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CIEN - Q2 2015 Ciena Corp Earnings Call

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PRESENTATION

Operator

Welcome to the Ciena Corporation second-quarter 2015 earnings conference call. My name is Loraine and I will be your operator for today's call. At this time all participants are in a listen-only mode. Later we will conduct a question-and-answer session. Please note that this conference is being recorded.

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

Gregg Lampf - *Ciena Corporation - VP, IR*

Thank you, Loraine. Good morning and welcome to Ciena's 2015 second quarter review. With me today is Gary Smith, CEO and President; Jim Moylan, CFO; and Francois Locoh-Donou, Senior Vice President of our Global Products Group.

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

In our prepared remarks today, Gary will discuss management's view on the market and our progress in the quarter and Jim will provide some color on our results and provide guidance. We will then open the call to questions from the sell side analysts taking one question per person with follow-ups as time allows.

Before turning the call over to Gary, I'll remind you that during this call we will be making certain forward-looking statements. Such statements are based on current expectations, forecasts and assumptions regarding the Company that include risks and uncertainties that could cause actual results to differ materially from the statements discussed today. These statements should be viewed in the context of the risk factors detailed in our most recent 10-Q filing and in the context of the transaction-related cautionary statements included in our May 4 press release announcing Ciena's intention to acquire Cyan.

Our 10-Q is required to be filed with the SEC by June 11 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 results or otherwise.

Today's discussion includes certain adjusted or non-GAAP measures of Ciena's results of operations. A detailed reconciliation of these non-GAAP measures to our GAAP results is included in today's press release available on ciena.com. This call is being recorded and will be available for replay from the investor section of our website. Gary?

Gary Smith - *Ciena Corporation - President and CEO*

Thank you, Gregg, and good morning, everyone. For some time now we have been stressing the importance of two related dynamics in the market. The first is the shift to on-demand consumption of network resources and the second is that this shift has significant implications to both the service provider and web-scale communities. In fact, this shift is blurring the lines between these sets of buyers as they become increasingly interdependent.

Our outstanding second quarter reflects Ciena's industry-leading ability to address these market dynamics. I think it also underscores the importance of having established trusted relationships with both Tier 1 service providers and global web-scale providers as they build open, on-demand network environments.

We have purpose built a broad-based and increasingly profitable business specifically to address these market developments. Ciena's continued diversification, steadily improving operating leverage and overall financial performance demonstrate our successful execution of this strategy.

Accordingly, Q2 revenue grew 11% over the second quarter of last year, roughly doubling the estimated growth rate for the overall general market. We also booked record order volume in the quarter. And at 11%, our adjusted operating margin is nearly twice as high as it was in the year-ago period. All of this continued progress illustrates both the strategic value of our portfolio and the effectiveness of our operating model.

Ciena's sustained momentum is being driven by the continued adoption of our OPn architecture, which is designed to facilitate the shift to on-demand networking for applications ranging from service providers, Next-Gen Metro builds to data center interconnect applications for web-scale and service providers alike.

As the only player with a complete next-gen portfolio that covers edge, metro, long-haul and data center interconnect, we are seeing broad strength across our market. For example, I'm pleased to announce that we signed another top five global web-scale provider for data center interconnect connections in the quarter further strengthening our leadership position in this important market.

Also in Q2, Ovum released its share data for the DCI market naming Ciena the global leader for the entire category. And just last week, Dell'Oro also named Ciena number one globally in overall DCI and number one with Internet content providers, specifically.

In addition to our gains in the web-scale market, we have continued to make progress with cable operators and our Tier 1 service provider customers as illustrated by another strong quarter with AT&T. AT&T is the largest buyer in our global market and we are committed to maximizing the opportunity presented by the Domain 2.0 program. As we anticipated, Domain 2.0 has expanded our addressable market within AT&T, initially around next-gen metro.

We also recorded an outstanding revenue quarter with other customers in North America. We have often said that we believe carrier spending is shifting towards next-generation solutions that enable network operators to better monetize their networks. Our performance in North America in what has been a measured carrier spending environment overall, further validates our repeated assertion that the shifts within CapEx budgets are a better indicator of Ciena's opportunity than the total envelope of carrier CapEx.

And with the on-demand shift happening first in North America, we see our strength here as a positive indicator for the emerging longer-term opportunity as the shift begins in earnest internationally.

As we are experiencing all of this success today, we are also continuing to make substantial strategic investments in critical product innovations that will help us expand our market leadership in the future and broaden our role with customers. As an example, we recently launched Waveserver, a stackable data center interconnect platform that utilizes open source software. Waveserver provides 60% more capacity per rack unit versus competing platforms in the market today positioning us to extend our lead further in the DCI market.

Waveserver joins Coherent Select, WaveLogic 3 Extreme, WaveLogic 3 Nano, and two small cell backhaul platforms as new offerings already so far this year. And we will be introducing additional packet optical products in the second half of the year as well. And of course, we are expanding our investment in SDN/NFV and open networking with our agreement to acquire Cyan.

As we said in the announcement last month, this acquisition is complementary to our existing investments and allows us in fact to advance our strategy while accelerating the availability of a complete on-demand solution for virtualized networks and services in an open ecosystem.

