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CIEN.N - Q4 2023 Ciena Corp Earnings Call

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OVERVIEW:

Company Summary

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PRESENTATION

Operator

Good morning, and welcome to Ciena's Fiscal Fourth Quarter 2023 Financial Results Conference Call. (Operator Instructions) Please note, this event is being recorded. I would now like to turn the conference over to Gregg Lampf, Vice President of Investor Relations. Please go ahead.

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

Thank you, Drew. Good morning, and welcome to Ciena's 2023 Fiscal Fourth Quarter and Year-End Results Conference Call. On the call today is Gary Smith, President and CEO; and Jim Moylan, CFO. In addition to this call and press release, we have posted to the Investors section of our website an accompanying investor presentation that reflects this discussion as well as certain highlighted items from the quarter and the year. Our comments today speak to our recent performance, our view on current market dynamics and drivers of our business as well as a discussion of our financial outlook.

Today's discussion includes certain adjusted or non-GAAP measures of Ciena's results of operations. A reconciliation of these non-GAAP measures to our GAAP results is included in today's press release. Before turning the call over to Gary, I'll remind you that during this call, we'll be making certain forward-looking statements.

Such statements, including our quarterly and annual guidance and our long-term financial outlook and discussion of market opportunities and strategy, are based on current expectations, forecasts and assumptions regarding the company and its markets, which include risks and uncertainties that could cause actual results to differ materially from the statements discussed today.

Assumptions relating to our outlook, whether mentioned on this call or included in the investor presentation that we'll post shortly after are important part of such forward-looking statements, and we encourage you to consider them. Our forward-looking statements should also be viewed in the context of the risk factors detailed in our most recent 10-Q filing and in our upcoming 10-K filing, which will be filed with the SEC by December 29.

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Ciena assumes no obligation to update the information discussed in this conference call, whether as a result of new information, future events or otherwise. As always, we will allow for as much Q&A as possible today. (Operator Instructions) With that, I'll turn the call over to Gary.

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

Thanks, Gregg, and good morning, everyone. Today, we reported very strong fiscal fourth quarter results, including revenue of $1.13 billion and adjusted gross margin of 43.7%. Our team has been executing exceptionally well. And in Q4, we shipped more hardware across our portfolio than ever before.

For the full fiscal year, we delivered revenue of $4.39 billion, a 21% increase over fiscal 2022 which, as you can expect, drove very strong market share gains. We also drove a 43% increase in adjusted annual EPS. Notably, in FY '23, revenue for our routing and switching portfolio also increased 27% year-over-year I think, a strong demonstration of the momentum within this element of our expanded addressable market.

Before I continue, I want to be absolutely clear that our Q4 performance, our commentary about market dynamics and the outlook we are providing today is very consistent with what we said last quarter and indeed, as we move through most of fiscal 2023. There have been no major changes to industry dynamics including that demand remains incredibly strong as evidenced by high levels of customer activity and engagement across all segments and regions.

The single variable that remains uncertain today is the precise timing around the flow of new orders aligning with reduced lead times from our service provider customers, particularly those in North America. And as a reminder, Supply chain constraints led to elongated lead times, which resulted in large advanced order volumes.

In fiscal 2023, a faster-than-anticipated improvement in lead times is requiring some customers to digest the large amounts of equipment ordered in prior periods. I would also note that the cloud providers were really the first to experience this dynamic and are very clearly the first who have worked through it. And in fact, orders from our cloud provider customers as well as our total orders were up once again in Q4.

And we strongly believe that what we're seeing with cloud providers is a leading indicator and that service providers will similarly return to normal order patterns in the coming quarters. And that belief, combined with strong fundamental demand, our leading innovation and customer relationships as well as our outsized backlog, which we're still carrying, we enter fiscal 2024, very confident in our ability to continue to grow faster than the market and to take share.

So moving to some highlights across the portfolio. In Optical Networking, we continue to extend our leadership from both a market share and technology perspective. In fact, we increased our global market share in optical by more than 5 percentage points on a year-on-year basis, which, in fact, puts us in an even stronger position than our pre-pandemic market share.

Looking ahead, we will be first to market yet again with our next-generation 1.6 terabit WaveLogic 6 in mid-2024. And we intend to press down on this technology advantage as competitors have launched only 1.2 terabit alternatives. In Q4 specifically, for optical, it was a record quarter for both WaveLogic 5 Extreme and 6500 RLS, driven by cloud provider network expansions.

During the quarter, WaveLogic 5E surpassed 100,000 total modems shipped, making it the most widely deployed 800-gig solution in the market. And as WaveLogic 5 success continues, WaveLogic 6 is, of course, building momentum, including orders from a large subsea customer and a strategic win and adoption with a cloud provider in Q4. In Routing and Switching, we continue to grow our share as a challenger in this market, ending the year with greater than $500 million in annual revenue.

