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Ciena Corp. (CIEN)

Q3 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

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 Third Quarter 2019 Financial Results Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

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

Gregg M. Lampf

Vice President-Investor Relations, Ciena Corp.

Thank you, Sharon. Good morning and welcome to Ciena's 2019 fiscal third quarter 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, will join us for the Q&A portion of today's call. In addition to this call and press release, we have posted to the Investors section of our website an accompanying investor presentation that reflects this discussion as well as certain highlighted items from the quarter. Our comments today speak to our fiscal third quarter financial performance, our current view of the market environment and our industry position as well as our guides for the fiscal fourth quarter and some commentary around fiscal 2020.

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, including our guidance and any commentary about our 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 on our most recent 10-Q filing and on our upcoming 10-Q filing which is required to be filed with the SEC by September 12, and we expect to file by that date.

Today's discussion also 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. Ciena assumes no obligation to update the information discussed in this conference call whether as a result of new information, future events or otherwise.

With that, I'll turn the call over to Gary.

Gary B. Smith

President, Chief Executive Officer & Director, Ciena Corp.

Thanks, Gregg, and good morning everyone. Today we reported another very strong quarterly performance as we gain benefit from our strong competitive position within the industry and continued to gain market share. Third quarter revenue was up 17% year-over-year and more than 10% sequentially. North America contributed significantly in the quarter including from service providers and our web-scale customers. And in fact, for the first time ever our top customer in the quarter was a web-scale company followed closely by a Tier 1 service provider. EMEA also had a strong performance in Q3, up nearly 50% sequentially largely on the strength of our web-scale business even if some of our more recent service provider design wins have yet to ramp in EMEA.

In addition to meaningfully outpacing market growth from a revenue standpoint so far in fiscal 2019, recall that as we entered the year we indicated that we would significantly increase profitability this year and beyond. In Q3 we performed extremely well on measures of profitability, including 16.2% adjusted operating margin and adjusted earnings per share of $0.71. Our consistent and differentiated financial performance continues to essentially be driven by outstanding execution of our strategy as well as a solid overall demand environment and favorable industry dynamics.

Specifically, we continue to diversify our business across geographies and customer segments. As an example of this in Q3, our top 10 customers were comprised of three web-scale companies, three North American service providers, two international service providers, one MSO, and one wholesale network provider. Importantly, we also continue to have the most compelling portfolio today and the most credible and robust roadmap for future development made possible by our considerable investment capacity, capability, and vertical integration.

We have the strongest offering in the market today for coherent optics. This was recently recognized by analyst firm IHS Markit in its 2019 Network Hardware Vendor Scorecard report in which Ciena secured the highest overall global score. During the quarter, in a vote of confidence of our ability to be first to market and well ahead of the competition with single wavelength 800-gig systems we booked our first orders for our WaveLogic 5-powered 6500 platform with a large subsea customer in the Asia-Pacific region. Importantly, I would highlight that our degree of vertical integration means that we are not beholden to the merchant market and its delivery dates. Rather, we are in full control of our own development timelines. Also in optical during the quarter, our momentum continued with Tier 1 service providers including a sizable award for a 400-gig metro optical architecture with a large North American customer and we also won a new metro and long haul build with a Tier 1 MSO.

With respect to packet networking, our continued investment in this portfolio to introduce new features and functionality is driving new business. In the third quarter we landed a significant packet win with a Tier 1 service provider customer in North America. We also secured a design win in EMEA with a Tier 1 service provider. With this momentum, we are expecting a strong finish to the year for our overall packet networking portfolio.

Our Blue Planet portfolio also continues to evolve and mature drawing increased customer engagement. In fact, we recently solidified a new win with a service provider in the APAC region for the entire suite of Blue Planet Intelligent Automation software solutions. And overall, I would say that our automation software portfolio continues to grain (sic) [gain] (00:06:49) traction globally, and in fact we remain on track to deliver on our FY 2019 revenue target of between $50 million and $60 million.

In summary, our ability to deliver the industry's leading innovation while diversifying our business and leveraging our global scale is the foundation of our success. Our strong market and technology position and continued execution of our strategy is enabling us to deliver extraordinary financial performance and drive continued share gains. Customers continue to pursue a flight to quality with vendors who offer leading innovation and engagement models and those with the financial strength and stability to deliver consistently now and into the future. We meet those stringent requirements and we are confident that Ciena is the strongest long-term partner to customers around the world. Today's quarterly results are a testament to that competitive advantage.

With that, Jim will take us through the Q3 results and our outlook. Jim?

James E. Moylan, Jr.

Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

Thanks, Gary. Good morning everyone. We delivered a very strong top line performance in Q3 with revenue of $960.6 million representing 17.3% growth year-over-year. Of note in the third quarter, non-telco revenue was

41%. This includes customers like web-scale, MSOs, government, and enterprise and demonstrates the continued diversification Gary spoke about earlier. With respect to web-scale as a stand-alone customer segment, direct [Technical Difficulty] (00:08:35) 27% of total revenue in the quarter. Our year-to-date order flow is strong and exceeds our year-to-date revenue. As expected, after incredibly strong bookings in Q2 our orders moderated somewhat in Q3 and came in under revenue for the quarter.