Our acquisition of Cyan is a highly targeted investment in this direction that elevates the business value of networks by increasing the monetization of network assets, speeding the time-to-market with differentiated services, and vastly improving efficiency through both lower costs and faster implementation of new technologies. I am pleased to report that integration planning is underway and subject to customary approvals, we continue to expect to close the transaction in our fourth fiscal quarter.

In summary, Q2 was a tremendous quarter for Ciena. We specifically designed the Company to be the leader in open on-demand networks for a more diverse set of buyers across the globe, resulting in faster than market growth and sustained profitability. As our results in customer wins illustrate, we are executing well on this model. As we continue to increase our focus on software, we are confident in our ability to lead the industry into this critical new era of on-demand. Jim?

Jim Moylan - *Ciena Corporation - SVP Finance, CFO*

Thank you, Gary. Good morning, everyone. I will start by underscoring Gary's statement that Q2 was an outstanding quarter for Ciena with excellent overall financial performance and continued forward momentum.

But before I get to the numbers, I'd like to highlight some data points that illustrate our continued diversification. Non-telco customers represented 33% of our business in Q2 with MSOs as a particular strength. We recorded our best ever quarter with two major cable players and our best ever MSO revenue performance overall driven in part by continued growth in demand for Ethernet business services.

Web-scale customers continue to be an important growth driver for Ciena. We added a top-five web-scale provider in the quarter and more than 80% of our 200Gshipments went to web-scale customers. Our 8700 Packetwave Platform, which expands our opportunity in data center and metro networking, now has 15 customers compared to 12 last quarter. And we shipped 26% more total packet capacity this quarter versus Q2 2014.

Our coherent optical business continues to grow and is now well beyond $1 billion annual run rate. We now have 209 total customers for coherent optics, 158 of which are 100Gcustomers and Converged Packet Optical revenue in Q2 is up more than 20% year-over-year. In metro applications specifically Dell'Oro recently named Ciena as number one in global metro market share surpassing Huawei in this important and growing market.

Turning now to our financial performance, we believe our second-quarter results continue to show the momentum that we built in the market for the past few years. Revenue came in at $622 million driven by non-telco customers and overall strength in North America. At 44.4%, Q2's gross margin reflects a strong quarter for services and a products mix that included a higher proportion of line cards. Operating expense in Q2 was $208 million.

Our second-quarter adjusted operating profit of $68 million represents an adjusted operating margin of 11%. Orders, which were a record in Q2, were meaningfully greater than revenue and our backlog continued to grow.

Additionally, book to revenue in the quarter was the highest we have seen to date meaning that we are increasingly booking and shipping more orders during the same quarter, converting backlog to revenue faster and improving our cash flow. This increased velocity in the business reflects the strategic investment in inventory that we made last year to reduce lead times for a growing number of customers who require faster delivery.

We also continue to take steps and to make progress in strengthening our balance sheet. During Q2, we had a successful outcome for the maturity of our convertible notes with over 96% of the outstanding 2015 notes settled through the issuance of Ciena stock. For the portion of the notes not settled in equity, we paid approximately $7 million in cash at maturity. The resulting reduction in leverage continues the significant balance sheet improvement we have seen over the past few years and it positions the Company well for future growth.

Exclusive of the cash payment at maturity, we generated $25 million in cash from the business. We were able to generate this cash despite the timing of the payment of our Companywide fiscal 2014 incentive bonus during the quarter. Adjusted earnings per share were $0.35 and we ended the quarter with approximately $817 million in cash and investments.

And now for Q3 guidance. We expect revenue in the range of $610 million to $640 million. We expect Q3's adjusted gross margin to be approximately 43%. We expect adjusted operating expense to be approximately $210 million.

Now I'd like to take a step back and provide an update on our annual view for 2015. At the beginning of the year, we stated that we expected a strong 2015 for Ciena. It has certainly been a strong year to date and we remain on track with regard to the annual revenue and operating expense expectations we provided in March.

At the beginning of the year, we also said that we expected to achieve an adjusted operating margin in a range of 8% to 9% for the full year. In both Q1 and Q2, we delivered very strong gross margin driven largely by product mix, services margin and cost reductions. Given that first-half performance and our expectations for the second half including approximately 43% adjusted gross margin for the remainder of the fiscal year, we are raising our guidance for adjusted operating margin to a range of 9% to 10% for the full fiscal year.

While we do expect to close the Cyan transaction in our fiscal Q4, all of the previous expectations are exclusive of any financial effect of that acquisition.

Also, there has been no significant change to the foreign exchange rates in effect when we spoke in March so our projections and guidance have not been impacted by FX changes since then.

To close our prepared remarks, we believe that our overall performance and steady gains in operating leverage are the direct result of our sustained market momentum, our continued diversification, and our execution against a well conceived and successful strategy. We are very confident that Ciena is well-positioned globally to deliver open, on-demand software driven networks for an increasingly diverse set of buyers.

Loraine, we will now open the line for questions.

QUESTIONS AND ANSWERS

Operator

Thank you. We will now begin the question-and-answer session. (Operator Instructions). Mark Sue, RBC Capital Markets.

