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PRESENTATION

Operator

Welcome to the Ciena Corporation's first-quarter 2015 earnings conference call. My name is John and I will be your operator for today's call. (Operator Instructions) Please note that the conference is being recorded.

I will now turn the call over to Gregg Lampf.

Gregg Lampf - *Ciena Corporation - VP, IR*

Thanks, John. Good morning and welcome to Ciena's 2015 first-quarter review. Before we get started, I just wanted to let everyone know that due to the snowstorm here in Maryland, we are holding this call in a hotel. We apologize for any background noise you may hear from some adjacent meetings.

With me today is Gary Smith, CEO and President; Jim Moylan, CFO; and Tom Mock, Senior Vice President, Corporate Communications. Steve Alexander is at Mobile World Congress in Barcelona, so he won't be joining us this morning.

This morning's press release is available on National Business Wire and Ciena.com. We've also posted to the investor section of Ciena.com an accompanying investor presentation, including certain highlighted items for 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 and Jim will provide some color on our results and provide guidance. We will then open up 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 will 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-K filing. Our 10-Q is required to be filed with the SEC by March 12 and we expect to file by that date.

Ciena assumes no obligation to update the information discussed in this conference call, whether as a result of new information, future events, or otherwise. Today's discussion includes certain adjusted or non-GAAP measures of Ciena's results of operations. A detailed reconciliation of these non-GAAP measures to our GAAP results is included in today's press release, available on Ciena.com.

This call is being recorded and will be available for replay from the investors section of our website. Gary?

Gary Smith - *Ciena Corporation - President & CEO*

Thank you, Gregg, and good morning to everyone on the call. Thanks for joining us today.

Before getting into the quarter, I think it is probably an appropriate point in the development of the business to step back and provide a little context. When we first set out to transform the business, we specifically designed Ciena to become the leading specialist in open, on-demand, software-driven networks for a much broader and more diverse set of buyers. We built the business to deliver more consistent results and greater operating leverage.

We are executing well on this model, I think as reflected in our strong Q1 results. Results that position us well to meet our profitability goals for fiscal 2015. Although order timing and foreign-exchange headwinds impacted revenue in the quarter, we were able to deliver excellent operating profit and EPS.

With a strong performance across all other operating metrics, we are now consistently delivering on our business model with improving operating leverage and profitability. Jim will provide more detail behind these results, but I do want to comment briefly on our financial performance.

Revenue in the quarter was lower than expected due to a significant strengthening of the US dollar, as well as the timing of orders from the US government sector that we expected to turn to revenue in the quarter. We now expect to receive these orders in the current quarter with revenue recognized over Q2 and Q3.

While our bottom line is not immune to volatility in foreign exchange rates, operating income was largely unaffected by FX this quarter as a result of offsetting effects on the revenue and expense elements of our business, as well as more favorable gross margins. We continue to see robust demand from a broader set of customers. This is in line with our expectations coming into the year.

Order flow in the quarter was strong across a diverse range of customers. This is primarily due to customers' critical and growing need for on-demand networking capabilities in the cloud.

As we have said before, the need for on-demand network resources is redefining traditional domains to a simpler topology that reflects more cloud-centric usage, connecting users to their data, which we refer to as content to user, and connecting data centers together, which we refer to as content to content. And we believe that truly building an open and global on-demand environment requires a leading position with both the web scale players and the global Tier 1 service providers, as their roles are becoming increasingly interdependent as they connect content to content and content to users in real time.

Last quarter we shared our leadership position in the web-scale market and we continue to make progress in this area. For example, we have been selected by Digital Realty, the world's largest wholesale data center provider, to connect data centers and carriers within their digital network ecosystem. Our 6500 will allow Digital Realty to offer new on-demand services that combine virtual servers, storage, and networking resources.

And as was the case in Q4, our second-largest customer in the quarter was again a major web-scale player. The web-scale opportunity continues to grow and we are uniquely positioned to address the needs of this market. And that includes both direct sales to web-scale players and new projects with Tier 1 service providers who are building out network services to support specific web-scale customers.

In addition to our progress with web-scale buyers, in Q1 we also further strengthened our leadership position with service providers, especially in the critical Metro segment of this market. With full-year 2014 figures just coming out, research firm Dell'Oro shows Ciena gaining 3 percentage points of Metro share worldwide.

We had a very strong quarter for Metro in Europe, including deployments with three of the largest service providers in the region, positioning us well for future growth in the most strategic parts of these European networks. And in CALA, we are deploying what we believe is the largest nationwide Metro project in Brazil.

In North America we are pleased to announce that we have been selected by Windstream to deliver a next-generation packet optical Metro solution as a central part of their new next-gen Metro strategy. Metro is clearly a strategic segment to us as much of the overall market growth for at least the next three years is expected to be Metro-driven. In fact, we believe Metro represents a market opportunity that is at least 2 to 3 times larger than traditional long-haul.

But another reason why Metro is so important is because it means for content to get to users. It's proximity to both the content and the user means next-gen Metro requires a higher degree of packet conversions and software to deliver an on-demand experience, factors that lead us to expect Metro applications to drive higher margins over time and make our next-gen Metro solutions stickier than traditional transport.