Moving to gross margin, our Q3 adjusted gross margin was 44.7% reflecting the benefit of a stronger than expected product and geographic mix in the quarter. Q3 adjusted operating expense was $273.2 million.

With respect to profitability measures which have been a focus for us, as Gary mentioned we delivered strong results in the third quarter including adjusted operating margin of 16.2%, adjusted net income of $112.3 million, and adjusted EPS of $0.71. In addition, in Q3 our adjusted EBITDA was $178 million and cash from operations was $83.1 million. We ended the quarter with approximately $843 million in cash and investments. Finally, we continue to execute on our share buyback plans. In the third quarter we repurchased approximately 1.1 million shares for $45.4 million and remain on track to buy back approximately $150 million in share value by the end of fiscal 2019.

Looking ahead, in fiscal fourth quarter 2019 we [ph] look (00:10:19) to deliver revenue in a range of $945 million to $975 million, adjusted gross margin in a range of 42% to 43%, and operating expense in the fourth quarter to be approximately $275 million.

In closing, we posted exceptional third quarter results today by continuing to execute on our strategy of delivering the industry's leading innovation while diversifying our business and leveraging our global scale. Combined with our Q4 outlook, fiscal 2019 will be an extraordinary year for Ciena marked by significant market share gains as we advance our competitive position and drive double-digit revenue growth and increased profitability.

Considering that expected annual performance this year, we believe it's important to comment at a high level and somewhat earlier than usual on our current views of fiscal 2020. We have never been more confident of our ability to continue taking market share and we expect to grow revenue next year at a rate of roughly double that of current expectations for market growth which is in the low single digits. That performance would be consistent with current consensus revenue expectations for 2020. Additionally, we expect to achieve new operational efficiencies and additional leverage as a result of several actions we've taken during the last 12 to 18 months that will positively impact the business. As a result, we have increased confidence in our ability to achieve our target 15% operating margin in fiscal 2020 and drive meaningful EPS growth. We will provide additional detail on fiscal 2020 during our fourth quarter earnings call in December.

With that, operator, we'll now take questions from the sell-side analysts.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from George Notter with Jefferies. Please go ahead.

George C. Notter
Analyst, Jefferies LLC

Q

Hi guys. Thanks very much and congratulations on these terrific results. I guess I wanted to start out, Jim, maybe asking a question about gross margins. If I go back, you thought of the company as a 42% to 43% gross margin business over the short and intermediate term as you guys were taking footprint, and obviously the gross margin result was much better here, 44.7%. I think you guys had a positive surprise last quarter as well of course. But it seems you guys are still adding footprint, so what do you think about gross margins now? Is this sort of the new norm for you guys even in a mode where you're taking footprint? And tell us what's going on on the margin side. Thanks.

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

As we've always said, George, that there are a lot of variables that impact our gross margin. New deals, sometimes we'll give credits to customers for big new deals and sometimes those hit our results and sometimes they don't, and so that's something that it's hard to call exactly when they're going to hit. As a result of those kinds of variables, we have shown some volatility in our gross margins. It's moved from 41% to 44.7% over the past six quarters. I believe that right now we're in a 42% to 43% range. We certainly haven't given up on getting to the mid-40s. I don't know exactly when that's going to be. I don't think it's going to be next year. But I would say that we're going to post significant profitability this year and next year really at this range of gross margins.

George C. Notter
Analyst, Jefferies LLC

Q

Got it. And then just as a follow up, I guess I also wanted ask about customer attitude. You guys have talked about taking market share but curious about customer attitudes around Huawei. Historically they've been ever present I think in the international side of your business and I think historically they've been pretty disruptive on industry profitability. But do you see things changing there? Are they getting invited to RFPs? Do you see them competing with you on new business or is that changing given all the security issues that are out there?

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

A

George, this is Gary. I think it depends very much on what region you're talking about and what country. I do think over the last couple years you're seeing sort of a potential rebalancing of spend in the face of sort of overdependence on them. They've taken such large market share in telecom infrastructure generally I think just from a market point of view. I think a rebalancing of that I think you're seeing now. It's really difficult to discern the impact on our business to-date. I would say no substantive impact to-date. But we are in the infrastructure business and that takes time for decisions to roll through in terms of revenues. I think it is very geographically dependent, but overall I would say that a lot of the international carriers are looking to reduce their dependence over time.

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

A

Thanks, George.

George C. Notter
Analyst, Jefferies LLC

Q

Thank you.

Operator: Next question comes from Paul Silverstein with Cowen.

Paul Silverstein
Analyst, Cowen and Company, LLC

Q

I've got a lot of questions. I'll try to keep it to two or three. First off, Jim, just to clarify. I've seen the slide deck. You reiterated your 6% to 8% growth. On the call short time ago you said double the single-digit market growth rate. I trust you're still talking 6% to 8% for next year just to be clear for fiscal 2020 revenue growth?

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

Yes. Yeah, we also said that we think that the current consensus number is consistent with about where we're going to be.

Paul Silverstein
Analyst, Cowen and Company, LLC

Q

Well you're anticipating this. So when you say that you're referring to growth or you're referring to the absolute dollar number given that this year there's going to be a larger base [indiscernible] (00:16:32)?

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

The revenue dollar number.

Paul Silverstein
Analyst, Cowen and Company, LLC

Q

The dollar number. Okay.

