THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

CIEN - Q3 2015 Ciena Corp Earnings Call

EVENT DATE/TIME: SEPTEMBER 03, 2015 / 12:30PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

Gregg Lampf *Ciena Corporation - VP IR*

Gary Smith *Ciena Corporation - President, CEO*

Jim Moylan *Ciena Corporation - SVP Finance, CFO*

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

CONFERENCE CALL PARTICIPANTS

Sanjiv Wadhwani *Stifel Nicolaus - Analyst*

Brian Modoff *Deutsche Bank - Analyst*

Tal Liani *BofA Merrill Lynch - Analyst*

Mark Sue *RBC Capital Markets - Analyst*

Amitabh Passi *UBS - Analyst*

Paul Silverstein *Cowen and Company - Analyst*

Ashwin Kesireddy *JPMorgan - Analyst*

George Notter *Jefferies LLC - Analyst*

Doug Clark *Goldman Sachs - Analyst*

Simon Leopold *Raymond James & Associates - Analyst*

Catharine Trebnick *Dougherty & Company - Analyst*

Tim Long *BMO Capital Markets - Analyst*

Dmitry Netis *William Blair & Company - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Ciena Corporation third-quarter 2015 earnings conference call. (Operator Instructions) As a reminder, this call may be recorded.

I would now like to introduce your host for today's conference, Mr. Gregg Lampf, Vice President of Investor Relations. Mr. Lampf, please go ahead.

Gregg Lampf - *Ciena Corporation - VP IR*

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

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

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

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

Our 10-Q is required to be filed with the SEC by September 10, 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 in the Investors section of our website.

Gary?

Gary Smith - *Ciena Corporation - President, CEO*

Thanks, Gregg, and good morning to everyone on the call. Our third-quarter results demonstrate significant improvement in profits and cash generation, validating the strength, I think, of both our strategy and our overall business model.

With more kinds of applications and businesses relying on the network to deliver services and experiences on demand, we see a tremendous opportunity for Ciena to increase its strategic value to a very broad range of customers. That greater value is increasingly evident in our financial performance.

In Q3, we delivered strong gross margin, operating margin, EPS, and cash generation, reflecting our continued ability to drive operating leverage in the business even when presented with some short-term revenue headwinds.

This past quarter we saw a change in the timing of network implementations of certain customers -- North American Tier 1 service providers, in particular, due to a number of customer-specific factors. Accordingly, Q3 revenue was lower than expected.

We believe these factors are temporary in nature and do not represent a fundamental change in market demand or Ciena's overall momentum in any way. This is purely an issue of timing. In fact, we see growing underlying demand, and we continue to win more than our fair share of new deals.

In fact, Infonetics recently named Ciena as the global optical leader in market momentum and a leading optical supplier overall. We're also highly encouraged by the positive customer response to our acquisition of Cyan and the subsequent formation of our new Blue Planet division, helping position Ciena for the next major wave of growth in the industry.

Only Ciena offers the highest-performing hardware platforms that are required today and the best-performing software platform that will be essential tomorrow as the market continues its shift towards virtualization and SDN. I'd like to take a moment to outline the strength of this comprehensive differentiation: first, where we are today and then looking further ahead to the next phase of network transformation.

Today, our market's most immediate need is for high-capacity networks that converge layers and functions while automating provisioning and operations. As you know, Ciena is highly differentiated in this market, a position that is further enhanced with our recent launch of the industry's only 15-terabit switch.

In the fastest-growing segments of the market, Ciena is taking a leading position. Dell'Oro just confirmed Ciena is number one in North American Metro share and in the top three globally, reflecting our clean sweep of the Tier 1 Metro market at home as well as growing position internationally.

With Tier 1 service providers having largely made their Metro supplier decisions, Ciena is well positioned to capitalize, as 100- and 200-gig push through the Metro towards the network edge in the coming years. In fact, we've already begun receiving our first Metro orders from Verizon.

In addition to Tier 1s, coherent optical is also critical to the data center interconnect applications of Web-scale providers, a customer segment in which Dell'Oro named Ciena number-one globally in overall DCI and number one with ICP specifically.

The launch of Waveserver last quarter further strengthens that position. Web-scale customers have responded enthusiastically, and we've already received our first Waveserver orders.

In extensive customer engagements we are receiving very positive feedback on the market-leading performance of the platform's WaveLogic chipsets as well as the openness, flexibility, and ease-of-use of its unique software approach. Trial Waveservers are shipping this month, with general availability expected in October.

So clearly, Ciena has positioned itself as a highly differentiated leader in meeting the critical needs of the market today. But as I mentioned, we are also positioning and investing ourselves to lead the next transformative change on the horizon.

With our acquisition of Cyan and the formation of the Blue Planet division, we are establishing a leader in SDN and NFV software, positioning Ciena for what is expected to be a significant opportunity. With customers naming Cyan as one of the top three orchestration software providers globally, according to Infonetics, we are working aggressively now to translate Cyan mindshare and Ciena incumbency into early footprint.

We believe first movers will have a significant competitive advantage as network operators around the world are already evaluating orchestration solutions. In addition to time-to-market, Blue Planet provides differentiation with a multivendor solution for automating services from creation to orchestration to delivery across both physical and virtual demands.

