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Ciena Corporation

Fiscal Second Quarter 2018 Financial Results Conference Call

May 31, 2018

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Vijay Bhagavath, *Deutsche Bank*

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P R E S E N T A T I O N

Operator:

Good morning, my name is Sharon and I will be your conference Operator today. At this time, I would like to welcome everyone to the Ciena Fiscal Q2 2018 Financial Results Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question and answer session. If you would like to ask a question during this time, simply press star, then the number one on your telephone keypad. If you would like to withdraw your question, press the pound key. Thank you.

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

Gregg M. Lampf:

Thank you. Good morning and welcome to Ciena's 2018 Fiscal Second Quarter Review. With me today is Gary Smith, President and CEO, and Jim Moylan, CFO. Scott McFeely, Senior Vice President of Global Products and Services, will join us for the Q&A portion of the call.

This morning's press release is available on National Business Wire at ciena.com. We have also posted to the Investor section of ciena.com an accompanying Investor Presentation that includes certain highlighted items from the quarter. Our comments today include detail on our fiscal second quarter results, comments on the Packet Design transaction we announced this morning, our views on the market environment and our outlook. We'll then open the call to questions from the sell-side analysts, taking one question per person with follow-ups as time allow us.

Before turning the call over to Gary, I'll remind you that during this call we will be making certain forward-looking statements. Such statements are based on current expectations, forecasts and assumptions regarding the Company that include risks and uncertainties that could cause actual results to differ materially from the statements discussed today. These statements should be viewed in the context of the risk factors detailed in our most recent SEC filings. Our 10-Q is required to be filed with the SEC by June 7, and we expect to file by that date. Ciena assumes no obligation to update the information discussed on this call, whether as a result of new information, future events, or otherwise.

Today's discussion include 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.

This call is being recorded and will be available for replay on the Investors section of our website.

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

Gary B. Smith:

Thanks, Greg, and good morning, everyone. We are now two quarters into our three-year financial performance targets that we outlined in December. Our diversified business, global scale and clear technology leadership positions us well to achieve those goals as we expand our addressable market and continue to take market share with a focus on exposure to high-growth markets. Illustrating our early progress, we delivered a solid top line performance in our fiscal second quarter. Increasing demand resulted in record order flow and total bookings, which were significantly higher than our Q2 revenue. That performance and backlog gives us even greater confidence in our ability to achieve and even exceed our target revenue growth rate for the fiscal year.

There are three principle drivers accelerating our growth today: India, web-scale, and international Tier 1 service providers. With respect to the latter, as the industry structure continues to evolve, we're seeing an additional set of Tier 1 service providers approach us directly to help them with their network transformation plans. This is principally because they view us as a financially stable partner with global reach and an ability to sustain our innovation leadership over the long term.

While these drivers are helping to grow our footprint and capture additional market share, the combination of the sheer volume, size and timing of these early deployments, primarily with the international service providers, is resulting in some pressure on our gross margin. We believe that pursuing these opportunities is absolutely the right strategy for our business long term, and we have a proven long track record of demonstrating that our business model can reasonably absorb these start-up costs and recover gross margin over time.

Also today, we announced the signing of a definitive agreement to acquire Packet Design, a provider of network performance management software focused on Layer 3 network optimization, topology and route analytics. As we said when we announced our long-term financial targets, expanding our Blue Planet software business and our network automation capabilities, is a key driver of growth, competitive differentiation and expanding profitability. Packet Design will accelerate our software strategy and contribute towards our long-term financial goal of growing our Blue Planet and associated services business by approximately 14% to 16% annually over the next three years.

I would also say that Packet Design is both additive and complementary to Blue Planet, extending our intelligent automation capabilities beyond Layer 0-2 and into Layer 3, with critical new features to support a broader range of closed-loop automation and optimization use cases across multi-layer, multi-vendor networks. Packet Design's portfolio is absolutely leading edge. Their IP experts are world-class, and the unique combination with Blue Planet, will give us a definitive advantage in software-based network automation. We expect to close the acquisition during our fiscal third quarter.

Before I turn over to Jim for details on the quarter, I would like to share a few observations about the current market landscape.

Firstly, the continued move to cloud-based services and rapid proliferation of over-the-top content with both consumers and enterprises is resulting in continued investment in the transition to more open, programmable and adaptive network. Specifically, those trends are fueling a corresponding increase in the need for fiber to be built out to data centers and continued demand for high capacity optical solutions in all of their various forms to maximize fiber utilization. This plays directly to our strengths and aligns perfectly to our portfolio with both our WaveLogic coherent technology and our Blue Planet automation platform.

From an industry structure perspective, as I alluded to earlier, we continue to see a growing bifurcation amongst vendors. There are the smaller niche players who are, quite frankly, struggling to maintain relevance, and there are those that have a diversified business and global scale. Ciena clearly has these. Additionally, we have the leading technology in the industry.

In addition to these competitive advantages, we also remain the only player in the market with all of the necessary pieces to address customer need - systems, components, software and services. As a result, we are still the only company in our space that is growing and profitable.

Finally, let me address the pricing environment. It has been and continues to be challenging. But we do not believe there is anything new to this dynamic, despite some recent comments from others in the industry. We've been talking about this competitive landscape for a long time and in my view it certainly won't be going away any time soon.

