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Ciena Corp. (CIEN)

Q1 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by, and welcome to the Ciena Fiscal Q1 2020 Financial Results Call. At this time, all participants are in listen-only mode. And after the speakers' presentation, there'll be a question-and-answer session. [Operator Instructions] Please be advised that today's conference is being recorded. [Operator Instructions]

I'd now like to hand the conference over to your presenters today Vice President of Investor Relations, Gregg Lampf. Please go ahead.

Gregg M. Lampf

Vice President of Investor Relations, Ciena Corp.

Thank you, James. Good morning, and welcome to Ciena's 2020 fiscal first quarter review. With me today is Gary Smith, President and CEO; and Jim Moylan, CFO. Scott McFeely, our Senior Vice President of Global Products & Services, will join us for the Q&A portion of today's call.

In addition to this call and the press release, we have posted to the Investors section of our website an accompanying investor presentation that reflects this discussion, as well as certain highlighted items from the quarter. Our comments today speak to our fiscal Q1 2020 performance, developments in our business, our view on current market dynamics as well as our 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 guidance and long-term financial targets, are based on current expectations, forecasts, and assumptions regarding the company and its markets, which include risks and uncertainties that could cause actual results to differ materially from the statements discussed today.

These statements should be viewed in the context of the risk factors detailed in our most recent 10-K filing and in our upcoming 10-Q filing, which is required to be filed with the SEC by March 12, 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.

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

Gary B. Smith

President, Chief Executive Officer & Director, Ciena Corp.

Thanks, Gregg, and good morning, everyone. Today we delivered outstanding first quarter results, the diversification across our business combined with our technology leadership, including our 5th-generation 800-gig WaveLogic modem technology that is available today, continue to set us apart in the market.

Specifically, we reported Q1 revenue of $833 million, reflecting 7% growth year-over-year, on the high-end of our guidance range. Q1 gross margin was also very strong, driven by a favorable product and customer mix in the quarter. And importantly, we performed very well with respect to profitability measures. Both operating margin and

EPS in the quarter were higher-than-expected and cash performance was strong. Finally, our orders in the quarter were greater than revenue.

As we previously mentioned, our unique degree of industry diversification across customer segments and regions, in particular, continues to provide resiliency and balance in our business and plays a significant role in our strong financial performance. This is particularly relevant as the broader economy is faced with the growing uncertainty surrounding the spread of Coronavirus. Thus far for our industry, the challenges currently presented by this situation have been largely contained to the China market, the supply chain and logistics.

For Ciena, by design, we have among the lowest exposure in our industry to the China market, and the Chinese supply chain. As a result, as we sit here today, we believe that we are better positioned than most of the industry players to manage through the current set of challenges presented by the coronavirus. However, the situation is obviously very fluid and uncertain at this time, and we are not immune to potential broader business implications as it evolves. Jim will give you additional color when he provides our guidance.

Now, I'll turn back to the highlights of our Q1 performance. Again, the comments I'm about to make regarding our regional performance and forward view are without any further impact of the coronavirus situation, but rather how we see things from where we are today. In Q1, Asia Pacific performed well particularly Japan, and we continue to see opportunity for growth in APJ in 2020, and India, much as anticipated, we experienced softness, as we started the year, but we continue to believe there is opportunity for modest growth in the second half of the year.

In a EMEA, we had a very solid contribution from service provider customers in Q1. And we continue to see opportunity to expand market share, as many carriers in the region reevaluate their infrastructure partners and their next-generation builds.

We had an excellent quarter in our Americas region in Q1, our North American service provider business was strong, including two 10%-customers in the quarter, Verizon, and AT&T, and revenue from other verticals, including MSO customers like Comcast and Charter, and the US government was up about 5% year-over-year in Q1.

We expect material contribution from these service providers in 2020, as well as growth from CenturyLink later this year. And we also expect continued growth in the Americas to be driven by other customer verticals. Web-scale was also a solid contributor in the quarter, as this vertical continues to perform well and as expected. We also anticipate a strong Q2 in Web-scale.

As a reminder, we anticipate this market to grow roughly 7% to 10% this year. And we believe that we can grow our Web-scale revenue at roughly market rate and maintain our market share leadership in this position. We also continued to add new customers every quarter in this segment. There is no doubt the confidence in our technology leadership is a significant driver of our performance, and continued strong customer engagement.

As I mentioned at the start of the call. I'm pleased to confirm that WaveLogic 5 Extreme, our next-generation coherent optical technology is now available. In fact, by now you should have seen our numerous announcements with Southern Cross, Verizon, and Comcast, as well as Internet2 where we've begun initial field deployments. As evidenced in these customer networks, we have delivered on our promise to be the first-to-market with an 800-gig solution, well-ahead of any competitive offerings.

WaveLogic 5 Extreme is fully featured and performing better than anticipated across a multitude of applications. We continue to expect initial revenue in Q2, with more material revenue in the second half of the year. In addition to that [ph] mount achievement (7:51), we also recently announced several new products and capabilities in our 5G Network Solutions.

First, we added three 5G-optimized routing platforms, designed to enable network operators to migrate from 4G to 5G and meet the low-latency high-performance demands of fronthaul, midhaul, and backhaul transport. And we also introduced Blue Planet software automation enhancements comprised of dynamic planning capabilities and end-to-end network slicing in this solution.

