.

What we're seeing is just an uptick in cloud adoption, both at a personal level and at a global enterprise level. It's about getting bandwidth much faster, closer to the customer in their various forms. That's why we're seeing an uptick across all of the sectors: submarine, datacenter interconnect, metro edge. All of the engagements that we have are all about, how do we get more capacity, more efficiently out to there.

This is not embedded in some false security of supply demand piece. Absolutely not. This is about real demand of traffic and for all the reasons that I think we can all understand, and we see in our daily lives.

James Moylan

One thing I'll say though, Fahad, is this. That for a long, long time this industry has grown at low to mid-single digits overall and we've grown at sort of 8%. Our last guide for three years said we do expect the industry to continue to grow at historic rates and we expect to grow at 6% to 8%. None of that has changed, in our view. The world continues to act as it has been acting. We're not saying that this kind of order flow is going to continue for the long term. We think that order flow will be good. It's not going to be at the higher levels that we're seeing this year.

I don't want you to think that we're calling up our growth rate. I would say this. I think given what we think our backlog will be at the end of this year and assuming that our suppliers deliver on their commitments to us, we'll have a growth rated revenue next year that's well above the 6% to 8% that we've seen in the past. I can't give you a number on that but it's going to be good. But again, our long-term view of the future of the industry grows at 3% to 5% and we're going to grow in that world of 6% to 8%. That's what we think today.

Fahad Najam

My follow up is kind of a piggyback on George's question on the extending lead times of the supply chain shortages. To what extent are these forcing your customers to change architects and maybe ship or tailor to more plausible (inaudible) plausible into an existing router. You don't have to ship a new power system or power supply, etc. Do you think there's a risk of customers adopting plausible (inaudible) because they still need the bandwidth?

Scott McFeely

No, not at all. In fact, I think ironically the dynamic may be the opposite because in order to take advantage of those pluggables, you actually have to upgrade your entire switching and routing infrastructure to a 400-gig infrastructure. That is constrained by the supply chain as well.

Fahad Najam

Appreciate the effort. Thank you.

Gregg Lampf

Thanks Fahad.

Operator

Your next question comes from the line of Tim Long from Barclay's. Your line is open.

Tim Long

Thank you. Sorry about that before. Two questions if I could. First, let's just beat a dead horse and then a second one. Jim, or Jim and Gary, you know, last guidance implied no decommits and when we look at the Q4 to get to the full year, it looks like a pretty big sequential increase. Probably something like 20%. I'm not sure exactly what mid-single digits for the year means. Why would we assume that the (inaudible) everything gets delivered as expected? What visibility do we have that the supply chain is going to live up to the commitments they have when that hasn't happened over the last multiple months here? That's number one.

Then number two, I was hoping you could just dig more into the switching routing part of the business. Obviously, you've added Vyatta. If you could just talk about how much that helped the numbers. You talked about expanding TAM and use cases, so if you could just, Gary, maybe give us a little color on how you see the trajectory of that business potentially moving over the next few years here. Thanks.

James Moylan

Jim, I'll take the first part and what we've always tried to do and what we continue to do today is we're trying to give you, give the world, a set of numbers that are reasonable and reflect our view of what the world looks like today. We expect that there will be some decommits. I will say this. That we had decommits in Q2 which we were largely able to mitigate and therefore, we came in line with our revenue.

Hopefully, we've built in enough, you know, sort of margin for error that we can handle some decommits. But again, it's our best view of the future and yes, it's if you look at the entire year, we're roughly $250 million or so below what we have said about the year in the past. Roughly half of that is because of the fact that our optical subcomponent vendors are unable to get parts. The other half is because of the channel lockdowns. It's not precisely 50% but roughly half and half.

Scott McFeely

Then to your question about breaking down a little bit the dynamics that are going on in the routing and switching business update. I'll say this just to repeat the business itself was up 27% sequentially, quarter-on-quarter and about 70% year-on-year. That's a combination of organic growth and inorganic growth of Vyatta. I'd say roughly split half and half roughly, between the two.

But what's driving that, the primary use cases for that portfolio that we're focused on are all centered around the evolution of the metro and the edge. We see growing interest in our wireless transport infrastructure as people build out fiber to the tower and look at architectures moving to 5G. Enterprise connect, as Gary talked about enterprise connecting to the cloud. A new space for us around residential access, getting a lot of interest in the architecture there and then backing off from that and bringing all three of those use cases back deeper into the network, a common routing and switching aggregation platform.

Those are the four areas that we're investing in. We think it represents a significant TAM expansion over the years for us, and the early signs, as you can see, and the results year-over-year we're having some really good early success there.

Tim Long

Thank you.

Gregg Lampf

Thank you.

Operator

Your next question comes from the line of David Vogt from UBS. Your line is open.