Within these dynamics, we have proven and demonstrated that we can thrive. We've been successfully executing on our strategy to diversify our business and delivering differentiated financial performances as a result.

With that, I'll turn over to Jim for details on our second quarter performance and guidance.

James E. Moylan, Jr.:

Thanks, Gary. Good morning, everyone. Today, we delivered fiscal second quarter revenue of $730 million, led by continued growth in APAC service providers, as well as with our global web-scale customers. Notably, India alone delivered $79 million in quarterly revenue, up 20% year-over-year. In our web-scale business, where we have number one market share across multiple categories, more than doubled over the same period last year as a percentage of revenue.

In Q2, our gross margin was 40.7%. As Gary mentioned, we've been successful in securing a high volume of new opportunities, resulting in pressure on our gross margin, predominantly due to several early deployments at international service providers. As we had said before, early stages of deployments often carry correspondingly lower gross margins; however, we are very confident in our ability to improve our gross margin profile over time and we have demonstrated this in the past repeatedly.

We also reported Q2 adjusted operating expense of $240.6 million. With respect to profitability measures in the second quarter, we delivered adjusted operating margin of 7.7%, adjusted net income of $33.8 million, and adjusted EPS of $0.23 per share.

In addition, in Q2, our Adjusted EBITDA was $77.1 million, we generated $37.4 million in cash from operations, and our free cash flow was $31.1 million. We ended the quarter with approximately $980 million in cash and investments. And we are executing on our share repurchase plans having repurchased approximately 1.4 million shares of common stock for an aggregate amount of $33.4 million.

I'll now turn to some performance highlights from the quarter that illustrate the continued momentum across our business.

With respect to regions, APAC was once again our fastest-growing region. India contributed more than 10% of total global revenue in Q2 and remains our fastest-growing country. We also continue to see strength in Australia, South Korea and Japan, and we are exploring new market opportunities in emerging geographies, such as Indonesia.

EMEA also had a strong performance in Q2, up 15% year-over-year. Notably, our global scale and strong position with web-scale customers contributed to the growth in EMEA this quarter. We also secured a significant win with a Tier 1 service provider in the region, which we'll begin to roll-out later this year.

Moving to the web-scale vertical. Our direct web-scale business comprise more than 17% of total revenue in Q2, which is the highest it's ever been. This vertical continues to be a significant upside opportunity for us. In fact, two of our top five customers this quarter were web-scale customers, including one that was nearly a 10% customer. Direct revenue from this customer vertical in the first half of fiscal 2018 was more than double that of the same period last year.

Finally, with respect to our portfolio, our WaveLogic Ai remains the only viable 400 gig coherent technology in the market today. We secured 12 new wins in the second quarter alone, bringing us to 29 customers now deploying 400 gig capable WaveLogic Ai in their network.

Our Waveserver platform, which is both best-in-class and currently unmatched competitively, continues to be in extremely high demand. The platform generated $93 million in revenue in the second quarter, nearly approaching the entire annual revenue figure for last year.

And our software business continues to make progress, marked by our largest ever bookings quarter for Blue Planet orchestration and a growing footprint at three major customers.

Looking ahead to our fiscal third quarter 2018, we expect to deliver revenue in the range of $775 million to $805 million, gross margin in the low 40s range, and operating expense of approximately $242 million to $245 million.

In light of our success in leveraging the increased market opportunities that we've referenced and our confidence in continuing to grow the top line, we now expect to achieve a revenue growth rate of 7% to 9% for fiscal 2018. You'll note that this is up significantly from our previous guidance and it clearly shows the number and size of opportunities to take market share that we are seeing.

In closing, we delivered another solid quarter of revenue growth in Q2, as well as a record quarterly order flow and continued market share gains. We are going through a period of gross margin pressure because we are seeing new opportunities to take market share, namely with international service providers. We are responding to that demand. However, we are confident that this gross margin pressure is a short-term phenomenon. We have demonstrated that we can recover over time from the lower gross margin levels associated with early deployments. That is why we remain confident in our three-year financial targets that we laid out in December.

Thank you for your time today. Sharon, we'll now take questions from the sell-side analysts.

Operator:

At this time, I would like to remind everyone, in order to ask a question, press star, then the number one on your telephone keypad. We'll pause for just a moment to compile the Q&A roster.

Your first question comes from Doug Clark with Goldman Sachs. Please go ahead, your line is open.

Doug Clark:

Great. Thanks for taking my question. I want to unpack the gross margin piece a bit. So first, in the April quarter kind of backwards looking, you didn't address mix at all. Software and packet sales were both a bit weaker than we had anticipated which I would expect would be a gross margin headwind. Can you kind of address that a little bit? And then secondarily, on a going forward basis beyond the July quarter, at what point do you think that we start to get back to the mid 40% level?

James E. Moylan, Jr.:

Yes. As you noted, Doug, we did decline a bit in software, that's typically a high gross margin area for us, and so that did affect our margins for Q2. We think this is just sort of the ebbs and flows of what happens in our software business. As we mentioned, we had a great bookings quarter in Blue Planet orchestration. We are rolling out our new control plane and network managing system today to a bunch of customers. So we expect a very strong year for software. That should recover.