And with respect to Blue Planet, in Q1 we secured new wins with two major international Tier 1 service providers, both outside of the US. We also added four new logos for our route optimization and analysis products, and we took strong orders for our Unified Assurance and Analytics software on the heels of closing the Centina acquisition.

With rising macroeconomic concerns and uncertainty, customers, more so than ever are pursuing a flight-to-quality, where they are seeking strategic vendors who offer long-term innovation leadership and financial stability. And we are clearly very well-positioned with the financial strength, expanding technology leadership, diversification and global scale to meet their needs now and into the future. And we are very focused on taking advantage of this opportunity.

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

James E. Moylan

Senior Vice President, Finance and Chief Financial Officer, Ciena Corp.

Thank you, Gary. Good morning, everyone. Q1 marked the strong start to fiscal 2020. As Gary mentioned, total Q1 revenue was $833 million, and adjusted gross margin was 45% driven by favorable product and customer mix. Adjusted operating expense on the quarter was $266 million. With respect to profitability measures, in Q1 we delivered adjusted operating margin of 13.1%, adjusted net income of $82 million, and adjusted EPS of $0.52.

For using your models, the tax rate, we used in Q1 for our adjusted net income and EPS was 21.6%, a bit lower than we expected. Tax planning is allowing us to make better use of the lower effective US tax rate on exports. We'll expect to use this 21.6% tax rate for the remainder of 2020. In addition, in Q1 cash from operations was very strong at $40 million in what is typically a seasonally lower cash-generating quarter.

Adjusted EBITDA in Q1 was $135 million and we generated free cash flow in the quarter, again a sign of strong cash generation. We ended the quarter with approximately $960 million in cash and investments. As Gary mentioned, our balance sheet is yet another differentiator that speaks to our long-term strength and viability, particularly in the current environment. Finally, we continue to execute on our share buyback plans, repurchasing approximately 1.3 million shares using $51 million of cash during the quarter.

I'll now turn to our Q2 outlook. Before I go into detail, I'll reiterate what Gary said with respect to the coronavirus situation. Specifically, we believe that we are better positioned than most to navigate through the current supply chain challenges presented by the coronavirus. However, we are not immune to business impacts including in our Q2. Specifically given what we know today, we expect that fiscal Q2 revenue will be reduced by approximately $30 million, predominantly due to supply constraints and logistical challenges to execute in certain countries, resulting from the coronavirus.

Taking that into account, we expect to deliver revenue in a range of $875 million to $905 million. To be clear, without the expected impact of the coronavirus, the midpoint of our revenue guide would have been approximately $920 million. Like every other company, we're giving you our best view at this point in time. Also, in Q2, we expect gross margin in the 42% to 44% range and operating expense of approximately $275 million.

In closing, the fundamentals of our business are sound. We have the best technology, we are diversified across geographies and verticals and our scale is a competitive strength, and we continue to gain market share. As I mentioned, the coronavirus will impact our business to a certain extent in Q2. Its impact on the remainder of fiscal 2020 is uncertain at this time, and it would not be appropriate for us to speculate.

If we do not include any potential impact beyond Q2, our expectations for fiscal 2020 are unchanged. This includes with respect to revenue, cash flow, and adjusted operating margin of 15%, and we remain confident in our long-term financial targets.

James, we'll now take questions from the sell-side analysts.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And our first question comes from the line George Notter with Jefferies. Go ahead please, your line is open.

George C. Notter
Analyst, Jefferies LLC

Q

Hi, guys. Thanks very much. I guess, maybe, I'd start on the coronavirus discussion. Gary, you were talking about Ciena's positioning being better than others in the wake of the coronavirus situation. Can you kind of talk about what you're looking at there in terms of both the supply side and the demand side in China, and elsewhere that's affected? Thanks.

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

A

Sure. Largely to-date, this has been somewhat contained to China and obviously, spread into some of the APJ countries as well. From a supply chain point of view, Ciena a long-time ago does not have exposure to manufacturing into China directly and direct supply chain. Obviously, some third or fourth order contract manufacturers do. So we're not immune from it. But unlike most of our competitors, we don't have significant direct supply chain based in China.

And then secondly on the demand side, as many of you know, we do not sell directly to the major carriers in China, and that's a very conscious decision on our part. So, we don't have exposure to the demand side from China. But that being said we are present in many of the other APJ countries that have had challenges and some of which are in sort of locked down and it's difficult to get to some of their sites for installation, for example. So it is having an impact on us, which is reflected in a change in our Q2 guidance.

George C. Notter
Analyst, Jefferies LLC

Q

Got it. Okay. And then just switching gears for a second. You saw really strong gross margin performance this quarter. I guess, I heard what you said certainly in terms of customer mix, product mix. But can you talk a bit more about what surprised you there? I think certainly coming into the quarter, you guys are looking for gross margin numbers that were quite a bit lower? Thanks.

James E. Moylan
Senior Vice President, Finance and Chief Financial Officer, Ciena Corp.

A

Yeah. Thanks, George. We said 42% to 44% for the quarter and for the year and we still expect that's the range in which we'll be operating. However, we had a great quarter in Q1 and it was totally driven by mix. As we've said before, it depends upon the stages of various projects. If we're early in a project, we're going to have lower margins. Later on, we're typically going to have higher gross margins. We had a particularly good software, so that was a part of it as well. It's hard for us to call. I think we're 42% to 44% today, but we did great in Q1. We'll see what happens in the rest of the year.

