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PRESENTATION

Operator

Good morning. My name is Sharon, and I will be your conference operator today. At this time, I would like to welcome everyone to the Ciena Fiscal Fourth Quarter and Year-End 2018 Financial Results Conference Call. (Operator Instructions) Thank you.

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

Gregg M. Lampf - *Ciena Corporation - VP of IR*

Thank you, Sharon. Good morning, and welcome to Ciena's 2018 Fiscal Fourth Quarter and Year-End Review. With me today is Gary Smith, President and CEO; and Jim Moylan, CFO. Scott McFeely, our Senior Vice President of Global Products and Services, and Rick Hamilton, our Senior Vice President of Blue Planet, will join us for the Q&A portion of today's call.

In addition to this call and the press release, this morning's report includes prepared remarks that were made available earlier today on the Investors section of our website. We have also posted on -- an accompanying investor presentation that reflects this discussion as well as certain highlighted items from the quarter and fiscal year. Our comments today speak to our view on current market dynamics and how we're addressing the opportunity in front of us. Our Q4 and fiscal 2018 performance included discussion of our long-term financial targets and near-term outlook.

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 that include risks and uncertainties that could cause actual results to differ materially from the statements discussed today. These statements should be viewed in the context of the risk factors detailed in our most recent 10-Q filing and in our upcoming 10-K filing. Our 10-K is required to be filed with the SEC by January 2, and we expect to file by that date. Ciena assumes no obligation to update the information discussed in this conference call whether as a result of new information, future events or otherwise.

Today's discussion includes certain adjusted or non-GAAP measures of Ciena's results of operations. A detailed reconciliation of these non-GAAP measures to our GAAP results is included in today's press release.

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

Gary B. Smith - *Ciena Corporation - CEO, President & Director*

Thanks, Gregg, and good morning, everyone. Today, we reported a remarkable year of performance in 2018. With outstanding fiscal fourth quarter results, including revenue, gross margin and operating margin, that were particularly strong. For the full fiscal year, we delivered sustained, industry-leading growth and profitability, including double-digit percentage revenue gains and 22% growth in adjusted EPS. This differentiated performance is driven by the consistent execution of our strategy. Our unique ability to successfully design and carry out a strategy to diversify the business, drive the pace of innovation and leverage our global scale has given us a clear and accelerating market leadership position. The fundamental demand drivers for our business remain very strong. Specifically, the cloud providers continue to invest in network infrastructure assets to drive their business. And here we are operating from a position of strength with more than 40% plus market share in the global webscale DCI market. Our outlook for Asia-Pacific remains very positive with a broadening set of growth drivers in the region and continued strength in key markets.

Additionally, new initiatives related to fiber densification, like 5G and fiber deep, continue to drive new investment strategies from service providers and cable operators alike. And we're seeing increased interest from service providers for software automation of these networks. We have made significant long-term investments over several years to address customer needs in these high-growth markets and applications. And as a result, we are benefiting from that strategy and investment and believe we will continue to do so going forward. Executing on that strategy includes pressing down on our technology leadership and investment capacity. Key to that is the Adaptive Network, our vision of the new target end-state for network operators. This vision includes programmable infrastructure that leverages our industry-leading WaveLogic coherent technology.

In addition to our modem current technology, our wins here are often driven by our roadmap, which extends beyond 400 gig and delivers multiple form factors and our customers' confidence that we will execute as planned on this roadmap.

The Adaptive Network also addresses the shift in IP infrastructure away from the core towards access and aggregation, which includes support of coherent optics and multiple new purpose-built hardware platforms in our Packet Networking portfolio. Also critical in delivering the full potential of the Adaptive Network is the software control and automation capabilities of Blue Planet. And as you know, we've invested heavily to build a comprehensive software automation suite and service delivery capability that enables our customers to scale their networks while bending down their cost curves. As we enter fiscal 2019, Blue Planet will operate as its own division within Ciena. This formation enhances our ability to support a range of consumption models by allowing the software business to operate independently of our hardware business where it makes sense. Along with this change, we will further break down the revenue in this operating segment to provide greater clarity into the performance of our automation business, and you can see this in today's press release.

The Adaptive Network vision is transforming the conversations we're having with customers, allowing us to demonstrate the holistic value of our portfolio and enabling our customers to more clearly see how they can evolve their networks.

With that, I'll now turn it over to Jim to review today's results in more detail and discuss our long-term targets. Jim?

James E. Moylan - *Ciena Corporation - CFO & Senior VP of Finance*

Thanks, Gary. Good morning. Q4 was a strong end to fiscal 2018. Total revenue was $899 million. Q4 adjusted gross margin was 44.7%. Adjusted operating expense in the quarter was $278 million, due to higher variable compensation tied to our strong performance. Adjusted EPS was $0.53. Adjusted operating income was $124.7 million or 13.9% adjusted operating margin. And we, again, had record orders in the quarter, with bookings significantly greater than revenue, and we finished the year with $1.26 billion in backlog.

Our performance in Q4 was a direct result of the continued momentum across our business. We are benefiting from both our leading market position and from strong demand, both of which we expect to continue going forward. Also, in anticipation of our adoption of ASC 606 in fiscal 2019, we've adjusted certain terms and conditions of a number of customer contracts. This resulted in a onetime approximately $16 million benefit to revenue and to gross margin in the quarter. This onetime revenue will not be repeated in future periods. And to be clear, absent this dynamic in the fourth quarter, our results still would have been above our guidance range.