With respect to what's going to happen here in our gross margin, what I'd say is that as we move into Q4, given the size of the revenue guidance that we have put out there, mainly with big international service providers, we don't think that we can get to sort of the mid 40s in Q4. We would expect it to improve slightly from where we sit today and in Q3. But it will frankly depend upon the size of the opportunity ahead of us.

As far as when will we recover, the one thing I can say is, we're very confident in our three-year forecast which do depend upon a recovery in gross margins, in fact, an improvement in gross margins from the sort of mid 40s level. So we're confident about that.

Doug Clark:

All right. Thanks for the detail. Then my follow-up is actually focusing on the North American market. Can you talk about the dynamics with your two largest customers here. In particular, it looks like kind of the largest customer was down about 20% year-on-year. So visibility into spending patterns in North America would be helpful.

Gary B. Smith:

Yes, I think—hi Doug—I think both Verizon and AT&T—I think AT&T our expectations were to be flat to down for the year and I think it'll be consistent with that. I would expect them to be a bit stronger in the second half from where they are now. Verizon has been pretty steady throughout the year and I would expect that to be the case. We've got multiple engagements with them, not just on the Metro, but on long haul and other packet business as well.

Doug Clark:

All right. Thanks a lot. Good luck guys.

Gary B. Smith:

Thank you.

Operator:

Your next question comes from George Notter with Jefferies. Please go ahead, your line is open.

George Notter:

Hi guys. Can you hear me?

Gary B. Smith:

Yes, we can hear you, George.

George Notter:

Great. Thanks very much. I was interested in the commentary about the bookings and backlog. You said that I think you had a record quarter in terms of bookings and backlog. Can you talk about magnitude there or give us any sense for how well you did? It sounds like there was quite a big differential relative to revenue in the quarter. And then also just curious about the narrative about improving opportunities internationally. Is any of that related to what we're seeing in the marketplace with ZTE? Thanks.

Gary B. Smith:

Thanks George. Yes, I think the order flow was record order flows for us and it exceeded frankly our expectations and I think principally around this demand that we're seeing with international Tier 1 carriers. We began to see as we turned the year frankly it has just strengthened and that's included and are really taken up expectations for revenues for the year to be about 7% to 9% growth which is above where we started clearly. And that's really as a result of this. So, the order flows give us great visibility into the second half and that gives us a lot of confidence in the sustaining of this momentum.

I would say that the—principally around the announcements with ZTE, I've got to say I don't think that has really been at all impactful to us. We really haven't seen any change in the dynamics. This sort of demand I think started before that and I think it's largely as a result of the sort of bifurcation of the industry and I think it's about these large carriers looking for a long term secure partner that has global scale and the ability to continue to fund innovation.

The funding of innovation in this space is getting more and more expensive. So it makes sense that you're going to get fewer larger players being able to supply to the marketplace.

George Notter:

Thank you.

Operator:

Your next question comes from Meta Marshall with Morgan Stanley. Please go ahead, your line is open.

Meta Marshall:

Great, thanks. I just wanted to get a sense on the international wins like how much of the gross margin pressure should we think of them being international pricing versus kind of initial chassis and then we kind of see upside as we move to (inaudible) later on?

And then maybe on the second question, on the web-scale business honestly that's doing really well, do you think that that strength can carry into the second half or do you think that there is some lumpiness that will kind of come with stronger first half orders? Thanks.

Scott McFeely:

On the question of international customers it is definitely the latter, Meta. It's all about early deployments. We know from a long history of winning deals that early deployments are going to have start-up costs and lower initial gross margins. Those gross margins will recover over time as we upsell and we move to card fill. So certainly it's the latter. Now we would say and we said that outside of the U.S. where we have the Chinese players there is some margin differential, but that's not the predominant piece of what's happening today.

Gary B. Smith:

And Meta, with regards to the web-scale, I mean I think it's very broad based with them across multiple customers now and multiple applications and we're seeing particularly that global expansion and we are sort of uniquely positioned around that given our global reach and scale. And I would say the predominant characteristic about this marketplace is they really appreciate leading technology and that's really where they are focused. Scott, do you want to talk about some of the 400 gig stuff that we're rolling out with them?

Scott McFeely:

Yes, I think one thing just to remind you of the state-of-the-art I'd say on the shelf today for coherent technology is 400 gig and we're really still the only viable shipping 400 gig capability. So they are buying into technology, they are also buying into the technology roadmap that we put in front of them. So we are very confident that we can continue to have that technology leadership and the relationships with those folks going forward.

James E. Moylan:

We like where our market share is with those customers. We think you are going to like it as well when we show it.

Gregg M. Lampf:

Thank you. Next question please?

Operator:

Your next question comes from Vijay Bhagavath with Deutsche Bank. Please go ahead, your line is open.

Vijay Bhagavath:

Thanks. Hey, good morning. Hi Gary, Jim.

Gary B. Smith:

Hi Vijay.

Vijay Bhagavath:

Yes, hey, my question is on your U.S. business and how do you contrast this with India? You are obviously seeing growth and strength in India, how do you compare and contrast that with the U.S.? Is the U.S. pretty much more of the same or do you expect order acceleration or improving activity heading into next year? Thanks.