George C. Notter
Analyst, Jefferies LLC

Q

Okay. Thank you.

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

A

Thank you, George.

Operator: Our next question comes from the line of Paul Silverstein with Cowen. Go ahead please, your line is open.

Paul Silverstein
Analyst, Cowen and Company, LLC

Q

Good guys, if I could just take it back to the coronavirus commentary. And I just want to make sure it sounds like it's not an issue of your access to components. But if I take your face value telling us that there was a significant impact from your inability to get to sites in certain countries. Can you [ph] all (17:05) elaborate on that? How many countries are we talking about? And is in fact all the shortfall through the – it's a demand the fact that your customers just can't accommodate your ability to deliver, but you're not constrained in terms of the actual components at this time?

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

A

Okay, Paul, let me take the logistics part of that I guess rather than sort of [ph] remember (17:29) we called logistics. Yeah, there are a number of sites that we can't get access to both on the submarine side to do installations and also in places like South Korea. Even in Singapore, folks are working from home and that's having an impact in terms of our ability to get to the some of the sites and do installation. So, that is certainly some of it.

Scott, do you want to talk about some of the supply chain?

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

A

Paul, on the supply chain side, just to clarify it a bit. So, obviously, we don't do any R&D. We don't do any new product introduction. We don't do any contract manufacturing directly in China. We do have some suppliers that source from China, many of which we have second sources for.

Some secondary suppliers – they are exposed to China and we're not immune to that. We have very close communications with our contract manufacturers and those suppliers in terms of what their plans are? And their expectations are? And how that material comes back online for the rest of the quarter? And that's factored into the numbers that we have here.

Paul Silverstein
Analyst, Cowen and Company, LLC

Q

And Jim, when you said – when you reiterated guidance, that's taking into account the shortfall from corona in Q2, but assuming there's no additional impact throughout the year?

James E. Moylan
Senior Vice President, Finance and Chief Financial Officer, Ciena Corp.

A

Correct. Yes, Paul, that's correct.

Paul Silverstein
Analyst, Cowen and Company, LLC

Q

All right. I'll pass it on. Take the other questions offline. Thanks, guys.

Operator: Our next question comes from the line of Simon Leopold with Raymond James. Go ahead please, your line is open.

Simon Leopold
Analyst, Raymond James & Associates, Inc.

Q

Great. Thank you for taking the question. Gary, you made reference to a number of opportunities. And I wanted to see if maybe you could drill down on which ones have the biggest potential to maybe move the needle for you.

Specifically, I want to drill down on sort of the non-AT&T, non-Verizon, non-hyperscale part of the business. You mentioned Japan, you mentioned the cable guys. I don't think you mentioned Deutsche Telekom in your prepared remarks. So, could you help us understand how to think about that particular group's effect on the 2020 outlook?

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

A

Yeah, absolutely. So, we talked a little bit in the commentary around some of the MSO sector. So, if I look at where I think we're going to see good strength in 2020, I think it's the MSO space. We've had a number of wins in that space in addition to the large market share that we already have. And we see a lot of activity in the MSO space, Comcast, Charter, et cetera. So quite bullish on that.

Looking at some of the other big Tier 1s in North America, CenturyLink I would highlight as well we think for the year, certainly in the second half of the year is going to be strong. As you know, we're pretty much – we had some significant wins in the last two years there and that will begin to roll out. So it's beginning to roll out now. But I think we'll have a strong second half.

Also, some of the other verticals in North America, I would highlight would be the government. I think is after a few years of really being sort of somewhat underinvested I think we're beginning to see plenty of activity in the government space. So we feel good around North America, overall and not just the couple of primary large carriers that have been our big customers there. So I feel good around North America.

Europe, I think we're seeing some of the benefits of decisions that were made like Deutsche Telekom that's beginning to roll out and effect into our numbers. I do think there's an opportunity in the carrier space to continue to take share in EMEA. So I do feel good around that for the rest of the year. So those are two areas.

I think Japan had a very good start to the year. We'll see how that goes with some of the challenges had around the coronavirus, et cetera, but so far so good. So those are the areas that I would highlight around strength in the business.

Simon Leopold
Analyst, Raymond James & Associates, Inc.

Q

Thanks. And just as a follow-up from a product or segment perspective, last quarter you had a very strong Packet Networking, in this quarter as you suggested, it would fall off sequentially and it did. Could you maybe step back and talk to us about that particular business for not just the year, but see if you can take it out longer-term as you have in the past? It sounds like growth prospects are good. I'd just like to get an update on that. Thanks.

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

A

It's Scott. So on the Packet piece as we said last quarter and we had a great quarter, not to expect that to be the go-for normal quarterly run rate through 2020. Q1 basically came in as we expected on the Packet business. And we're still bullish in terms of the plan for the year.

What we said over a three-year period for [ph] this Packet business (22:43), we expect it to grow faster than the aggregate in the sort of 8% to 10% range over our three-year plan. And we think we're in good shape to do that. We're looking at expanded application spaces on the portfolio, working with the new launch of our router portfolio, focused specifically optimized around 5G but more generically other IP application sets as well. So 8% to 10% over the next three years is kind of the expectation in the early periods but we're on track for that.

Simon Leopold
Analyst, Raymond James & Associates, Inc.

Q

Thank you.

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

A

Thank you very much.