With respect to our performance for the full fiscal year, last year at this time, we shared how we intend to manage the business, and what to expect over the next 3 years through a set of long-term financial targets. In fiscal 2018, we achieved outstanding results against those targets. Annual revenue was up more than 10% from fiscal 2017, which was significantly above our target growth rate of 5% to 7%. Adjusted EPS for the year was $1.39, which exceeded our targeted 14% to 16% annual growth rate. Free cash flow generation for fiscal 2018 was $162 million or 48% of adjusted operating income. While this was slightly below our target range, we remain confident in achieving our long-term goal.

And finally, adjusted operating margin for fiscal 2018 was approximately 11%, and we are confident that our 15% adjusted operating margin on an annualized basis is an achievable goal.

This overall performance is a direct result of our focus on leveraging our leading technology and relationships to win new customer footprint and incumbency and drive long-term market share gains.

Following our strong 2018 performance, we will now provide a new set of 3-year targets that reflect the performance of our business during 2018 as well as our current estimates of market growth. As we continue to focus on both top line growth and bottom line performance, we believe the most important indicators of our progress going forward will be revenue growth and adjusted EPS growth. With that in mind, we believe we will continue to gain footprint and take market share. As a result, we have a new higher target for annual revenue growth. We now expect to average approximately 6% to 8% revenue growth over the next 3 years.

With respect to operating margin, through projected revenue growth and disciplined operating expense management, we expect to achieve at least 15% adjusted operating margin for fiscal year 2021. We will remain focused on driving increased profitability.

Given our expectations for higher growth and continued operating margin improvement, we have increased our target for adjusted earnings per share growth. We now expect to grow our EPS at an average of greater than 20% per year over the next 3 years.

Finally, we continue to target annual free cash flow generation to be approximately 60% to 70% of adjusted operating income over each of the next 3 years. We've also revised the 3-year targets associated with the strategic drivers that underpin our summary financial targets. Specifically, we continue to target annual revenue growth for our optical systems business to be approximately 4% to 6% over the next 3 years. We also continue to target annual revenue growth for our global network services business, what we call attached services, to be approximately 4% to 6% over the next 3 years.

In our Packet Networking business, we are increasing our expectations for this portfolio to target annual revenue growth of approximately 8% to 10% over the next 3 years. And given the changes in our software and services business, we are providing new long-term targets that align with how we are organizing this business.

In our printed script, which we published earlier this morning, we stated that going forward, we will book our software segment reporting and we'll break it down into 2 revenue lines: Platform Software and Services and Blue Planet Automation Software and Services. We're giving targets for each of these revenue elements. Specifically, we are targeting annual revenue growth from platform software and services of 4% to 6% over the next 3 years, consistent with the expected growth rate of our correlated optical systems business. For our Blue Planet Automation Software and Services, we are targeting $100 million to $120 million in annual revenue in 2021, beginning with approximately $50 million to $60 million in fiscal 2019.

I'd also like to provide a view into our expectations for fiscal year 2019. We expect to generate revenue at approximately the midpoint of our 3-year target range of 6% to 8% annual growth. For the year, we expect to deliver adjusted gross margin in a range of 42% to 43%. We also expect to adjust -- to report adjusted OpEx in the range of $255 million to $260 million per quarter.

And finally, for our fiscal first quarter 2019 performance, we expect to deliver revenue in a range of $745 million to $775 million, adjusted gross margin in the 42% to 43% range and adjusted operating expense of approximately $255 million.

I'll now review the balance sheet and our capital allocation activities. We settled our 2018 convertible notes with the majority being paid in cash upon conversion. With the recent performance of our stock price, we also exercised our option to convert the 2020 convertible notes, settling them with a combination of shares and cash. As a result, we now have no convertible debt on our balance sheet. We also refinanced our existing term loan, increasing it to $700 million, extending the maturity to 2025 and reducing our cost of borrowing.

In addition, we successfully executed our plan to return capital to shareholders. During fiscal 2018, we repurchased 4.2 million shares for an aggregate price of approximately $111 million. We have also changed the method of tax withholding on employee equity awards to use cash instead of selling shares, which further reduces shareholder dilution.

Given our strong balance sheet and our expectations for cash generation over the next 3 years, today, we announced that our Board of Directors authorized a new program to repurchase up to $500 million of our common stock starting in 2019 and extending over the next 3 years or so. We expect that we will repurchase approximately $150 million in Ciena's stock during 2019. This replaces the existing program, but it does not change our overall capital allocation priorities or our previously stated intent to retain minimum liquidity in the $700 million to $800 million range.

In closing, our business is built for and focused on the trends that are driving the market today and into the future. We've demonstrated a sustainability to capture market share and our strategy positions us extremely well in both the current and the expected market environment. Through continued execution, we expect to be able to invest in our business, grow revenue and drive increased profitability in fiscal 2019 and beyond.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And your first question comes from George Notter with Jefferies.

George Charles Notter - *Jefferies LLC, Research Division - MD & Equity Research Analyst*

I guess I wanted to ask about the competitive environment out there. Obviously, there has been some dislocation, and I think with some of your competitors in North America and obviously even some of the Chinese guys, I think, are potentially looking to -- have some issues with U.S. relationships. And if I just step back and look at the competitive environment, I look at your opportunity to take market share, I mean it seems very robust. And I'd love to see kind of what your thoughts are on that front, and how you think that translates into share gains going forward.