Gary B. Smith:

I mean, they are very contrasted marketplaces in terms of their dynamics. You know, one is a more mature market, the other one is the fastest growing Internet market in the world, so correspondingly you're seeing the difference in demand in terms of percentage growth rates, etc.. But I would say in North America I actually would expect an uptick in the second half, you know, from what we are seeing, both in terms of the Tier 1 North American carriers, web-scale particularly and just even into the sort of regional carriers, MSOs, you know, so I actually think the second half will be stronger for North America.

Regards to India, you know, and we have said this pretty consistently, I think this is a multi-year fundamental growth dynamic that's underpinning the fastest-growing Internet markets in the world and I don’t see any sign of that stopping.

Vijay Bhagavath:

So Gary, quickly, I mean if you note multiyear strength in India is that also kind of reasonable to assume that your gross margins would be pressured for quite some time because the willingness to (inaudible) like India is much lower than here in the states? Thank you.

Gary B. Smith:

You know, frankly, that hasn’t been our experience in India I think because of our total cost of ownership and our architecture I think that has been well received in India. And bear in mind we have been in India for a long time, so we understand the dynamics of that marketplace. We have a very broad base of customers in India, all of the major Tier 1 carriers now are our customers, the government, the Department of Defense networks, and obviously we help a number of the web-scale players there as well.

So that has not been our experience in India. We have witnessed some large particular expansions where we have gone into new areas with these carriers and the pressure on margin for that is sort of as Jim said, it is less about pricing and more about just the start-up costs frankly, and it’s a very similar dynamic that we’ve seen in other parts of the world, it’s just on a large scale.

Vijay Bhagavath:

Okay, thank you.

Gregg M. Lampf:

Thanks, Vijay.

Operator:

Your next question comes from Samik Chatterjee with JP Morgan. Please go ahead, your line is open.

Samik Chatterjee:

Hi, good morning. Thanks for taking my question. I just wanted to start off near term, and just on the quarter again on the gross margin front, just wanted to understand (inaudible) you were issuing guidance last quarter, you mentioned software as one of the things that probably drove some of the weakness (inaudible) your guidance, but what—I just wanted to check if there is anything else that changed in terms of visibility into this particular quarter because you mentioned international deployment, but did that sort of change your revenue expectations or were there other contributing factors there?

James E. Moylan:

Samik, just to be clear, are you talking about Q2 or Q3?

Samik Chatterjee:

Yes, Q2.

James E. Moylan:

Yes, the biggest change for us was that software was a little light that contributed a big portion of the drop in gross margins from the 42.6 to the 40.7. There's always changes in mix as we move through a quarter and we clearly had some international wins in the quarter that affected our gross margin to the downside, but the biggest thing was the software change.

Samik Chatterjee:

Okay, got it. And so just a follow up on that. When I look at gross margins when you are in the initial phase of deployment and then sort of ramp up later, how should I think about incremental gross margins at the initial phase versus the later stages when you start to ramp up?

James E. Moylan:

Yes, there is no general answer for that Samik. It depends upon the customer and how he is deploying and all that. So I can't give you a way to think about it. What I can say is that we have demonstrated in deals all over the world for many years that we can recover from the early stage deployment gross margins and get to a sort of mid-40s or thereabouts gross margin range for the customer over the lifecycle of deals.

Samik Chatterjee:

Okay, got it. Thank you.

Operator:

Your next question comes from Simon Leopold with Raymond James. Please go ahead, your line is open.

Simon Leopold:

Great thanks. First I wanted to just confirm what is hopefully obvious and then a quick question, I'm assuming your one 10% customer was the usual one 10% customer, just want to make sure that that in fact is the case? And then I also wanted to talk a little bit more about the packet networking segment, that among your products has the best growth outlook in your three-year horizon, you've talked about 6% to 8%. I wanted to see if you still feel that way given the recent weakness?

And let me know if it's correct to think about initiatives like 5G and Fiber Deep in the cable space as driving improvement, and if we can expect that kind of improvement in the second half of '18 or we have to be more patient on packet networking growth? Thank you.

James E. Moylan:

Yes, the top customer was the customer that your…

Scott McFeely:

And Simon, it's Scott McFeely. I'll take the packet one. If I look in the rearview mirror we've been successful growing our packet portfolio sort of in the 10% range year-over-year for several seasons. We do expect by the way the second half to be stronger than the first half in packet.

What you're seeing is some quarterly variability. The growth usually going forward comes from multiple applications. You mentioned a couple of key ones for us 5G and Fiber Deep would actually—opens up the addressable market for that portfolio and that's what makes us bullish about our long term three-year projections on that part of the portfolio.

Simon Leopold:

Thank you.

Gary B. Smith:

Thanks Simon.

Operator:

Your next question comes from Jim Suva with Citi. Please go ahead, your line is open.

Jim Suva:

Thank you very much and I have two questions. One is very easy and the other one a little bit more insightful, so I'll ask them both at the same time. The first question is, for your annual guidance and the quarter outlook, how much should we think about is from your announced acquisition if anything does it help the revenues?

Then my other question is, on the international service providers with the growth margin pressure and you mentioned the confidence that gross margins will improve as you go forward. The question is, is there anything unique whether it be the duration, the timing, the ramp of these international service providers compared to past contracts that we've seen from the Company in the past?