We added 40 new routing and switching customers in Q4 alone,and now have more than 300 in total. During the quarter, we received initial orders for WaveRouter, our industry-first converged metro platform, which became generally available in Q3. And as some of you may have seen, we announced last week, we are partnering with Flex to add new U.S. based manufacturing capabilities for our unique next-gen pluggable optical line terminals of OLTs and our optical network units, ONUs, as broadband access is a key part of our addressable market expansion strategy over time.

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We're very excited to support the Department of Commerce's broadband equity adoption and deployment of the BEAD program and to ensure our customers can meet the Build America, Buy America requirements of this program. Also in Q4, Blue Planet had a good quarter with $20 million in revenue. And as some of you also may have seen, we've just recently announced a new collaboration with BT Group which is using Blue Planet solutions to automate the orchestration and delivery of network services.

And lastly, our Global Services segment had a record quarter in Q4 with revenue of $150 million, an increase of 20%. And interestingly, obviously, driven by installation and deployment services which again is a positive leading indicator of service providers' ability to consume product. Taking a perspective around customer segments, clearly, we had a record quarter with cloud providers as they continue to invest in data center interconnect for their traditional business and begin to provision their networks for AI-related traffic. Indeed, our WaveLogic leadership continues to be particularly highly valued by this critical customer segment.

And as I mentioned, orders from cloud providers were up once again over the prior quarter. Significantly, for the first time, our 2 10% customers in Q4 were both cloud customers. Also in the quarter, direct cloud provider revenue accounted for 35% of total revenue, the highest percentage ever. And for the fiscal year, Direct cloud provider revenue grew 57%, reaching $1.2 billion or 27% of total revenue.

So importantly, as we reflect on all of this, the fundamental demand drivers for our business remain incredibly strong. Over the past 20 years, the 30% plus annual growth in bandwidth demand has been driven by many mega trends like the monetization of the Internet, the move to the cloud, mobile, the digital transformation to name a few. And we have been the leader in servicing that demand for bandwidth with our leading technology.

It is becoming increasingly clear that over the next several years, AI will be a catalyst for continued strong bandwidth growth. And we are incredibly well positioned to address these opportunities across our portfolio and from our customer relationship perspective. We have industry-leading optical technology to high-speed delivery at the edge to network automation. We will continue executing on our strategy to be the best-in-class innovator in optical, bringing to market leading innovation like WaveLogic 6, while expanding our market opportunities in routing and switching.

Specifically in that, we will continue investing in our portfolio to address higher growth areas in converged metro core, PON and virtual routing. We are already winning deals and taking market share. So in summary, we delivered an outstanding year in fiscal 2023, gaining significant market share and further advancing our leadership position.

Obviously, we are well positioned to continue to grow faster than the market, driven by our leading innovation and the diversity and strength of our customer relationships. With that, I'll turn it over to Jim, who will provide more detail on our results as well as our business outlook. Jim?

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

Thanks, Gary. Good morning, everyone. Ciena delivered very strong Q4 results. Revenue came in at $1.129 billion and adjusted gross margin was strong at 43.7% reflecting a favorable product mix as well as improvements in component costs in the quarter. Q4 adjusted operating expense was $338 million. With respect to profitability measures, in Q4, we delivered adjusted operating margin of 13.8%, adjusted net income of $111 million and adjusted EPS of $0.75.

In addition, in Q4, adjusted EBITDA was $179 million. Cash from operations was $196 million and free cash flow was $173 million, driven by a $140 million reduction in inventory. We repurchased approximately 4.2 million shares for $189 million, completing the $250 million repurchase targeted for the year.

With respect to performance for the full fiscal year, annual revenue was $4.39 billion. We drove adjusted gross margin of 43.5% for the year and adjusted OpEx for fiscal year '23 totaled $1.33 billion, precisely as we planned.

Moving to profitability. Adjusted operating margin in fiscal 2023 was 13.1% and adjusted EPS was $2.72. Free cash flow for fiscal 2023 was $62 million. Strength of our balance sheet is a significant differentiator, particularly in this uncertain environment, and we ended the year with approximately $1.25 billion in cash and investments.

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Inventory ended at $1.05 billion, down roughly $140 million from Q3, but somewhat higher than we expected due to a shift in product mix delivered to customers. We expect inventory to come down by $250 million to $300 million by the end of the year.

Now turning to guidance. We will be giving new 3-year revenue targets today. To start, however, I want to compare and contrast the targets we gave last year at this point in time to the new 3-year targets for fiscal 2024 through fiscal '26. You'll recall that last year, we provided a 3-year revenue compound annual growth rate of 10% to 12% through fiscal year '25. We made it clear then that 10% to 12% revenue growth is not our long-term sustainable rate of growth. However, we provided that target, knowing that fiscal year '23 would be a year of outsized growth and that we would return thereafter to our long-term trend of 6% to 8% annual growth.