All of these market needs regarding both hardware and software are growing, and the continuing shift to on-demand consumption of resources is directly linking network performance to that of business performance, which further elevates the value of what we have to offer. In fact, we have purpose-built Ciena to advance that agenda. Our strategy, our model, and our execution are enabling us to achieve our financial objectives, and we are confident in our ability to lead the industry into this new on-demand era whilst growing the business and continuing to improve profitability.

Before turning the call over to Jim, I'd like to take a moment to address the senior management changes that we've recently announced. On October 31, Philippe Morin will be stepping down as the leader of our global field organization after four years in that role and five and a half years with the Company. I want to personally thank Philippe for all of the contributions he's made to Ciena during his tenure and especially the important role he played in ensuring the success of the Ciena-MEN combination. We wish him truly the very best in his career going forward.

I'd also like to take a moment to congratulate Francois Locoh-Donou on his appointment as Chief Operating Officer, effective November 1, which I think reinforces the strength and depth of Ciena's management team. As COO, Francois will be taking on responsibility for the global field organization in addition to his current role as head of the Global Products Group. We're looking forward to even tighter alignment and collaboration between these two important elements under Francois's leadership going forward.

Jim?

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

Thank you, Gary. Good morning, everyone. We strongly believe that the performance of our comprehensive portfolio provides Ciena substantial differentiation in the market today and into the future. The addition of Cyan further enhances that differentiation, and we are delighted with our progress to date.

In terms of integration, as a result of our commitment to quick decision-making we had the organizational structure, portfolio solution strategy, and go-to-market plan for the combined Company in place at the closing of the acquisition last month. We continue to be impressed by the level of talent to that Cyan has brought to Ciena, and with our existing software initiatives now combined into the Blue Planet division we are seeing great collaboration and integration across the team.

Early indicators are proving out the business case for the acquisition as well. We have already realized on schedule most of the cost synergies we've targeted, and we expect to realize the remaining synergies as we move into 2016. Additionally, we expect Cyan revenue contribution to be strong, and mainly from the Z-series at least for the near term.

As Gary mentioned, we're also pleased with our Blue Planet customer engagement so far. The pipeline is growing with a mix of US and international customers both large and small.

I'll speak now to the results for the third quarter. At $603 million, Q3 revenue was lower than expected. Our Q3 results clearly show that we built a sound business model that is capable of providing excellent leverage and profitability, even when we are presented with some short-term revenue headwinds.

Again, we believe Q3 revenue was affected by account-specific factors that do not represent a change in our momentum or in underlying market demand.

Roughly 40% of revenue came from outside the US, about the same percentage as last quarter. It was a strong quarter for CALA revenue in particular.

We continue to diverse our business. Non-telco represented just over a third of Q3 revenue, consistent with recent trends and up from about 25% just a couple of years ago.

Direct sales to Web-scale providers, an important part of our non-telco business, continued contribute between 5% and 10% of revenue. I'd mention here also that we're selling to them indirectly through major service providers.

It's worth noting that in Q3 a major Web-scale provider was our largest customer for 100-gig Metro. Also, 22% of all 100-gig shipments and 68% of 200-gig shipments went to Web-scale providers. For all customers, shipments of 100-gig and 200-gig combined were up more than 50% over Q3 of last year.

Revenue from packet applications was up 12% over Q2, driven in part by a new packet customer in India. This includes revenue from our 8700 Packetwave platform, which added two customers in Q3, including a major North American service provider. It also reflects a very good quarter for 6500 packet revenue, which more than doubled over the year-ago period, albeit from a relatively small base.

This growth in higher-margin packet revenue contributed to a strong adjusted gross margin of 45.3%. Gross margin also continued to benefit from greater embedded software content, increased software subscription revenue, and an overall favorable product mix that included a high proportion of software-intensive line cards.

Operating expense in Q3 came in lower than expected at $202 million. We continue to drive strong controls around our operating expense.

We generated $71 million in adjusted operating profit in Q3, for an adjusted operating margin of 12%. Orders in Q3 were less than revenue, partly due to the customer-specific issues mentioned earlier. However, following record quarters in Q2, we are actually overperforming on our orders plan for the year-to-date.

As you know, in this business we experience lumpiness across many metrics including orders. This is why we always advise the investment community to view our business through a wider lens than any single quarter.

As a reminder, we have been actively working to increase the velocity in our business by booking and shipping more orders during the same quarter, increasing efficiency and improving cash flow. This increased velocity is reflected in the continued strengthening of our balance sheet in Q3, as we generated $117 million in cash from operations.

We ended the quarter with $927 million in cash and investments. Adjusted earnings per share in Q3 was $0.37.

Now our guidance for Q4. We expect revenue to be in the range of $665 million to $700 million. Of this amount, we expect revenue from the acquired Cyan business to be in the range of $40 million to $60 million.

Adjusted gross margin percentage is expected to be approximately 44%. We expect adjusted operating expense of about $225 million, which includes roughly $14 million in OpEx for the acquired Cyan business.

Looking at Ciena's 2015 OpEx overall, exclusive of the Cyan contribution we will easily be within the $820 million annual envelope for OpEx to which we guided early in the year. As has been the case over the last several years, we continue to be very disciplined in our management of operating expenses.