Mark Sue - *RBC Capital Markets - Analyst*

Good morning, gentlemen, and it is good to see the operating margin and guidance increase. At a high level as you increase your on-demand software centric network solutions and you increase your customer diversification, are you able to price your products more at a premium than in the past? In the past it was cost and then some profit above that. Are the discussions becoming increasingly strategic with your customers as you diversify, and furthermore -- can you give us an update on WaveLogic and how that can further improve your gross margins over time?

Gary Smith - *Ciena Corporation - President and CEO*

Hi Mark, Why don I sort of summarized the customer engagements and I think you said it well, it is much more strategic. I think it is back to this sort of on-demand positioning with our customers. We are very often involved in the marketing of their services so it is more seen about a revenue generation than an actual cost or expense and it is linked increasingly to the success of their business. And that in turn with the intelligence that we are putting into the network is more software oriented across the portfolio.

So if you look at our improvement in gross margin over the last couple of years, it is really about the increased software capability that we have across the platforms, in subscription software, which shows up in services, in cost reductions, which is really things like WaveLogic technology which is predominantly software, essentially. So all of those things improve our ability to drive value into our customers and therefore from a pricing point of view, very simplistically we have more flexibility and power.

From a WaveLogic point of view, Francois, do you want to touch on the capabilities of that going forward?

Francois Locoh-Donou - *Ciena Corporation - SVP, Global Products Group*

So Mark, as we continue to improve the performance of our coherent engine, what we are seeing is an ability to reduce our cost for an equivalent amount of capacity. We are able to reduce our cost and power per bit consumption, which does help our gross margins. But in addition, we are able to differentiate on performance and one of the things that we have seen over the last couple of years with SDN and the large number of applications running on optical networks, is the performance and scalability of optical networks continues to be mission-critical and perhaps is even more important than it was before. And therefore, the performance of WaveLogic 3 and the differentiation that it creates for us in the marketplace is another factor of positive trends towards our gross margin.

Mark Sue - *RBC Capital Markets - Analyst*

Thank you. Good luck, gentlemen.

Operator

Kent Schofield, Goldman Sachs.

Doug Clark - *Goldman Sachs - Analyst*

Hi, this is actually Doug Clark on behalf of Kent. I wanted to ask about the web-scale customer traction. You announced one major customer in the quarter and also launched Waveserver. Wondering how Waveserver works into that strategy and if you see that as an opportunity to expand into additional accounts from here?

Francois Locoh-Donou - *Ciena Corporation - SVP, Global Products Group*

So yes, absolutely. Waveserver is a great fit into the data center interconnect market. This is a market where we have been deploying 6500 and as Gary said, we are leaders, number one in the global data center interconnect market but Waveserver really extends our opportunity because it allows us to deploy in smaller data centers than we've had before and also potentially with Tier 2 Internet content providers.

Really the uniqueness and differentiation in Waveserver relative to anything we've seen in the marketplace is twofold. Number one, it provides just more compactness and scalability and cost per bit performance than anything that has been done before. And number two, I think that is the piece that has been I think missed in general is that Internet content providers really are obsessed with automation and software automation and with Waveserver, we've also launch what we have called an Emulation Cloud that allows Internet content providers to effectively simulate their implementations or clusters of nodes and allows them to operationalize the technology a lot faster. So Waveserver really for us is a milestone and a great opportunity to extend our presence in the data center market.

Jim Moylan - *Ciena Corporation - SVP Finance, CFO*

The other thing that I would like to point out, we don't want people to lose sight of the fact that although we have highlighted in this quarter that we won another of the top five web-scale customers, we serve a broad range of web-scale customers including companies like Equinix and Digital Realty, customers that we won because of our capability and that is just the direct sales. We also sell them capacity through our carrier customers on a managed service provider basis, which effectively doubles the direct sales that we have. So it's a very important market for us, very strategic. We are well-positioned and I think we will continue to do very well in that market.

Doug Clark - *Goldman Sachs - Analyst*

Great, thanks. That's good detail. And then one quick follow-up as well. The segment mix was certainly strong towards Converged Packet Optical, wondering if you could talk through the dynamics of the relative product segments?

Jim Moylan - *Ciena Corporation - SVP Finance, CFO*

Yes, Doug, as you have followed us over the years, I think we should be careful not to trend line the results of any one particular quarter in any product set or any geography. What you ought to look at is the progress over time and the geographies and across the product set. So we feel great about what happened in Converged Packet Optical in the quarters. We have done very well in packet networking over the past few years and I think both of those will continue to grow over time.

Doug Clark - *Goldman Sachs - Analyst*

Great. Thanks, guys.

Operator

Rod Hall, JPMorgan.

Rod Hall - *JPMorgan - Analyst*

I guess my main question, Gary, I wanted to go back to your commentary around AT&T. We know that there's an RFP out for the 100G metro upgrade. I just wonder if -- are your comments suggesting that you guys have a significant position in that RFP? Have they made any decisions yet? Can you just give us an update on what is going on with that particular RFP and then I have a follow-up.

Gary Smith - *Ciena Corporation - President and CEO*

Rod, without getting into too much detail and specific customers, we are deploying Converged Metro with AT&T and that was included in our revenues for this quarter and we see a good rollout of that over the coming years. So I can't comment on a particular RFP but we are actually rolling out the metro as we speak.