And what I'm getting at is, I wonder are these a little bit longer duration, therefore say the first six months are pressured, but because they're much longer it's a lot more attractive to you? How should I think about these newer contracts versus the historical ones that we should – we have seen? Thank you so much.

Scott McFeely:

Thanks Jim. Just to be clear, our revenue guidance does not really have much, anything material from our acquisitions, so this is all our organic business that we're talking about in terms of revenue upside.

Gary B. Smith:

And Jim on the dynamics around this international piece, I would say it's not particularly different than we've seen in the past and it's always, it's always going on. What we're seeing now what is different is we're seeing more of it going and at greater scale, so more customers. So to give you some context to this, we've won about eight new international Tier 1 carriers this fiscal year alone and given the already high market share globally that's particularly extraordinary.

And I think it talks to this dynamic around that sort of flight to quality around a global player that's got scale and can continue to invest. So we are seeing the number of them is different than we've seen in the past and also the scale. We're seeing their initial build outs to be larger than we've seen in the past and also some of our existing players, places like India, their expansion is more ambitious and more aggressive than we've seen in the past.

So normally, as Jim was talking about, with our balance and diversification of our business, our growing software business and the other things that we're doing we can keep that gross margin in the middle of the road as we've done. The sheer nature and scale of this right now provides a challenge for us, but let me reemphasize this. This is a very good news story. These are quality Tier 1 customers that will be with us for many years and getting the relationships and footprints in place is fantastic news for us to drive our three-year goals.

Jim Suva:

Thank you very much for the details and clarification. That's greatly appreciated. Thank you.

Gary B. Smith:

Thank you, Jim.

James E. Moylan, Jr.:

Thank you.

Operator:

Your next question comes from Michael Genovese with MKM Partners. Please go ahead, your line is open.

Michael Genovese:

Thanks. Just two questions here, one is that some of the competitors have spoken more about competing in India, so just help us think about how to think about the competitive environment in India? And then secondly, on the 29 Waveserver Ai customers, are those primarily in the web-scale vertical or are you seeing a mix in Telco as well at this point? Thank you.

Gary B. Smith:

Okay, on the India dynamics no real change to the dynamics that we've seen. I mean it's been the players that have been in there for long periods of time. They typically, given the scale as well of the deployments, they really go with the larger players and because you need to have a lot of infrastructure in India as well to support that. And I would remind you that we've got 1,500 people on the ground in India, so getting entrants into the Indian market is multi-faceted and is incredibly expensive and long term. So my own sort of view is, it's not the market for new entrants, it's the existing players that are going to continue to be the dominant players in that marketplace.

Scott McFeely:

Yes, Gary I'll just add on the India piece. India has a uniquely challenging operational environment as well and being in there for many years and having the experience of dealing with that operational environment and having the sophistication and maturity on things like control plan are critical to be building out those national infrastructures. So that's why those customers tend to lean back on the larger carriers that have been there with that experience for a while.

On your question on Waveserver, yes it is skewed towards the web-scale providers, but we're also seeing uptake in service providers well around the world that are doing datacenter in effect as a service offer as well, so that's starting to come online as well.

Gary B. Smith:

The other thing I'd highlight in addition to there's a big focus on India for obvious reasons, but I would say we're seeing the benefits of growth across the Asia Pacific region as well. Japan, Korea or Australia and as Jim said in some of the other Southern Asian markets that are smaller for us, but growing, we're seeing sort of buoyant demand.

Gregg M. Lampf:

Thanks Mike.

Operator:

Your next question comes from Dmitry Netis with William Blair. Please go ahead. Your line is open.

Dmitry Netis:

Great, thanks a lot guys. So I have two questions, one if I look at your revenue, your revenue is three times larger today than it was back in 2008. Your gross margin is down 20% from that timeframe however. You've done a very nice job controlling expenses to drive leverage on high revenue base, but what I'm trying to get to is, is there anything you could do to drive the change in the industry landscape or change the competitive dynamic a little bit, given your commentary that some of the guys out there that seem to be pretty aggressive out there, yet you're calling them, as they're losing kind of business or going out of business almost and there's a bunch of them out there potentially on the Metro side of the business, but trying to get to the kind of landscape topic if you will and the margin pressures we've been seeing for almost 10 years now and whether there's anything you can do about that?

James E. Moylan, Jr.:

We believe that the smartest thing for us to do is to continue to take market share. If you look at our market share over the past seven or eight years, we've grown from the low teens up to around 20% of the global market and we've done that through a combination of technology, great relationships and going out around the world and taking share, that's the smartest thing for us to do.

We've certainly looked at whether we could do consolidation. That doesn't seem to be likely for us at least in the near term. We will see about how it goes forward, but the smartest thing for us to do is to continue to bear down on our competitors, particularly the smaller ones and take share. So that's what we're going to do and that will over time improve the landscape of the industry. It's just going to take a little longer than we all would like it to take.

Gary B. Smith:

Dmitry, I'd also offer the perspective having gone through the journey that you just highlighted. I think the industry structure is changing, it is changing right now. You're seeing a real bifurcation between those that own the core technology and those that don't, those that have really global scale in terms of reach. And I would also highlight, we have the largest optical salesforce in the world and everybody focuses on the technology, you've got to have global scale because the cost of staying in a leadership position is continuing to increase.