Finally, we expect Cyan to be accretive to our fourth-quarter 2015 results. With only two months left in the fiscal year, we are confident that 2015 will be a year of progress, growth, and higher profitability.

At the beginning of the year, we guided to an annual adjusted operating margin range of 8% to 9%. Following our Q1, we raised that guidance range to 9% to 10%. Given our year-to-date performance, and our Q4 projections, we now expect to exceed 10% adjusted operating margin for the full fiscal year.

We are achieving the operating margin goals we set for ourselves, and we expect to build on that performance going forward. Our model is working well. Our strategy is in step with what the market needs today and tomorrow, and we continue to execute well against that strategy.

We're excited about the demand we're already seeing for 2016 and Ciena's differentiated position and market momentum give us confidence in our ability to grow and diversify the business while driving additional operating leverage.

Brian, we'll now open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Sanjiv Wadhwani, Stifel.

Sanjiv Wadhwani - *Stifel Nicolaus - Analyst*

Gary, I was wondering if you could give some more details on the delays in implementations, specifically what's going on there. Is this a digestion of macro-related issues?

Doesn't seem that it's macro, but curious to get some more details. How many service providers are in that mix right now? Thanks.

Gary Smith - *Ciena Corporation - President, CEO*

Yes. Let me say from the bat, I think it's not macro, is my view to it. It's very specific elements that are particular to the individual carriers.

So, said differently, it's difficult really to come up with an overall trend to it. I definitely don't think we're seeing anything at an overall tending level.

Very particular. There are different issues with each of these carriers, very specific to them. Some are business-related, related to potential or consolidations that didn't happen, etc. It's items like that. So I don't think you can really pin a single thing to it.

I would say that it is really North America, and it's Tier 1s, and it's a handful. It's three or four carriers.

I think it is temporary in nature. In our dialogue with them, we think normal service will be resumed, as we'd said, which is what's reflected in our guidance for Q4 and our confidence in 2016.

And I also think it says something about the strength of our diversification of the Company that we can see these temporary headwinds and still grow and perform financially in a good way. I think it says a lot about the stability that we've got as a business, the broader-based customers that we have, that we can actually ride through these kinds of challenges.

Sanjiv Wadhwani - *Stifel Nicolaus - Analyst*

Got it. So you are seeing some of this business coming back in Q4 and extending into 2016, I guess?

Gary Smith - *Ciena Corporation - President, CEO*

Yes, we are. I think we're -- it's never a completely mathematical equation, I would say. But it's not lost business; it's not a real change in the plans for these carriers. It's an issue of timing, and that will wash its way through. We're seeing the underlying demand very strong and in other segments of the market in fact accelerating.

Sanjiv Wadhwani - *Stifel Nicolaus - Analyst*

Got it.

Operator

Brian Modoff, Deutsche Bank.

Brian Modoff - *Deutsche Bank - Analyst*

Yes, thank you, thanks. Guys, can you talk about your operating expenses? You talk about $800 million as your target for this year. Obviously you are run-rating $900 million now from Q4's number.

Can you talk about how you see operating expenses going forward? Do you plan some reductions? What is your view on that? Thanks.

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

Yes. Actually $820 million was our guidance for the year, and that's why I referenced that we'll be well within that range. That's for fiscal 2015.

As we -- by the way, we haven't -- we've barely begun our plan for 2016, so I don't have a number for 2016. But I think you should always be careful about taking a number in a quarter and extrapolating that.

That's just -- we're going to have movements in our OpEx just as we have movements in other elements of the income statement. We do have some more synergies to get out of the business, which we'll do.

So I guess what I would say in general is we're committed to very strong OpEx control, as we've done over many years now. And as we begin our plan, we know there will be lots of requests for needs in the business, but we're committed to improving our operating margin and we'll do that next year.

Brian Modoff - *Deutsche Bank - Analyst*

Okay, thanks.

Operator

Tal Liani, Bank of America.

Tal Liani - *BofA Merrill Lynch - Analyst*

Hello. Let me pronounce it a little bit better: Tal Liani. I want to ask a broader question. When you look at the market, there was a 100-gig cycle, there is a Metro cycle. Some carriers did first the 100-gig long-haul, then they are doing the Metro later next year; and some carriers started straight with the Metro.

So what I'm trying to understand is, when I look at the quarter and the guidance for next quarter -- also I think if I add up Cyan, the guidance is about $10 million light versus my previous expectation. So when I look at the environment, where is the weakness?

Is the weakness coming in long-haul projects, 100-gig in the long-haul? Is the weakness more about timing of Metro? Is it more about timing of some systems?

I'm trying to understand: why do we see weakness at such an early stage in the cycle? Is it more related to some strategic decision not to do certain things versus doing other things? Or is it just about spending cycle or anything like it?

This is -- it's coming in a very odd time for weakness. Meaning as we ramp into the second half of the year, we should see strength, given the projects at AT&T and Verizon, etc. We shouldn't see weakness.

So I'm trying to understand tactical timing versus strategic decisions.

Gary Smith - *Ciena Corporation - President, CEO*

Okay. The first I would say: I wouldn't over-extrapolate this. I really wouldn't. It's three or four customers in North America that are quite large, that they'd classify as Tier 1s; and they have very specific items that are associated with them.