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

Yeah.

Paul Silverstein
Analyst, Cowen and Company, LLC

Q

What drove the gross margin upside in Q3?

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

We just expected to hit a couple of new deals affecting the quarter and it just didn't hit the quarter. So I'd say that that's it in a nutshell. It's hard for us to call the number within a couple of percentage points, Paul.

Paul Silverstein
Analyst, Cowen and Company, LLC Q

But Jim, the translation of that would be your line card to chassis ratio was better because you didn't have those new deals?

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp. A

Generally yes although new deals can mean more than just commons. We can have credits or other things that affect the capture of new deals.

Paul Silverstein
Analyst, Cowen and Company, LLC Q

All right. I'll ask one last question out of respect for others on the call. With your 800-gig coming out end of the year, you just announced your first customer. What are you factoring in in terms of the glide path for revenue? To what extent does that prove to be meaningfully incremental and what timeframe? If you and Gary could comment on that and not just from...

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

I think 800-gig...

Paul Silverstein
Analyst, Cowen and Company, LLC Q

Gary, I apologize. Before you respond, not just 800-gig narrowly defined but also the greater reach you're going to have with 400-gig and the impact that's going to have on your service provider customers, not just from a direct web-scale standpoint. Thanks.

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

Yeah. I think – Paul, it's Scott. I think that's what gives us the confidence to say we're going to continue to have an extremely strong competitive position and grow significantly faster than the market. So that's sort of factored into the guide if you like and that's certainly part of that.

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

Thanks, Paul.

Operator: Next question comes from Simon Leopold with Raymond James.

Simon Leopold
Analyst, Raymond James & Associates, Inc. Q

Thanks. I'd like to just squeeze in a quick clarification hopefully for the benefit of all. Jim, when you talk about the 15% operating margin comfort for fiscal 2020, I just want to confirm that that's the value you expect for the full year, not a target you hope to achieve in one or two quarters for the year but the net for all of fiscal 2020?

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

It's a full year number. Our first quarter is always sort of out of trend line and we don't get to a high operating margin in Q1, but we will make up for it in the subsequent quarters and we're certainly targeting 15% for next year.

Simon Leopold
Analyst, Raymond James & Associates, Inc.

Q

Great. That's what I thought, just wanted to just make sure. And then in terms of the WaveLogic 5 introduction in 800-gig, I think there might be some confusion among some folks about how synonymous those two launches are. So just to confirm. You've talked about WaveLogic 5 coming out this year. Does that also mean that the 800-gig features are available in calendar 2019 as well simultaneously?

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

A

Yeah. So to try to clarify, WaveLogic 5 is our brand for that generation of coherent optics. It certainly includes the 800-gig capability. And as I said, we made great progress as we talked to you 90 days ago and we remain confident about our target for the end of the year, and that would be in customers' hands in the form of products.

Simon Leopold
Analyst, Raymond James & Associates, Inc.

Q

Great. Thanks. And given the strength in EMEA, you did comment earlier about kind of the trends relative to Huawei. Maybe if you could help double-click in terms of some of the trending in EMEA. So we've talked about Deutsche Telekom in the past. I guess I'd like a better understanding of how you see the drivers in that particular region given that there's maybe some relative slowness in terms of deployment of 5G in EMEA. How much of this is about single customer? How much of this is about data center interconnect? Just help us understand that trend of sustainability from the EMEA strength. Thank you.

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

A

Yeah, Simon. This is Gary. I think it's pretty broadly based in terms of the strength that we're seeing there. I would say that the revenue growth in Q3 was largely driven by the web-scale data center interconnect and the expansion of the data centers there, and we think that's going to continue. We have a number of Tier 1 wins that really haven't got to meaningful revenue and we expect that over the course of the next six to 12 months to come in. So we actually feel quite bullish around our business in EMEA. And I think, back to my earlier comments around sort of somewhat overdependence on Chinese vendors, I think that's particularly the case in Europe and I do think that most of the major carriers are looking to reduce that dependency over time, and I think that's a positive dynamic for us. So we feel pretty bullish as we turn the year about Europe.

Simon Leopold
Analyst, Raymond James & Associates, Inc.

Q

Thank you.

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

A

Thank you, Simon.

Operator: Your next question comes from Rod Hall with Goldman Sachs.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Yeah. Hi guys. Thanks for the question. I wanted to start with the phasing of revenue this year and then maybe talk a little bit about next year as well. So the guide implies kind of flattish revenue as we look into Q4 and yet you've had very strong trends up through this stage. I just wanted to see whether – what's maybe driving that sequential change or lack of change in revenue, whether that is what you're seeing in enterprise and government or is there some pause ahead of 800-gig? Just kind of help us understand why that guide is what it is in Q4 and realizing that this has been an extremely strong year in the middle part of the year.

And then I also kind of wanted to extend that into next year. Are we seeing some pause ahead of 800-gig and would you therefore expect seasonality to be any different as we move into next year? Kind of help us understand how next year phases in terms of revenue in your minds. And then I've got a follow up.