Fiscal year '23 followed 3 years of low annual revenue growth due to the unprecedented set of dynamics that resulted from the global pandemic and the subsequent supply chain challenges. Given that our revenue performance in fiscal year '23 was outsized as expected, and with confidence in our ability to continue leveraging our market and technology leadership going forward, we believe that we remain on track to be in that 10% to 12% revenue CAGR for the 3 years ending in fiscal year '25.

With that, as we look ahead, we believe it's valuable to look at a period that excludes the outsized growth in fiscal year '23 in order to provide a more accurate reflection of our anticipated average growth rate going forward. Accordingly, Today, we are providing a new set of long-term targets for the 3-year period encompassing fiscal year's '24, '25 and '26.

We believe that we are well positioned to deliver strong top line growth and profitability for the long term. With that, we expect average annual revenue growth of approximately 6% to 8% for the next 3 years, which is consistent with the growth rates we have delivered over the long term whether the past 3, 5, 10 or even longer years.

All of this reflects our confidence in the fundamental demand drivers for our business. We expect to leverage those opportunities by continuing to lead in optical, while expanding our addressable market in routing and switching. Additionally, with respect to operating margin, we continue to focus on driving leverage from our operating model.

Accordingly, we are targeting to achieve adjusted operating margin of 15% to 17% for fiscal year '26. As we think about fiscal year '24 specifically, I want to reinforce a few points. As Gary stated, the fundamental demand drivers for our industry, including the growth in bandwidth demand remained strong. As expected, we entered 2024 with $2.6 billion in backlog, which is still outsized both on a relative and an absolute basis, over twice our historical levels in absolute dollars.

And we have begun to see both increased spend and plans for strong 2024 CapEx by our cloud provider customers. We believe that the recent increase in orders from cloud customers is a leading indicator that service providers order patterns will improve in the coming quarters. However, as Gary stated earlier, current service provider order flow is low, particularly in North America as these customers continue to work through relatively high levels of inventory.

While we expect service provider order patterns to improve as we move through 2024, the timing and volume of that improvement remains uncertain. Taking these factors into consideration, we will guide to a slightly wider than typical range of revenue in fiscal year '24. Accordingly, we expect our revenue growth in fiscal year '24 to be in a range of 1% to 4%.

Within this environment, optical industry growth estimates for 2024 are currently being updated by industry analysts. Based on what we've seen from those sources and our own assessment, we believe the prevailing expectation is for largely flat market revenue in 2024. Given our diversification, leading position and differentiation, we expect to take share and to grow revenue faster than the market.

With respect to gross margin for fiscal year '24, we expect it to be in the mid-40% range, with some variability by quarter, but generally reflecting the positive impacts of improving supply chain conditions. For operating expense in fiscal year '24, we intend to continue investing strategically both to advance our leadership position in our core markets and to expand our addressable market in the key growth areas, including converged metro core and broadband access.

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Therefore, we expect adjusted operating expense to average $355 million per quarter in fiscal '24. This number may vary by quarter, and we expect OpEx to start slightly lower and increase through the year. Finally, as we improve our net working capital by reducing inventory levels throughout the year we expect to generate significant cash in fiscal '24. We believe that we will generate free cash flow of at least $400 million during the year.

We also plan to repurchase another $250 million in Ciena shares under our $1 billion Board approved plan. Finally, with respect to Q1 '24, we expect to deliver revenue in a range of $980 million to $1.06 billion, adjusted gross margin in the mid-40s percentage range and adjusted operating expense of approximately $350 million. In conclusion, our strong Q4 and fiscal year results underscore our industry leadership, driven by our technology advancements across our portfolio and a diverse customer base.

Looking ahead, we anticipate a return to normalized order patterns that go through 2024 and for CAI as a growing driver of bandwidth growth. And we are confident in our ability to seize market opportunities and to deliver profitable growth as we combine our leadership in optical with our continued investments to expand capabilities to address new markets in routing and switching. With that, I'll turn the call over to Q&A with questions from our analysts. Drew?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question comes from Samik Chatterjee with JPMorgan.

Samik Chatterjee - *JPMorgan Chase & Co, Research Division - Analyst*

I guess just given the information that you shared and particularly around the guidance, and thanks for all that color, a lot of details on the call today. When we think about the 1% to 4% growth rate that you're guiding to for next year, how should I think about what you're embedding in it? Clearly, cloud, you have a lot more confidence in the growth. But when I think about the other verticals, telco, cable, can you just share your thoughts about particularly if you're assuming telco sort of is in decline in terms of revenue next year? Or any other any color on the other customer verticals would be helpful. And I have a follow-up.