But that is only for the large people with global scale and with large channels. So I think you really are seeing that bifurcation. Who is growing at 7% to 9% growth? And whilst our margins maybe in the short term under a little pressure, we're the only player that is growing and that is profitable and so I think you are seeing a change in the marketplace reflected in our performance.

Dmitry Netis:

All right, I appreciate that response. My second quick question would be on the Vodafone and Liberty Global with them buying Liberty Global assets, how does that impact your business positive or negative?

Gary B. Smith:

I think that's probably a net positive for us in Europe we have relationships with both of those players and I think getting stronger players, stronger Tier 1 carriers in Europe makes a lot of sense. You saw our performance in Q2, we're up 15% and I don't think that's going to play quarter-to-quarter, but we are seeing a nice steady improvement in our European business. That environment seems to be getting better.

Gregg M. Lampf:

Thanks Dmitry.

Operator:

Your next question comes from Tim Long with BMO Capital Markets. Please go ahead, your line is open.

Tim Long:

Thank you, just two if I could. Good talk about the software and the Blue Planet business, it sounds like it's going to get better in the second half. Could you just give us a sense of timing of when do you think we will see the ramp and maybe that becomes a little bit more sustainable or a positive contributor, I know in the long-term model it grows much faster, but if you could just give us a sense as to when some of these new wins will start more regularly contributing? And then second Jim, the new op ex range 242 and 245, do you think that's kind of a good run rate looking out over the next couple of quarters as well? Thank you.

Gary B. Smith:

Tim, let me take the Blue Planet, I think the sort of context of this is important, it's still a nascent space and you're seeing that frankly in our performance, you're seeing good quarters then you go down a bit and then come back. But I think the underlying trend is positive, we are seeing good momentum now. We're honing in on a few of the applications that we think are playing extremely well in the market. Our order flows for the quarter was extremely strong. We've had record order flows for Blue Planet in Q2. But again, I would say it's nascent, I would think the rest of the year would be an improvement in revenues.

But I think it's also about critical mass and I think part of the strategy, the acquisition we announced today is also part of that as we flush out our capability set that we see is the required one in the marketplace. So in answer to your question, I think as we get through '19 I think you should see a more consistent sort of performance and good steady growth and I think we should be able to get to that sort of 14% kind of growth rate in the software space and that will help—that will also help our gross margins as well as we move forward.

James E. Moylan, Jr.:

And on op ex, Tim we're right on plan with our op ex for the year. As far as Q4 we're not prepared to give guidance right now. The range that we're talking about is not a bad base, but we're having such a very strong order flow year that we expect to continue for the next two quarters, that if anything we might have higher sales commission as we move into Q4, that's what I can say. And as far as from there, who knows what we said repeatedly is that our plan is always to grow revenue faster than we grow op ex. That's one of the primary reasons why we've shown operating leverage over the past seven or eight years. That will be our plan for 2019, I can assure you that.

Tim Long:

Excellent.

Gary B. Smith:

Thank you.

Operator:

Your next question comes from Alex Henderson with Needham. Please go ahead. Your line is open.

Alex Henderson:

Great, thank you very much. I was hoping you could talk a little bit about the backlog of orders that you are building, parsing between how much of that growth is coming from India and how much of that growth is coming from other international markets? And then the second question is on the mix between services and platforms. I would assume that as you're doing more footprint build, you would be seeing less or a higher mix of installation services which generally carry lower margins and if you could parse on that I would appreciate it? So those are the two questions for you.

James E. Moylan, Jr.:

Hey Alex, yes the growth in our backlog really is two major places. One is India and the other is GCN. We've had a big inflow of orders from our web-scale customers that are sitting in our backlog. It is one of the reasons why we've called up our revenue for the year.

Gary B. Smith:

And you're right Alex on the services mix and that is one of the things that weighs on margins when you look at new customers. It's the cost for that Tier 1 customer to deploy, so it's also cost for us and we end up sharing that. And that includes some of the installation services not always, but typically the installation service as well which is lower margin from a services point of view. That also is weighing on us right now. But as I would say that's standard operating procedure, we've been there before and I think that is part of the dynamic displaying on our margins, but it's a very positive story.

Alex Henderson:

Is that service installation cost particularly heavy or lighter than normal in India, I don't know how that cost is versus installation...?

Gary B. Smith:

Actually to answer your question on that is both, you've got some large customers that actually have different approaches to how they carry out the installation, so you've got a mix of models there in India.

Alex Henderson:

Thank you.

Gary B. Smith:

Thanks Alex.

Operator:

Your next question comes from Tejas Venkatesh with UBS. Please go ahead, your line is open.

Tejas Venkatesh:

How fast do you believe the optical systems market ex-China has grown this year?

Gary B. Smith:

Low single digits.

Tejas Venkatesh:

All right, so that represents a lot of share gain.

Gary B. Smith:

Yes, if you look at most of the industry analysts are in that kind of range and we would concur with them.

Tejas Venkatesh:

Got it and a couple of long term questions, how are you thinking about the revenue and gross margin impact of the trend towards open line systems? And I also want to get your thoughts on the 400 GR and whether it could eat into your Waveserver market over time, where you're seeing a lot of growth?