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

Sure. First thing I'd say, Rod, is that with our guide for Q4 we will have posted, assuming we hit it, around 15% revenue growth this year which is extraordinary after 10% last year. And we've always said that individual quarters can reflect ebbs and flows of orders and customer actions and all that sort of thing, and so I guess I would emphasize that we're going to grow 15% this year, not that our revenue for Q4 is flat to Q3. We also think that as we move into next year we're going to go back to the long-term range of revenue growth that we have said which is 6% to 8%. And of course that's off of a much bigger base and it's going to be at significantly increased profitability. So that's what I would emphasize here.

With respect to the quarterly flows, we did have a particularly strong revenue quarter in Q1. It had to do with ebbs and flows frankly and certain customers wanted a lot of equipment early last year. We think that next year our quarterly flows are going to be more like what they've been traditionally.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

And are you – could you just answer, Jim? Are you guys seeing pent-up demand for 800-gig? Do you think that as that product becomes available in volume, and I'm assuming you still expect volume by the end of Q1, that you'd see some release of demand? Or how do you think that affects the revenue numbers especially as we move through the first couple quarters?

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

A

Hey, Rod. It's Scott. The way I look at this is the demand for coherent optics from a port perspective continues to increase. The bandwidth demand continues to increase and it gets served by the best data-to-shelf technology that we have. People are not sitting there waiting for the next – they have needs for this bandwidth and it's going very quickly from the factory into the network. So I don't see a pent-up wait for 800-gig at all; I see continued increase in bandwidth demand.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Okay. And then I just – one more, if I can, and then I'm done. I just wanted to check on the competitive environment in hyperscale and see whether you guys have seen – because you've seen such strength there. I mean, it's amazing performance there and I'm wondering if some of these alternative 600-gig solutions just aren't gaining traction. Can you just say kind of what's going on competitively and whether you guys are kind of winning head-to-head with 400-gig solutions against that 600-gig that's out there or is it anticipation of 800-gig? What is – kind of give us an update on what's going on with hyperscale right now.

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

A

Yeah. I would say that we're obviously having a very good year in web-scale. We've got a lot of long-term projects and sort of good visibility into it. We think our market share is now greater than 50% globally. Market growth we think is about 12%, and I think we've grown about 50% year-to-date, so we're clearly taking share and our competitive position continues to be very strong. Obviously there's the competition there; we can't expect to have no competition in that space. But a couple of things I would stress. We've established incumbency and embedded in their systems and we have a great roadmap for them, and I think we're very confident around that continuing to be a very strategically important piece for us globally. The other thing I would stress is our global reach is helping where we partner with a lot of these web-scale players in [Technical Difficulty] (00:26:59) different world and I think that's helping our competitive position.

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

A

Thank you, Rod.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Great. Thank you.

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

A

Thanks, Rod.

Operator: Your next question comes from Tejas Venkatesh with UBS.

Tejas Venkatesh
Analyst, UBS Securities LLC

Q

Thank you. Given the changes in the 10% customers I wonder if you're able to share the specific percentages of your top customers. And then relatedly, did Verizon go below 10% and what does that mean on a go-forward basis?

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

Yeah. Actually AT&T for the first time in a long time was not a 10% customer. It was just under 10% and nobody should read anything into that except that we're growing in a bunch of customers and we're still doing very strongly with AT&T. So the other customer of course was Verizon. We're having a great year with Verizon. The percentages, you'll see it in the Q. They're 12-ish to 13-ish sort of.

Tejas Venkatesh
Analyst, UBS Securities LLC
Q

Got it. Thank you.

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.
A

At least tops.

Tejas Venkatesh
Analyst, UBS Securities LLC
Q

Understood. And then I'd like to ask a follow up to your comments about fiscal 2020 revenue growth. There are of course a number of moving parts including 800-gig coming on, the threat of pluggables, and then the strength in packet. How are you thinking [ph] qualitatively (00:28:18) about these puts and takes?

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.
A

Well, we talked about 800-gig. We're going to be first in market with 800-gig and that's important. I'd say that what's most important is that we show a most credible roadmap and customers believe that we're going to deliver on what we're saying. And so 800-gig is going to be a part of our story next year, but as Scott said really it's the growth of coherent demand that's going to drive our results more so – well, maybe not more so but at least as much as the fact that we'll have 800-gig in market. Packet we're going to grow. We said at the beginning of this year 8% to 10% was our three-year growth rate. We're going to be around that this year, maybe a little bit better. And then the other piece that you were asking about?

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

He was asking about pluggables on the data side. From a timing perspective in the market our perspective is that pluggables don't really become a material or a meaningful marketplace until 2021...

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.
A

Yeah.

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

...so not really a big piece of our 2020 plan.

Tejas Venkatesh
Analyst, UBS Securities LLC
Q

Thank you.

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

A

Thank you, Tejas.

Operator: Next question comes from Michael Genovese with MKM Partners.

Michael E. Genovese
Analyst, MKM Partners LLC

Q

Great. Thanks very much. Can you talk about where we are in the 400G telecom cycle in terms of both long haul and metro? How early or late are we in those rollouts?

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

A

I'll say this two ways. So 400-gig, when you think about it, on the fiber side people have been using it as a cost per bit solution for a long time. What hasn't happened yet is 400-gig E clients being the normalized interface into these things. When that happens I think 400-gig around the world will be the dominant transmission side on the fiber side as well because you need to be able to carry it end-to-end transparently. That to me – everybody is very hyped about 800-gig versus 600-gig, but that to me is the real key with our WaveLogic 5 technology is we'll be able to carry that 400-gig signal everywhere in the world and that'll be a first, that'll be absolutely a market differentiator. And so to answer your specific question, I think we're at the very early cycle because the clients haven't gotten there yet.