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

Yes. Samik, if I sort of answer by sort of what we feel is going to be strong, and we have visibility to good visibility, I think, is cloud submarine, India or 3 large elements that I would say we feel very positive about both in terms of what we've got in backlog and pipeline and activity. I think service providers generally are working through their inventory. They're all at various stages of progress to that.

I think the the uncertain one on precise timing is really the larger North American Tier 1 service providers. And again, we talk about them collectively and they're all the different stages with different progress around the absorption of all of this. Some are actually in very good shape. Our view on timing for the convert to a normal book to revenue and order flow -- our assumption is that it would be in midyear, which I think is consistent with what you've probably heard from a number of other different companies around the industry. There's a lot of absorption that they took in 2023.

There's some cleanup there, we think, in the first part of '24. But generally, if you look through that, their underlying demand is strong. I mean capacity growth and traffic growth continues to be very robust and to the service providers, certainly not an issue of budget, frankly, either. It's really just some of these larger ones just absorbing and being able to get deployments of the stuff that we've shipped to them.

Samik Chatterjee - *JPMorgan Chase & Co, Research Division - Analyst*

Okay. And if I -- for my follow-up, a bit more longer-term question. I mean you issued the guide for 6% to 8%, which is consistent with what you've done historically and what your guide has been. One of the key investor concerns I hear around that long-term growth trajectory is really the -- the

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acceleration of the pluggables market or the impression thereof that that pluggables market is accelerating and Ciena doesn't really replicate the share it has on systems when it comes to pluggables.

When you think about sort of where share gains have come from, particularly, as you highlighted robust share gains, like how do you think about that 6% to 8% growth, the impact of pluggables there? Are there any sort of upsets there where you're gaining more share than you have historically to provide offsets? Any color there?

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

Yes. I mean, I would just comment on the sort of pluggable piece we've sort of, I guess, been having this sort of conversation but the last 3 or 4 years, it's taken a lot longer for pluggables the 400ZR and you've still got a lot of inventory of the stuff that's already been shipped. So that's really not impacting the market right now.

If I think about -- when pluggables will happen, and I think we're very well placed for that, both with the customer relationships and with leading technology. So we see that more as a -- as we've talked about as an opportunity than a threat. Even at 400ZR, we'll obviously be in marketing with WaveLogic 6 variants on to the 800ZR as well. So we will take more than our fair share of that market, we believe.

And I think about it in the context of sort of 6% to 8%, Samik, I think we will continue overall, to take market share in optical. I think there's no question about that. But obviously, we're getting to a point where we've got a large market share, and it's a bit of the sort of law of large numbers, you're not going to take 5 percentage points each year.

But we're augmenting that growth with our TAM expansion in the key areas around routing and switching, which gives us even greater confidence in diversity about our ability to grow going forward.

Operator

The next question comes from Amit Daryanani with Evercore.

Amit Jawaharlaz Daryanani - *Evercore ISI Institutional Equities, Research Division - Senior MD & Fundamental Research Analyst*

I have 1 I had a follow-up as well. So I guess, first one, I would like to understand on the cloud side, you folks are talking about a fairly good bit of strength in the quarter. It was really stronger than expected to continue next year. Can you just talk about specifically maybe from a product portfolio, you said what is driving the strength in cloud? And if you actually see any signs of AI-centric infrastructure tailwinds benefiting your business already?

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

We're seeing in the cloud players, growth around all dimensions of the business, and we have quite a broad relationship with them. So we're seeing it in sort of data center interconnect into the into their long haul with things like Waveserver. We're also seeing it in submarine where they're investing significantly around the globe and also in their country expansions.

We're working closely with them in a number of markets where they don't necessarily take the fiber themselves, but they partner with a local carrier. We're seeing a lot of those opportunities. And of course, we're incredibly well placed to participate in that. I would single out places like India, for that, where it's the fastest-growing Internet market in the world and you've got the cloud providers all being being very aggressive in investing in there.

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So you think about it in overall terms for the year, they're up over 50% for us in revenue. We are also seeing an improved order flow from them. And again, the point I would make is it's across multifaceted applications and product applications with cloud plays.

Amit Jawaharlaz Daryanani - *Evercore ISI Institutional Equities, Research Division - Senior MD & Fundamental Research Analyst*

Got it. And then maybe if I just go back to the full year guide that you folks have provided of 1% to 4% revenue growth and until you understand the macro environment you're sitting in outside. Is there a way to think about how does that growth breakdown across the different geographies for you? And I know North America seems to be the one place that's somewhat weaker for you, but when you look back historically, when you've had this digestion period with the North American companies, is it a 1 2-quarter phenomenon? Or do you think it could be longer given in a way how much product they into through the pandemic? Just any color on how does growth break down across geos? And then what is the digestion time frame look like as you go forward?

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

As we look into '24, we think that we will particularly be growing in the international space. We'll have a higher growth rate than average there, that Americas is probably lower, and the GCN will probably be in between those 2. That's how we think about it as we enter the year.