Scott McFeely:

Yes I'll take both of those actually, so the I'll start with the 400 gig GR piece, so first of all that's going to be a one use case that will evolve in the data center (inaudible) for campus and short reach metros. From a component perspective, we announced our participation in the component industry through our Ciena Microsystems. Certainly that was one of the use cases we targeted with that. I'll point you back to our or three-year plan we explicitly called out our revenue line against that component piece.

On the open line system piece, it's an interesting dynamic because historically in our industry we've sort of had a Razorblade, razor model where the online systems go in at relatively lower margins and the channel ads were at higher margins. The folks that have pushed towards open line systems have recognized the benefit of being able to make those transaction decisions on the wavelengths and recognize that they're not going to get the same economic model. So the pricing for an open line system is quite a bit different than the pricing for a closed system. So net-net, by the way, ironically, the overall margins assuming you can win the transponder piece ends being about the same.

Tejas Venkatesh:

And then 400 GR?

Scott McFeely:

I talked about that in the first answer, so we do see the 400 GR as a use case for short reach campus based or short reach metro DCI opportunities going forward. And we do have a technology play to address that.

Tejas Venkatesh:

Thank you.

Operator:

Next question comes from Jeff Kvaal with Nomura Instinet. Please go ahead, your line is open.

Jeffrey Kvaal:

Yes, I was hoping that you can clarify a couple of things for us and one of them is last quarter that you had cautioned us not to extrapolate the web-scale strength in the quarter out through the balance of the year obviously things have gotten better, if you could talk a little bit about that I would be grateful?

Gary B. Smith:

Yes, Jeff I think the order flows that we received in Q2 and Jim highlighted this around the web-scale is where we’re particularly strong and frankly stronger than we had anticipated. We're seeing robust demand across all of the web-scale players. The major ones and also some of the emerging web-scale players as well, I would also highlight that. We have a number of wins in that space as well.

And I think particularly of note is their international expansion. We're particularly seeing the major content players looking to get into these countries like India, different countries in Europe, Asia Pacific particularly and so we are uniquely positioned with them on that, so a distinct uptick that we've seen in Q2 which gives us confidence for the year.

James E. Moylan, Jr.:

They really like our WaveLogic Ai. They really like where we're going with the WaveLogic chip and so it's not just current technology that they're attracted to, it's what's coming next.

Scott McFeely:

And I think Ai Jim, WaveLogic Ai obviously is a key component to it, but also the work that we've done with them over the last couple of seasons on their operational fit, the software interfaces, etc. are very important to them as well.

Jeffrey Kvaal:

Okay, great. So would it be fair to say that they have accelerated their own plans versus what you were thinking a quarter ago or you're just doing better within the plans that they already had in place?

Scott McFeely:

I'd say both. I think we're seeing expansion of the number of logos that we have in terms of the customer relationships but within those customer relationships I think the amount of capacity they're putting in is exceeding our expectations and I think probably even theirs.

Jeffrey Kvaal:

Okay, thank you all very much.

Gregg M. Lampf:

Thanks Jeff.

Operator:

Next question comes from Catharine Trebnick with Dougherty. Please go ahead, your line is open.

Catharine Trebnick:

Thanks for taking my call. I appreciate it. Two questions on vertical markets, one last year you talked a lot about, there was this undertone of some federal business that was to come pull through, could you give us a little idea or color behind the opportunity there heading into Q3 and Q4? And the other one is, could you touch upon the subsea business, that's a healthy business and is that a lot a major part of where some of your Waveserver new business opportunities are coming? Thank you.

James E. Moylan, Jr.:

On the government side, I'd say that because of the things that have been happening and how government is spending, there's been a delay in government spending over the past really year. We're starting to see some movement finally. We have a nice position in that business and hopefully we'll get some recovery as we get into Q3 and Q4.

Scott McFeely:

Yes, then on the submarine business it continues to be a great business for us and I'll remind you that sort of went from nothing five years ago to the number one market share position largely driven by our innovation leadership in optics. You mentioned is Waveserver sort of the major deployment model, I'd say WaveLogic Ai the optical technology is absolutely a key in terms of us continuing our leadership there and that is getting deployed in those submarine networks. It tends to be today though not necessarily in a Waveserver platform, it tends to be more in a classic service provider platform 6,500 specifically.

Catharine Trebnick:

Okay, and how is the international piece of that, are you doing a lot of the business through Google and Amazon and Facebook or is it mostly coming from the carriers?

Scott McFeely:

Both. Certainly the influence of the folks that you mentioned, the Googles of Facebooks and the Amazon is significant in both, whether they're doing it direct on cables or they take equity positions in or through the service provider their influence is significant and that's sort of back to Gary's point of having both sides of those relationships are critical.

Catharine Trebnick:

All right, thank you very much.

Gregg M. Lampf:

Thanks Catharine.

Operator:

Next question comes from Tim Savageaux with Northland Capital. Please go ahead, your line is open.

Tim Savageaux:

Thanks, good morning. Question on another—can you hear me?

Gary B. Smith:

Yes, we can hear you.

Tim Savageaux:

Yes, okay great, sorry about that. Question on another market vertical that we haven't discussed too much this morning and I gather it sounds like international and web-scale are sort of key drivers to the upside in a pretty extraordinary revenue growth especially that you're implying for Q4. But I wonder if you could comment on the cable TV vertical in terms of overall demand dynamics what you're seeing out of that in terms of opportunities this year and maybe more importantly next year as a growth driver and what looks to be an increasingly kind of diversified set of growth drivers?