So with continued gains in both the service provider and web-scale markets, we clearly are operating from a position of strength as we drive an open global network for the cloud. And we believe we are poised to extend that leadership.

Last week, we introduced four new solutions as part of our OPN open architecture to allow our customers to fully leverage web-scale principles across all kinds of networks. We expect these products and others to be launched over the course of the coming year to continue to expand our role in the network as well as our reach with new buyers.

The new solutions include Coherent Select, which is the first Metro optimized implementation of Coherent technology. Simultaneously simplifying and bringing new levels of flexibility to Metro aggregation networks. Our new WaveLogic 3 Extreme chipset maximizes capacity no matter the distance, from local interconnections to transoceanic submarine links. And WaveLogic 3 Nano targets applications such as Metro where maximum efficiency is more valuable than maximum capacity, providing up to 75% power savings and half the space of WaveLogic 3.

Finally, we launched two new Ethernet platforms to bring Ciena's automating and provisioning capability to the small cell backhaul market. All of these innovations, together with our ongoing market expansions, are further diversifying our business. Our continued success in new verticals contributed to non-telco customers making up more than a third of our Q1 revenue, and that is compared to just 25% a couple of years ago.

Metro applications in Q1 represented also more than a third of our overall 100 gig shipments and, coincidentally, about a third of our overall 100 gig shipments went directly to web-scale customers. And as you know, web-scale growth is a major driver of submarine traffic and we continue to win in that market as well, having announced three new submarine wins in the last quarter alone.

Despite foreign exchange headwinds, international customers represented 44% of Q1 revenue and we continue to see our relationship with Ericsson as a critical path to further international expansion. In fact, we have now shipped product to Ericsson for three Tier 1 service providers: Telstra and two as of yet unannounced customers, one in Europe and one in Asia. We have also since secured an additional European customer by partnering with Ericsson. And overall we are on track to meet our expectations for that partnership in 2015.

So as I look back over Q1, it was a quarter highlighted by our continued diversification, our expanding portfolio and opportunity, and most importantly, our improved operating leverage and profitability. I think that our Q1 performance validates not only our strategy, but also our ability to execute against it and capitalize on our competitive advantages in the marketplace.

Before I turn the call over to Jim, I want to take a moment to thank Tom Mock for the last 18 years of dedicated service at Ciena. And, despite our best efforts, Tom is insisting on retiring at the end of this month, so in effect, this will be our last quarterly call with Tom on the line. As many of you have worked with Tom over the years, I am sure you will agree when I say that he will be truly missed. I want to thank him for his many contributions to Ciena and we wish him the very best in his retirement.

Jim?

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

Thank you, Gary. Good morning, everyone. Our first-quarter results and the momentum we have in the market reflect the solid platform that we built over the past few years. Our portfolio and go-to-market investments are helping us win in critical segments of the market and we continue to diversify across verticals, regions, and applications. We are expanding our role and our reach as we build a global on-demand environment for the cloud.

Our Q1 results indicate strong performance in nearly all of our operating metrics. We delivered a solid bottom line and continued improvement in operating leverage.

Before going into our Q1 results in more detail, I would like to spend a moment on the effects of the movements in foreign exchange rates. As you have seen from other companies, both within and outside of our industry, our financial metrics were impacted by the rapid strengthening of the US dollar against a variety of foreign currencies, particularly in January. In our case, changes in FX rates, particularly the Canadian dollar and the euro, did affect virtually every income statement line in some way, but the net impact on Q1 adjusted operating income was minimal for reasons I will explain.

Against that backdrop, Q1 revenues came in lower than expected at $529 million. The strength of the US dollar was a factor in our revenue for the quarter, reducing revenue by approximately $10 million. Revenue also was affected by the timing of orders from the US government. As Gary mentioned, we now expect those orders in Q2, with revenue coming in Q2 and Q3.

This is a perfect illustration of why we often say that you should view our results in fiscal halves or in full years to get the most accurate picture of the trends in our business.

As expected, Q1 gross margin recovered substantially from Q4's 38%, coming in at 44%. Last quarter we said that we expected gross margin to return to our more typical range in the first half of 2015. Q1 results bear that out and we were actually able to over achieve a little on gross margin this quarter due to a combination of ongoing product cost reductions and a favorable product mix. This included increased software content and a greater proportion of higher-margin line cards. In addition, gross margin was slightly affected by FX in the quarter through a reduction in cost of goods sold.

Q1 operating expense was significantly lower than expected at $197 million. The strengthening dollar reduced OpEx by roughly $4 million. OpEx also was affected by the timing of certain real estate and R&D projects, which we now expect to occur in subsequent quarters.

The combination of this lower OpEx and strong gross margin allowed us to over achieve on operating profitability, despite this extreme volatility in the foreign exchange markets. Our Q1 adjusted operating profit of $37 million represents an adjusted operating margin of 7%. Orders in the quarter were greater than revenue and, thus, our backlog grew.

Adjusted earnings per share was $0.12 and we generated $23 million in cash from the business.

Now let me speak to guidance. We certainly continue to believe that 2015 is going to be a great year for Ciena. As you have heard us say again today, demand is high, our leadership position is strong, and our visibility remains good.