Operator: And our next question comes from the line of Rod Hall with Goldman Sachs. Go ahead please, your line is open.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Hi. Thanks for the question. I wanted to start by asking about – just digging into coronavirus a little bit more. I'm really wondering what you guys' Italian exposure is at this point? And whether you've seen any evidence that network roll-outs there are slowing? And then, more on the positive side of things the software number was better than we expected. I wonder if maybe you could comment on trends there, what drove that number and how you expect that to shape up through the year? And then just color – further color on Packet Networking, could you just talk about fronthaul, backhaul opportunity? And maybe Scott how that's changed in the last quarter for you? Thanks.

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

A

I'll take the [ph] first couple of deals (24:15). Scott, you could do the Packet. We don't have really anything of significance in Italy. So that anything that happens there will be unlikely to affect us this year. With respect to software, we did have a good quarter. We're continuing to roll-out our new MCP platform software and we're getting good take-up from customers. We do expect a good year from Blue Planet as well. So we'll continue to do well we think with respect to software for the year.

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

A

Yeah. And just to pickup on the software piece on MCP [ph] as we (24:50) spent a lot of time talking about it in this form. For us that is our next-generation domain controller, cloud-native designed from ground up. We actually believe it's the first in the marketplace that has the breadth that it has from a Packet Networking multi-domain, multilayer management capabilities. And what you saw in Q1 is the accelerated adoption of that in our installed base. So that puts us in a great position to deliver on some of the promises of the Adaptive Network that we've been talking in the industry about.

Back on your Packet question on fronthaul and backhaul, so hopefully you saw the product announcements that we did a couple of weeks ago around our new product portfolio. I think just step back from that a little bit and talk about what's the basis of that. So we've talked in the marketplace about Adaptive IP. And for us that's built on a bunch of different dimensions of capabilities that have all come together in this product portfolio in this announcement.

The first sort of foundational is a next-generation cloud-native IP network OS that is the right cloud-based architecture, capable of running in a disaggregated environment on white boxes on an integrated coherent solution – sorry on an integrated Ciena solution like we talked about in the press release and optimize for the right go-forward IP protocols.

So the right routing protocols going forward as opposed to legacy IETF protocols from 20 years ago. When we instantiate that on a Ciena hardware, we can have the opportunity to integrate it with the world's leading coherent optics, which we've done in this product portfolio in the announcements. And bring to bear a bunch of stuff that we've had from our history in terms of differentiating, how we deploy these on service provider networks, service level agreement support be able to deploy in outside plant and to be able to deploy at mega distributed scale.

We sort of marry that then with the Adaptive tool set that comes both from the market-leading domain controller, I mentioned MCP but also our automation software suite around Blue Planet. And that we think delivers a very compelling value proposition in the marketplace and allows us to play in spaces that we haven't played before.

The first instantiation of all that value is in these 5G-optimized routers [ph] that was deployed (27:19) in a 4G environment but evolved to 5G as well. If you look back historically in our Packet business, we've been very dominated by wholesale operators providing basically Layer 2 services to the MNOs. This now allows us to step beyond that and to compete basically right down to the cell site router through all the IP backhaul as well, which is a significant market expansion opportunity for us.

And we're starting to see RFPs that are looking at next-generation networks optimized around their 5G access infrastructure and that's the opportunity set we're going after with this. So long, long answer to a short question, but hopefully that gives you some color.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

No. That's great. Thanks, Scott. Thank you, guys.

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

A

Thank you, Rod.

Operator: And our next question comes from the line of Michael Genovese with MKM Partners. Go ahead please, your line is open.

Michael E. Genovese
Analyst, MKM Partners LLC

Q

Thanks very much. Hey, guys. How are you thinking about the 800G competitive environment? How long do you think you're going to be the only product in the market? I think the competitor that's coming out with one also is trying to have a 600G cycle with another product. So, just how are you thinking about the market this year? And sort of when competition might catch up?

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

A

Yeah. Thanks, Mike. I'll take that one. So first of all, hopefully everybody got a chance to see the public customer references that Gary referenced on WaveLogic 5 deployments in live networks. And for those that haven't maybe just to point out some of the key things that those announcements really highlighted. So first of all, first single carrier 800-gig deployment that happened to be a datacenter interconnect application. But also, across those announcements, you saw single carrier 600-gig in a mixed fiber environment with deployed performance greater than 1,600 kilometers. You saw a 400-gig transmitted over 4,000 kilometers delivering on our promise to be able to carry 400-gig e-services anywhere in the world [ph] and (29:23) we generated. And you saw us demonstrating the software control that delivers on the promise of sort of variable transmission rates from 200-gig, 400-gig, 600-gig and 800-gig.

So you asked the question in the context to 800-gig, but there are a lot of market-first coupled up in those announcements. And I do want to highlight that these were on real production networks that means mixed fiber types. That means, they need to coexist with existing wavelengths and it has all the complexities that you have to deal with in a real network as opposed to demonstrations in a controlled lab environment. This was real production hardware and we're in the process of ramping that. And we expect to recognize revenue for that product in this quarter and ramp through the second half of the year.

And as we said all along, over the last number of quarters we've been talking about this. We had expected to introduce this on two product platforms 6500 and Waveserver and the combination of those customer announcements are actually across both those product platforms so delivering on that promise as well. I will say that, this gave us a great opportunity to see the performance of this optical engine in real customer environments. All the announcements that we showed you, were done with performance to spare, confirming what we've seen in our labs and delivering on our promise, not only to be the first to market with 800-gig but to have the highest performing optical engine in the marketplace. And to the timing, I think it's going to be well ahead of anybody else having 800-gig to be able to deploy in that kind of real-world environment.