Michael E. Genovese
Analyst, MKM Partners LLC

Q

Okay. Great. And then I want to ask a broader question just on the outlook here because basically you beat the quarter but didn't raise the outlook. But everything you're saying on the call makes a lot of sense and sounds very positive. I just want to sort of directly ask though is there anything either macro-wise or company-specific in the last quarter that makes you more cautious than before or is this just sort of a nice sort of conservative outlook that we're getting?

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

A

I wouldn't say it's conservative. We try and give the best outlook that we can – the most accurate one that we see and pass that on. I think what you're seeing is an extraordinary year as Jim said where we've grown sort of 15% in a market that we think is really sort of growing 2% to 3%, and we've been pretty consistent around that. So obviously trees don't grow to the sky and you're talking about much, much bigger numbers than we thought. We're kind of a year ahead of where we thought we'd be when we gave you sort of three-year guidance.

I think basically what we're saying is a return to more normalized growth. We're probably more confident than ever around two things. One, our ability to continue to take share globally; and number two, the operating leverage that we can get going forward. So we actually think we're in a very strong position. We're not seeing anything. There's normal ebbs and flows on the macro side but we're able to drive through that because of our diversification. You're seeing some slowness in places like India, some of which was anticipated, but I think the fact that we've now got a business of global scale that's so well diversified allows us to drive through many of these issues.

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

And just to state the obvious, our forward-looking statements are very consistent with what the world is expecting both for Q4 and for next year, so our guides are right where the market is. The one thing we've said is that our profitability next year is going to be very strong and so our bottom line performance is going to be very, very good next year.

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

A

Thanks, Michael.

Michael E. Genovese
Analyst, MKM Partners LLC

Q

Gary, James, Scott, thanks very much.

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

Thanks, Michael.

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

A

Thanks, Michael.

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

A

Thanks.

Operator: Next question comes from Jeff Kvaal with Nomura Instinet. Please go ahead.

Jeffrey Thomas Kvaal
Analyst, Nomura Instinet

Q

Thank you, gentlemen. I wanted to delve into, Jim, that last point about profitability. But specifically on the gross margin side, I think traditionally we have been accustomed to periods of rapid revenue growth where the margins suffer or lag a little bit given the new deals that you're signing. And I guess I'm a little – I'm wondering why we wouldn't maybe break out of that 42% to 43% range if the revenue growth starts to slow a little bit I mean obviously off a great fiscal 2019. Shouldn't some of those new deals be maturing a little bit and therefore the margins may be edging up a bit?

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

Well, I'd say that we certainly expect to get back to the 45% gross margin number. We're just saying that it's not next year. All I can say about next year in particular, and we haven't really guided for next year's gross margin, I don't think it's going to be at the mid-40s level. The improvement in profitability is really going to come from our actions that we've taken to transform our business, but that's what I'd say. It's a mix question, and by the way we're still developing our 2020 plan in detail and so there's still work to be done. But we still feel good about being able to hit 15% operating margin next year.

Jeffrey Thomas Kvaal
Analyst, Nomura Instinet

Q

Okay. And then secondly, would you mind just being as specific as you can about what we should be expecting for WaveLogic 5 timelines, which products in customer hands and [ph] when through (00:35:06) trials and when contributing to revenue? I just want to make sure we have all of that laid out. Thank you.

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

A

Yeah. What we've said consistently is the target and we're comfortable with the target is have product in customers' hands by the end of the year. The product that we'll instantiate on first will be Waveserver and on 6500, and we would expect that to ramp through the first quarter and start to be a material revenue contributor after the first quarter.

Jeffrey Thomas Kvaal
Analyst, Nomura Instinet

Q

Okay.

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

A

Thanks, Jeff.

Jeffrey Thomas Kvaal
Analyst, Nomura Instinet

Q

Thank you all.

Operator: Next question comes from John Marchetti with Stifel.

John Marchetti
Analyst, Stifel, Nicolaus & Company

Q

Thanks very much. Gary, I was wondering if you could talk a little bit about the DCI strength in the European market. I'm curious if that's customers that traditionally haven't necessarily participated with you on the web-scale side or if it's more of the traditional set just sort of expanding into that market. Just curious if you're seeing some new participants in there or if it's more a geographic expansion with existing relationships.

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

A

I think for us I think it's actually both, John. We're seeing some new wins in what I would say would be the sort of smaller web-scale data center connectivity type folks. And we're also seeing some of the larger global players that you know and love get more aggressive into Europe as well. So I think it's a combination of both of those things. I think it's a pretty healthy market right now in the web-scale space.

John Marchetti
Analyst, Stifel, Nicolaus & Company

Q

And then if I can, just coming back to the 800-gig for a moment. Given the expectation obviously for some initial adoption particularly within the DCI market and you mentioned the subsea win, how do we think about that maybe moving into the telco market as we go through fiscal 2020? You mentioned obviously that on the network side or the transport side you've been seeing fairly decent uptake of 400-gig there. Curious what your expectations are for 800-gig particularly on that telco side as we look into next year.