David Vogt

Great. Good morning and thanks for taking my question. I just wanted to come back, and my line cut out earlier. I just wanted to come back to the lack of supply, specifically ICs (phon). I guess it's our understanding that this is a fairly well-known headwind and I guess I'm just curious. How do you square that commentary that the book to bill and backlog are strong, but I would imagine your customers are incredibly sophisticated? They know there are shortages of ICs. Is there risk that they've already adjusted their order cadence a little bit earlier and so that raises some risk that there could be an air pocket later? Maybe not this year but into 2023?

Then I didn't hear any discussion of maybe what a recession might look like next year if we do move into a more slower growth GDP environment, what that would look like for not only your order growth and your backlog but what your customers might respond to. Then I have a follow up on the numbers being pushed out into next year.

Gary Smith

David, let me take the recession one first and then I'll take Scott for the first part of your question. You know, I think we're obviously mindful of the macro sort of economic challenges that it looks like the world is going to go through. But I would say a couple of things. In our conversations with all of our customer base in its diversity, you know, we are not seeing any let up in their forecasts in demand and they're long-term plans. I mean, we've got pretty good visibility into the next one to three years around the overall dynamics of what they're seeing to do.

You know listen, I think the industry is never immune to a recession, but it's generally performed extremely well during the recession because people need access to the network. Network operators and web scale are going to continue to invest in their network and getting more traffic out there. I think we feel very good around the durability of the demand that we're seeing. In terms of fulfilling what we've got, I think what we're trying to do right now is just really catch up with the backlog and the pent-up demand.

I mean, as Jim said, I don't think we're going to see order flows at the rate that we're seeing them right now or this year, but I don't think it's going to fall off a cliff or go through an air pocket either. I think you've seen a change in the dynamic around this is really an infrastructure business and I think people are getting used to ordering out longer term. I think you will see that. These lead times will get better over time for sure, but I think you will see greater long-term visibility with our customers.

James Moylan

Remember that we're advertising and talking to our customers about longer lead times. It's absolutely imperative that they then place longer duration orders on us than has been the case in the past because they do need the gear. We're not, as we said, we're not claiming that this rate of order intake is sustainable. But we are, we do strongly believe that demand for our products and services will continue to grow, and we'll continue to take market share.

David Vogt

Great, maybe just as a quick follow up. That's helpful. Your given lead times, at last appear to be persistently long and not tightening here in the near term. How would you handicap sort of that $250 million revenue shortfall, the likelihood of being able to capture that next year given where lead times are and where commits are at this point and your purchase order commitments?

Right, so I mean obviously it's a difficult visibility to predict, but you mentioned that you'll obviously think you'll grow faster than 6% to 8% next year. But is the expectation based on your order book and where your supply chain is today that you'd be able to capture most if not all of that next year?

James Moylan

Well, I mean, if you just look at the delivery dates, it probably would be in next year's but all we can say about next year today really is that given where we think our backlog will be at the end of this year, we do expect to have a significantly higher growth rate in 2023 than the 6% to 8% we promised in the past. I can't give you an exact number because I don't know the number, but I think it's going to be a great year next year.

Gary Smith

I would just add that I think sort of—and again, we're not talking about '23 right now, but our sort of view is what's got to happen is we've got to get greater predictability from the supply chain, and we've got to get the volumes that supply chain have committed for '23. We're not really banking on improved lead times from our suppliers.

Gregg Lampf

Thank you, David.

Operator

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

Rod Hall

Yes, thanks guys. Appreciate it. I just had five more questions on supplies, and I wondered if you could (multiple speakers).

Gary Smith

Just five?

James Moylan

We've got five more answers for you, Rod

Rod Hall

No, I wanted to dig into the verticals a little bit. I'm just looking at the cable number was kind of, usually that's easily up in April and it kind of flatlined. I don't know if that's supply oriented, so I just wondered if maybe you could talk a little bit about the demand dynamics there. Then likewise, government is up a lot. I mean, that was a big number in April. Just curious if you guys could dig into those vertical demand dynamics a little bit. How much is effected by the supply? How much of this is demand? Just curious what's happening there. Thanks.

Gary Smith

Yes, Rod, I would say the cable piece is purely supply. I mean, we're seeing very, very strong demand out of that and it could have been a lot greater if we'd have had, I hate to use the S word again, supply. I don't think there's anything to that. Government, there was a couple of larger projects, look, that we delivered in the quarter. You get a lot of ebbs and flows on the government stuff, very project based. I think the cable space, together with the sort of tier one carriers in North America, very, very robust demand and again, is really a function of just us supplying.

Rod Hall

Do you think, I mean, the government number, Gary does that kind of ratchet back down again, April just where the pulse is project-oriented revenue or is that?

