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CIEN - Q3 2014 Ciena Corp Earnings Call

EVENT DATE/TIME: SEPTEMBER 04, 2014 / 12:30PM GMT

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PRESENTATION

Operator

Welcome to the Q3 2014 Ciena Corporation earnings conference call. My name is John, and I'll be operator for today's call.

(Operator Instructions)

Please note that this conference is being recorded. I will now to the call over to Gregg Lampf, Vice President of Investor Relations.

Gregg Lampf - *Ciena Corporation - VP of IR*

Thanks, John. Good morning, and welcome to Ciena's third quarter 2014 review. With me today is Gary Smith, CEO and President; Jim Moylan, CFO; and Tom Mock, Senior Vice President of Corporate Communications.

This morning's press release is available on national business wire and ciena.com. After the call, we will be posting to the investor section of ciena.com and accompanying investor presentation, including certain highlighted items from this quarter being discussed today, as well as our historical results.

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

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

Our 10-Q is required to be filed with the SEC by September 11, and we expect to file by that date. Ciena assumes no obligation to update the information discussed in this conference call, whether as a result of new information, future events or otherwise.

Today's discussion includes certain adjusted or non-GAAP measures of Ciena's results of operations. A detailed reconciliation of these non-GAAP measures to our capital results is included in today's press release available on ciena.com. This call is being recorded and will be available for replay from the investor section of our website. Gary?

Gary Smith - *Ciena Corporation - President & CEO*

Thank you, Gregg, and good morning, everyone. As evidenced by the strong results we posted this morning, our business continues to progress and develop as we expected. Our Q3 performance is yet another proof point of our execution against a successful strategy.

We continue to grow the top line, demonstrate OpEx discipline and expand gross margin. More importantly, the opportunity we see in front of us continues to grow, and we believe it is very durable, not only due to market growth, but also due to our ability to expand our addressable market.

In fact, our expanding addressable market has contributed to our greatly improved performance over the last two years, during which we grew revenue by 27% and increased our adjusted operating margin from 2.5% to 10%. We have been able to drive these improvements in part because we have expanded our portfolio to address a broader application space, and we have diversified our business in terms of customer types, geographies and market verticals, all indicators of our transformation over the past few years.

As we have noted previously, our approach is well aligned with the new priorities of a broader set of customers. Consequently, we believe we will continue to grow faster than our market and continue to drive improving operating leverage and profitability in 2015, as well as over the long term.

In Q3 specifically, all metrics came in positively. With revenue of $604 million, our third quarter adjusted operating margin of 10% demonstrates our ability to deliver meaningful expansion in operating leverage and as a result, we generated $43 million in cash and we're GAAP profitable for the quarter.

In terms of progress with customers, Q3 was especially rewarding quarter for Ciena as we continue to expand our role and our reach in several key accounts. Firstly, we are excited to announce today that AT&T has selected Ciena to be a domain 2.0 supplier, expanding our role as they transition to a next generation cloud-based architecture that embraces NFV and SDN. The domain program is all about enabling AT&T to quickly take advantage of shifts in markets and architectures.

Obviously, we believe this is a significant achievement for Ciena. It has expanded our addressable market within AT&T and directly aligns with our open architecture. Particularly around converged Metro applications, as well as packet networking solutions in SDN applications. There are some upfront commercial effects associated with the structure of the partnership, which Jim will address in a moment.

Another newly announced when further illustrates diversification within our global key accounts. BT Openreach is now utilizing solutions from both our packet networking and software portfolios to expand its ethernet business service offerings for cloud computing and on demand applications.

And finally, we are secured our first major win through our new partnership with Ericsson in Q3, and it truly is a flagship account. Through Ericsson, Telstra have selected Ciena as a critical supplier of packet optical platforms and management software for their nationwide network build. So, our geographic diversification also continues with this tier 1 win in Australia.

Q3 was also an important quarter for our portfolio diversification. We launched 8700, a major new platform for multi-terabyte packet switching that fundamentally changes the economics of Metro networks. We also began shipments in Q3.

And we also introduced a new software suite called Agility which enhances our overall SDN solution, expands our addressable market, and continues the diversification of our offerings. Data center operator Equinox and a Brazilian tier 1 carrier are already deploying software from the Agility suite, and field trials are underway with multiple tier 1, tier 2 and MSO providers as they look to transition to on-demand models as the market evolves.

And that leads me to my final point on our progress in Q3, which is about the market. Recently, there has been some concern that technology shifts such as the migration to SDN could disrupt network operators' overall CapEx in the near term and that merger and acquisition activity could delay some projects in the second half of 2014. I think it is fair to say that in certain US tier 1 carriers, it does appear that these influences are affecting second half spending, but it is very customer specific.