But as you have seen in our Q1 results, we are not immune to volatility in FX rates. Given the dramatic effects that we saw in Q1, we want to help you understand the impact that the recent strengthening of the US dollar has on our expectations for the full fiscal year.

When we reported our Q4 results, we said that we expected 2015 revenue growth to be in the range of 7% to 9% for the full year. If the US dollar had not strengthened as it did, we would continue to expect our revenue to be in that same range for the year. However, we now expect that the current FX rates will reduce our 2015 revenue expectation by approximately $50 million to $60 million.

After considering this impact, we now expect an overall revenue growth rate in fiscal 2015 in the range of 5%. Of course, that expectation could change depending in part on what happens to FX rates as we move through the year. That said, it is important to note that we are taking market share and we continue to believe that we are growing faster than the market, despite these FX rate effects.

In addition, at current spot rates FX will also reduce our operating expense this year, such that we now expect that OpEx will average approximately $205 million in quarter -- per quarter for the full year. We also expect the change in FX to reduce our cost of goods sold for the year.

When all these changes are taken together, we continue to expect that we will achieve our previous guidance of 8% to 9% in adjusted operating margin for fiscal 2015. In fact, when combined with our improved gross margin performance, we also believe that our adjusted operating income for 2015 will be in line with our previous expectations. We also continue to expect to generate in fiscal 2015 roughly double the cash from our business that we did in 2014, excluding any repayment of outstanding notes.

Turning now to our fiscal second quarter, we expect Q2 revenue to be in the range of $585 million to $615 million. If FX rates have not changed from the beginning of the year, both ends of this revenue range would have been higher by approximately $15 million. We expect Q2's adjusted gross margin to be between 42% and 43%.

We expect Q2 adjusted operating expense to be approximately $210 million. We do not expect significant cash generation from the business in this quarter, largely due to the fact that we payout our fiscal 2014 companywide incentive compensation during the quarter.

Finally, due to the cost of hedging, we again expect the charge in other expense of about $4 million. I know all of this FX discussion has been a lot to absorb, but I do want to emphasize that even after the impact of the fluctuations in foreign currency exchange rates to date, we expect our bottom lines, both at the operating profit line and at the net income line, to be about the same as the numbers we expected at the beginning of the year. In other words, FX changes to date have affected the income statement at certain lines, but the net effect of all of these changes is minimal for the full fiscal year.

I'd like to close our prepared remarks by reiterating that we are committed to capitalizing on this platform we have built to deliver balanced, diversified growth and substantially increased profitability. As customers continue to adopt web-scale principles, Ciena is positioned to help all kinds of network operators transform their business through strategic, on-demand networking.

John, we will now open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Amitabh Passi, UBS.

Amitabh Passi - *UBS - Analyst*

I just had a couple of questions. Jim, first one for you, and I apologize if I missed this, I think I heard you say 5% revenue growth for the full year, but you reiterated operating margin at 8% to 9%. But I thought I also heard you say that in terms of operating profit dollars and net income dollars, your expectation hasn't changed.

So I was a little confused by that; lower revenue, same operating margin. How is it that the operating profit and net income dollar expectations are still consistent with where they were?

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

There's only one way mathematically to get there and that is to assume that our gross margin is going to improve from our previous expectation.

Amitabh Passi - *UBS - Analyst*

All right, just wanted to clarify that.

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

Amitabh, you'll get there, just pencil it out.

Amitabh Passi - *UBS - Analyst*

Okay. Then, Gary, maybe just a broader question for you. You talked about several Metro wins. Just a point of clarification.

Were most of the ones you highlighted in your commentary 100 gig wins? And then maybe just give us a sense of the demand in the competitive environment, particularly vis-a-vis Cisco.

Gary Smith - *Ciena Corporation - President & CEO*

Amitabh, most of those wins I referred to were 100 gig and most of the what we would call next-generation converged packet Metro, which is really what we are talking about, not the legacy Metro, most of those are 100 gig. We've invested very heavily in that space. We think we have leading capabilities, more of which we will deliver during the course of this year.

So from a competitive point of view, obviously as we get closer to the end user it's a slightly different set of competitors within that capability and Cisco is certainly a -- would be more of a competitor as we get to the Metro space. But it's also a much, much larger opportunity. I think it's at least 2 to 3 times.

And I think it strategically important; because it is so converged, it's really the point of service delivery to get content into users. It's also the opportunity to put software applications and obviously a lot more packet capability on it as well. And over time we think that will deliver more gross margins.

Amitabh Passi - *UBS - Analyst*

Okay, thank you. I'll step back in queue.

Operator

Ron Hall, JPMorgan.

Ashwin Kesireddy - *JPMorgan - Analyst*

Thanks, this is Ashwin on behalf of Rod. First of all, Tom, congratulations on the retirement.

Tom Mock - *Ciena Corporation - SVP, Corporate Communications*

Thank you.

Ashwin Kesireddy - *JPMorgan - Analyst*

My question really is on competitive environment in general. Can you talk about competition in Metro, maybe about the web 2.0 customers? One of your competitor announced new products towards the end of last year. I'm just wondering how you see the competitive environment playing out this year.

Also, if you could talk about any Metro RFPs in pipeline and potentially you could have one in Q1 which could probably help your revenue accelerate in second half of this year that would be helpful too.