Gary B. Smith - *Ciena Corporation - CEO, President & Director*

Thanks, George, appreciate it. I would say, in both of those the sort of elements, nothing -- these kind of dynamics have been around for a little while. And I think you're beginning to see that show up in our performance over the last couple of years. Frankly, in the revision that we've had for the forecast and the targets rather for the next 3 years, that's sort of encompassed in that and that will continue, I think, to play through. We're clearly in a very strong position both from an innovation point of view, a global scale point of view and in, what I would term, this sort of flight to quality, frankly. It's large carriers, webscale and folks that really want to connect their data centers and want to understand that they're dealing with a player that has sustainability and can continue to innovate and support them. So I think there incredibly positive dynamics for us that are showing up in our financial results and in our forecast for the year.

George Charles Notter - *Jefferies LLC, Research Division - MD & Equity Research Analyst*

And then just one follow-up. I assume that M&A is off the table to some degree. And I'm just looking at some of the balance sheet changes you guys have made with converts and then also the new repurchase program. I assume you guys are looking at nothing from an M&A perspective that we should anticipate going forward.

Gary B. Smith - *Ciena Corporation - CEO, President & Director*

Obviously, nothing that we're talking about now. I wouldn't rule out that. When I think as we look at our balance sheet, we still retain flexibility to look for those kind of opportunities, if they're appropriate. But it's now we're at a point with our balance sheet where we can take a balanced approach to it. Jim, I don't know do you have any sort of thoughts on that?

James E. Moylan - *Ciena Corporation - CFO & Senior VP of Finance*

I'd say our balance sheet has never been in the shape in which it stands today. We've also been upgraded by the rating agencies several times over the last couple of years. So in addition to what's showing on our balance sheet, we have a lot of flexibility and a lot of ability to take down capital if we choose to for opportunities, so we'll continue to look.

Operator

Next question comes from John Marchetti with Stifel.

John Warren Marchetti - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Senior Analyst*

I just wanted to touch base real quick on the sort of outlook on the gross margin side. We think with some of the upside that we're seeing in revenue and some things like that, that we get a little bit more benefit to those gross margin lines. I'm just curious if you can walk through a little bit of the puts and takes there, and what you're seeing from a pricing environment or things like that, that may be weighing on that a bit.

James E. Moylan - *Ciena Corporation - CFO & Senior VP of Finance*

Well, just to be clear, our costs per unit of capacity are variable. So we don't really get a big volume effect on gross margin. At the margin, yes, we get a slight effect on gross margin as we get higher volumes. But for the most part, our gross margin is determined by our contractual prices, and what we've done over the last year or 2 is, we've seen a lot of opportunities to take share. And so we've done that, and sometimes when we're taking share, particularly if we're taking out an incumbent, we're going to take some onetime costs or early stage lower gross margins with the idea that over time we will get back to a good gross margin on those contracts, and by and large, we've done that over and over again. As we look into this year, we are still enjoying the effects of some of the early stage gross margins from the deals we won last year, and we expect to see some more wins this year. So I'd say that right now, our gross margin is in the 42% to 43% range, and that's what we've guided to.

John Warren Marchetti - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Senior Analyst*

Okay. And then I just -- maybe as a quick follow-up to that, is there a big change margin-wise from a mix perspective as you continue to push in the DCI market and things like that? How should we think maybe about that weighing on margins relative to something in the optical networking group?

James E. Moylan - *Ciena Corporation - CFO & Senior VP of Finance*

Our gross margins across verticals are not that dissimilar. These are all big companies. They have the same choices to purchase from, and the competitive dynamic applies in all of those verticals. We do have higher gross margin on things like Packet Networking and software and those related services, but our optical and Packet Networking margins across verticals are not too dissimilar. Now early stage of projects, gross margins are lower than later-stage gross margins, so that we do see. It's a mix issue there.

Operator

Next question comes from Simon Leopold with Raymond James.

Simon Matthew Leopold - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Two things I wanted to check on. First, if you can offer any kind of update on progress on CenturyLink that's been a bit quiet. And from a longer-term perspective, it's been, I guess, well publicized the number of your competitors are coming to market during 2019 with 400 gig and perhaps even 600-gig solutions. Clearly, you've enjoyed a time-to-market advantage at 400 gig. How do you see the dynamic playing out with that particular availability changing in 2019 from competition?

Gary B. Smith - *Ciena Corporation - CEO, President & Director*

Thanks, Simon. Let me take the first part of that. Obviously, I don't want to comment on specific customer RFPs. However, I would say that our Adaptive Network vision is incredibly well aligned with where CenturyLink wants to take its network. I would also add that we've recently refreshed our contract with them, and we expect to continue expanding our relationship with them and that is reflected in our outlook that we talked about today.

Scott Alexander McFeely - *Ciena Corporation - SVP of Global Products & Services*

And Simon, it's Scott McFeely. Thanks for the question. On the optical competitive landscape, I just maybe offer this. I think looking back in the rearview mirror, we have a track record of delivering market-leading capabilities when it comes to coherent optics. We have an extremely competitive forward-looking roadmap, and we're very, very aware of the claims in the marketplace of our competitors in terms of their future roadmaps as well. Taking all that into account, we're very confident that we're going to continue to take share in the optical parts of our business, and probably more important than how we feel is how our customers feel. But this customer group is a very sophisticated set of buyers. They're very aware of the roadmaps in the industry. They make buying decisions not just on point in time, but on a much more sophisticated set of criteria, top of mind of which is forward roadmaps and their belief and ability to execute those roadmaps. And I'd say, if you look over the last couple of quarters in particular, more and more of those folks are voting towards Ciena.