I want to take the opportunity actually, and I wouldn't normally do this on this call. But to get this to market was a many, many year journey, and it was contributions from multiple disciplines. And I really want to recognize and thank all of the Ciena team across many functional groups that they continue to push the envelope and they continue to build on an incredible reputation to deliver. And I also want to thank customers that have done this journey with us over multiple generations. I'm a long answer guy today, I apologize for that.

Michael E. Genovese
Analyst, MKM Partners LLC

Q

Those were great answers, Scott. Thanks. And Jim I want to ask you a question as a follow-up and it's a hypothetical. So, hypothetically speaking, if there were no coronavirus, do you think you would have raised the guidance today from the bottom end of 6% to 8% to the middle range of 6% to 8% for this year?

James E. Moylan
Senior Vice President, Finance and Chief Financial Officer, Ciena Corp.

A

Mike, that's a hypothetical question. We've told you what we expect today and I just don't think it's right for us to speculate there. We're going to have a good year, a great year. We're doing very well. All the things we've talked about our business, our business model, and our financial strength still remain and we're very confident about the future.

Michael E. Genovese
Analyst, MKM Partners LLC

Q

Appreciate it. Thank you.

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

A

Thanks, Mike.

Operator: And our next question comes from the line of Jeff Kvaal with Nomura Instinet. Go ahead please, your line is open.

Jeffrey Thomas Kvaal
Analyst, Nomura Instinet

Q

Thank you very much. I was wondering if you all could delve into some of the dynamics inside of the Web-scale numbers for us please? The mix has come down a decent amount in the last couple of quarters. It sounds like you feel pretty good about what's happening in the upcoming quarters. What can you tell us about the permutations there?

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

A

I think we feel very confident around our position in this space overall. Q1 was about as we expected. Q2 I think will be up based on what we're seeing. What is particularly satisfying in that space is two dimensions; one, broadening customer base. And a lot of folks understandably is focused on the larger players, Web-scale players in there. But there's beginning to be an increasingly broader set of customers that are looking to build their own networks and optimize their data center connectivity. And we are taking more than our fair share of those new names. So, that is pleasing.

The second thing is with the existing large customers that we've got the engagement around their road map and their future rollouts has been incredibly encouraging. We've worked very closely with them on things like WaveLogic 5, on some of the software pieces to it. So, the integration into what is now very large global networks is – we're very enthusiastic about that.

And the third dimension to it I would also add is the collaboration that we now have with them internationally, where we're helping them get connectivity in markets where we're very strong outside of the US. That collaboration has been very strong. Places like Europe, Asia-Pacific, India, I would particularly highlight which is a big growth market for them, Middle East. So, the relationship continues to expand. And that gives us a lot of confidence. I know we've got a very large market share there but we're very confident of maintaining that market share given those dynamics that we're seeing in that space.

And the other thing I would add just from an overall demand point of view in that space, we've seen no let-up in terms of their almost insatiable demand for data center connectivity and build-out, not just in the US, but globally.

Jeffrey Thomas Kvaal
Analyst, Nomura Instinet

Q

Okay. Thank you, Gary. And then also I guess we are on the verge of having a third large national wireless play as the T-Mobile deal closes. That has typically not been neither side of those have been big customers of yours. I'm wondering as they become a bigger play if there is a potential opportunity for Ciena perhaps not in fiscal 2020, but down the road?

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

A

I would think the answer to that is yes. Whilst Sprint has not been a large customer in more recent years, they've got a very, very, very large installed Ciena base. In fact, they were our first-ever customer commercially. So we have a long and great relationship with them. So we do think that is going to be a good opportunity and this looks like resolving.

I don't think it's probably a 2020 opportunity, Jeff. But as we get to 2021, I think the build-out there and other infrastructure builds for the 5G I think there's good opportunity for us. And that does pervade some of our thinking into why we're so positive around the North American market.

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

A

Thank you, Jeff.

Jeffrey Thomas Kvaal
Analyst, Nomura Instinet

Q

Okay. Thank you all very much.

Operator: Our next question comes from the line of Samik Chatterjee with JPMorgan. Go ahead please, your line is open.

Samik Chatterjee
Analyst, JPMorgan Securities LLC
Q

Hey, guys. Thanks for taking the question. I just wanted to follow up first on Scott's comments where you have to be 800-gig or the WaveLogic 5 product. Scott, if you can kind of share – you mentioned you expect revenues in this quarter? How are you thinking about the ramp of revenues relative to maybe some of the previous generation product like the 400-gig? If you can share any thoughts on that?

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

Yeah. So a couple of comments. So first of all, I think, we do expect revenue this quarter but it won't be material this quarter. The ramp is going to be in the second half of the year. And if you look at the model for the year – second half of the year was bigger than the first half of the year, partially due to the fact that we expect that this timing on WaveLogic 5 and we expected those dynamics to play themselves out in the second half of the year. So I'd say we sort of modeled that into our plan for the year.

In terms of the transition timing, I'd say this. And as we moved from previous generations to, say, WaveLogic 4 in particular, WaveLogic AI, sorry in particular, there is a dependency in terms of the infrastructure or the Line Systems. They need to be able to deal with higher baud rate transmission capabilities.