Gary Smith - *Ciena Corporation - President & CEO*

Okay, why don't I take the first part of that? In terms of the competitive environment, I think, as I mentioned on the previous question to Amitabh, as you get closer to the edge it's a slightly different set of competitors emerging there and certainly Cisco is one more obvious one. But we think we are very well placed with our next-generation platform that is specifically designed for this space and we've got increasing capabilities during the course of the year, as we will announce.

The environment generally -- if you take the top North American opportunities -- and I think the other one you are referring to is the Verizon opportunity that has been publicly talked about in the RFP. Should Ciena secure that -- and, by the way, we think we are very well placed for that. There's as a very good fit both for relationship point of view and credibility and also from a solution point of view. Should we win that we basically would have the top five facilities-based carriers in North America will have already chosen Ciena to basically rollout their next-generation Metro.

So I think those decisions have already been made and so when we think -- the decision on Verizon will be announced shortly. On the product side, let me hand over to Tom.

Tom Mock - *Ciena Corporation - SVP, Corporate Communications*

Yes, I would say one of the things that is interesting about the Metro area, and Gary sort of alluded to this, is the fact that you are closer to the end-user so there's more complexity in the devices. There's more conversions, there's packet switching required; sometimes OTN switching required.

One of the reasons we have been so successful in that space is because we've been able to converge those into a box that actually fits the application very, very well. There's also in the Metro area quite a drive in terms of distances by the web-scale providers and we've also seen some success in that market as well.

It's not just connecting users to content affecting that area, that's where some of the more complexity and some of the greater need for packet switching comes in. It is also a good market for being able to interconnect data centers that are being placed closer to the users, and that's one of the things that has driven us to be ranked number two globally in Metro WDM in 2014.

So we see it is a good growth engine for the Company. We see it is as a good fit with our technology, and we also see it as a good fit with some of the things we are doing on the agility side to help service providers put more functionality closer to the user.

Ashwin Kesireddy - *JPMorgan - Analyst*

I had a follow-up on Gary's commentary on Verizon. In your fiscal 2015 guidance, are you already factoring in this win and how much of revenue are you expecting from this deal?

Gary Smith - *Ciena Corporation - President & CEO*

We are not factoring any real revenue for this year. By the time we get to the rollout I think most of that will be beginning. There might be some late in 2015, but I think really it would come online in 2016. So in the guidance that we have given we are not really factoring in any revenue. That's going to be a layered on opportunity as we go through 2016.

There's a lot of other Metro wins, as I said, that are beginning to roll out of the major carriers in North America, including AT&T, which is beginning to deploy 100 gig into the Metro. That was also strong in Q1. CenturyLink, Comcast, Bell Canada, Sprint, most of the North American players have made their choices and it's the Ciena platform. And that is beginning to roll out in 2015.

Ashwin Kesireddy - *JPMorgan - Analyst*

Okay, thank you.

Operator

Jess Lubert, Wells Fargo.

Jess Lubert - *Wells Fargo Securities - Analyst*

Thanks for taking my question. Tom, congratulations again.

Couple questions. First, can you discuss the pricing of the big 100-gig Metro opportunities you are working on? And with the big US opportunity should we be expecting concessions similar to what we saw last year with your biggest customer?

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

Remember when we talked about that deal we said that it's a normal part of winning new positions to have a price discovery mechanism and to give discounts at the beginning. We also said that we don't expect the kind of very significant in-quarter effect for any deals in the future as we saw in Q4. So I would say that the competition in all these Metro deals is tough and we are going to be having to give some price concession, but as of now, we don't expect to kind of effect going forward in any deal that we see -- that we saw in Q4.

Tom Mock - *Ciena Corporation - SVP, Corporate Communications*

One thing to keep in mind, Jess, is we also introduced some new chipsets. Those are going to help improve our cost points for Metro and that's going to allow us to remain competitive, even if the prices do come down.

Gary Smith - *Ciena Corporation - President & CEO*

You've also, Jess, you've seen the strength of the gross margin in Q1 and we also divulged the amount of Metro shipments, which were substantial in the quarter as well. And they actually helped the margin, given the convergence on the platform.

Jess Lubert - *Wells Fargo Securities - Analyst*

Okay. So it sounds like you're not expecting a big step-down function if you were to win that big opportunity up front. Is that a fair statement?

Gary Smith - *Ciena Corporation - President & CEO*

Correct, correct.

Jess Lubert - *Wells Fargo Securities - Analyst*

My second question, I was hoping you could discuss what you are hearing from customers regarding the 8700 platform, how that's going versus plan. I didn't hear that on the call. Perhaps you can touch upon how impactful you believe some of you new web-scale capabilities are likely to have with these accounts over the course of the year.

Tom Mock - *Ciena Corporation - SVP, Corporate Communications*

We have added some new customers to the 8700 roster for the quarter. We are at 12 customers now; I think that's up three from the last quarter.

We see this as a good way for us to expand our reach inside networks that are using our packet capabilities. Typically we've acted more closely to the edge of the network. This will allow us to get more back into the Metro infrastructure of the network.

This is also a box that is optimized to pack traffic into 100G files, so it's a nice fit with some of the other things we're doing on the infrastructure side. It's also a device that is larger in scale and more software intensive, and those kinds of trends tend to make it a higher-margin product for the business.