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

The other part of your question around what have been the digested. And I'm really sort of honing in on sort of North America Tier 1s. I think it was sort of overused word in the last couple of years, unprecedented around the sort of whiplash of supply chain.

And you can see, listen, our revenues were up 21%. So that's a lot of equipment for these cloud providers and service providers to digest. I think the cloud players were the first to see the issue and are clearly coming out the other side. We're seeing signs that many of the service providers are coming out the other side of this.

But it's really the precise timing of that. We think it's probably midyear about this last quarter. And I think what we said last quarter was another couple of quarters of digestion on the Tier 1s. And I I think that's probably a view that we still maintain. So sort of midway through our fiscal year as we start to come out of our Q2 into Q3, we expect them to get back to collectively to normal order cycles.

Operator

The next question comes from Tal Liani with Bank of America.

Tal Liani - *BofA Securities, Research Division - MD, Head of Technology Supersector & Senior Analyst*

Yes, First, just -- would you mind to repeat your revenue growth targets for next year? We have an internal disagreement here about what you said we need a confirmation. I want to ask a question about your participation or your -- the impact of your business of the carrier efforts to reduce spending. So we're seeing kind of Nokia losing share because of migration to open RAN. And at the core, carriers are trying to adopt new technologies that are much lower in spending or require much less spending. So their CapEx to revenue ratio can go down over time. In that kind of environment over the next few years, what are the implications for Ciena? And what are the areas where you would be exposed to these efforts? And what are the areas that there's no exposure.

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

Just to be clear, Tal, we guided revenue for '24 to be in a range of 1% to 4% up. We guided Q1 to be $980 million to $1.06 billion. That's what we said and mid-40s gross margin in both cases.

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

In terms of the second part of your -- well, the main question, Tal, in terms of the service providers, what we're seeing from them is exactly as you say, they're trying to optimize as usual, their networks, their span, their whole sort of financial model. And frankly, overall from that, we're incredibly well placed. When you think about we've got the leading technology with spectral efficiency, which is a massive sort of cost saver for them.

And by the way, we've got leadership there now and we're about to extend that with WaveLogic 6. So the timing of that could not be better. If I think about it architecturally, their biggest costs are around their whole metro infrastructure, which they're looking to simplify -- and again, from an architectural point of view, adaptive IP plays incredibly well into that. It's a much more simplified, lower-cost architecture, and we've already had significant wins with them, and they will be rolled out over the course of the next 2 to 3 years.

So as I step back from this absorption short-term absorption issue we've got, I actually feel quite bullish around the Tier 1 service providers, particularly in North America, perversely given the short-term dynamic because of exactly the dynamic that you're talking about.

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

We've been first to market with every generation of optical technology, and each generation of optical technology represents a step function down in terms of cost per unit of bandwidth. So that's clearly a great benefit for their efforts to restrain CapEx and will come out with 1.6 terabits this year. So we're following that path.

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

I would also add a sort of comment around because they've seen some of the stuff around concern around their budgets and the rest of it. I think, clearly, what you're seeing in North America is they're coming to the end of their RAN spend on 5G. That is tailing down. So they've got an opportunity to reduce their overall OpEx, but it's really an CapEx rather. But it's really around what are they going to spend it on? And I feel quite bullish around their spending on the -- taking cost out into their metro and transport networks.

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

And just to mention one other trend that they are really focused on is the whole concept of sustainability, meaning power. And again, each generation of WaveLogic technology provides a much lower power footprint and we're contributing to that as well. So frankly, our development plays right into their needs, which is why we've been able to do so well in that market.

Operator

The next question comes from Meta Marshall with Morgan Stanley.

Karan Juvekar - *Morgan Stanley, Research Division - Research Associate*

This is Karan Juvekar on for Morgan Stanley. So I guess the first question, I guess, how should we think about the telco versus non-telco customer mix as we go across next year? Would it be fair to say generally flat sequentially from fourth quarter levels just as service provider remains a little

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constrained. And then, I guess, as that service provider spend does come back towards midyear or towards the end of the year, I guess, how should we think about a more normalized run rate contribution from here?

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

I think you will see service -- the mix, I think, well, from an order point of view, will skew more towards the service providers as they come back into the second half. Still expect very strong order flow from cloud. But if I look at it overall, I do think the service provider -- it will come back to a little more of the normalized balance, but I do think that Cloud is now a larger part of our business sort of direct. And I think it might not continue at the levels it at right now in absolute percentage share terms with service providers. But I think the service providers will come back stronger in the second half. So it will be blended this year is another way of saying that.