That got in the way of the pace of transition, I'd say, to previous generations. Much of that infrastructure now has been enabled and will no longer be a hurdle in many of our customers' accounts in terms of moving to these next-generation technology. So I would expect the transition to go faster. In some cases, in some applications and in previous generation moves but in terms of the numbers in terms – from our perspective from what we see right now that's baked into the growth in the second half of our business plan.

Samik Chatterjee
Analyst, JPMorgan Securities LLC
Q

Got it. And just a follow-up. Gary, you mentioned kind of the opportunities in EMEA a couple of times. Now are you kind of thinking of those? If you can kind of outline which markets you think the biggest opportunities are? Are you seeing kind of more opportunities in countries like UK where there is now a regulation capping market share for certain vendors? Or are you looking at kind of a general move away from certain partners that's kind of overall in the region that's going to help you?

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

I would say two aspects to it. One, just generally speaking, we have a smaller market share there given the historical dynamics with it. When I see opportunity, it's really around two dimensions. One is there's a big Web-scale buildup going in Europe and we're obviously extremely well placed with those folks.

But also, it's got more attention has been obviously the Tier 1 carriers. And we do see opportunity with those carriers. I think, it's as much about realignment where you've got a couple of players with very large market share. And I think a number of these Tier 1 carriers are beginning to reflect on just the concentration there and bringing in a strong new vendor. We've seen that at Deutsche Telekom. Obviously, we've won that we're just in the rolling that out. But we're seeing it with other Tier 1 carriers as well.

So I do think there's opportunity and it's multi-year. I think the thing I would remind everybody is, these are very big strategic decisions for the carriers point number one; takes time. Number two, it's infrastructure, which takes time both to migrate and to award. And so we're a couple of years into this and we're beginning to see the benefits to some of these decisions like Deutsche Telekom. But there's plenty more in front of us frankly. And I think it is a terrific opportunity for us. But it is a multi-year opportunity. I think we'll see some of it this year [ph] in the SaaS (40:29) and we'll see some next year.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Great. Thank you.

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

A

Thank you, Samik.

Operator: Our next question comes from the line of Tim Long with Barclays. Go ahead please, your line is open.

Tim Long
Analyst, Barclays Capital, Inc.

Q

Thank you. Just two if I could, actually both related to Web-scale. So first one, you talked about – Gary, you talked about a lot of opportunities, new players, European and other expansions. The growth rate is a lot slower than what we saw last year. So can you just touch on that? Is that digestion? Is it lack of any incremental share because we gained so much last year? So just give us some color on the lower growth rate there, despite all the positives?

And then second related to that could you just update us on ZR and where is Ciena, what do you think the Web-scale guys are? What kind of impact could that technology have on this vertical as we look out the next year or two? Thank you.

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

A

Yeah. Let me talk about sort of Web-scale. I think the quick answer to your question, Tim, around that is, we had an incredible year last year and we took massive amounts of market share. And obviously, we've got well over 50% in that space. And so I think to be realistic, we can't expect to have those kind of more than double-digit growth rates going into this year.

We do think the overall market there will grow about 7% to 10%. And we think we will grow probably in line with that market. I do not think we will lose market share there given the dynamics that; A, the relationships, the embedded nature of those relationships; B, we've got the best roadmap for them. They've been integral in helping design that. Very much [ph] lent-in (42:26) on a lot of the developments that we're now delivering into market and the roadmap and visibility that we have with them.

But I do think it's going to get to a more normalized rate of about the 7% to 10%. I would say that we've got a much broader-base of customers there now than we had last year. So it gives us some confidence around the diversification of it.

On the ZR side, Scott, do you want to comment on?

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

A

On the ZR, so first of all just to reiterate what our perspective of that market opportunity is, we do believe that it will be a subset of the metro-based data center interconnect market that would be able to take advantage of ZR capability. We have put numbers in the past on that of being sort of like the $500 million market opportunity in total.

I don't think our perspective on that size of opportunity has changed at all. What has changed I think is our perspective of the timing of that market continues to push a bit to the right. We do believe it will be a 2021 market opportunity. We are building product to that off of the WaveLogic 5 family. When we announced WaveLogic 5, a couple of seasons ago, we announced a WaveLogic 5 Extreme product, which is the basis of all the announcements you've seen last week. And we announced the WaveLogic 5 Nano product line. That nano product line will be available from us at the – towards the end of 2020. So we think we're in decent shape to intercept that market.

The other thing, I'd say about it is, I think there's a perception that "this is a commodity market." Commodity [indiscernible] (44:03), says you can have many, many suppliers you can pick them up at Walmart because this is not an easy technology to deliver. So I think there will be fewer suppliers that deliver the goods than people imagine as well. So there is some thoughts on it, Tim.

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

A

Thank you, Tim.

Tim Long
Analyst, Barclays Capital, Inc.

Q

Okay. Thank you very much.

Operator: Our next question comes from the line of Jim Suva with Citigroup Investments. Go ahead please, your line is open.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you very much. You mentioned this quarter gross margins were benefited from several factors, mix and so on and so forth. And then in your prepared comments, you mentioned in the second half of the year things are looking pretty good from a revenue perspective with CenturyLink and rollout of other things. Can you remind us as we look forward like in the second half of the year and such is there any view on the mix that may impact margins? Like for example is hyperscale or some of the global ones more or less profitable? Or is it more having to do with the phase of the rollout of what you're doing? Thank you.