So we are seeing good traction with the product at customers so far. It's been on the market for a little over a quarter now and we've already got 12 customers for it. And those are customers from various parts around the world, not just in the United States.

Operator

Simon Leopold, Raymond James.

Simon Leopold - *Raymond James & Associates - Analyst*

Tom, I wanted to congratulate you on your next phase. It's been a long time, so we will miss you here. So good luck with whatever you are doing next.

Nonetheless, let's go into the questions. I was hoping you could talk about two things. One is what's going on with the mix. In terms of this quarter, it looks like most of the delta was in converged packet versus what we were expecting, so just wondering how you are thinking about the mix of your segments going forward.

And then, Gary, you talked about Metro margins being better, and I was kind of surprised. And you've answered that in part to Tom's comments on some of the new chipsets, but I'm wondering if you could help us understand how this compares historically. Because I've generally thought that long-haul has been a better margin market than Metro and we also seem to see more competition in Metro than long-haul, so I'm a bit surprised regarding this idea that Metro margins improved. So if you could help us with that aspect. Thank you.

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

Let me speak to the growth rate of the segment just for a moment, Simon. As you can see, we have seen growth across just about all of our segments, except for optical transport which are our older platforms, and we expect to see that over time.

If I were to look and speculate on where the higher growth would be, I think you are going to see higher growth over time in packet networking and higher growth over time in our software business. That's where we are going to see higher growth, but we expect everything, other than converged packet optical -- I'm sorry, excuse me, optical transport to grow over time.

Simon Leopold - *Raymond James & Associates - Analyst*

But in the April quarter do you expect the most sequential growth in converged packet relative to where it was this quarter versus October?

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

Most likely, yes. As you know, though, we can always be fooled by serial movements in any number in our income statement. But, yes, that's what we would expect.

Tom Mock - *Ciena Corporation - SVP, Corporate Communications*

Turning to your margin question, the cost reduction does play a factor in that, but an equally important factor is the fact that most of these applications we are seeing are requiring some level of switching. And that higher level of functionality gives us an opportunity to put more value into the network.

I think that's one of the reasons that we have been able to do better than some of our competitors is because we have done a better job of integrating some of those technologies into the platform. Easier to put in their networks, easier to integrate with their existing long-haul facilities, and more capable at helping them delivering the services faster to their end-users.

Simon Leopold - *Raymond James & Associates - Analyst*

Great, thank you for taking my questions. Good luck, Tom.

Operator

Kent Schofield, Goldman Sachs.

Kent Schofield - *Goldman Sachs - Analyst*

Great, thank you. First off, congratulations to you, Tom. On the data center interconnect market; we've seen a lot of product launches there, so I was wondering if you could do a little bit of a dive in terms of the competitive environment for those platforms, what you are seeing, and how you see that evolving going forward.

Tom Mock - *Ciena Corporation - SVP, Corporate Communications*

I will start with that and, Gary or Jim, add some color commentary as you see fit. Today that market is largely dominated by simple point-to-point transport, and as we have seen in the longer haul parts of the data center interconnect market, as time goes on, their needs get more sophisticated. In some cases they need switching capability, in some cases they want to go longer distances at higher capacities.

So one of the things that we have been working on is how can we get them the most capacity in a fiber over a Metro distance to be able to connect data centers within cities. We also believe that over time there is the ability to add traffic management to that. There is the ability to add some automated protection to that, and then there's the ability also to run software applications that will allow the platforms we have got to better interconnect with the stuff that's going on inside the data center.

You may recall, about six months ago we talked about some work we have been doing with Brocade that allowed us to have the software they have running in the data center actually control some of the behavior of the network in order to set up and tear down capacity. Because one of the things that's happening here is, even though a lot of these initial deployments are fairly static, over the longer term as people start to migrate applications between data centers we will see that connectivity become more dynamic.

So the initial entrants in the market have made special-purpose products to go into that space. It has largely been very simple, optical transport platforms that simply get capacity from one place to another and don't necessarily allow the interaction with software applications that would allow you to make that more dynamic. We see that's really going to be a more important part of the data center interconnect market.

Kent Schofield - *Goldman Sachs - Analyst*

And one quick follow-up. Would the second-largest customer on the web-scale side of things; is that the same customer as last quarter?

Gary Smith - *Ciena Corporation - President & CEO*

Yes, I believe it is, Kent.

Kent Schofield - *Goldman Sachs - Analyst*

Okay, thanks so much.

Operator

Subu Subrahmanyan, The Juda Group.

Subu Subrahmanyan - *The Juda Group - Analyst*

Thank you. My first question was on the Metro market. You told us what it was as a percentage of 100 gig ports. Was wondering if you could talk about what it represented as a percentage of revenues and what ASPs are compared to long-haul.

The other question was you now have more cost optimized platforms, but last year were you selling more of what would traditionally be a long-haul platform into Metro, which depressed margins? And as you add more packet functionality and lower cost components, it improves Metro gross margin going forward.

Gary Smith - *Ciena Corporation - President & CEO*

Let me take that. Roughing out on the revenues, it's about half as well. The rough correlation exists between the ports and the revenues.