Rod Hall - *JPMorgan - Analyst*

Okay. And that includes the 100Gtechnology, I assume, Gary?

Gary Smith - *Ciena Corporation - President and CEO*

Correct.

Rod Hall - *JPMorgan - Analyst*

Okay. The other thing I wanted to just maybe ask Jim about, a couple of points on the margin. One is, the OpEx is just a touch higher than we expect. You guys are guiding for full-year OpEx in line with your prior commentary. Anything we ought to know about in terms of the puts and takes around the OpEx?

And then also while we are on the margin topic, could you guys just talk a little bit about the pricing environment. The gross margins seem very strong here. Thanks.

Jim Moylan - *Ciena Corporation - SVP Finance, CFO*

On the OpEx side, there is going to be some quarterly fluctuation in our OpEx driven largely by what is happening within our R&D investment envelope and timing associated with the release of new products, the need for spending just prior to that, that sort of thing. So we are still very comfortable with what we said about OpEx for the year, which is approximately $205 million on average per quarter which would get you to a number of about $820 million for the year. We still feel very good about that. There will be some quarterly movements as we said but confident we will be able to hold our OpEx to that range.

Gary Smith - *Ciena Corporation - President and CEO*

Rod, on the overall sort of pricing, I would say as we see the sort of shift to on-demand, which is really around service creation as opposed to being perceived as an infrastructure or pure cost, the price sensitivity around that gets less and increasingly as you are adding value into that customer base, it is more software centric. So the game is changing over the last couple of years. Yes, it is about price per bit and transporting bits efficiently, absolutely, and we do that better than anybody else. But increasingly it is about software content across the portfolio to deliver us an on-demand environment and that gives us opportunity to increase our margins. You are seeing that trend. We've made good progress and I think we will continue to do so.

Rod Hall - *JPMorgan - Analyst*

Great. Thanks, guys.

Jim Moylan - *Ciena Corporation - SVP Finance, CFO*

If you take our guidance for the second half of the year for gross margin and add it to what we did in the first half, you will see that we had a very nice progression in gross margin, or we expect a very nice progression in gross margin in 2015 from 2014. And that is because of a lot of things. It is because of software content. It is because that many of the places and customers in which we were attacking and we were building out networks are now getting into more mature phases and we are building out more line cards into these projects.

Also our services margin is improved and that has also to do with software content. We sell software subscription and that is included in our services revenue. So for all of those reasons, we feel very good not only about this year's gross margin but about the progress that we expect to make going forward.

Rod Hall - *JPMorgan - Analyst*

Thanks, Jim.

Operator

Michael Genovese, MKM Partners.

Michael Genovese - *MKM Partners - Analyst*

Just wanted to ask about the with the orders as strong as they were in the quarter but the sequential guidance only being up slightly. If you could just comment on that. Is that taking a conservative view after a very strong quarter, or is that because of a tough cable comp? What is going on with the sequential guidance?

Jim Moylan - *Ciena Corporation - SVP Finance, CFO*

We have always said Mike, as you know, that quarter-to-quarter movements can be a little bit distracting and not very indicative of our forward progress. We feel really good about what we are going to do in the second half of this year. We've tried to make a call for the third quarter and for the full year that reasonably reflects what we think is going to happen. So that's all I will say about it. Feel great about what is going on in the business, feel great about future progress going forward.

Michael Genovese - *MKM Partners - Analyst*

That is fair enough. Just one clarification then on the MSO comment -- sorry, web-scale comment with winning a top five. Can you just tell us how many of the top five web-scale customers you have?

Gary Smith - *Ciena Corporation - President and CEO*

Three. We have -- what we are talking about here, to Jim's point, is direct relationships; we actually provide services to all of them indirectly but directly is three.

Michael Genovese - *MKM Partners - Analyst*

Thanks a lot and congrats on a great quarter.

Operator

Jeff Kvaal, Nomura.

Jeff Kvaal - *Nomura - Analyst*

Thank you, gentlemen. I wanted to ask you about, Jim, your comment about velocity of sales given that it sounds like things are picking up in terms of your ability to book and ship in a quarter. Can you tell us what that might mean in terms of interpreting your record orders commentary? Does that mean that the record orders essentially just showed up in this quarter, or does that mean that they apply to future quarters? And then as part of that, does that change your general visibility (technical difficulty)?

Jim Moylan - *Ciena Corporation - SVP Finance, CFO*

Yes, I think the last point I will address first. Clearly a bigger backlog, Jeff, means that we do have more visibility in what is going to happen and you should also know that it's not always the case when we get orders that customers want them immediately. In some cases they want them out a quarter or two quarters or some period of time that reflects the period over which they are building their networks. So although the fact that we had record orders in the quarter is a hugely positive statement and the fact that our backlog grew is a hugely positive statement, it's actually not exactly the same statement as the fact that our business is experiencing higher velocity. The two can be separate.

I think actually both are true. We are growing our backlog and secondly, we are able to deliver on much shorter lead times. We have improved our lead times considerably over the last year and we are able to pretty much meet demands for lead times across our product set, which is a big improvement for us. We are very happy about that.

Jeff Kvaal - *Nomura - Analyst*

Thank you, gentlemen.

Operator

Amitabh Passi, UBS.