Karan Juvekar - *Morgan Stanley, Research Division - Research Associate*

Yes. Okay. That makes a lot of sense. And then just one more -- one follow-up. So I know inventories ended up a little bit higher than you were expecting. I would just -- and you mentioned just shift of product mix to customers. Is there any more detail you can give? And maybe on that $250 million to $300 million number you gave for next year on inventories coming down, the linearity of that across next year would be helpful.

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

Yes. On the question of the inventory level, really, it reflects the different customers make changes in their requested deliveries as we move through a quarter, it's very common. They do it very often. And frankly, if it goes for mix shifts from service providers to GCNs during the quarter, that results in higher levels of fixed -- of finished goods inventory. We saw that as we came through 2023.

We believe that as we move through fiscal year '24, that a lot of that movement inside of their delivery dates is going to settle down. And so we think that our finished goods inventory in particular, will come down during the year to a level that much more closely is in the level of what we've done in the past. Now I said we're going to reduce our inventory by $250 million to $300 million a year that will be generally pro rata across the year.

Operator

Okay. The next question comes from Ruben Roy with Stifel.

Ruben Roy - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Equity Research Analyst*

Gary, I had a question. In the prepared remarks, you made a comment about cloud customers beginning to provision networks for AI traffic. I'm wondering, as you get closer to your cloud customers and you start thinking about AI traffic relative to historical bandwidth growth. Would you say at this point that AI traffic would be incremental to sort of that 30% plus growth that we've seen historically. The reason I ask is just in the context of the 6% to 8% longer-term growth return to sort of the normalized growth doesn't seem like AI traffic would be incremental, but I'm just wondering how you're thinking about that.

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

No, listen, that's a great question. I mean, I think let me give you sort of a perspective on what we're seeing in right now. we're beginning to have the sort of first conversations around with the cloud providers where they're placing orders on us in advance of anticipation for some of the cloud traffic. I would say that they're working on the applications outside of sort of the ChatGPT versions that are out there now, they're working, obviously, on all of these various applications.

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And I don't think anybody particularly has any sort of insight into what the Ruben the model for that will be from a traffic flow point of view. But I think we're all of the view that at some point, all of that's got to come out of the data center to get monetized. And it's -- no one really has the ability to sort of model that out, but we know it's big. None of that -- when we talk about sort of 6% to 8%, none of that has really taken that into account because we can't kind of model that.

But I think it's going to be -- my personal opinion, it's going to take traffic growth up, which has classically been in the sort of 30%. It's got to take that up. And so I think when will that be, the timing of it and exactly the model of it, I don't know. But my personal guess would be end of '24 coming into '25 when you start to see these additional applications come out of the data center. But we really haven't modeled -- been able to model that in our projections.

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

One of the industry analysts did come out recently with a view of a higher growth rate by 5% or 6% in terms of bandwidth demand as a result of AI.

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

So close to like 40% going up from 30% to 40%. Yes.

Ruben Roy - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Equity Research Analyst*

I appreciate the detail both of you. And for a quick follow-up, I think Samik asked about the pluggables earlier. And I was just wondering, again, as you get closer to cloud customers, are they starting to ask you about optics inside of data center, I'm asking that at the European Optical Conference, there was a lot of discussion around coherent light, I'm just wondering kind of how you're thinking about potential opportunities inside as you go forward.

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

No. I think as we've sort of talked, we are very bullish around the opportunity to Intercept. As you think about what's going on in the data center, particularly with AI and the rest of it, traffic growth is going up dramatic inside the data center, where we have no exposure to that right now.

And I think the timing for that is probably as we get to '25, something like that. But I think there is an inflection point there from all of the conversations we're having with them were coherent light, as you described, really should bed into the perfect application for them. And clearly, we're the world's leader in coherent technology. And we do see an intercept into there, and we're investing in that, as Jim has said, we are doing a variant of WaveLogic6 that will absolutely be focused on the inside the data center applications.

Now again, we modeled that into our -- given it's sort of a '25 opportunity, we've not really taken a lot of consideration of that right now into the 3-year guide. But that clearly is a massive opportunity for us further out.

Operator

The next question comes from Alex Henderson with Needham.

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Alexander Henderson - *Needham & Company, LLC, Research Division - Senior Analyst*

I wanted to go back to Tal's question but with a very different spin on it. It strikes me that the decision to move to Ericsson and downplay Nokia was a function of the absolute horrific performance of the 5G core, which isn't working properly in almost any location. And as a result, the inability, therefore, to drive out the improved functionality that the 5G core would deliver such as network slicing and other elements that are really driving revenue differential for the largest the Tier 1s.

And in turn, that's created a situation where they can't monetize 5G the way they had expected. And as a result of that, are cutting back CapEx on 5G because they can't get it to work properly. Now the question I've got for you is does that result in an aggregate reduction in CapEx across the board? Or do they say, "Yes, I need to fix 5G core, and that in turn means I need to take some time to do that and let's shift spending away from 5G into other areas that are necessities like optical -- or does it mean that they cut optical spending as well as they are under pressure given the lack of monetization?