The point I would make about Metro is what we are talking about in these new rollouts is really a next-generation Metro that is highly-converged platforms that require a lot of switching, OTN, control plane, a lot of packet convergence. And when I talk about what we are rolling out at AT&T and CenturyLink, etc., and with -- hopefully with Verizon as we go through 2016, these are based on these kinds of platforms. Highly-converged platforms, not simple transport, as Tom was saying.

Subu Subrahmanyan - *The Juda Group - Analyst*

Understood. And then two quick clarifications. Could you tell us what web-scale represented as percent of revenue? And, Jim, you mentioned, I think it was under [Jess's] question, is we have lower revenues and same level of operating profit dollars shouldn't operating margin percent actually be higher than before?

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

On the web-scale percent of revenue, we haven't disclosed that precisely. It's still probably, as a direct number, under 10%, but it's our fastest-growing vertical.

Although if you included the sales that we make to Tier 1 operators who are building capacity to serve the web-scale set of customers, it would be in excess of 10%. And we believe that we are number one in share on just the direct sales. If you add the indirect sales that are specifically for web-scale customers, we are clearly number one in terms of market share.

With respect to the FX discussion, I just want to remind everybody of the numbers so you understand how it all works. We said that revenue is going to be affected for the year and reduced by about $50 million to $60 million. We said that if you parsed through the language that we used about OpEx that's about a $20 million reduction in OpEx.

We also say that our operating income number is going to be about the same as we had earlier in the year. So that difference, obviously, is made up in the COGS line. And in order for our operating margin to be roughly the same -- I'm sorry, in the same range and the same number based on a lower revenue number, the operating margin percent, by definition, does have to go up.

Subu Subrahmanyan - *The Juda Group - Analyst*

Okay, I just wanted to clarify that. Thank you.

Operator

Brian Modoff, Deutsche Bank.

Vijay Bhagavath - *Deutsche Bank - Analyst*

Vijay on behalf of Brian. If I may, the way I look at the Company and the stock is there are three fundamental catalysts. One is the 100-gig Metro opportunity in the US telcos and in Europe, etc., and then the 100-gig long-haul buildouts at AT&T, and then the third is continuing strength in Web 2.0.

So like to understand from you; when you look at your web-scale data center opportunity, give us some numbers in terms of year-on-year revenue growth in terms of percentage contribution. Would it be approximately 10% of revenues currently from web-scale data centers and would it be 2x of the revenue growth you are seeing from the telcos in terms of how we should look at Web 2.0? That would be the first part of the question, thanks.

Gary Smith - *Ciena Corporation - President & CEO*

Let me kind of answer it generally and try and get down to some specifics to you. I think what's driving the whole on-demand environment right now is really the content. That is what is driving the networks.

The web scale folks are building clearly content to content, data center to data center, and they are building out, in many cases, direct capacity for that. And also, obviously, from content to users, some of them are building specific, in collaboration with the Tier 1s around the world, those kinds of dedicated capacity. And we are involved in all of that because we are strong in all the global Tier 1s for the web-scale folks.

So I would answer it in sort of specifics in a number of ways. One, our non-telco revenues have gone up from about 25% a couple of years ago to that we hit a milestone in Q1 of over a third of our revenues now come from non-telco infrastructure revenues, and that includes the web-scale guys.

Directly, they are about approximately 10% of our total figures, but if you also put in the collaboration where we put dedicated capacity into Tier 1s, it's a very strong driver of our overall growth. And that number is substantially more than the direct amount of business that we are doing.

So if you put those things together it's 20% to 30% of our total revenues come from those folks that we can actually identify from the web scale. And we see that increasing. We see other opportunities with emerging web-scale players that we are not currently with, and we expect to secure some of those during the course of this year as well.

Increasingly, our portfolio is geared to support them both directly and with the sort of global web-scale features, as per the number of additions to the portfolio we announced the other week. So I think if you think about it in those terms, obviously 100-gig content to content. We are also seeing them buildout Metro as well where they want to get caching in closer to their end-users.

Vijay Bhagavath - *Deutsche Bank - Analyst*

Thanks, Gary. Then a quick follow-on would be Infinera is seeing a strength with web-scale data centers, so on a deal-by-deal basis in the field, would you have to compete quite aggressively versus Infinera? Or is it a positive sum game, there's enough opportunity for both of you? Help us understand the competitive dynamics in web-scale data centers.

Gary Smith - *Ciena Corporation - President & CEO*

If you think about the Metro opportunities to date with the Tier 1s, it's probably more, on a global basis, Alcatel and Cisco that we would compete with. If you talk specifically about some of the simpler applications around data centers, then there are a number of smaller players in there, but by the time we roll out our complete portfolio, I think we will be very well positioned.

And so we've got lots of different capabilities we can deploy to scale, from simple point-to-point data center environments that are just looking for pure transport all the way up to a fully-converged packet switching and OTN and very high density where we've got specialist wave logic technology being deployed. So I think as we go through the course of this year it will become clear that we've got absolutely comprehensive portfolio that will scale right the way from the simpler transport point-to-point all the way through to fully-converged, high-density, software-enabled Metro applications.