Amitabh Passi - *UBS - Analyst*

I wanted to go back to the strength in North America. I think your AT&T business was about flat quarter over quarter yet you delivered about 20% growth. You talked about strength in cable MSOs. I just wanted to get a sense for the sustainability or the strength you saw in North America or again, should we expect sort of quarter-to-quarter volatility? But it was quite impressive particularly given your largest customer was flat sequentially.

Gary Smith - *Ciena Corporation - President and CEO*

I think it actually talks to the overall diversification that we have achieved within North America. We're in the enterprise space, government, cable that Jim highlighted up to the web-scale, which we have talked about, Tier 2 type carriers. And I also think it talks to this emerging of the whole metro piece in its various dimensions. And I think that opens up to a lot more customers generally and I think we are seeing that certainly in North America. And I think we are seeing signs of that outside of North America as well as some of these international geographies begin to make the same kind of shift we see an opportunity to address new and different customers internationally as well. So that is why we are encouraged by the overall momentum that we are seeing.

Amitabh Passi - *UBS - Analyst*

So nothing unusual, Gary? Seems like the underlying trends appear to be sustainable going forward?

Gary Smith - *Ciena Corporation - President and CEO*

Absolutely. We see very sort of broad based demand across the board. Geographies and customers are going to fluctuate quarter to quarter for sure. I wouldn't read too much into that, but generally I think you can see the trend now across all the customer bases, across all the geographies. It is going in one direction.

Amitabh Passi - *UBS - Analyst*

And then just as a quick follow-up, can you maybe just give us an update on where we are with the Verizon 100G rollout, just how things are progressing? Would be good to get an update on that.

Gary Smith - *Ciena Corporation - President and CEO*

They are progressing extremely well. We are deeply engaged with them as you would expect in all of the trials, etc. and I think as we said, we don't expect to take meaningful revenues this fiscal year but we do expect to start to take revenues as we get through 2016 and we are very focused on the rollout for them.

Amitabh Passi - *UBS - Analyst*

Through fiscal 2016, or calendar?

Gary Smith - *Ciena Corporation - President and CEO*

It will start in 2016, probably calendar.

Amitabh Passi - *UBS - Analyst*

Okay. Thank you.

Operator

Ehud Gelblum, Citi.

Ehud Gelblum - *Citigroup - Analyst*

A couple of clarifications. I know this is a silly question, but Jim, I didn't actually hear you reiterate the 5% growth for the year. Just want to confirm that so we can get a sense to what you are looking at for Q4.

Jim Moylan - *Ciena Corporation - SVP Finance, CFO*

Yes, we reiterated our revenue and OpEx guidance that we talked about in March, which was slightly different from where we started the year from.

Ehud Gelblum - *Citigroup - Analyst*

Right. I heard the OpEx, I didn't quite hear the revenue, so thank you. That is good. One quick question on the duration of the backlog and then I want to talk about gross margin for a bit. But on the duration of the backlog as we try to understand the revenue progression in the next -- in Q3 and Q4 this year, and again, this is been asked already in contrast to the record bookings quarter. Are these bookings -- are these things actual orders for things that people need now, or are these bookings sort of like two- and three-year contracts where your customers, perhaps these Web 2.0 guys said these are the demands and needs we're going to have so we are going to lock-in prices now and we are going to order them now even though you expect to ship them over the course of a couple of years, as a multiyear contract, which is terrific on the visibility front as opposed to traditionally you are not exactly a book and ship business but more so where a booking comes in and we expect it to go out in the next three to six months. Did the duration of these bookings go out more?

Gary Smith - *Ciena Corporation - President and CEO*

I would say it really talks to the whole diversification piece. You've got a lot of different sets of customers and to your point, we've got customers that require deliveries ideally within days and we've got customers that are doing projects that as Jim was saying are out six to nine months in terms of their project planning and delivery. So the answer to your question is, we've got both and so record order quarter can mean a lot of different things but obviously the demand overall is very strong. And it's a good thing but it's a mix. It is a mix of things that will roll into this quarter. There's a couple of projects there that will be a couple of quarters out. So it gives us better visibility and we are able to actually because of the increase in our velocity of our business, get some of these orders to revenue faster.

So it's coming together nicely in terms of the overall business model as we have different kinds of customers with different kind of dynamics around what they want, when. You've got all of that mix in the pot.

Ehud Gelblum - *Citigroup - Analyst*

So it sounds like these actually are project-based orders as opposed to maintenance upgrade orders, as in we know we are going to need this for the next three years, so let me just place the order now (multiple speakers)?

Gary Smith - *Ciena Corporation - President and CEO*

I would say to you it is very -- we don't actually take many orders that are more than sort of six to nine months out from revenue. It does happen but it's actually quite unusual. So it's not people saying from a platform point of view I'm going to roll this out over three years. They would not place the orders that much in advance.

Ehud Gelblum - *Citigroup - Analyst*

Okay. That's very helpful. Quick question if I could on the gross margin. Gross margin this quarter was strong. AT&T stayed flat, obviously fell as a percentage of your mix and if you look next quarter, are we to assume that the thing that brings the gross margin back down to 43%, is it a pickup in Tier 1s whether it AT&T or other Tier 1s that kind of does that, or is it international versus US mix that brings it back down again?