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

A

Yeah. Like every technology cycle, the cost per bit is important to all of our customers and having your hands on this market-leading technology gives you a market leadership place in cost per bit. So no question there'll be interest in the service providers there as well, maybe less so in terms of an application that uses 800-gig but in other applications, and we talked about one. When they're still offering 400-gig E or using 400-gig E as the service capability, they need to be able to transport that all over their network and they're going to need technology, the WaveLogic 5 technology to do that.

John Marchetti
Analyst, Stifel, Nicolaus & Company

Q

Thank you.

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

A

Thank you, John.

Operator: Next question comes from Samik Chatterjee with JPMorgan.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Hi. Good morning. Thanks for taking my question. I just wanted to start off with seeing if you can help me address one of the kind of questions that we get most often from investors which is given that you had 10% revenue growth last year, roughly 15% this year, and you're guiding to kind of 6% to 8% next year, one of the broader impressions investors have is that the 5G spend of – telecom service provider spend preparing towards 5G will start to moderate and particularly with large Tier 1s like AT&T and Verizon. So I just wanted to see if you can help us address kind of how you're thinking about the ramp of revenues with the telecom service providers, particularly the large Tier 1s from here on and how you're thinking what kind of investments from them towards 5G preparedness.

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

The first thing I'd say is that we don't sense any slowdown with respect to North America. We see a lot of strength in North America generally speaking and we've also taken share in North America. So we believe that North America is going to be a very strong market for us as we move into next year. We are seeing a bit of a slowdown in India. That's part of the reason why our orders flow slowed a bit this quarter. It's really a period of digestion on the part of the Indian players. We think they're still committed to long-term build outs and all of that's factored into our outlook.

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

A

Samik, I would say specific to the 5G piece, I still think you're at the fairly early stages of that build out. You're seeing carriers build out converged metro networks. We saw some of the wins that we have this quarter are indicative of investment to basically facilitate 5G traffic and backhaul across a converged network. I think we're at the early stages of that build out. I'm not specific now talking about just the pure RAM piece of it; I'm talking about the infrastructure to make it all work. So I think you'll see that over the next one to three years as a build out on a global basis with most of the major Tier 1s.

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

A

Thanks, Samik.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Got it. And if I can just quickly follow up on the APAC commentary that Jim had just in terms of what's your visibility in getting that region back to growth, we've had – we understand the decline in India. But as we look into next year kind of what's the order flow and how you're thinking about APAC for next year?

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

Yeah. We think in APAC we'll grow next year. The slowdown from last year really is mostly in India as a result of the big service providers digesting the big spends they've had. They committed to their build outs and we think they're going to come back online for us. So we'll expect to see some growth out of APAC next year. India is not the only place where we're doing particularly well. We're doing well in Japan, Australia, some of the smaller countries like Vietnam and South Korea.

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

A

Thank you.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Thank you.

Operator: Next question comes from Tim Long with Barclays.

Simon Leopold
Analyst, Raymond James & Associates, Inc.

Q

Thank you. Two if I could. Gary, could you just go back to the kind of web-scale players? Obviously been really strong and I think you mentioned you had pretty good visibility, but obviously a lot of other companies in this sector have had some severe lumpiness there and some weakness. So do you think that business is diverse enough and enough customers and you have enough visibility that we won't see some kind of disruption into that business over the next year?

And then secondly, if you could just touch on Blue Planet. We've been kind of at a level the last few quarters actually gone down a little bit. You mentioned a key win there as well. How should we think about that business? Should it be kind of maybe taking another step function up at some point or start to grind higher as we move through the next year or two? Thank you.

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

A

Yeah. So let me take first of all the web-scale piece. I think demand there and our relationships are pretty broadly based. Three of our top 10 customers for the quarter were web-scale players and that gives you some sort of insight into the balance of the business. And then there's multiple smaller web-scale players and data center players too which were also – is a growth market for us, none of which particularly get to large concentrated spend but in aggregate is pretty important to us. So I think in summary, we feel pretty confident around our ability to continue to be the number one provider in web-scale going forward.

We've got over 50% market share. We were up nearly 50% year-to-date which I think is sort of a testament to our competitive position. And I think with the technology that we have rolling out over the next 18 months we're pretty confident around being able to continue to be the number one player there. And I think demand overall, we see no abatement in the proliferation of data centers around the globe by all of the major web-scale players. And there are more web-scale players coming online as well; they're sort of I guess you'd call them the sort of the medium-size web-scale players. So we're pretty bullish around this space generally over the next couple of years.

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

A

Thanks, Tim.

Tim Long
Analyst, Barclays Capital, Inc.

Q

And Blue Planet?

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

A

So Tim, the second part of your question was Blue Planet, yeah. I think you're going to get ebbs and flows quarter-to-quarter on the revenues but we're actually seeing increased engagement across the customer base as the suite of automation capabilities strengthen. So we're pretty confident of achieving our target for the year. I would expect that to increase, decent growth as we go through the next couple of years. It's still a nascent space. We're learning. We're putting together our portfolio which I think is now in a pretty good place. So I would expect pretty good growth in that space over the next 18 months or so.

Tim Long
Analyst, Barclays Capital, Inc.