James E. Moylan
Senior Vice President, Finance and Chief Financial Officer, Ciena Corp.

A

Yeah. Thanks, Jim. First, I'd say that, if you look across customers there's not a tremendous amount of difference in our gross margin. The customers are all big. They have the same choices in the competitive environment and every customer is the same pretty much. We're competing against the same group of companies. So not a big difference in – across customers. However, there is typically or has been a significant difference in margin between the early stages of a project in which we're rolling out the Line System, the commons, photonics that sort of thing and later in the projects when we're filling the chassis with capacity. And that's been a model that's been going on for a long time, and we think it will continue for the most part. And that's the real big difference.

The other difference too is that in new customers, we tend to compete with transport. And as we mature that relationship, we tend to be able to sell higher-margin products such as Packet in particular, hopefully, Blue Planet. And those products have higher-margin profiles by nature of their complexity and software content than does transport. So that – it's totally about where we are in the life cycle of a project and where we are in the life cycle of a customer.

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

Thank you, Jim.

Jim Suva
Analyst, Citigroup Global Markets, Inc.
Q

Thank you very much for the details. It's greatly appreciated. Thank you.

Operator: And our next question comes from the line of Amit Daryanani from Evercore. Go ahead please, your line is open.

Amit Daryanani
Analyst, Evercore ISI
Q

Yep. Thanks a lot for taking my question, guys. I guess, first one just to understand the $30 million revenue impact in the April quarter from the coronavirus is up. I guess, is there a margin and free cash flow impact as well given the fact it's a supply and logistical issue? And would you expect this demand to recover in the back half of the year? Or it's too early to call that?

James E. Moylan
Senior Vice President, Finance and Chief Financial Officer, Ciena Corp.
A

Well, the $30 million lost revenue will have a gross margin attached to it. So, there will be an impact on the gross margin dollars. I don't think that that will have a significant impact on the gross margin percent. And so by definition, it could have an effect on the free cash flow.

Now, there's always this – free cash flow is affected by events that happened earlier, right? We get the revenue and we collect the money later on in the quarter. So, if for example these losses in revenue occurred late in the quarter, maybe you won't have a significant impact on gross margin. If it occurs sort of right now then yes, it will have an effect on free cash flow in the quarter. Did that answer your question?

Amit Daryanani
Analyst, Evercore ISI
Q

It does.

James E. Moylan
Senior Vice President, Finance and Chief Financial Officer, Ciena Corp.
A

All right.

Amit Daryanani
Analyst, Evercore ISI
Q

And then I guess do you expect this to recover at some point in the back half of the year?

James E. Moylan
Senior Vice President, Finance and Chief Financial Officer, Ciena Corp.
A

Well, what we've said is I think by definition the answer is yes, because we've said that we expect that assuming no further effects from the coronavirus, our guidance for the year stands.

And I just want to point out too that, this $30 million is not really due to demand per se and we're parsing that carefully. What we're seeing is the effect of logistics in certain countries. We had demand, we had orders, and we would have recognized that revenue save for the fact that given the coronavirus situation we could not get to sites. So, it's not really a demand issue, it's a logistics issue. And we also said that it's also a supply chain issue.

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

Thank you, Amit.

Amit Daryanani
Analyst, Evercore ISI
Q

Got you.

Operator: Our next question comes from the line of Meta Marshall with Morgan Stanley. Go ahead please, your line is open.

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

Great. Thanks. A lot of my questions have been answered. So, maybe I'll just focus on – there's reports of your large European competitor kind of examining strategic options. And so I wanted to see if you've seen any ability to take advantage of that dislocation? And whether there's any kind of strategic outcomes that would concern you? Thanks.

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

I think the sort of industry structure, Meta, is an interesting one. I think what you've seen with Ciena in the last sort of two to three years is really taking advantage of that direction that's been moving over many years. I think you've got a number of generalists that have obviously had some challenges. And I think that's enabled us as a focused player to take share. Because we're incredibly focused, we're the best in the world at what we do. And that is increasingly more and more valued as folks want higher capacity closer to the end user on the application.

So, if you look at the share that we've taken frankly in the last two to three years of, pretty much all of the existing players in this space and we now have the largest market share of anybody in the world and we do not operate directly in the largest market, which is China. So, that tells you I think the gains that we've had. But we feel very good around our portfolio and roadmap and continuing to take share.

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

Q

Got it. Thanks.

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

A

Thanks, Meta.

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

A

Thanks, Meta.

Operator: Our next question comes from the line of Tim Savageaux with Northland Capital. Go ahead please, your line is open.

Tim Savageaux
Analyst, Northland Capital Markets

Q

Hi, pardon me. Good morning and I wanted to focus back in on the cloud space, which was pretty weak in the quarter and looks like it could be challenging to grow given that start for the year. I wonder if you might be seeing a dynamic of customers waiting for 800-gig solutions that would really kind of push growth into the second half? Or any changes in market share? Because it looks like you have to kind of double your run rate from where you are to grow to your targets. I wonder if you have any – what sort of visibility you have to get there?

And then to follow-up kind of related there does seem to be some relationship right between a drop-off on the cloud side and very strong gross margins. But Jim, if I heard you right, you're encouraging us not to read too much into that? Thanks.

James E. Moylan
Senior Vice President, Finance and Chief Financial Officer, Ciena Corp.