Scott McFeely:

Yes, I think if I look at it at this year and where we're exposed in the cable operator sort of infrastructure whether it be their long haul or their Metro infrastructure, that's been pretty steady business for us this year. I think the opportunity for us looking forward is as they drive fiber deeper into their access network with the Fiber Deep initiatives I think that's a significant opportunity for us that's going to be a 2019 and beyond event.

Tim Savageaux:

Great, thank you.

Operator:

Next question comes from James Kisner with Loop Capital Markets. Please go ahead, your line is open.

James Kisner:

First is a clarification. Congrats on the nice revenue outlook for the year. I'm just wondering should we assume that that is a somewhat of a go forward or are you expecting at this point to be growing at that targeted rate in next couple years or should we assume a probably slower rate of that higher base? And just separately, I was just looking for geographic breakout, I mean you mentioned I think web-scale being—helping to drive this EMEA result, but it's obviously been a nice acceleration.

I'm just kind of wondering about the underlying trends in EMEA sort of ex Direct Webscale and then separately and sort of conversely in CALA, that region has been bleeding off here. Is that something we should continue to expect going forward or I mean it's not a big market I know, but it's just been kind of trending down, it's down about 50% since July, should we continue to expect that or might that also be an opportunity? Thanks.

James E. Moylan, Jr.:

Yes, I don't think you should see this growth rate this year as a pull forward per se. What we sort of said about this year was we thought we'd be at the low end of our 5% to 7% growth rate this year and what's happened is we're going to be actually above the high end of the rate. I don't think that's a pull forward, but I would say that we have said that we're going to grow 5% to 7% for each of the next three years. I don't think there's any different outlook as we look into the next two years, we're just going to beat that this year. So combination of all of those numbers is we're confident that we can hit the targets that we laid out for you at the beginning of this year.

Gary B. Smith:

James, with regards to the dynamics EMEA sounds the web-scale element to it, we are actually feeling increasingly better around EMEA. As I think we signaled at the beginning of the year, we've had some challenges in EMEA historically. Last couple of years I think we've had a very nice recovery in the last couple of years now and we feel pretty good around that trajectory. We also have a couple of significant Tier 1 wins when we talk about international are actually in Europe, so that gives us some confidence as well.

So in a lot of those conversations this morning we have talked about India and Asia Pacific and web-scale, but actually we've got some big Tier 1 wins in EMEA too that will help sustain our growth going forward.

Our commentary on CALA I think it is accurate. I mean it's a couple of large carriers really dominate the space there and they had major build outs and we're talking about Brazil predominantly, for the Olympics etc. , and we've seen the economy and the rest of it be very challenging since then. I do expect perhaps not in the second half that's not included in our second half perspective, but I think it steadied and I do think as we get into ‘19 and ’20 I think there's an opportunity for growth in CALA for sure.

James Kisner:

Thank you very much.

Gregg M. Lampf:

Thanks James.

Operator:

Your last question comes from Woo Jin Ho with Bloomberg Intelligence. Please go ahead, your line is open.

Woo Jin Ho:

Great, thank you for taking my questions. So Gary, Jim, you guys mentioned a couple of times that we've been here before in terms of these large footprint wins and pressure on gross margins, but as these footprint wins transition over to capacity to drive the margin growth these have been on the IP, just talk about the visibility on the timing of the rollouts to give you some confidence into 2019?

James E. Moylan, Jr.:

Well, we're not really saying anything specifically about 2019 right now, Woo Jin. We have said that we're confident that our three-year targets are good we are, I will say this that when we look at these big footprint wins, we look at a multiyear financial outlook and we weigh the early stage margin declines as of this compared to the late stage margin increases, we look at the strategic nature of the customer and we look at the country, we look at all of these things and we make our decisions based on that strategic view of a customer win. What we're seeing now is no different from what we've had in the past and we've repeatedly shown that we recover from these periods of gross margin pressure. I believe we will do that this time as well.

Woo Jin Ho:

Great. And then for my followup clearly you guys are upbeat on the technology lead you have with your WaveLogic Ai chip, how much has that influenced your Telco deals?

Gary B. Smith:

I would say that, I think there are three elements. When you specifically talk about the Telcos, I think what they're seeing is, yes they want the technology leadership and this next generation architecture and just as importantly the ability to continue to innovate on that leadership.

So I make no mistake, I mean we've got technology leadership right now. We're going to continue to push that because we've got the scale and scope to be able to do it. So it's not just about what you're delivering now, it's around your roadmap and ability to deliver on that and that's what I think is significant with these guys and your ability to support them and be financially stable.

It's not hugely dissimilar with the web-scale, except I would say they are more biased towards the technology piece. And listen, we've got both, we've got the technology in market today that's leading, we've got a roadmap that will continue to lead and we've got the global scale and financial stability as well.

Woo Jin Ho:

Great, thank you for taking my questions.

Gary B. Smith:

Thank you.

Gregg M. Lampf:

Thank you, Woo Jin and thank you everyone for joining us. We look forward to seeing everyone on the road over the next several weeks. Thanks for your time this morning.

Operator:

This concludes today's conference call, you may now disconnect.