And if you can give us a sense on -- traditionally your gross margin was dominated much more by the mix between chassis and line cards. Was that particularly strong this quarter? If you can give us a sense, geographies, line cards, chassis and Tier 1 versus non-Tier 1, what were the factors this quarter and what do you expect the factors to be next quarter?

Gary Smith - *Ciena Corporation - President and CEO*

I think what you are seeing is a combination of all of those things obviously go into the margin. But I think if you were to sort of distill it down, it is really about increasing levels of software across the portfolio. Even if you take the line card example, why are the margins higher on that because you've got more software in it. If you take the example of the WaveLogic cost reductions that we are bringing in to market, essentially that is really because we're putting more software content out there that people are prepared to pay for.

So all of those dynamics are in play and obviously supply chain improvements and efficiencies, economies of scale, all of those things come into play but if you sort of step back from it, it really is around fulfilling this architecture, the OPn architecture around on-demand, which is more software centric. And so that really is the overall dynamic. You are seeing it in the first part of this year with some good step function up in gross margins.

We continue to be confident about the progress that we can make there. Obviously it is the most difficult thing for us to forecast terribly accurately, there's an awful lot of different dynamics go into that. But we think on balance as we look at the remainder of the year it is about sort of 43%. Could it be higher? That's certainly possible but our best judgment right now is roundabout that sort of 43% mark, which as Jim said, let's assume that for the sake of the conversation. That's a pretty good step function up on 2014 which was 42%. We would be at 43.5% for the whole year and so we are beginning to see the operating leverage from the design of the business both from a diversification point of view and increased levels across software across the portfolio.

Ehud Gelblum - *Citigroup - Analyst*

Appreciate it.

Operator

Paul Silverstein, Cowen and Company.

Paul Silverstein - *Cowen and Company - Analyst*

Gary and Jim, if you said earlier in the call, I apologize I have been cutting in and out. I know you haven't given it in the past, so can you tell us the nature -- not the names, but the nature of your top five customers, Cable MSO, service provider, Web 2.0, whatever?

Jim Moylan - *Ciena Corporation - SVP Finance, CFO*

Yes, and by the way, this is going to move around quarter to quarter but essentially this quarter we are dominated by, of course AT&T is important to us. MSOs is important to us and international customer is in APAC is a very important -- a big carrier is important to us. That is what I would say.

Paul Silverstein - *Cowen and Company - Analyst*

And were there any Web 2.0s in the top five?

Jim Moylan - *Ciena Corporation - SVP Finance, CFO*

Not this quarter. In the top 10, yes. Not in the top five.

Paul Silverstein - *Cowen and Company - Analyst*

And is that the first time they have been in the top 10, or have one or more of the -- I think historically you've had two of the top five and now you have three. Historically in other quarters have they been among the top five, top 10?

Jim Moylan - *Ciena Corporation - SVP Finance, CFO*

Yes. We had in both Q4 of last year and Q1 of this year a web-scale customer was our second largest customer and so we are still making progress with that customer. Don't get too hung up, as we have said about any particular one quarter. I think the overall trend is very positive in that space.

Paul Silverstein - *Cowen and Company - Analyst*

One more question, if I may. I know it sure doesn't seem it from the numbers and from your commentary but relative to the concern that has been out there that what AT&T did to you all several quarters back is going to happen again and it's going to happen among other carriers. I take it that hasn't been the case and there is no visibility to that happening?

Gary Smith - *Ciena Corporation - President and CEO*

There is no visibility to it. I do not think happen. We've got a much more diversified base.

Paul Silverstein - *Cowen and Company - Analyst*

Okay. I will pass it on. Thanks, guys.

Operator

George Notter, Jefferies.

George Notter - *Jefferies LLC - Analyst*

I wanted to ask about your delivery of 16QAM modulation through the WaveLogic technology. You guys seem to be really early in terms of delivery of that. Can you talk about your time to market advantage and how many of your customers are deploying it? I guess then I am also curious about what that does for you in terms of incremental ability to compete for deals, the incremental benefit you might be getting through the P&L as well? Thanks.

Francois Locoh-Donou - *Ciena Corporation - SVP, Global Products Group*

Thank you. So we were first to market on 100GQPSK. We are also leading on 100 gig BPSK, which is a modulation format for long-distance, and we have done the same thing on 16QAM. That is one of the reasons we have continued to invest in our coherent DSP engine, WaveLogic 3, and variations of it.

As you will have seen, we have launched WaveLogic 3 Nano, which is a mature oriented low-power consumption version of the chip; and WaveLogic 3 Extreme, which drives performance across a number of applications. And it is based on those engines that we've been able to be first to market on 16QAM.

As you will have seen, we started shipping 200Gline cards this quarter. In fact, about 80% of these shipments have gone to web-scale providers because they are very hungry for high-bandwidth and need the spectral efficiency. And our 16QAM, the 200G shipments, are based on 16QAM modulation, and that is doing two things for us.

Number one, really extending our differentiation in the web-scale space in particular; but number two, helping the improvement in gross margins that Gary has talked about. And it's a good example of how different software modulation techniques actually help our gross margins on bandwidth shipments.