A

Yes, we are encouraging you not to read a correlation there. With respect to a pause to wait for 800-gig, we're not seeing that at all. The demand for capacity is such that they really must put capacity in place even if it's not 800-gig. And I'd say this that the Web-scale companies are project-oriented just like the service provider companies. There are going to be ebbs and flows in their spend. And so we expect a very good year with the Web-scale. We expect we'll have a nice quarter in Q2. I think if you look back at some of the quarters, we did last year, I don't think you'll have a doubt that we can get to the numbers we posted or I mean we've suggested we're going to get to this year. Anyway, we're well placed and we're going to do well with that group this year we believe.

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

A

To me the other thing I would say on it is we – to your point around visibility, we have very good visibility with them. We have strategic relationships with them. They're very sharing of their plans both nationally and internationally and we're collaborating with them on all of that, the road map stuff as I've said. So we have very good insights into their plans. We have the largest market share there that we've grown over the last few years. And we absolutely are confident of at least maintaining that market share in the 7% to 10% growth rate for the year.

And the other thing I would say is we had a pretty good order flow from the visibility in Q1 and in the first part of this quarter as well. So that's what gives us confidence to be able to do that.

And to Jim's point, you do see ebbs and flows with them, individually and collectively. And that's why we've got a diversified business that's able to drive through that. And increasingly, as I talked about on the – some of the prepared comments that market is broadening out as well. There are some smaller players in the data center plays coming in there that want to connect and optimize their data centers. That's providing a good opportunity for us as well. Not massive individually, but collectively important.

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

A

Thanks, Tim.

Tim Savageaux
Analyst, Northland Capital Markets

Q

Thanks.

Operator: Our next question comes from the line of Tal Liani with Bank of America. Go ahead please, your line is open.

Tal Liani
Analyst, BofA Securities, Inc.

Q

Hi, guys. I have three questions, two are quick ones and one is more involved. I want to start with the corona but try to look at it in a positive way. Is your product – your kind of products that you're selling in Europe, is there an opportunity to displace some of the vendors just because they can't provide? Or is the behavior of customers is such that they'll just wait if they don't get the right product from Huawei because there's no supply, they'll just wait for them to deliver it later in time?

The second thing is, and I don't know if it's an issue or not at all. But if in a scenario that we all start to work from home for a period of time, will there be a demand for networking gear just because you need to support different type of connectivity? Is this something that is a positive – a potential positive? Or you think that that's not a potential driver? I'll pause here. I have another question on routers, which is completely different.

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

A

Okay. Let me take the first question on the competitive exposure. I think – listen, it depends how this plays out. I think two things; number one, we'll see how this plays out in terms of their supply chain. But I do think, it's an opportunity. I actually think not in the short term, but in the longer term for us because I think we've got a diversified supply chain.

And I think it is bringing home to many of the European carriers just their degree of concentration with these existing partners. So, I think it's subtle, but I think important. I don't think it's a short – there might be one, a little bit short-term opportunity. I don't think it's much, Tal. I think it's more going to be around those folks reflecting as part of their strategic decision-making over the next 18 months. With regards to the second part of the question, Jim, do you want to talk about the work from home and the...?

James E. Moylan
Senior Vice President, Finance and Chief Financial Officer, Ciena Corp.

A

I think it's a very interesting question, Tal. And I will say that just like many other companies, we've taken a lot of steps to protect our employees with respect to the coronavirus. We are encouraging in some cases, in some countries people to work from home. We've talked about travel bans into some countries. So we've done a lot of things that will accelerate what has already been in many cases a movement toward working from home.

And we certainly – we at Ciena are looking at expanding our collaboration toolset. I think other companies are doing the same thing. It would not surprise me, if this combination of new technologies around collaboration and this situation that has occurred here is that you will see more people work from home. And over time, yes that's going to mean more bandwidth needed in a lot of different places. It's not a near-term effect. But yes, I think the direction is good for us.

Tal Liani
Analyst, BofA Securities, Inc.

Q

Got it. My next question is more about the routing, the 5100 that you launched. So on one hand we see Cisco going into optical by making an acquisition also offering semiconductors to cloud saying, you develop your router with my semiconductor, you develop your optical with my semiconductor. On the other hand, you're going into routing.

And I want to understand the strategy. Do you – is this an offensive or defensive strategy? Meaning, why are you going into routing? Is it because you believe that the networks will collapse into thinner layers, into a single layer or you see an opportunity to grow from optical up to routing? I'm trying to understand if you're just responding to Cisco and others that they incorporate optical in their router or that it's a different opportunity or different applications something I can see now?

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

A

Yeah, it's a great question. So the short answer to the question actually it's both an offensive play and a defensive play in the sense. It's not something that we woke up yesterday morning and decided we wanted to move here. It was a strategic decision we took many years ago. And it expands our market share both on the access side and in our infrastructure side of the equation. We do believe on the infrastructure side of the equation. The winning hand going forward will be best-in-class optics. Great carrier service provider, great products sets, yes, IP, but also multi-layer, multi-domain automation software. And if you look at all those things in combination, combine it with our service provider relationships, we like our opportunities.

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

A

Thank you.

Tal Liani
Analyst, BofA Securities, Inc.

Q

And is there any acquisition you're addressing within? Okay. I will take it offline, that's fine. Thank you.

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

Thanks. I appreciate the questions, and thanks, everyone, for your interest. We appreciate the time this morning. We look forward to following up with everybody today and over the next several weeks. Thank you. Have a good day.

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