Vijay Bhagavath - *Deutsche Bank - Analyst*

A final question for Jim, if I may. Anything, Jim, on the operational side; the way I mean is with the web-scale data centers you have to turn the purchase order around quicker versus how you would respond to a telco bid. Am I thinking this correctly in terms of how your operational processes would be different to respond to a Web 2.0 order versus one of your traditional telcos? Thanks.

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

I would say generally you are correct. I would say that the Tier 1s are sensitive lead times, but they do often give us orders farther in advance and we do have time to react. At least they can give us a plan for a year or a quarter where we will have some idea of what they are going to do, whereas the web-scale guys do tend to move pretty quickly.

And so, yes, we have adjusted our operating processes. We did -- last year you will recall, Vijay, we did change some of our supply chain behaviors. We brought in some finished goods, 100-gig cards, to be able to generate lead times. And we brought those lead times down to a very short period, so we are very much able to serve the needs of web-scale.

And it's not just the web-scale, by the way. In the enterprise, on success-based opportunities, the lead time is critical and we can win or lose deals based on our lead times. So we have done the things in our supply chain to enable us to hit those lead times.

Operator

Ehud Geldblum, Citibank.

Stan Kovier - *Citigroup - Analyst*

Thanks, everyone. It's Stan Kovier dialing in for Ehud. Thanks for taking the question.

I just wanted to ask a little bit about the US business. Obviously we know what the AT&T numbers were and it seems like, with government weak, the non-AT&T part of the business fell about $55 million in the quarter. I just want to understand what portion of that was related to the fed versus non-fed.

And then also, just back to the strong gross margin, can you help us understand where exactly the concentration of line cards that you are shipping that helped you on the margin side is coming in? Is that actually just from AT&T and can you cite maybe more specific projects, or is that with web-scale?

I just want to understand the phases you are in of some of those deployments. And beyond the cost side of things on the chips being lower and the FX, where you are getting that improvement in gross margin just from a mix standpoint on the line card side. Thank you.

Gary Smith - *Ciena Corporation - President & CEO*

Let me talk to the first part of that, Stan. In the US, the government sector orders that we had expected to get in that rolled out of that were about $15 million to $20 million approximately. We expect overall the North America to rebound strongly into Q2, so I wouldn't read too much into that from a trending point of view on a quarter-to-quarter basis. About half of that, close to half of that was just government sector in terms of timing and then you've got enterprise and Tier 2s, etc., that we think are going to come on strong for the Q2 and Q3.

In terms of the margin expansion, it's really -- it's not just simple line cards. It really was a greater preponderance of software, a greater preponderance of certain kinds of Metro where you've got high packet and switching capabilities built into the platform, so they helped drive gross margins in addition to some of the cost reductions.

And just to be clear, some of the new chips we announced the other week, whilst we were shipping one of those chips, we really haven't received a lot of benefit of that cost reduction yet either. So that is all in front of us as we roll out 100-gig both in long-haul and in Metro.

In terms of the line card specifically, we have had a lot of wins over the last three to four years, particularly internationally where we have put, in essence, a lot of chassis out there. We are now beginning to get a steadier cadence of growth in terms of those channel adds, which tend to be at higher margins. That is also playing a role as well in our improved margin position.

Tom Mock - *Ciena Corporation - SVP, Corporate Communications*

Just to add a little bit to that comment about the US in the first quarter, we said over and over again that you can't really look at quarter-to-quarter performance as a trend. You have to look over longer periods of time. We expect a very, very strong year in our US business this year. It will be higher than last year overall and so you will see stronger performance in the subsequent quarters.

Stan Kovier - *Citigroup - Analyst*

Thank you.

Operator

Mark Sue, RBC Capital Markets.

Mark Sue - *RBC Capital Markets - Analyst*

Thank you. Good morning, gentlemen. There's a lot of positive things going your way for us as you enter this year. If I consider your comment that Ciena is now in a better position of strength and also combined that with all the hard work you've done with COGS improvement in more software, are you now able to price your products more for value and less on a mark-up on cost?

Operationally, things are moving in the right way, so are you -- can we start having the strategic discussion with your customers to kind of pay more for value -- for the value that you add? Thank you.

Gary Smith - *Ciena Corporation - President & CEO*

Mark, I think that's a good point. There's two comments I would make to it.

First of all, you've got a more converged solution, so you've got a lot more capabilities being delivered and, importantly, it is really about service creation. To your point, you are closer to the end-user and so it's less of a capital expenditure; it's more around investing where they are actually getting revenues from their customers. And so it has changed the dynamic of the engagement.

We spend as much time with the product marketing people at some of the major carriers around the world as we do with the infrastructure folks. And as you get closer to the services piece, it's much more success based, and that tends to be more software orientated and, therefore, higher gross margin. That's why we are so focused on this broad Metro space, because that's where we see the opportunity to really amplify that and get the margins where we want them to be, which is consistently in the mid-40%s.

Mark Sue - *RBC Capital Markets - Analyst*

That's helpful. Then maybe just a quick follow-up. There's a big focus to double your cash generation this year, maybe how we should think about that. That must be a function of increasing net income or is it just improvements in working capital as well? Jim, maybe your thoughts and how we could and continue to improve the cash flow generation, thank you.

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

Yes, it's both this year. We will have higher net income and we will do a little balance sheet cleanup, so it's both. We expect that to continue going forward.