George Notter - *Jefferies LLC - Analyst*

Got it. And then just as a follow-up on that, you are delivering 2x the capacity by implementing 16QAM. Are you getting a price improvement on a per wavelength basis because of that, or is it something that helps you sustain pricing at the prior levels? I guess I am just trying to figure out if it's really incremental in terms of the revenue impact to the Company.

Francois Locoh-Donou - *Ciena Corporation - SVP, Global Products Group*

So the fact we can get 2x the capacity on a wavelength, eventually the way that web-scale providers and carriers compare that is they do their comparisons on a price per bit basis. So, of course, it gives us an advantage. But in an environment where customers don't have a lot of fiber and spectral efficiency matters, it gives us potentially an additional certainly negotiation position. And this is the case in MSOs, and Jim has mentioned the importance of MSOs to us and it is also the case with web-scale providers.

George Notter - *Jefferies LLC - Analyst*

Got it. And then just one last question on that. So when do you think you will see other competitors in the space also delivering 16QAM commercially?

Francois Locoh-Donou - *Ciena Corporation - SVP, Global Products Group*

I wouldn't comment on where each vendor would be able to do that. What I would say to you is we continue to invest in modem technologies as a core competency as the core differentiator for Ciena. And what you will see from us is we will continue to move the bar beyond 16QAM. There are other modulation formats. There are other technologies in coherent DSP that we are going to be putting out in the market, so I continue to believe we are going to be leading the market in this space.

George Notter - *Jefferies LLC - Analyst*

Thank you very much.

Operator

Jess Lubert, Wells Fargo Securities.

Jess Lubert - *Wells Fargo Securities - Analyst*

A couple of quick questions. First, just on the revenue outlook, can you help us understand how come we shouldn't be thinking about better than 5% growth in fiscal 2015 given the strength this quarter and record orders entering the second half?

Jim Moylan - *Ciena Corporation - SVP Finance, CFO*

The only thing I would say about that, Jess, is every quarter we try to give the best call we can given what our outlook is for the quarter. We look at backlog; we do a bottoms-up from our salesforce as to what they are thinking and we try to give it to you as squarely as we can. Could we do better than what we said? Yes, we could do better than that but all I can say is that it reflects our best view today based on back look and outlook by the sales guys.

Jess Lubert - *Wells Fargo Securities - Analyst*

But there is no reason to think that as we look out toward Q4 that your expectations have moderated from where they were when you originally gave the 5%?

Jim Moylan - *Ciena Corporation - SVP Finance, CFO*

Absolutely not. There has been no moderation of anything. We feel better about our business today than we did at the beginning of the year.

Jess Lubert - *Wells Fargo Securities - Analyst*

And then can you update us on the status of the US Federal deal that had slipped from last quarter? How many of those closed this quarter? How many are left? Any visibility on that?

Jim Moylan - *Ciena Corporation - SVP Finance, CFO*

We took some of that in Q2. There will be some more coming that is in our expectations for the year. I guess I would say though that we did highlight it as one of the reasons why our revenue came in where it did but we feel very, very good about our future in the government business. We do think we have some very unique solutions. We will have some applications that will be pointed at them and so we feel really good about them. The progress over time, I think, will be very good.

Jess Lubert - *Wells Fargo Securities - Analyst*

And then the last one for me, I was hoping you could update us on the contribution of the 5400 in the period and help us understand what you are seeing with respect to switching attach rates on the 6500 and how you would expect switching revenue to progress during the second half?

Jim Moylan - *Ciena Corporation - SVP Finance, CFO*

Let's see here, we have some data -- we have 41 customers on the 5400, that is an increase of one for the quarter. We have about 40, 6500 OTN switching customers. If you look at that compared to last quarter, that is up from just a few. So our switching revenue this year is $51 million. It is up 6% year-over-year but it's really the fact that we have integrated OTN into our 6500 platform, which is really the most important piece of this picture and gives us a very nice competitive position. Francois?

Francois Locoh-Donou - *Ciena Corporation - SVP, Global Products Group*

You will continue to see that trend as the deployments in the metro for packet-optical technologies continue to increase. Really our ability to bring packet OTN and transport technologies in the same system is a key differentiator that is allowing us to win a lot of business in the carrier metro networks.

Operator

Simon Leopold, Raymond James.

Simon Leopold - *Raymond James & Associates - Analyst*

First, a quick one and then a trending question. I am aware that your sales aren't going to strictly match to carrier CapEx but just wondering if you can give us some color on how you expect AT&T to trend in the second half of your fiscal year given that their CapEx model suggests much higher spending in the second half but you've done particularly well with them when their spending was low. That's the first part.

The second thing I was hoping you could give us a little bit more color on what is going on in the packet networking segment. I was a bit surprised because I thought that segment was going to be a bigger part of the mix in the April quarter. It sounds like you're landing design wins and I am just wondering how to think about the trending for packet networking, whether we are seeing applications broaden from maybe the cable MSO used for enterprises, whether that has applications for maybe some residential type broadband services and how to think about packet networking either in July or longer-term? Thank you.

Gary Smith - *Ciena Corporation - President and CEO*

Why don't I take the first question, Simon. I think even -- I would make the comment generally it is not -- and as you say we've [made it for a while], it's not about the total spend, it's about what they are spending it on. I think the same thing applies as you get down into the carrier specific, and you talk about somebody like AT&T, that is really a market in itself. It's the largest buyer of these kinds of technologies in the world and it's really about what they are spending it on.