And whilst we are not immune on to customer specific dynamics, our Q3 performance was strong, in large part due to our strategy of diversifying into high-growth applications beyond pure infrastructure, including software defined networking, where we are succeeding as an early provider of network apps, control software and programmable platforms. In converged Metro applications, which presents an opportunity that is larger and growing faster than the core market.

Data center applications where we address high-end applications like automated cloud service delivery, as well as simple data center interconnectivity. And finally, the Web 2.0 community whose players are not only building their own networks, but are also influencing the architectural direction and capacity requirements of the network operators who count them as critical customers.

All of these market developments and the rest of the progress made in Q3 are positives for our business and represent a durable opportunity that extends well beyond a few broad-based service providers. As we expand our addressable market by targeting high-growth, high-value segments, we are confident in our opportunity to grow the business and drive additional operating leverage in 2015. With that, I will now turn call over to Jim.

Jim Moylan - *Ciena Corporation - CFO*

Thank you, Gary. Good morning, everyone. We had an outstanding third quarter. We have invested in our business across customers, products and markets, and our performance in this past quarter, as well as the consistent improvement we have seen in our operating model, reflects the success of those investments. It also demonstrates very clearly that the operating leverage we have been projecting for the past few years is achievable and should give investors confidence that we can continue to show improvements in operating margin.

I will cover some highlights of our third quarter, speaking only to non-GAAP results. You can refer to our press release for reconciliations to GAAP results.

Q3 revenue came in as expected at $604 million, reflecting 8% sequential growth and 12% growth over the year ago period. It is also our first quarter with revenue over $600 million. It is worth noting that this milestone comes just five quarters after our first $500 million quarter.

Order flow continued to be strong, coming in just below revenue. Adjusted gross margin in Q3 came in at 44%. Again, our investments and customers, products and markets is driving the strong margin performance for this quarter and for the fiscal year to date.

Adjusted operating expense in the third quarter was $206 million, or 34% revenue, a bit lower than we guided. With an adjusted operating profit of $61 million, Q3's adjusted operating margin was 10%, another milestone for progress.

We were cash flow positive in Q3, generating $43 million in cash. We ended the quarter with $718 million in cash and investments, which does include the proceeds from the term loan facility that we closed during the quarter.

As we head into Q4, there are several significant variables that contribute to a broader range of potential outcomes for both revenue and gross margin than we typically expect. Our Q4 performance will depend upon the degree to which these variables occur within the quarter and in what combination. It is important to note that the impact of these variables is short-term in nature and that they in no way changed our view of the fundamental dynamics of the market, the pricing environment or our business model.

First, we currently expect to take initial revenue on several international projects in Q4 which combine for a large impact in the quarter. As we have discussed in the past, these early stage network deployments can cause downward pressure on margins due to the concentration of lower margin chassis, as well as related startup costs.

Second, you will recall that we took steps earlier this year to increase our 6500 inventory, and we can now react more quickly to customer demand for that product. As a result, we are well-positioned for a couple of large new projects that could potentially be booked and turn to revenue in Q4. The timing and order -- of the orders and revenue recognition, however, is not yet totally clear.

And third, as Gary mentioned, we were recently selected by AT&T as a domain 2.0 supplier. This is a major positive for Ciena. It has the potential to expand our opportunity at AT&T, allows us to address a wider range of applications, and to participate as they move forward with an SDN and NFV strategy.

Our agreement with AT&T includes certain commercial concessions that are structured as upfront incentives. While these incentives and concessions are a normal part of doing business with large service providers, we currently expect that they will have a significant and disproportionate impact on both revenue and gross margin in Q4.

I'm going to speak to guidance now, and I will point out that without the combined impact of these three variables, we believe that our Q4 gross margin and revenue would likely have met or exceeded expectations. That said, our guidance for our fiscal fourth quarter does take into account our best estimates of the effects of these impacts and is as follows.

We expect Q4 revenue in the range of $570 million to $610 million. We expect Q4's adjusted gross margin to be down from Q3, in the high 30s to the low 40s percentage range. We expect adjusted operating expense to be approximately $210 million, in line with our target of averaging roughly $205 million per quarter in FY14.

Ciena will have a very good year in 2014. It is a year of financial progress and one that reflects continued improvement in operating income. We expect the impact due to the Q4 variables to be short-term in nature and that the first half of 2015 will reflect a return to our more typical adjusted gross margin range of low to mid 40%s.

I will close by saying we still are highly confident in our opportunity for sustained profitable growth, and we expect to continue to show operating leverage and increased profitability in FY15. John we'll now open the line for questions.

QUESTIONS AND ANSWERS

Operator

Thank you, we will now begin the question and answer session.

(Operator Instructions)

Paul Silverstein, Cowen.