But it does not really reflect the overall demand. Because I would totally concur with you, Tal. Overall, we're seeing very strong demand.

We've had compound aggregate growth rate in the double digits for a number of years now, and we see that broad trend continuing. So we're not seeing any real change in the overall demand or planning.

It's very specific issues. I can give an example of one of them is taking time to get into the next-gen Metro; so the transition from some of their spending on long-haul into next-gen Metro really related to back-office issues.

There's others I can point to around M&A-type challenges and strategic decisions around short-term CapEx. So it's those kinds of items, Tal, that we're seeing.

And again I would say it's three or four customers. Disproportionate impact because they are large and North American.

But largely we're seeing on a global basis very robust demand in all of our other segments, and I think this is very temporary. If you look at the midpoint of our guidance -- and again I wouldn't take the numbers literally -- about $40 million to $60 million of Cyan. We're about where we thought we'd be for the year on revenue as we come out of that midpoint in the range.

So I wouldn't extrapolate too much from this. I really wouldn't.

Tal Liani - *BofA Merrill Lynch - Analyst*

Got it. Okay. When you look at next year, I'm not looking for specific guidance on numbers and just looking to understand how will the market evolve. What do you think are going to be the main drivers for next year?

And when I say what, I don't mean about product; I more mean about global projects. Where do you think you are going to see acceleration versus deceleration in deployments?

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

Yes. We'll clearly see acceleration on Metro. We believe we'll continue to see acceleration on the Web-scale.

We are introducing -- we will have in the market by the end of this year our Waveserver product which is pointed right at data center interconnect and should go well with Web-scale. I'd say those are the two biggest single places of acceleration.

We have some -- one or two big wins in EMEA which we expect to see pretty significant acceleration as we move into next year as well. That's what I would say. As we begin to develop our plan, those are the trends that we're talking about.

Tal Liani - *BofA Merrill Lynch - Analyst*

Got it.

Operator

Mark Sue, RBC Capital Markets.

Mark Sue - *RBC Capital Markets - Analyst*

Thank you. Also I just wanted to say thank you to Philippe and congrats to Francois.

On the timing of transition from the three to four customers, how should we think about the duration, Gary? Is it one or two quarters? Is that still into next year? Just the duration of when they might return.

And underneath that, you are seeing very positive trends with some of your other customers, although there are some concerns that the data center spending might be slowing from a CapEx point of view. If you could give us some color there.

Gary Smith - *Ciena Corporation - President, CEO*

Okay. I would say, Mark, in terms of timing, it's mixed. I think one or two of them will snap back very quickly; I think it's a quarter. One or two of them I think it will be multi-quarter, and we're capable of filling in the gaps there, as it were.

So I think it's a mix, and I think we're taking a conservative view around that as we think through our 2016 planning. But I think the good news is that we've got enough diversification both from a customer segment and a product application that we're very confident that we can plow through this.

Mark Sue - *RBC Capital Markets - Analyst*

Any slowdown on the data center customers? Some are actually reducing their CapEx (multiple speakers)

Gary Smith - *Ciena Corporation - President, CEO*

No, we're -- sorry, I missed that part of it. Both within the Web-scale broadly, the content folks, and the data center, we're seeing increased pipeline and engagement with them.

Now, I actually think some of that is a direct result of our ability to put Waveserver platforms out there. There's a lot of excitement about that.

We're also having engagements with them around Blue Planet as well, both the data center and the content folks. So I don't necessarily think we're the best barometer of whether the market's going up or down.

Francois, I don't know whether you (inaudible) --

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

No. Mark, just to add to that, the fundamental shift in architecture that we've been seeing and we've described in our past calls, we're seeing that continue. We're seeing continued momentum with that and continued momentum with design wins in a number of carriers. So the bet we've made in connecting data centers, we're seeing substantial growth in that area.

The bet we've made on packet optical convergence in the Metro, we continue to see growth happening in that area. And the shift in architecture is actually reflected in our gross margin performance. That's why you're seeing the performance that you're seeing, with increased software content, increased number of line cards, and increased packet content in our 6500 platforms driving better margins.

Mark Sue - *RBC Capital Markets - Analyst*

That's helpful. If I could sneak one in for Jim: Jim, if I look at the cash flow, very impressive. Any thoughts on how we should think about working capital, all those things that can actually help generate even better cash flow next year?

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

Yes. As we said, Mark, we're very carefully and in a disciplined way managing our balance sheet, in addition to all the other elements of our financial segments. Working capital as a percent of revenue is a metric which we track.

When we first attacked the submarine market and in some of our other international markets where we were nonincumbent, we did go through a period of time in which we increased that ratio. We're committed to getting that back down into the 13% to 15% range, and I'm confident that we will.

Mark Sue - *RBC Capital Markets - Analyst*

Thank you, gentlemen.

Operator

Amitabh Passi, UBS.

Amitabh Passi - *UBS - Analyst*

Hi, guys; good morning. It's Amitabh from UBS. Gary, there's been some concern around the margin implications of your Verizon Metro win, particularly as you start to ramp with Verizon in 2016. I was hoping you could address that.