Q

Okay. Thank you.

Operator: Your next question comes from Jim Suva with Citi.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you very much. My question is regarding your commentary about the fiscal 2020 revenue growth outlook and the market commentary you gave. It's very clear that it sounds like you said that you'll grow twice the markets, but then you mentioned that you're comfortable with consensus numbers on a dollar basis. But the question is, well, with a higher base shouldn't it be higher or are we just kind of splitting the numbers 2Q? What I mean is off a higher base, if you still grow 4% to 6% or double the market growth you should be higher than consensus or am I just kind of misunderstanding what you're discussing? Thank you.

James E. Moylan, Jr.
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

Yeah. Just to be clear, we laid out at the beginning of this year a long-term growth rate of 6% to 8% for revenue, and we said this year we were going to grow a little – and I'm talking about 2019 – we were going to grow a little faster than that. We have grown quite a bit faster than that 6% to 8% range. What we've said is that next year we're going to return to that 6% to 8% range. And if you take a number in that range and apply it to where we think our revenue is going to be for this year, you will get pretty close to the consensus number so that's why we're referencing the consensus number.

I'd just say that we've had a year of great growth in 2018. We've had an extraordinary year in 2019. We've gained a number of points of market share. We've never been more confident about our ability to grow faster than the market and to keep taking market share, and we believe that's going to happen next year. So I guess that's the way I'd answer it. All numbers that we've given for forward-looking statements are consistent both with what we've said and what the market is expecting.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

I fully understand now. Thanks so much for the clarification.

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

A

Thanks, Jim.

Operator: Next question comes from Meta Marshall with Morgan Stanley.

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

Q

Great. Just a question on your merchant DSP business. Any pickup in – I know that that's been something that you've been willing to offer but there hasn't been a lot of traction there. So any pickup of interest after or kind of given the pending acquisition of Acacia? And then maybe more broadly, any inbounds from end customers who were some of – customers of some of Acacia's customers of just what their thoughts on kind of the acquisition work? Thanks.

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

A

Hey, Meta. It's Scott. So I'd say this. So we've had some traction on what we call our Microsystem business and the revenue in 2019 is on plan. It's not material to our overall results. We've had, I'll say, enhanced and increased engagement since the dynamic changes somewhat with the Cisco-Acacia news, and that may create opportunities for us and we'll see how that plays out over the next 12 months or so. We remain on our multi-year target of $50 million in our three-year plan. We think that'll be coincidental with when we think the pluggable market will start to materialize in 2021.

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

Q

Got it. Thanks.

Operator: Next question comes from Alex Henderson with Needham.

Alex Henderson
Analyst, Needham & Co. LLC

Q

Thanks. So everybody focuses on 100-gig to 200-gig, 200-gig to 400-gig, 400-gig to 600-gig, 800-gig. Are we now getting to the point as you see it where we're going to run into a limit to how far we can push the bit rates up and are we approaching a Shannon's limit type of environment? And how do you see the world changing if we're not pushing that bandwidth up but rather improving performance within the brackets that we've already established?

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

A

So I'll say this, Alex. Certainly there is a lot of physics but we're not there yet. We certainly believe there's a number of future generations of technology that are going to bring economic value to our customers. The other thing I'd say is getting at that economic value is getting more and more costly and only ones that I think are going to be able to do that journey are the ones that have scale, and we're pretty confident that we'll be amongst those folks.

Alex Henderson
Analyst, Needham & Co. LLC

Q

So along those same lines, from a competitive perspective it's our understanding that both NEL and Nokia have had issues with their DSPs as they try to implement subcarrier capabilities and constellation shaping at 600-gig and have delayed their product rollout timelines. Is that having any impact on your ability to win business particularly in EMEA and APAC?

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

A

I'd say this. Consistent with what we said last quarter is one of the drivers of our upside surprise to the year was I'll just say the lack of competitive headwinds that we did expect to see in the marketplace going into the year, and that has continued to be a reality for us on the back part of the year as well. So the short answer is probably yes.

Alex Henderson
Analyst, Needham & Co. LLC

Q

And just going back to your product, your 800-gig product because I just want to make sure I understand it fully. You've taped out the DSP for 800 gigs, you've got the DSP back and you're on schedule to roll that out in the fourth quarter. That is not a – is this a full 800-gig product in the calendar fourth quarter here? Correct?

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

A

What we've said is year end is when we will roll it out to customers and we're confident with that. By the way, everybody fixates on the DSP. It's not just the DSP; it's all the other components that go into a modem. And people I think probably are a little bit confused because they go out into the merchant component market and they see others that don't have the components to support beyond the DSP for 800-gig. That's not our situation. We 100% control the key innovation technology for that entire drivetrain and that's why we're able to be out in the market earlier than anybody. We've made great progress on the plan. The customers that we deal with are very intimate with where we're at in the technology and the vote of confidence was with the Q3 order this year.

Alex Henderson
Analyst, Needham & Co. LLC
Q

But just to be clear...

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

Thank you, Alex.

Alex Henderson
Analyst, Needham & Co. LLC
Q

...the DSP has come back, correct?

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

We don't comment, Alex, on internal milestones, methodology. There are multiple chips in it. I'll just say we're extremely confident on where we're going to be in the marketplace.