Paul Silverstein - *Cowen and Company - Analyst*

Guys, first off, if you could provide us with the customer accounts on 100 gig and optical switching, I don't think I've heard them. If we could get those numbers, that would be appreciated.

And then my question for you is, I recognize -- I'm sure there's sensitivity about any one particular customer, but if you could provide us with additional insight in terms of AT&T specifically, especially on the commercial concessions. And also, Jim, I think I heard you reference a couple of potential new wins. It didn't sound like they were closed, but if I heard you correctly, you said that they could be secured and they could hit revenue, it's possible in the quarter. Is there any insight you could give us in terms of the number, the nature and the size of those prospective wins?

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

Paul, it's Tom, I'll start with a quick answer to your question around customer accounts. In terms of customers for our coherent optical solutions, we are at 134 in the 100G range, and 142 in the 40G range and 186 all together. In terms of new customers in the quarter, we added five customers for 100G; we also added couple of customers for OTN switching, and we're now at a total of 39 customers there.

One other thing I'd point out, just in terms of diversification for the Company, if we look at our shipments of 100G ports for the quarter, close to 20% of those were shipped to Web 2.0-type companies. Another close to 20, say 18%, were MSOs and another 7 were submarines We have about 44% of our shipments of ports in the quarter that were outside traditional telco-type businesses.

Jim Moylan - *Ciena Corporation - CFO*

Great. And Paul, you rightly referenced the fact that our quarter that we now look at is influenced by a number of variables, and it's the combined result of these three which causes the range that we put out in front of you. And we note that there is always some variability in our quarter, but it is the size of these three variables that really results in a disproportionate effect on the quarter.

As to AT&T, we are going to be careful about what we say about any particular customer, but we do view this domain 2.0 award as a major positive for us. We are very pleased to be a partner for AT&T. They're moving forward pretty quickly into new network architectures, SDN, NFV, and we're very pleased to be a part of that.

There are always, in an opportunity of this size, commercial concessions and incentives that are going to be given, and in some cases, these are structured as discounts, which reflect a reduction in both revenue and gross margin. As always, the size of these impacts is going to be commensurate with the size of an opportunity.

So, I would say that even without the effect of these variables, we would have exceeded expectations for Q4. That even with these variables, if they hit to their full extent in Q4, the target that we put out for operating margin for the year of the low end of the 7% to 10% range is achievable if we get midpoint of the guidance.

And I'd just finally say that it's really important that everyone realizes that the impact of these variables is short-term in nature. At least the disproportionate amount is short-term in nature, and that we don't view this as a change in our view of the fundamentals dynamics of the market, the pricing environment or the business model. I guess I would say, again, we think we're going to return to increased operating leverage and profitability in 2015.

As to the projects and some more color on AT&T, Gary, why don't you address that?

Gary Smith - *Ciena Corporation - President & CEO*

Paul, I would say, listen, it's obviously a significant positive for the Company, and we're very excited about it. We have secured and expanded our long-term opportunity within the world's largest carrier.

And we've got a long history of a relationship and a great partnership with them over the last decade or so, and I think it's proven to be profitable for both parties. We been Supplier of the Year over the last two of the three years.

And I think it's also -- it should be viewed in the context of our investment in strategic customers, very consistent with what we've done over the last few years. And I think with proven that we can deliver operating leverage through this kind of strategy, in addition to diversifying within the large customers and applications and diversifying into other customers and market segments as well. We're absolutely delighted with the announcement this morning.

Paul Silverstein - *Cowen and Company - Analyst*

Guys, I apologize. I want to be respectful of others on the call, but just to be clear, on those wins, or potential wins, were you referencing projects within existing customers, or are those new potential customers that you're referencing?

Gary Smith - *Ciena Corporation - President & CEO*

Paul, sorry about that. It is both, actually. We have some new opportunities, some of them domestic and within the government arena, as well as some existing book to revenue opportunities within some existing accounts as well.

Paul Silverstein - *Cowen and Company - Analyst*

All right, I will pass it on, thank you very much.

Gary Smith - *Ciena Corporation - President & CEO*

Thanks, Paul.

Operator

Mark McKechnie, Evercore.

Mark McKechnie - *Evercore - Analyst*

Great, thanks. And congratulations on that AT&T win.

Gary Smith - *Ciena Corporation - President & CEO*

Thanks, Mark.

Mark McKechnie - *Evercore - Analyst*

I wanted to ask you on some clarity on the gross margin outlook. You talked about a couple things back in Q4, the new customer shipments internationally, the AT&T startup.

I do understand the new customers impacting margins. Is some of that because of the Ericsson Telstra deal as well, or is the Ericsson OEM relationship where I would guess that those would be generally lower gross margins? Or is that going to start shipping later?