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

I believe, Alex, that they have spoken about the fact that their spend on RAN is coming down. Now I don't know what's driving that in terms of the performance of the 5G core, I just don't know. But what everything we've seen publicly and everything that we have heard from our customers is that their spending other than RAN is going to be sort of flattish as we move into '24 and that their spend with us is going to be flat to maybe a little bit up.

So that's what we know from what we see in the industry and what we see from our customers. I don't -- it's hard to know how they're going to allocate all that, but we don't see a big effect from any of their decisions on RAN today.

Alexander Henderson - *Needham & Company, LLC, Research Division - Senior Analyst*

Second question is on the inventory side. A number of companies have been forced to take some inventory write-downs as a result of the very large build of inventory that's happened over the last couple of years. I didn't hear any mention of that with you guys. Have you actually absorbed some inventory write-downs that are built into the numbers and offset them with improved pricing?

Or is just improved pricing? And can you give us some sense of what the magnitude of the reduction in prices in the quarter? And how you think that plays out as we go forward in time and you get your supply chain back into normal conditions?

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

The first thing I'd say is we don't see any material risk to a big inventory write-off. We do a very careful look at our inventory down to the component level, compare it to demand in each of our products and to the components that are built into those products. And so we don't feel that there's a material risk of a big inventory charge. We do -- every quarter, we have what we call excess and obsolete charges in the range of $4 million to $6 million, and we think that will continue.

As far as the margin situation, the margin situation is really driven by our mix and a bit of component cost reduction because of the fact that we're no longer buying as much from the broker market as we did last year and earlier this year. By the way, we do expect an improvement in that as we go into next year, which is why we're confident in guiding to the mid-40s gross margin range. And we think that's going to be less than 100 basis points in terms of our cost next year.

Operator

The next question comes from George Notter with Jefferies.

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

Maybe just to continue on the gross margin question. I was pretty impressed by this quarter's gross margins given the much higher mix of cloud provider revenue and then also the big spike up in services revenue and installation revenue. Can you talk about what was going on this quarter on gross margins? Is there something there kind of underneath -- I know you said favorable product mix, I think, Jim, also, but more context there would be great.

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

It's interesting, George. When you think about the gross margins across our customer base, although there -- if you look at the web scale versus the service providers, they're in very different businesses, but they are very big companies and they have choices, and we have to compete for the business. Now we are fortunate and blessed that we have the best optical gear in the world, and that helps in the competition.

So when you think about that across our customer base, the gross margins are not all that dissimilar. Yes, in particular applications or particular products, there are differences. But across the customer base, they're not all that different. The big difference in our gross margin is really mix. And then that is particularly with respect to in the optical business, line systems versus capacity adds.

And line systems are just by the nature of the way the business works, our lower gross margin, capacity adds are higher. We -- as you remember, we came into this year expecting a very high mix of line systems. We sort of got to that mix, maybe not quite as high as line systems mix as we thought. And that's why our gross margin was impacted in addition to the couple of hundred basis points at the component costs cost us. As we move into next year, I think we'll have both probably a little improved mix again and a lower amount of component costs. So we do expect an improvement in our gross margins next year.

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

Got it. Great. And then just as a quick follow-up. Could you give us an update on delivery of the WaveLogic 6 product. I know -- I think you guys had said GA in the first half of next year, but can you just confirm that that's on track? And when do you expect customers to start testing the products.

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

Yes. So yes, it's absolutely on track. We've got orders already as we shared in some of the prepared remarks, and we're beginning to engage with customers then coming into our lab to view our various variants of it. So as we turn the year here and get into our Q1 -- further into Q1, Q2, we'd expect to start to increase that engagement with customers. And so the release would be mid-'24. And we're on track for it. Absolutely.

Operator

The next question comes from Simon Leopold with Raymond James.

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

I want to start off with the commentary you offered about growing faster than the market might sort of gloss over the fact that you're actually in more than one market. And so I'd like to hear sort of your take on how the growth rates may be different in your assumptions for your packet optical platforms versus the routing and switching segment? Because I'm assuming you're going to see much faster growth from routing and switching, but just want to see what's baked into the overall guidance.

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

It's a fair question, Simon. What I'd say, though, is when you look at network gear, whether you're talking about optical are routing and switching. The underlying growth rates are not terribly different. They're in the low to mid-single digits. What's different for us is that with our expanded set of capabilities in routing and switching the TAM or the available market, which is out there for us is growing. So yes, we do expect to grow faster in routing and switching over the next year and over the next several years, then we grow in our optical business. I still believe that we will be able to take some share in optical.

But as Gary said earlier, we have a large share now. And the ability to continue to take share is a bit limited. We'll hold on to our share and grow it a bit, but where we expect to really show growth is routing and switching.