Simon Matthew Leopold - *Raymond James & Associates, Inc., Research Division - Research Analyst*

And just to clarify, the gross margin guidance you've offered, does that assume some gross margin pressure from these competitive forces?

James E. Moylan - *Ciena Corporation - CFO & Senior VP of Finance*

We're trying to give our best view of gross margin going forward, taking into account everything that we're seeing in the market today, Simon.

Operator

Your next question comes from Paul Silverstein with Cowen.

Paul Jonas Silverstein - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

First off -- a handful of just three questions. First off, can you characterize the pricing environment? And have you seen any change in pricing behavior from Coriant/Infinera? Secondly, Gary, I think you've made comments in the past, including last earnings call, about a number of the carriers in Europe and elsewhere being full up with Huawei above and beyond the current geopolitical environment in terms U.S. vis-à-vis China and recent actions by the U.K., Japan and other regions. But you -- can you comment, are you seeing any benefit or is it too early? And then in your guidance, what is -- your old comment in the past about AT&T and Verizon, what are your expectations? What you have embedded in the guidance? And finally, there's been concerns in investment community about webscale CapEx. Can you make any comment on your outlook? I trust from your guidance that there's been no change. I recognize we're talking DCI, not inter-data center, but any insight would be appreciated.

James E. Moylan - *Ciena Corporation - CFO & Senior VP of Finance*

Paul, that was 4 questions.

Paul Jonas Silverstein - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Yes, but they're all very discrete, Jim.

Gary B. Smith - *Ciena Corporation - CEO, President & Director*

Let me take the -- let me run through the first one. On the pricing environment, overall, the sort of dynamics that we're seeing are not new, and so I'd say no real changes in the overall sort of pricing environment. You've still got some very desperate competitors out there and that dynamic is still in play, but as Scott commented, I think it's now about a flight to quality and folks that are going to be around can sustain their roadmap and have got global scale. So that dynamic has not particularly changed. Regarding the sort of European and sort of commentary around some of the China competitors, again, I would say that, that dynamic has been in play as it relates to us actually for quite a while, notwithstanding the sort of publicity of the last few weeks. And so that really has been baked into some of the wins that we've already have; I think are really about rebalancing of the market and the customers in some of those dimensions, combined with what I would describe as this sort of flight to quality and sustainability and innovation. So we haven't seen any sort of particular change in that. I think that's been underway for a while. Regarding Verizon, we had a strong year with Verizon this year, and I would expect a strong year in 2019 as we expand our relationship with them.

Operator

Next question comes from Tal Liani with Bank of America.

Daniel Bartus - *BofA Merrill Lynch, Research Division - Research Analyst*

This is Dan Bartus on for Tal. Wanted to focus on the Packet Networking business and the increase in your outlook from 6% to 8% to 8% to 10%. Maybe you can just speak about any color, what you're seeing in the markets to raise that? Maybe it's somewhat 5G related. And then also just generally, that's very strong growth versus what we're seeing in other networking areas, for instance, routing. So if there's anything you can call out in terms of why that growth rate is deviating from other networking market trends, that would be helpful as well.

Scott Alexander McFeely - *Ciena Corporation - SVP of Global Products & Services*

Yes. Tal, thanks very much. It's Scott McFeely.

Gary B. Smith - *Ciena Corporation - CEO, President & Director*

It's Dan for Tal, sorry.

Scott Alexander McFeely - *Ciena Corporation - SVP of Global Products & Services*

Oh, it's Dan. Sorry, Dan. I think if you look forward from a Packet Networking business, it's probably important to actually understand where we're coming from as well. So we've been working really hard to actually diversify that business outside of the dependency on a fairly concentrated set of accounts and we've made great progress in that in 2018. So part of our forward projection is to leverage and take advantage of that work that we've done in '18. But if I look at the broader industry dynamics, the opportunity to drive fiber densification into the access network, driven by things like 5G and fiber deep in the MSO space, gives us great opportunity. That drives a new set of platforms and a new set of capabilities, including integrating coherent optics into these platforms; starts to move that market into a place where we have more strength. So I think those are the key dynamics that we see looking forward.

Operator

And next question comes from Jim Suva with Citi.

Jim Suva - *Citigroup Inc, Research Division - Director*

Can you give us a little bit of an update on the webscale and nontelecom-related markets? I think last quarter, you saw some very strong growth there. So just kind of curious about how that's going. And then a different but unrelated question is, in the past cycles, going from like 2G to 3G, 3G to 4G, sometimes there's been a pause before the major rollout. Any sense on should we expect that to happen? It appears upon your results, it looks different this time. And if so, why would that be the case?

Gary B. Smith - *Ciena Corporation - CEO, President & Director*

Jim, let me take the first part of that. Our nontelco business continues to prosper and expand. And I think in '18, we ended up at about 35% of our total business is now nontelco. Obviously, the webscale folks being the largest element of that. Our perspective on the whole sort of webscale and sustainability around that is -- and Scott touched on this, their CapEx, we've got good visibility to that and I think that continues to be strong both in terms of their data center connectivity broadly and also in their submarine markets, which was strong as well. So I think in the order backlog that we have, the roadmap alignment that we have with them, the CapEx discussions that we're having with them, I think we have pretty good visibility to that, and I think it's very sustainable.