As our net income grows, our cash flow will grow. That's sort of dollar for dollar.

On the working capital line, remember that we have been attacking internationally in areas where we have been doing big projects, where typically we don't get acceptance until we complete the project, and that begins the cash collection cycle. So many of these projects have been on our balance sheet for longer than our normal business in the US. We are still going to be attacking in many of these areas, but the percentage of our business that these big projects represent will go down.

And so I look for our working capital as a percentage of our revenue to decline over the next several years, which will be another source of cash. So I think we're going to generate good cash this year, assuming that the world continues the way it is now for the next several years.

Mark Sue - *RBC Capital Markets - Analyst*

That's great. Thank you, gentlemen.

Operator

Paul Silverstein, Cowen and Company.

Paul Silverstein - *Cowen and Company - Analyst*

Thanks, guys. In terms of pricing, I take it pricing -- the rate of decline hasn't changed.

Gary Smith - *Ciena Corporation - President & CEO*

We don't see much change in the pricing environment. And obviously with the cost reductions we are doing and getting closer to the Metro and the end user, we see the ability is, as Mark was saying, to deliver value.

Paul Silverstein - *Cowen and Company - Analyst*

Jim, Gary, relative to -- I guess a bull would say on margins that you just put up some very strong numbers, a bear would say one quarter doesn't a trend make. Relative to the concern a lot of investors have that what AT&T did a quarter or two ago every carrier in the world is going to do to one extent or another at some point, if not immediately.

Is there -- again, I know the numbers were strong and the commentary on mix and pricing, etc., was all strong. But anything incremental you can say relative to that concern? And then I have one follow-up if I could.

Gary Smith - *Ciena Corporation - President & CEO*

I think the -- what was different around what happened in Q4 was it was very concentrated. It's how we structured the deal, which is very unusual. For some very specific reasons we decided to structure it that way and take it in a quarter.

What I said now I said then, which was really this is no different than the stuff that goes on on a regular basis with all of the major carriers, except normally it's extrapolated out through the course of a year and we are able to manage it accordingly. And I also think, Paul, to your point, we had a very strong quarter in Q1 with AT&T, particularly as they began to deploy more and more of their Metro. And they are just at the beginning of that, starting to deploy their 100 gig.

You can see from a gross margin point of view, in Q3 of last year we were 44%; in Q1 of this year we are 44%. Really the decline in Q4 was attributable to one particular negotiation. We do not see that being repeated again in the foreseeable future with any of the Tier 1 carriers.

Paul Silverstein - *Cowen and Company - Analyst*

Okay. And then I recognize it's hard to predict the future in your business, let alone one quarter, let alone a year or two out, but relative to concerns about the extent of this upgrade cycle, there's not a lot of history. I think we have had 1.5 upgrade cycles in the last 15 years if I recall.

I recognize it's not the late 1990s in terms of the underpinnings of the cycle, the health of the customers. But what are the data points you can cite that suggest that this will be measured in years from now as opposed to there's a handful of quarters left? It seems like we're at the beginning of Metro, but the simple question is what are the data points that would indicate this is a multiyear as opposed to a multiquarter upgrade from here?

Gary Smith - *Ciena Corporation - President & CEO*

Having lived through the various cycles of the last sort of 20, 30 years, I would say what's different about this is I think, first of all, it's grounded in real business models of people making money, real applications that are demanding massive amounts of capacity, and I just don't see that changing. We are at the fairly early stages of that. When you think about machine to machine, it has not really started yet in any appreciable way.

I think all of the -- and it's very broad-based. It's not just a few large carriers building infrastructure. Very often we are delivering capacity right into the front-end of the networks that go straight into usage by the content folks and just the enormous amount of demand that is being driven by those is unprecedented.

The way they are building the networks it's much simpler. It's content to content and data center to data center connectivity. I think that's going to be a massive requirement for the next five to 10 years. If you think about then getting that content out to the users, and that could be in their mobile devices into their machines, we are at the fairly early stages of that.

So whilst it will have its ups and downs, I think the underpinnings of the demand are fundamentally different than we have seen in the telecom infrastructure world to date.

Paul Silverstein - *Cowen and Company - Analyst*

Gary, you're seeing no trail-off in the number of RFPs and the other leading indicators that speak to that?

Gary Smith - *Ciena Corporation - President & CEO*

Yes. I mean we see increasing pipeline, increasing demand. Said simply, it's a broader set of customers that are now driving demand for converged packet optical. It's enterprise, research, education, government sector, web-scale content providers, web-scale data center, neutral providers. A wide array of customer base and I think that makes for a much more balanced business, which I think is the whole point.

We don't want to see these large, cyclical, short-term movements. And I think we're beginning to get very confident that we can deliver consistent profitability and improve our operating leverage over a long period of time.

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

I'd also say, Paul, that we believe that we can continue to make take market share. We think with our solutions, our set of engagements with customers, with expanding our role and reach that we are going to continue to take market share. So if you look at us in particular, we see a nice future ahead of us.

Gregg Lampf - *Ciena Corporation - VP, IR*

Thanks, Jim. I appreciate you calling in, Paul, from overseas and everyone else. We look forward to connecting with you again next quarter and during follow-ups. Thanks, everybody. Safe travels home.

Operator

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