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

And that makes sense to me just to confirm that you're -- given sort of your modest position and product cycles, routing and switching could conceivably grow at a double-digit rate in the fiscal year within this forecast. Is that fair?

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

Yes. Yes. That is absolutely fair. So listen, we expect to grow in optical, notwithstanding the sort of industry analyst view that the market is flat. We will do better than the market. There's no doubt about that. But I think routing and switching, we'd expect to be double-digit growth because it's also -- we're the challenger there, as Jim said, it's the law of smaller numbers.

I mean we're about $0.5 billion now in that routing and switching business, it grew about 27% last year. I don't think it will grow as much as that this year. But we're almost -- we've still got a fairly low market share there.

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

Yes. No, this is in line with what I was thinking. So I appreciate the clarification. I don't think it's well appreciated, which was the point of my question. And just my follow-up here is really getting an update on what you see, particularly in Europe, on the Huawei swaps, it's really a jump for a number of folks competing for that and some of your competitors have announced Huawei displacements. I'd like to hear your take on how you see that playing out.

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

When I think about Europe and the Huawei displacement, I sort of bifurcate the RAN piece from the sort of what I would call generally the sort of transport and routing and switching piece to it. Obviously, on the RAN, there's been a lot of geopolitical pressure on to the 5G and the rest of it, and that's sort of well understood.

I think on the stuff that's already in the ground there, and there's a significant share that they've got on the transport and routing switching side and even broadband side as well that is going to take longer. It's a multiyear change out, a, because of the operational challenges of moving them across.

So what we're seeing on most of the carriers is when they get to a certain inflection point where they are going to make decisions around their next-generation stuff or investments, that is when they are making the change. And we are seeing that. In fact, we won recently in Scandinavia, a Tier 1 player that exactly that shift over on the transport.

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So we are continuing to get more than our fair share there. I think it will be a multiyear program. So over the next 2 to 3 years as they change out their transport piece, but it's a great opportunity for us. There's no question about that. But we're in I know everybody asked me what innings we're in. So I guess we'll use a baseball analogy for that, shall we. We're in about the third inning of that.

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

And we'll take one last question.

Operator

And that question will come from Michael Genovese with Rosen Black.

Michael Edward Genovese - *Rosenblatt Securities Inc., Research Division - Senior Comm and Cloud Infrastructure Analyst*

For the sake of time, I'll just ask one question, and I'll forgo the follow-up. I appreciate you getting me in here. When I look at the 3 year -- actually, you know what, I take that back. I haven't asked that question. But when I look at the 3-year guidance of 6% to 8% with this year being lower, I mean that implies an acceleration. And hearing about everything going on, particularly more cloud, the international opportunities and then getting into the data center with 800G in about a year, I'm wondering if there's not an implication here that the long-term growth rate of the company has moved up slightly from 6% to 8%. It might not be 10% to 12%, but it might be higher than 6% to 8%. Am I -- do you have any thoughts on that?

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

Well, what I'd say is this. As you just did the math, clearly, our guide for the year and our guide for the 3 years implies higher growth rates in the 2 years after '24. And that's really because we are going to be hitting our stride in a couple of markets, including routing and switching and PON.

So both of those are going to drive very good growth rates. I also think that the Huawei displacement will start to gain some momentum as we move through the next couple of years. So yes, we do believe that the 2 years following '24 will be higher.

Beyond that, what I'd say is we've given you 3 years, Mike, that's a long time for us, and we feel great about the future, but we're not willing to say it's going to be higher than 6% to 8% beyond that.

Michael Edward Genovese - *Rosenblatt Securities Inc., Research Division - Senior Comm and Cloud Infrastructure Analyst*

Fair enough, Jim. Sorry, Greg, do you want to say something?

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

No, I was just going to reaffirm that, obviously, if you do the math talking about accelerating growth, once we get through this sort of absorption with the Tier 1s in North America this year, we feel very good around the out years, not just for the reasons that Jim said, but you also got -- also got WaveLogic 6 coming along here in its various variants as well. So we should be firing on all cylinders here.

Michael Edward Genovese - *Rosenblatt Securities Inc., Research Division - Senior Comm and Cloud Infrastructure Analyst*

Perfect. And then finally, just for that quick follow-up. I mean, just help us with the definition of mid-40s. I mean does mid-40s mean 45%? Or I guess it could be a 44% as well. Could you just help us with how you think about mid-40s.

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

Maybe get my Webster out, I don't know. This year, we did 43 points something and what that message is intended to give you is that we're going to improve to a number that centers around 45%. I'm not saying it's going to be 45%. I'm saying it centers around 45%.

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

Thanks, Mike. Thank you all for joining us today. As we enter the holiday season in the new year, well, it's all hoped for piece and goodwill. Thank you for joining us.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

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