James E. Moylan - *Ciena Corporation - CFO & Senior VP of Finance*

And on the question of pausing, what I'd say is that we've been first to market with every generation of coherent optical technology. And so as a consequence, we really haven't seen any big pauses as we move from generation-to-generation. Some of our competitors have seen pauses as they worked hard to get to whatever we had in the market. And the other thing -- the other dynamic that's going on for us is that the first and most aggressive consumers of the next generation of optical capability are the webscale guys, because many of their connections are relatively simple. They don't have big metro networks yet, although they probably will. And so it's just easier for them to adopt new generations, and their sort of certification cycles are quicker. As a consequence, we don't expect to see at least in our results any sort of a pause as we get to WaveLogic 5.

Gary B. Smith - *Ciena Corporation - CEO, President & Director*

The other thing I would say is really that dynamic can play here is diversification of geos and markets, because you've got different markets at different evolutionary parts of their lifecycle. And I think that's playing through as well, given our very diversified geographical spread and scale.

Scott Alexander McFeely - *Ciena Corporation - SVP of Global Products & Services*

And I think you also might asked a bit about the wireless side as to 4G to 5G transition in wireless. For our business, it's a little bit less about that and more about the fundamental drivers behind that, which is bandwidth and user experience and the response to that is actually more fiber and that drives the need for coherent optics. So that's really what's driving our business more than necessarily the wireless standards.

Operator

Next question comes from Rod Hall with Goldman Sachs.

Ashwin Kesireddy - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

This is Ashwin on behalf of Rod. I was wondering if you guys can comment on opportunity in India in 20 -- in fiscal '19. Obviously, strong growth this fiscal year. How are you thinking about that next year? And then, North America revenue looks like it kind of accelerated throughout fiscal year '18. How are you thinking about that in next year as well?

Gary B. Smith - *Ciena Corporation - CEO, President & Director*

Let me take the India one. Obviously, we've had a strong run in India with very good growth. And I think it's close to -- probably close to about 10% of our total revenues actually now in '18. Obviously, we can't keep growing at that kind of growth rate, but we still expect growth out of India as we go forward. We've got a very diversified base there. All of the major carriers plus the government, the Department of Defense network and with the -- we're very much aligned with a lot of the webscale activity there as well, and it's the fastest-growing internet market in the world. So we do absolutely see growth. It's going to ebbs and flows from quarter-to-quarter, but as we look at '19, I think we see -- we are still going to see pretty good growth out of India.

James E. Moylan - *Ciena Corporation - CFO & Senior VP of Finance*

And on North America, we've had good years. It's been driven by GCN growth. I mean, our GCN direct sales are up over 100% from '17 to '18. We think that, that will continue, won't grow at that rate again, we don't believe, but we'll have a good strong year with GCNs in 2019. But we also think that service providers in North America will come on stronger as we come into 2019. So we expect a good year in 2019 with -- in North America.

Operator

Next question comes from Samik Chatterjee with JPMorgan.

Samik Chatterjee - *JP Morgan Chase & Co, Research Division - Analyst*

I just wanted to kind of dig into the optical systems group. When I look at the fiscal year '18 performance, that appears to be the group where you had the most kind of upside on driving your strong performance this year. And when we look forward into kind of your new 3-year targets, we're not really seeing an increase on that front while you've kind of spoken about market share wins continuing into next year. So I'm just wondering, is there more you need to see in terms of market share wins to kind of change the guidance there or increase the guidance there? Or is there -- why is probably the guidance remaining the same when you've seen this kind of upside in FY '18?

James E. Moylan - *Ciena Corporation - CFO & Senior VP of Finance*

Yes. We grew our optical business over 10% double digits in '18. And that's a great performance. We're going to continue to have good performance out of optical. We don't think that, that 11%, 12%, 13% is a sustainable long-term growth rate for optical. We'd love for it to happen. It was driven on the backs of GCN performance. The 100% plus growth we had in GCNs, and we just don't think those kinds of growth rates can continue. But just to remind you, we did increase our overall revenue growth rates from 5% to 7%, to 6% to 8%. So we see good times ahead.

Gary B. Smith - *Ciena Corporation - CEO, President & Director*

And Samik, I would just add sort of the context for that around the optical market. That sort of growth rate that we think on the optical market is in the single -- probably the mid-single digit, 5%, 6% something like that. So we are still planning on taking market share here going forward.

Samik Chatterjee - *JP Morgan Chase & Co, Research Division - Analyst*

Can I quickly clarify on the gross margin guidance you guided to a fiscal year '19 of 42% to 43%. Do you specify guidance for fiscal year '20 or '21 embedded in your operating margin guidance?

James E. Moylan - *Ciena Corporation - CFO & Senior VP of Finance*

We haven't given that sort of guidance, but we have given you EPS guidance for 3 years. We've given you cash flow guidance and we've given you -- what's the other piece that we gave?

Gary B. Smith - *Ciena Corporation - CEO, President & Director*

Revenue.