You've now delivered three quarters with gross margin above 44%. Do you think you can handle the ramp and sustain margins at the levels that you are guiding to, around this 44% range? Or is there maybe another reset that we need to be worried about or we should be thinking about?

Gary Smith - *Ciena Corporation - President, CEO*

I would say that as we think about the blend of our business -- and again, I think we've got good diversification of customers and segments, and I think the operating efficiencies that we're garnering from that -- I think given our performance this year, I think we're increasingly confident that we can keep the margins in the mid-40%s range. I think as over time -- we're thinking around the next set of targets in fact, for our gross margin, which we'll communicate at an appropriate time; but I think it's fair to say that we're confident now of our gross margins being sustainable in this range as we go forward and grow.

That's through a combination of things: operating efficiencies, supply chain in the business, increased software in its various forms, embedded software, application software, orchestration software. Those elements, as we go forward I think will help both sustain our ability to continue to deliver mid-40%s margin and I think over time we'll look at an increased margin target that we will communicate.

Amitabh Passi - *UBS - Analyst*

Excellent. Then just maybe as a follow-up, how should we be thinking about the potential with the Waveserver? If I look at the 8700, I think we've barely broken above the $1.5 million to $2 million per quarter range.

Would the Waveserver be in that range, or are your expectations significantly higher for the Waveserver? Maybe just give us some sense of how the pipeline is developing there.

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

Yes, Amitabh, Francois here. Our expectations for Waveserver are pretty high. We have a number of existing customers in the data center interconnect market who really want to get their hands on the product.

The pipeline is already pretty strong. We already have, in fact, our first orders from Waveserver before the product is actually GA. So we do expect a strong contribution from Waveserver going into 2016.

Amitabh Passi - *UBS - Analyst*

Okay. Okay, thanks.

Operator

Paul Silverstein, Cowen and Company.

Paul Silverstein - *Cowen and Company - Analyst*

Thanks. First off, what's the expectation in terms of the gross margin impact from Cyan? It sounds like, given your comment that it's mostly Z-series, I would expect that it would be adverse early on. And then I've got another question, if you don't mind.

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

Yes, I don't think you should assume that it's necessarily adverse. Just like we, they have difference in mix, they have difference in customers, and so the margin is going to move around a bit.

I don't think at least in the near term as we move into next year it's going to have really any significant effect. Now, over time, as the software revenue grows, then it should be a positive element of margin.

But as far as whether that's going to affect us next year in any big way, no comment today.

Paul Silverstein - *Cowen and Company - Analyst*

So, Jim, before I ask you -- before I go back to the revenue shortfall issue, on the gross margin and the operating margins, given that you expect Cyan to have a neutral impact and given that you've now done four out of the last five quarters north of 44%, including this quarter above 45%, if you go through the levers in terms of line card to chassis, geo mix, etc. -- and going back to Gary's comment a minute ago -- is there any reason why the trend wouldn't continue somewhat higher?

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

We feel really good about our margin progression. The one thing that we'll all remember is that we had a couple of significant events which affect Q4's gross margin last year. If you take those out of the equation -- and I know people question that -- but if you do that, we will have shown six quarters at 44% or so or higher gross margin.

All the things that you've talked about are continuing. Software is going to grow as a percentage of our revenue. We think that the maturity of our business, as we move into an incumbent position with many of the carriers around the world and we start selling a richer mix of products, including cards, packet software, that's going to help.

And also, I wouldn't take away from the fact that we do believe that our WaveLogic implementation and hardware is very differentiated in the market. We've done extremely well in what we can do with those hardware platforms.

And we've taken cost out. So we feel good about our gross margin. We're not going to give you a specific number, as you would not expect; but we feel good about at least the sustainability -- and we're not going to be happy at mid-40%s margins. We'll hope to do better than that over time.

Paul Silverstein - *Cowen and Company - Analyst*

All right. My apologies to my peers on the call, but on the revenue shortfall issue, let me play devil's advocate. If I take the $40 million to $60 million you're expecting from Cyan and back that out, it translates to a pretty decent shortfall on an organic basis versus where the Street was at.

I understand some of these things are rarely one-quarter issues; and from what you've described it sounds like a couple of them you are expecting to be multi-quarter. But again it's a pretty big shortfall. What gives you the confidence that this revenue is actually going to play out?

From the degree, it sounds like it's projects. I just want to confirm, Gary: when you say it's primarily US, was there any non-US in the shortfall, or was it all US?

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

Let me start, Paul, and then Gary can come in on it. The first thing I'd say is that if you look at the consensus view prior to any Cyan additions, it was under $650 million. If you take the midpoints of everything, then we're calling for us to be in the range of $630 million or so, maybe a little more.

It's a $20 million number. We feel like we have to call it out, because of the expectations element, but overall it's not a big number.

It is projects. As we said, we won Metro and long-haul basically across North America; we won all of the big players.

We're starting to build momentum internationally with the same set of products, and we're confident that they are going to build out their Metro networks. So we do believe it's short-term.

Gary Smith - *Ciena Corporation - President, CEO*

I would say, Paul, it really is North America; and there's always puts and takes internationally in different regions and things you expect. And when we do our forecasting it is, I would stress, aggregated risk. So even with the Cyan number in there it's not literally an absolute number: it's an aggregated risk number, and that could be lower and the classic Ciena could be higher than that. It's just how we do our forecasting.