Gary Smith

Yes, as you know, I think the forecast for it, you know, depending on the ability to ship but I think that's likely to go down in Q3. But we are seeing, you know—so step back from those ebbs and flows we are seeing a sort of consistent investment by the government in their networks for all kinds of reasons that we can all probably know. We do feel good around that space. I mean, as I appreciate you highlighting it. We feel good around that for the next few years. There's a lot of network buildout and network modernization that's going on within the various government networks.

James Moylan

Our technology is—it fits their needs very well, too.

Rod Hall

Great, okay. Yes, that's all I've got. Thank you very much.

Gregg Lampf

Thanks Rod.

Operator

Your next question comes from the line of Tal Liani from Bank of America. Your line is open.

Tal Liani

Hi guys.

Gary Smith

Hi Tal.

Tal Liani

The risk that things get canceled next year because customers don't get the products. If I'm thinking about the cloud or the service providers hedging their side of the operation already for products and not running any operations. If they don't get the revenues associated, why start a project if there's still supply chain issues? The question is about the sensitivity of demand to supply, basically.

James Moylan

I don't think that's the driving force, though. I think the driving force here, Tal is underlying demand for bandwidth. That has continued to grow through every economic condition we've had for 20 years or 30 years. I don't think lack of supply is going to constrain their demand. I think it's, you know, it's they're going to have the demand as long as their customers are demanding services from them. As I said, we see no reduction.

Gary Smith

I think on the web scale specifically, there's no point building a datacenter if you can't connect it. I mean, I get the point, but you know, I want to get the sort of context of this right. We are shipping more than we did last year. We are shipping stuff, so we are providing connectivity to these folks. They're just not getting the full capacity that they wanted.

This is not a sort of binary situation. I mean, we are growing. We just posted a quarter with 14% revenue growth, despite all of this stuff. It's not as if we're not getting stuff out there. We are satiating some of the demand for our customers but it's not everything that they want.

There aren't, you know, no one else is doing it better than we are. There's not a lot of other alternatives to that and people wouldn't want to get out of the queue, I'm sure. By the way, we've got the leading technology and continue to have that. Those are the dynamics that we see, Tal.

Scott McFeely

The fundamental constraints, if you follow the chain, is common to everybody.

Tal Liani

Right, and Gary, maybe a follow up question is what isn't this environment bringing up more voices within cloud to self-manufacture solutions rather than buy from vendors, just because they'll have better control over the supply chain? Do you think that maybe lightbulb solutions or anything that is more about self-design, self-manufacturing, don't you think that this can actually grow as a response to the current environment?

Gary Smith

I think, Tal, from the conversations that I personally, I mean, I think the opposite is actually true, frankly. I mean, we're able to navigate through it because we're a specialist focused player and we're vertically integrated. We're actually in a better position to go and do that. I think to Scott's point on the VR pluggable thing, exactly the same reason is actually pushing that market out because it's more difficult to get the infrastructure to support that. The DIY stuff is actually more difficult than it was before.

Tal Liani

Got it. Thank you.

Gregg Lampf

Thanks Tal. Operator, we'll take one last question.

Operator

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

Simon Leopold

Hi. Thanks for taking the question. Kind of surprised nobody has asked this, actually. You talked about the supply chain worsening, and I get that, but it does seem to somewhat contradict some of the commentary we heard from some of your optical component suppliers. Basically, they've guided to improving telecom shipments in their respective June ending quarters and I just want to make sure I understand whether or not you're indicating that that's not really going to be the case, or if this is more about timing and why you don't sound more constructive if there's something else informing the challenges in optical components.

Then just a quick follow up if I might. If just an update on your own shipments of VR pluggable. Thank you.

Scott McFeely

Yes, Simon, to the first one, you know the simple summary is yes, it's timing. The history that those when they see improvement to when we actually get it through our supply chain and out to our end customers, it is timing. It is thought though about the gap or some of them talked specifically to the gap that they had in their June quarter. If you map that to our timing, it has an impact on our Q3 and to some degree on our Q4 as well.

I'll just remind you though that we also said there was two dynamics. One was the optical subcomponents that you pointed out. The other one was the integrated circuits that largely was due to China again there. It's second order effects in the supply chain that take a while to work their way through from China being opened up again to us being able to turn that into finished goods for our customers. Again, 100% timing based.

Gregg Lampf

VR.

Scott McFeely

VR, so on the VR side, Simon, I don't think our perspective has changed at all. We, you know, we had shipped VR into a number of customers around the globe and are working through their evaluation cycles. As you're probably aware, the majority of the volume over the next season or so is going to be dominated by a couple of players. We are fully engaged in those players, and we expect to be successful there in those because we firmly believe we've got the best plug in the market. But for us, and for the industry, it's largely going to be a 2023 event from any materiality.

Gregg Lampf

Simon, thank you for your question. Appreciate it and thank you, everyone for taking the time to connect with us. We look forward to connecting with everyone here today and the next several days. Thanks very much.

Operator

This concludes today's conference call. Thank you for your participation. You may now disconnect.