James E. Moylan - *Ciena Corporation - CFO & Senior VP of Finance*

Revenue. So we've given you a lot of facts about our 3-year targets. Now, I will say this that -- we said, we're going to have operating income, operating margin of at least 15% in 2021. I would say this that because our growth rate is higher than we expected it to be and we expect some very disciplined OpEx management as we move through the next few years, that getting to a 15% or so operating margin target can be accomplished we believe at gross margins below the sort of 45% to 46% range that we had been talking about. So we still target to get to 20% in 2020. But we won't get there by a gross margin...

Gary B. Smith - *Ciena Corporation - CEO, President & Director*

15%.

James E. Moylan - *Ciena Corporation - CFO & Senior VP of Finance*

15%, excuse me, target. 15% operating -- not 20%. 15% operating margin in 2020. And -- but we'll get there, again, by higher revenue growth and by a lower percent of OpEx to revenue.

Operator

Next question comes from Meta Marshall with Morgan Stanley.

Meta A. Marshall - *Morgan Stanley, Research Division - VP*

A couple of quick questions. One, on the Blue Planet business. I just wanted to get a sense of line of sight to the $100 million, $120 million target? And just whether there's kind of contracts in or RFPs kind of out there that you're responding to. And then maybe a second piece to that being whether Packet Design or DonRiver were a bigger kind of component -- inorganic addition to that. And then maybe second question, gross margins were particularly high this quarter, and I think everybody's talked about it of what is the contribution -- basically, you've said your gross margins would be depressed due to new deals. We haven't really seen that yet. When do we start to see kind of some of the -- is it just because there's been so many more new deals? Or is it just because we haven't seen the margin compression from some of the new deals yet?

James E. Moylan - *Ciena Corporation - CFO & Senior VP of Finance*

I'll deal with gross margin piece and then Rick can talk to Blue Planet. Our gross margin -- our adjusted gross margin for the year was 43% and that did have the onetime effects that we had in Q4. So that's why, first of all -- I believe our gross margin is 42% to 43% because first of all, that's what we did sort of in 2018. And secondly, we are seeing the effect of new deals both in 2018 and in 2019. So we're trying to do the best we can to give us -- give you our outlook for gross margin, and I believe that it's between 42% and 43% today. Rick?

Rick L. Hamilton - *Ciena Corporation - SVP of Global Software & Services*

Great. Relative to the line of sight to $100 million, not to comment specifically on that, but we see pipeline activity that we're super confident in. This digital transformation that the carriers, in particular, are going through is generating a host of new opportunity. So the activity is incredibly strong there. And yes, I think we're super confident in our ability to execute in that space.

Meta A. Marshall - *Morgan Stanley, Research Division - VP*

But to the question of what contribution did Packet Design and DonRiver have to that $100 million, $120 million?

James E. Moylan - *Ciena Corporation - CFO & Senior VP of Finance*

Well, here's what I say. The Packet Design and DonRiver combined were something like $20 million or $25 million run rate, roughly speaking. So next year, we said $50 million to $60 million. That's going to be a combination of growth in those 2 acquisitions as well as pretty significant growth in our base Blue Planet Automation. And we are extending our capabilities in that space. It's probably not going to be that important for you going forward, how much comes from DonRiver, how much comes from Packet Design and how much comes from the base Blue Planet business, because we will be selling solutions that combine those capabilities and it might not be even possible to identify which is which. One thing I would say is that it is a services -- it's going to be a higher percentage of services in that revenue line. And so whereas overall, the gross margins will be accretive to our base gross margins. They're not going to be just straight software margins. They're going to be a combination of software and services margins. Anything you would add there?

Scott Alexander McFeely - *Ciena Corporation - SVP of Global Products & Services*

No. I think you got it, that's great.

Operator

Next question comes from Michael Genovese with MKM Partners.

Michael Edward Genovese - *MKM Partners LLC, Research Division - MD and Senior Analyst*

First to clarify, the 0.3% customers, were they the same as last quarter?

James E. Moylan - *Ciena Corporation - CFO & Senior VP of Finance*

Let's see, yes, they were. Yes, there were. Yes.

Michael Edward Genovese - *MKM Partners LLC, Research Division - MD and Senior Analyst*

So one was the hyper scale?

James E. Moylan - *Ciena Corporation - CFO & Senior VP of Finance*

Yes.

Gary B. Smith - *Ciena Corporation - CEO, President & Director*

Yes.

Michael Edward Genovese - *MKM Partners LLC, Research Division - MD and Senior Analyst*

Okay, great. And then my question, I want to revisit the gross margins question and the difference between 42% and 43% -- or 42% to 43% and 45% that we're seeing. I mean I'm hearing from you I think that you're saying that it's a 100% explained by we're in this land-grab environment where there's footprint to be grabbed and lots of big new wins in countries where, say, Huawei is not -- has been being removed. You guys are winning big deals and that's the reason for the difference. So that's what I'm hearing, but I'm wondering are there any other factors that are 100%? Or is there one or two other factors or three other factors in there? And how important are those other factors besides just the land-grab environment that we're in?

James E. Moylan - *Ciena Corporation - CFO & Senior VP of Finance*

Yes. Mike, remember, in Q4, we had $16 million of onetime revenue, and it was all gross margin because it was all software. And that affected our gross margin in the quarter by about a percentage point. So the 43 point -- we actually on a -- adjusted for the onetime, I mean we didn't adjust it out of course, but it was 43.7% gross margin. For the year, our gross margin was about 43%, including the onetime item. So I think you have to take all this into account. Yes, we are taking market share, and there are early project costs and lower gross margin. We're seeing that. We saw it this year and we're going to see it next year. There's nothing else in it other than the onetime item that we talked about. And by the way, this is going to be good going forward because our market share is going to be bigger, and hopefully over time, the industry sort of environment is going to improve for us.