But to answer your question around the international, it was mixed. But generally the issues that we're talking about are very specific to North America.

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

I just want to add one other thing. Just to add to the mix of items, you'll see that we were very, very strong with AT&T in the quarter. So it's really customer-specific things that are going on right now, and we do expect them to be temporary.

Operator

Rod Hall, JPMorgan.

Ashwin Kesireddy - *JPMorgan - Analyst*

Yes, hi. Thanks for taking my questions. This is Ashwin on behalf of Rod.

Gary, I want to go back to one of the comments you made that there are very specific products and certain carriers which is probably causing a temporary pause here. I just wanted to understand if the carriers -- any color you could give us there would be really helpful.

Are the carriers asking you to build, like, new products or reengineer products? Any color there?

Gary Smith - *Ciena Corporation - President, CEO*

Yes, I would stress again -- the answer to that is no. It's not a market issue in any way, shape, or form. It's not a competitive issue.

It's stuff that we've won. It's the timing of some of those projects and the rollout. It's not architectural in any way, shape, or form.

It's three or four Tier 1 North American carriers with a different set of issues in each one, some of which has nothing to do with the network, frankly. They are business-related items.

So again, I would stress, I wouldn't over extrapolate that. We called it out because we've seen it. But if you look at the overall performance of Ciena in terms of our growth, etc., we think this is a very temporary blip on our radar screen.

We obviously have very good relationships with those carriers and executive relationships with them, and we're well qualified in what we think the issues are. So I don't want to over-rotate on it, but we did call them out appropriately.

Ashwin Kesireddy - *JPMorgan - Analyst*

Good, thank you. Can I have a follow-up question?

Gary Smith - *Ciena Corporation - President, CEO*

Sure.

Ashwin Kesireddy - *JPMorgan - Analyst*

I just wanted to understand or get more color on demand trends in Europe. And if you could provide more color on demand in APAC, ex-India, that would be helpful.

Gary Smith - *Ciena Corporation - President, CEO*

Yes. EMEA is -- mix is the obvious macro challenges in certain parts of the broader Europe, EMEA, Middle East, Russia particularly, Southern Europe where we're not particularly exposed. I would say generally sort of geographically, Northern Europe were actually doing well and have upside to it.

I think we have three large Tier 1 customers there that are moving very well for Ciena and I think bode well for 2016. So I am actually very hopeful of good growth actually in Europe as we go forward into 2016.

In APAC, from a macro point of view, as I think many of you know we're fortunate not to have any exposure to the challenges that is going on with China. I would stress that again.

We are suitably exposed to India, and that's going well for us. As many of you are seeing some of the 4G rollouts that are happening there, we're involved in many of those.

That is a good growth market for Ciena. We've been there many years. We've worked very hard to lay the foundations there. I think we're having a record year there in 2015, and I think will improve on that in 2016.

Ashwin Kesireddy - *JPMorgan - Analyst*

Thank you.

Operator

George Notter, Jefferies.

George Notter - *Jefferies LLC - Analyst*

Hi; thanks very much, guys. I guess I wanted to ask about the Waveserver launch. It sounds like you are going to release it generally in the October time frame. But from my perspective, I guess I'm trying to understand exactly what the net effect of that is going to be on your business.

I think you've got a reasonable amount of 6500 revenue that also shifts into PCI applications among cloud customers and data center customers. So how do you see the interplay between Waveserver and 6500?

Is it additive? Do you see it cannibalizing the 6500 to some degree? Just talk about the net effect as you launch that product and move forward. Thanks.

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

Yes, thank you. The short answer is the net effect is additive because those solutions are largely complementary. What the Waveserver will allow large Web-scale providers to do is to basically drive optical connectivity in the Metro between data centers that may not have had optical connectivity before. So it's net incremental to Ciena.

The other thing we're seeing is that we're starting to see demand for the Waveserver in the traditional carrier market, either because they are Web-scale providers or because they want to connect their own data centers. Again, this is largely applications where we haven't had the 6500 before, so that's going to be incremental to the 6500.

This market, as you know, is growing very significantly over the next three to four years. We expect the interconnect market to grow to about $4 billion within the next four years. And from the early signs of demand we're seeing on the Waveserver, we think we're going to capture a substantial share of that market.

George Notter - *Jefferies LLC - Analyst*

Got it. Thank you.

Operator

Doug Clark, Goldman Sachs.

Doug Clark - *Goldman Sachs - Analyst*

Hi, thanks. Two customer-specific questions. You talked about the broad trends in North America among the large three to four Tier 1s.

At your largest customer in particular, is that expected to be a one- to two-quarter temporary impact? My understanding was that they had already been deploying 100-gig in the Metro, not in large quantities, but had already started that process. So on that customer in particular, what are the dynamics that you characterized for the group before?

Gary Smith - *Ciena Corporation - President, CEO*

Doug, I would say that the largest carrier is obviously our friends at AT&T, and we had a very good quarter with them. We're going to have a very good quarter in Q4 with them as well.

So my comments are very specific to certain carriers and does not actually include AT&T. I would like to stress that.