So they can have an environment where they can be CapEx constrained or down or cut and we can still actually do extremely well because we are at the priority points of what they are doing on their network. I would expect to see a reasonable second half from them as well.

Without getting into too much detail about it, I think our engagement with them across multiple elements including rolling out of the metro gives us good confidence around the sustainability over this for the next couple of years.

Jim Moylan - *Ciena Corporation - SVP Finance, CFO*

And on the packet networking piece, as we have always said, just be careful about building a trend based on one quarter's results. We have done extremely well in packet networking. And that is another product which is integrated into our 6500 platforms. And so we sell that not just as a stand-alone technology but also integrated into our 6500 platform. We did say that we've had a 26% increase year-over-year in the packet capacity ship. The packet standalone switching was down a bit for the quarter.

I just would say that given what we are doing there, we have introduced the 8700 platform. We will have other products coming out over time. I think we are extremely well-positioned. Our customer list is diversifying even in that group. So we feel good about what is going to happen with that.

We are not going to comment on what is going to happen in the July quarter on packet networking. That is always dangerous for us to give any sequential guidance about pretty much anything other than the big numbers in our income statement.

Simon Leopold - *Raymond James & Associates - Analyst*

Could you talk a little about the applications for packet networking of how they may or may not be evolving, particularly maybe residential opportunities?

Francois Locoh-Donou - *Ciena Corporation - SVP, Global Products Group*

Yes. A couple of trends there. So the focus of our solutions is not so much residential aggregation or opportunities as it is mainly delivering Ethernet business services and mobile backhaul for whether it's independent mobile operators or fixed line carriers offering mobile backhaul services to mobile operators. So those are the two focus areas of deployments of our Packet solutions.

I would add though that a key trend we are seeing with the introduction of the 8700 is we are able to compete deeper into the aggregation of networks than we've had before and that allows us to pull through some products in the access space as well. So we are competing deeper into metro and aggregation with the 8700 and that is happening across the board. It is carriers, MSOs, actually research and education, entities and we are starting to see applicability as well in the data center space.

Simon Leopold - *Raymond James & Associates - Analyst*

Thank you very much.

Operator

Subu Subrahmanya, The Juda Group.

Subu Subrahmanya - *The Juda Group - Analyst*

Thank you. I have two questions. First on the Packet Optical space with Cisco winning the second position at Verizon and more talk about optical integration into packet platforms, Gary, curious to see how you see that progressing in terms of physical integration of traditional packet technology and optical into single platforms and how that might be changing the competitive environment?

My other question was on the non-telco side. 33% of revenues or both web-scale and cable north of 10% of overall revenues, can you give us some sense of what the [content in terms] of that 33% of revenues are?

Jim Moylan - *Ciena Corporation - SVP Finance, CFO*

Let me take the second half and then we will go back to the first half. As we said, we had a particularly strong quarter in the MSO space. We had record for the two biggest customers that we had, so feel great about that. Feel great about our progress in that space and that was the story in the quarter. We had a good quarter with web-scale. We have great expectations there as well but the quarter itself was really dominated by what we did on the MSO side.

Francois Locoh-Donou - *Ciena Corporation - SVP, Global Products Group*

To the question on the packet optical integration, so yes, that was a key factor in Verizon's decision but I would say that this is playing out across the board as carriers want to basically pack as many services as they can on their optical networks. The ability to take TDM services, Ethernet services and OTN services and aggregate them efficiently into optical wavelength containers is a critical differentiator and it is not something that we just started working on. Ciena has been working on these technologies for multiple years and when we believe we are now well ahead of the market in terms of Packet Optical convergence.

I would point out that in metro networks as these architectural changes take hold, it is making it hard for folks who only have optical transport capabilities to compete in these opportunities where packet OTN, control plane and leading edge transport capabilities are required and these are architectural changes that we are now starting to see across Tier 1 carriers and Tier 2 carriers.

Subu Subrahmanya - *The Juda Group - Analyst*

And if I could follow up, I just wanted to see if there's a -- traditionally, people who have not played in optical transport being more packet players, if you are seeing them more with integrated photonics especially in the data center or connect metro sort of markets?

Francois Locoh-Donou - *Ciena Corporation - SVP, Global Products Group*

No, I would say that the dynamic -- in the data center interconnect market, that today is still mostly point-to-point transport market where the goal of the data center operators is just to ship as many bits as they can in a strand of fiber and it's a pure optical transport opportunity. It's really in the carrier space where a mix of services need to be aggregated on the network that we are seeing this packet-optical convergence take hold in the metro. And really there where what we are seeing is an architectural drive is converging layer zero to two services in these metro networks and for layers above that, we are starting to see virtualization -- network function virtualization -- start to take hold as a different way of carrying layer 3 services and above.

Subu Subrahmanya - *The Juda Group - Analyst*

Thank you.

Gregg Lampf - *Ciena Corporation - VP, IR*

That's going to be our last question for today. We appreciate everyone taking the time to speak with us and listen to our call. We look forward to catching up with everyone over the next few weeks, few months and thank you very much. Have a good day.

Operator

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