Michael Edward Genovese - *MKM Partners LLC, Research Division - MD and Senior Analyst*

Okay. So just to tie the ribbon there though. So from what I hear from that is that longer term, I mean, 45% is not -- I mean, you still believe that 45% is -- I mean would "be a normalized." I don't want to put words in your mouth. Do you think this 45% is still...?

James E. Moylan - *Ciena Corporation - CFO & Senior VP of Finance*

We were doing 45% for 2 years or something; maybe over 2 years. And we think that's a good gross margin for us. But even at that time, we didn't think that was going to be our ultimate goal. We still have goals of getting to gross margins above 45%. But it's not happening now because we're taking a lot of share.

Operator

Your next question comes from Tejas Venkatesh with UBS.

Thejeswi Banavathi Venkatesh - *UBS Investment Bank, Research Division - Associate Director and Analyst*

Are you seeing any change in customer thinking around with use of pluggable? And how is Ciena approaching it?

Scott Alexander McFeely - *Ciena Corporation - SVP of Global Products & Services*

So from a pluggable perspective, I think take a look at the different application spaces and the move of miniaturizing coherent optics actually is a theme that's out there in the future. I think the application space where it will be applicable is a subset -- very specific subset of the market. And in particular, I think the places you'll see move first is the camp is very short, reach data center interconnect. And a move as we push coherent optics into the service-provider access network as fiber and bandwidth gets deeper into their access network on the backs of things like 5G and MSO fiber deep. That second access piece of the market, by the way, is a totally new space for coherent optics and a totally new space for our optical business. So it's new opportunity for us. We said, if you remember back when we made the announcement to make our coherent technology available outside of our system business, one of the longer-term motivations for that was pluggable market space, and we're very much still on that path. And if I look at what it takes to be successful in that space, it takes a technology capability around the DSP, it takes a technology capability around electro-optics, which we own through our acquisition of a couple of years ago of TeraXion. I'd also put to you that it also takes a knowledge of how to put these things together from a whole transmission system perspective. And we think we're kind of uniquely positioned across those dimensions to be able to take advantage of those 2 opportunities.

Thejeswi Banavathi Venkatesh - *UBS Investment Bank, Research Division - Associate Director and Analyst*

And as a follow-up on Blue Planet, how broad is the traction you're seeing? Is this 1 or 2 customers that are driving this? Or just how broad it is? I think in the past, you've disclosed how many customers you have, so hoping to get an update.

Rick L. Hamilton - *Ciena Corporation - SVP of Global Software & Services*

Yes. It's relative to our core business. It's, I would say, as broad as that as we have applications across the service providers worldwide. We have traction in the data center space, and we're actually seeing some traction into the higher-end adjacent markets like the top-tier enterprise space. So the technology and the need is applicable fairly broadly.

Operator

Next question comes from Tim Long with BMO Capital Markets.

Timothy Patrick Long - *BMO Capital Markets Equity Research - Senior Equity Analyst*

Just two questions, if I could. Gary, Jim, you mentioned new deal activity as it relates to gross margin. Just give us a little more color on what you're seeing for the pipeline for the next year or 2. And what kind of deals are out there? Are there really large ones? What verticals you're seeing them in? What product sets? What applications? And then secondly, back on the webscale, just give us an update on what you think there -- are there any intentions for them to vertically integrate more in optical?

Gary B. Smith - *Ciena Corporation - CEO, President & Director*

Well, I'll take the first part of that, Tim. I think the dynamic that Jim's talking around earlier on, I think we saw that coming into '18. And I describe it as this sort of flight to quality. By a number of large Tier 1s around the world, we saw that play out in '18, and I absolutely think that dynamic is going to play through in '19. And what we're talking about here specifically, I mean, Ciena has most of the Tier 1 carriers around the world. There are a few that we do not have. And many of those are actually started engaging with us and we secured in '18, and we think there's more that are going to come our way in '19. And they are very geographically dispersed, but I would highlight a couple of areas: one would be Japan, where we're doing particularly well there with a couple of large new Tier 1s to us. We're seeing this dynamic in Europe. I think the poster child for that is the one that we've talked about publicly is Deutsche Telekom, but there are others there as well. And I also think you're seeing that in North America as well. The large carriers in North America I think are looking very carefully around their partners as they move forward. It is predominantly manifested it in optical transport, but it is -- when you talk about packet optical now, you're talking about a converged network of regional, metro, long haul and including some data center connectivity as well. So it's very broadly based. I think it is a sort of shift that you're seeing in the industry, and I think that's continuing to play in '19. And that, frankly, is reflected in a great year in '18, strong guidance for '19, and upping basically our targets for the next 3 years.

Scott Alexander McFeely - *Ciena Corporation - SVP of Global Products & Services*

Yes. And Tim, on the webscale piece. Yes, it -- around vertical integration around optical, I'd say this, as we talk about in the pluggable conversation, I think, in the very short-span campus metro DCI, some of them will consider moving to a pluggable if you consider that case of vertical integration. But if you take a step back and think about our interactions with the webscale, certainly, technology and leadership is an important aspect of that and it has driven the market share we have there, but the relationship is multidimensional. So as they move international, as they get involved in submarine networks, as they get more in sophisticated in terms of their network and have back-office integration around that, it becomes a multidimensional relationship over time and having that technology leadership position has put us in a good position to be able to grow that relationship as we go forward.