That's part of the reason that you look at this and you can't conclude any kind of trending from an industry point of view.

Doug Clark - *Goldman Sachs - Analyst*

Okay, great; that's helpful. Then you had also mentioned during the prepared remarks that Verizon has started some early shipments. Given those and the early testing and progress with the customer, do you have any sense for how the ramp will proceed into 2016 and how your market share is shaping up at this point?

Gary Smith - *Ciena Corporation - President, CEO*

I don't think -- they are on track, I would describe it overall. The timing is about what we thought it would be.

We see a ramp up during the second half of our fiscal year, and I think we're on track for that. Obviously I can't comment from a competitive point of view, but we're delivering everything that we said we would deliver to them on time.

And they are, from a planning point of view, in exactly the same place that they told us. So I would describe it as on track.

Doug Clark - *Goldman Sachs - Analyst*

Okay, great. Then -- all right, sorry. Thanks.

Operator

Simon Leopold, Raymond James.

Simon Leopold - *Raymond James & Associates - Analyst*

Great, thanks. First I want to just get a clarification on how you're going to present the Cyan business going forward. Then I would like to ask a question about the customer mix here.

So you mentioned you've got a Blue Planet segment. But in terms of the way you expect to disclose in the coming quarters, will you disclose the Cyan Z-series within that Blue Planet segment, combined with Blue Planet product? Or does that get blended in somewhere else?

If you could help us out with that clarification, and then I will give you my question.

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

We're working through a lot of things with respect to our disclosure, but generally speaking Z-series will be in our Converged Packet Optical segment. So that's where you'll see it.

Recall that we do have a -- today we have a segment called Software and Services through which software revenue gets reported. So at least for the time being we're going to continue that segmentation of hardware, of three categories of hardware, and one category of software and services. So the Blue Planet stuff will come through the Software and Services line.

As we move forward here, first of all, we said last quarter and we intend to give you a little more information about our software business. We haven't totally decided in what form that will be, but we do think it's important that you see as investors what we're looking at internally on our software business. So you'll begin to see a bit more disclosure there.

Simon Leopold - *Raymond James & Associates - Analyst*

Great, that's helpful. Yes; that's exactly what I was trying to understand. So in terms of my question, Gary mentioned a moment ago that AT&T, your biggest customer, was very much within your expectations; and the numbers were very much within my own, so not a big surprise.

But then, trying to think about the cause of what was roughly $30 million gap versus expectations this quarter, 5%-ish of revenue, I think we've been -- I think most of us have understood what's going on at customers like Verizon. So I guess what I'm struggling with here is really: what was surprising to you? And maybe, how are you defining Tier 1 in the weakness for this quarter?

You've established that AT&T was as expected. We've known Verizon has been shifting towards Metro and it's too early to see a big Metro ramp.

Are you including Comcast in a Tier 1 definition? Did CenturyLink simply stop buying? I'm just still a bit confused on the source here.

Gary Smith - *Ciena Corporation - President, CEO*

Simon, I have to be a bit -- obviously you'd expect us to be a little cautious, appropriately, around calling out specific customers in this context. I think we've tried to paint the picture for you in a way that I think is transparent.

Many of the -- I would classify some of the names that you just mentioned as Tier 1 customers, with the addition of probably one other. And I think you're obviously aware of some of the various issues that are going on with our various customers.

So I don't think it would be appropriate to really go any further on that.

Simon Leopold - *Raymond James & Associates - Analyst*

Well, just to clarify, so this -- the gap here, the miss here was something that was a surprise, that was in your pipeline, and it is somewhat concentrated in terms of activity and was really a timing issue. But I want to clarify: was it based on any performance, based on back-office OSS? Or was it based more on budgeting issues for that customer?

Gary Smith - *Ciena Corporation - President, CEO*

I would stress two things. One, absolutely not performance. Not architectural. No change of opinion around what they want to do. No competitive issues whatsoever.

A combination of things like, A, capital constraints due to specific business issues or decisions and timing thereof, changes. Some implementation issues relating to back-office and timing thereof. So that would largely cover, I think, the large -- the footprint of issues.

But I just want to stress the business is not lost. They've not changed their mind in terms of what they want to do, but it is a timing issue.

And we do see that from time to time. Now we've had three or four of these come together at the same time, and that's presented a challenge for us.

But I would say that, again, back to my earlier comments, it's the strength of the business that we now have and the diversification that we have that, whilst 5% of our message is not insignificant, for sure, that our business model is able to drive that through. We had 12% operating profit.

If you look at the year, even with that softness from those major players built into our forecasts, we're going to take gross margin up between 200 and 300 basis points for the year. Our operating margin will be up 300 to 400 basis points for the year. Our revenue will be about what we thought it would be for the year.

So those are still, I think, testaments to the strength of the underlying business. Again, I wouldn't over-rotate on what we're seeing in these specific customers. Simon, does that help?

Operator

Catharine Trebnick, Dougherty.

Catharine Trebnick - *Dougherty & Company - Analyst*

Yes, thank you for taking my question. Two of them.

One is housekeeping. What was the non-telco percent of total revenue?

And then the second one would be, now with the acquisition of Cyan, what happens with the development project you had underway for SDN with Ericsson? Thank you.