Alex Henderson
Analyst, Needham & Co. LLC
Q

Great. Thank you very much for the questions.

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

Thank you.

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

Thanks, Alex.

Operator: Next question comes from Tim Savageaux with Northland Capital (sic) [Securities] (00:52:25).

Tim Savageaux
Analyst, Northland Securities, Inc.
Q

Hi. Good morning and congrats on the results. My question...

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

Thank you, Tim

Tim Savageaux
Analyst, Northland Securities, Inc.
Q

...kind of references – you're welcome – kind of references briefly, and that's around 400-gig ZR which extensively was the driver or at least one of the main drivers for the Cisco-Acacia acquisition. I wonder if you could refresh us on Ciena's position on the kind of pluggable market in general, ZR in particular. I think 2021 type expectation was given for the beginnings of the ramp there. Just how Ciena plans to participate in that market? You view that as kind of more a threat or opportunity and if that has changed at all post the Cisco-Acacia acquisition? Thanks.

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

Yeah, so a couple of things. 400-gig ZR as a spec basically is single span. Think of it as 80-kilometer metro DCI opportunity. There's lots of dynamics going on in the metro DCI as the GCNs look at their architectures and whatnot. I think that for sure that will be [Technical Difficulty] (00:53:45) ZR's adoption in the marketplace, and obviously it's the availability of the technology and there's lots of engineering and science to go into making that available. But also the users of that upgrading their switching infrastructure to be able to take advantage of it and figuring out the operational paradigms that go around it.

It will be a portion of the market. Our perspective is ZR specifically will be a small portion of that market. We have a bet in that off of the technology investment we have on WaveLogic 5. I personally don't believe there will be, like some people think, 100 different players in this market. I think it'll be very limited because of the investment in technology required and we expect to make an offer there. I think you can think of it as an alternative to some of our dedicated transport Waveserver revenue today but not 100% substitute of it either because this market is growing at a substantial rate.

Tim Savageaux
Analyst, Northland Securities, Inc.
Q

Thanks. And if I might be able to follow up quickly...

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

Thank you, Tim. Yeah.

Tim Savageaux
Analyst, Northland Securities, Inc.
Q

Are we moving on? Okay. Great.

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

No. Go ahead, go ahead.

Tim Savageaux
Analyst, Northland Securities, Inc.
Q

And you mentioned also previously kind of the – well Cisco-Acacia obviously speaks to vertical integration as well, clearly endorses your strategy from a DSP standpoint. But there are other elements I think previously referenced in the kind of optical food chain or ecosystem in terms of components. I think you mentioned you've got a fair bit of vertical integration going on there. But in general, I'd say if we think strategically for Ciena, is some stuff sort of increase vertical integration more likely than kind of incremental pieces of technology in new markets for Ciena? Or if you could talk about your overall strategic view on vertical integration as you stand now and maybe headed forward.

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

I would say overall I think we've invested both organically and somewhat inorganically over the years in ensuring, as Scott said, the capability to be very vertically integrated because the issue is, as Scott said, it's not just the DSP; it's the ability to have an ecosystem of the technology around that to bring it to market. And we own pretty much all of the elements around that and so we're able to pace our own destiny around that, and I think that is a key competitive advantage for us. So sitting here today, I don't think there's anything that we particularly lack on on that vertical integration journey. So we feel like we're in a pretty good place overall with what we've got.

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

Thank you, Tim.

Tim Savageaux
Analyst, Northland Securities, Inc.
Q

Thank you.

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

Thank you, Tim.

Operator: Our last question comes from Ryan Koontz with Rosenblatt Securities.

Ryan Koontz
Analyst, Rosenblatt Securities, Inc.
Q

Hi. Thanks for the question. I wonder if you could speak to the 5G trends and the metro investments required for that. Are you starting to see direct opportunities? And how do you feel like you're positioned with regards to the 5G metro upgrades? Thank you.

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

You know what, I think we are beginning to see that and I think we began to see it in hindsight about sort of 12 months ago. And it sort of manifests itself in various forms but largely is this sort of converged metro architecture. And you've got most of the major Tier 1 carriers now at some point in that build out, and that include – Verizon's really one of the most public ones in North America around that, you've got AT&T, you've got CenturyLink, you've got a bunch of Tier 1 carriers in Europe. So I think they're all at sort of various stages of it I think when we announced a couple of wins this quarter in that space. And I think you'll be seeing that build out really over the next one to three years which I think is going to be a pretty healthy underlying dynamic for the industry.

Ryan Koontz
Analyst, Rosenblatt Securities, Inc.

Q

Is that mostly the 6500 platform or are you also seeing some packet opportunities there, Gary?

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

A

It's both because of the nature of it being converged. Some carriers have taken a slightly different architectural approach, but generally speaking it is a converged architecture that includes packet. And so increasingly we're seeing that as the integrated capability of packet on 6500 and then some of the aggregation pieces are still stand-alone as well. So it's an opportunity for our packet portfolio overall, and that's why we're continuing to increase our investment in the packet portfolio really large.

Ryan Koontz
Analyst, Rosenblatt Securities, Inc.

Q

Super helpful. Thank you.

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

Thank you, Ryan. And with that, we thank everyone for joining us this morning. We look forward to catching up with folks over the next several weeks. Thank you and have a good day.

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