Operator

Next question comes from Jeff Kvaal with Nomura.

Jeffrey Thomas Kvaal - *Nomura Securities Co. Ltd., Research Division - MD of Communications*

I'm hoping to clean up a couple of things left over. I think, first, can you talk a little bit about some of the things that seemed a little bit lumpy to the good this quarter? And I guess Latin America in particular. Could you help us also follow-up on -- you had some strength in the packet business last quarter and how's that progressing? And then Jim, maybe for you, obviously, congratulations, no convert. That's wonderful. That's been like a 15-year journey for you. So we don't need to sweat that on the income statement anymore. Could you help us one last time walk through what the implications of closing the convert out means for the income statement?

James E. Moylan - *Ciena Corporation - CFO & Senior VP of Finance*

Let me take the second one, and then maybe Scott can take the first one. I think the great benefit of no longer having convertible bonds in our capital structure is that we can plan our capital structure and our balance sheet more carefully and with more certainty about what's going to happen. The second thing is that there is no longer going to be any uncertainty about the share count. You will know what the share count and just for your information, we think that next year share count will average around 156 million shares, starting a bit higher, maybe 157 million, and going down slightly as we do the combination of distributing shares and buying in shares. So that's -- the implications on our income statement are EPS. The other thing I'd say is that just to close out the modeling comments is that our GAAP tax rate, we believe, will be about 24 -- I'm sorry, our non-GAAP tax rate will be around 24% going forward. There are lot of tax entries in our books this year. There may be some going forward that are tied to the tax reform act. But I'll remind you that we are not a taxpayer for the next several years at least because we have the big NOLs. And so a lot of the entries, in fact, all of the entries that are GAAP related are mostly noncash items. So those are the 2 modeling questions. And, Gary?

Gary B. Smith - *Ciena Corporation - CEO, President & Director*

So in terms of the sort of strength in Q4, I mean, I think as we've talked many times, the nice thing now is we've got a very diversified business, and we can deal with ebbs and flows of markets, customers, product lines. If you look at the strengths in Q4 sort of relative to Q3, if you like, we had a very strong quarter in the MSO space, cable area particularly, trying to get fiber closer to the customer. CALA, which I think is steadily recovering from some of the challenges we had a couple of years ago. I would also highlight in Q4, we had a very strong quarter in Japan. And also, waves of continues to grow quarter-on-quarter from Q3 to Q4, a bit of a proxy for sort of the webscale-type connectivity. And I think we had a strong packet quarter -- stronger quarter in packet as well in Q4.

Jeffrey Thomas Kvaal - *Nomura Securities Co. Ltd., Research Division - MD of Communications*

Great. And could I just ask, Jim, the interest, what kind of interest should we be penciling in then?

James E. Moylan - *Ciena Corporation - CFO & Senior VP of Finance*

Well, the only debt on our books is $700 million of term loan. The interest rate on that is roughly 4.5% to 5% depending upon what LIBOR does. There are probably some minor entries in our interest expense relating to the amortization of debt cost, but $35 million plus a little is where we're going to be for the coming year or so.

Operator

Next question comes from Catharine Trebnick with Dougherty.

Catharine Anne Trebnick - *Dougherty & Company LLC, Research Division - VP and Senior Research Analyst of Data & Internet Protocol Networking*

Question, last -- this quarter you did 11% year-over-year growth in Europe and last quarter, it was 27%. So going back to your discussing carriers moving away from the Chinese vendors, can you pretty much quantify, which I know you don't want to do, but give some color on how much of the opportunity in Europe you feel you've conquered?

Gary B. Smith - *Ciena Corporation - CEO, President & Director*

I would answer it. You're absolutely right, Catharine. To split it out would be very difficult from a dynamic point of view but let me answer it like this. I do think the strength that we're seeing in Europe will continue through '19. And I do think overall, it's about the sort of flight to quality in its various forms. This dynamic is not new, and it's -- we saw it over the last couple of years. And I do think it will sort of continue and that's encapsulated in our forecast. And particularly in Europe, I think you're dealing with a couple of dynamics. You're dealing with this concentration of supply and trying to rebalance their -- the vendor marketplace and I think we are certainly benefiting from that. And also, I think there's been some underinvestment, frankly, in the carrier space in Europe for about the last 3 to 4 years. And I think you're seeing that being addressed and also the webscale folks are also building out into the submarine and into Europe market. That's also is providing strength in the European area as well. So I think it's a confluence of dynamics as always, but I think we feel pretty good around our European business moving forward.

Catharine Anne Trebnick - *Dougherty & Company LLC, Research Division - VP and Senior Research Analyst of Data & Internet Protocol Networking*

Well do you see any new opportunities in Europe in particular? I know you announced Tele2 during the quarter.

Gary B. Smith - *Ciena Corporation - CEO, President & Director*

Yes, we do. We see additional opportunities for new wins in Europe. To be very specific to you, yes. And we're engaged with a number of carriers that we think will expand and invest in their networks, and they -- some of those are new customers to Ciena.

Gregg M. Lampf - *Ciena Corporation - VP of IR*

We've come up on 9:30. We appreciate everybody's interest and looking forward to catching up with everybody over the next several weeks. Have a happy holiday, and happy New Year.

Operator

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