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

Yes, the non-telco was just over a third of our business. And I'm going to let Francois speak to the SDN project.

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

Yes, the relationship with Ericsson continues to grow strong. The development project with Ericsson was really focused on multilayer control of wide area networks.

What we've seen -- both Ericsson and us have seen from our customers over the last several quarters was a real focus on initially single focus of -- single-layer control of wide area networks. So our priorities right now are on achieving that, and we will focus on multilayer a bit later on.

So the development with Ericsson, no change in plans, but change in timelines from what we originally thought.

Catharine Trebnick - *Dougherty & Company - Analyst*

All right, thank you. Then some of the opportunity in Europe that was discussed, Gary, is that really benefiting you from the Ericsson relationship? Thanks.

Gary Smith - *Ciena Corporation - President, CEO*

Yes. The answer to that is some of the opportunities that we're seeing as we go through 2016 are based on our relationship with Ericsson. That's progressing well.

We have a number of wins there. Again, very nascent in terms of rollout, but I think it bodes well for the relationship. Again, some of our expansion in Europe is absolutely on the basis of our partnership with Ericsson.

Catharine Trebnick - *Dougherty & Company - Analyst*

All right, thank you.

Operator

Tim Long, BMO Capital Markets.

Tim Long - *BMO Capital Markets - Analyst*

Hi, thanks. Just two of them, one quick.

First, with Cyan integrated, any change to normal revenue seasonality based on that? I know it's a smaller piece, but just curious if that would impact it.

Then second, Gary, you talked a little bit more on this call about 200-gig. Sounds like the data center guys are taking that. Could you talk a little bit about that transition, what you expect from it, how much of a driver you think that will be?

And what kind of lead and maybe margin opportunity could there be as we get broader 200-gig adoption? Thank you.

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

I'll speak to the seasonality first. We don't expect the Cyan business to have any significant effect on our seasonality.

As you know we typically have, as our first quarter runs through a number of holidays globally, we're going to have a first quarter which is going to be off trend; but we think that as we go into next year we expect improvement in the year. With that I'm going to turn it over to Francois on the other piece.

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

Thanks, Jim. On the 200-gig, we're really excited about the pickup of 200-gig in the market. We're now shipping 200-gig to more than 12 customers.

Generally where adoption is fastest is in the Metro. So more than 80% of the shipments we're making on 200-gig are in Metro networks.

Really what that points to is the investment we've made in WaveLogic technology in digital signal processing. We're really seeing that it's giving us a reach and performance advantage in the marketplace that is helping us drive a premium.

And again, that's part of what you're seeing in our gross margin performance, and we expect that to continue.

Gregg Lampf - *Ciena Corporation - VP IR*

Thank you. We will take one more call and then we'll end the public call for today.

Operator

Dmitry Netis, William Blair.

Dmitry Netis - *William Blair & Company - Analyst*

Thank you very much for squeezing me in. A couple quick ones.

I think we've beaten the miss and the timing issue to death. I wanted to focus on the current customer demand, specifically this Tier 1 Web-scale customer you mentioned that came above 10%.

Do you -- is this tied to specific project activities? Does that carry specific demand in the next couple quarters? If you can give more color on that, that would be helpful.

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

Yes, just to clarify, we didn't speak about our Web-scale being a 10% customer. What we did say is that Web-scale are continuing to take a high percentage of our 100-gig and even higher percentage of our 200-gig shipments.

So we feel really good about what we've done with the Web-scale community. As I said, we talk about the direct sales and the indirect sales, and we think they're going to be the fastest-growing segment vertically, as we said, for a while.

The one thing I just do want to raise in this, we're talking a lot about the quarter, as it makes sense to do. I want to just step back a little bit and think about what we've done over the past several years.

We said when we started out here several years ago that we were going to grow our top line; we hoped to improve our gross margin; and we would tightly control OpEx. We set out numerical parameters about each one of those items.

And as you look back over the last several years we've essentially done exactly what we said we were going to do. We've gone from a breakeven position, when we first combined the two companies in our transformational acquisition, to over 10% this year. And as we look into 2016, we will be very disciplined with respect to our cost and aggressive with respect to our products and our customer engagements. And I think you're going to continue to see the kind of financial performance and improvement that you've seen from us over the past several years.

Dmitry Netis - *William Blair & Company - Analyst*

All right. Thanks, Jim. I might've missed your commentary in your prepared remarks. I don't know if -- I thought I heard ICT, but I guess -- was AT&T still your number one 10%-plus customer there?

Gregg Lampf - *Ciena Corporation - VP IR*

Dmitry, I'm sorry. We can't hear you. We're going to have to end the call in a minute. Hold on one second.

Gary Smith - *Ciena Corporation - President, CEO*

Dmitry, I think just to clarify what I thought I heard you say, let me just -- Web-scale was our biggest 100-gig Metro customer in Q3. There was a particular Web-scale customer who was the largest 100-gig Metro customer, which I think is what you're picking up on.

Gregg Lampf - *Ciena Corporation - VP IR*

All right. Thank you, everybody. We appreciate your attention. We look forward to connecting with everybody over the next few weeks. Thanks very much.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude today's program. You may all disconnect. Everybody have a wonderful day.