Gary Smith - *Ciena Corporation - President & CEO*

It is going to start shipping later. We haven't recognized any appreciable revenues for that relationship, as expected. The Telstra win, I believe doesn't impact until 2015.

The other dynamics that Jim was talking about, the other international customers are direct Ciena customers, and they're new ones. And it's -- we're at the early stages of the rollout which can, from an economic point of view, more investment mode on both sides.

This is a normal dynamic for us, and you've seen it -- to my earlier comments, you've seen us invest in these kinds of things over the years. And normally within the blend of things, it doesn't have this disproportionate an impact, but just when it comes together with a couple of these other elements, it affects us disproportionately in the quarter.

Mark McKechnie - *Evercore - Analyst*

Got you. I just want to get behind a bit more of the confidence that your gross margins return back to low to mid 40%s in the first half of 2015. Maybe with AT&T specifically, whatever you can tell us, but why -- it sounds like some startup costs there, and maybe some pricing concessions.

But I would think that some of the startup costs would be more OpEx related. Maybe you could help us on that a bit.

Gary Smith - *Ciena Corporation - President & CEO*

I would say Mark, without going into too -- I'm sure you can appreciate the -- we don't want to get into too much detail here, but there are various different kinds of commercial concessions. And some of those we take up front, there's a disproportionate amount of them in Q4 affecting both revenue and margin. Not particularly OpEx.

And in addition to that, we've got a couple of these large international projects which also look like will come to revenue -- they are at lower margins than our normal margin now. The blend of these things, as we look forward, these things are always happening in the business. And we've been able to continue to expand our operating margin pretty consistently over the last two to three years, and we're confident about that kind of mix in 2015.

We don't think it's always going to be a complete linear progression for sure, but if you look at us in chunks of the half year, you can see the improvement clearly. We think that's going to continue in 2015.

It is business as usual from the business model point of view, and we think we've significantly diversified the business over the last few years in terms of both customers, market segments and the applications that we play in. When we look at all that mark in aggregate and the blend and the mix around that and what is happening in the marketplace, we -- that gives us the confidence that we can return to the kind of gross margins that we've seen the last couple of years.

Gregg Lampf - *Ciena Corporation - VP of IR*

Thanks, Mark.

Jim Moylan - *Ciena Corporation - CFO*

I just want to make this comment, just as a general comment. I understand there's going to be a lot of curiosity about what we're talking about in Q4, and we respect that. But I hope you also will respect the fact that we have to be careful about what we say about any particular commercial negotiation.

And I'd remind everybody, this is a competitive business, and we see declines in price per unit of capacity as we move through time very consistently. And that's a result of more technology. It's a result of our customers wanting to take advantage of that.

And so we plan our business model in terms of how we drive our supply chain to account for a reduction in cost per unit of capacity. And we've been very successful in doing that, and I think we will continue to be successful in doing that. We look at Q4, a lot of things came together for us.

Mark McKechnie - *Evercore - Analyst*

Thank you.

Operator

Tal Liani, Bank of America

Tal Liani - *BofA Merrill Lynch - Analyst*

Hi, guys. I want to understand the dynamics behind this big contract, and I have two questions. First is, you are so well-entrenched within AT&T. You have all the way from the core switches to the edge and everything in between.

When we see such big discounts being given and such impacts on margins, the first question is, why do have to give such a discount? Meaning what is in the market that -- we thought that this is -- the market changed in the sense that once you are into a customer so deeply entrenched, there is no need to provide such discounts in order to win the next deal.

And can you just discuss the market dynamics and the outlook for lower margins also with other customers? And does it mean that the dynamics that we've seen 10 years ago are actually never changed? And every time there's a big cycle, it has to come with low margins? That is my first question.

The second question, I think you related to it, but I want to just understand. If there is pressure on revenues and margins because of discounts, how long does it take to recover and what takes it to recover? Does it mean that there is a cycle that you need to take costs out of the network, costs out of the product in order to recover margins? Or will volume compensate for the decline in pricing? Thanks.

Jim Moylan - *Ciena Corporation - CFO*

First part of that question, Tal, is we do have a great relationship with AT&T and with a number of large service providers, and we are incumbent in their network. However, they are moving forward with a new set of vendors and a new set of architectures.

And as is always the case in a situation to gain market share, which is what this is, we do have to give commercial concessions. It is a part of the business. We have done that, really, consistently over the past several years.

And as a result, we have seen some volatility in our margins. With at least the last year or so, we have seen a nice trend upward.

What I'd say in this case in particular is that it was a function of the nature of the negotiation and the timing, et cetera, that we ended up in this case with a disproportionate impact in our Q4. And that causes -- that, along with the international wins that we talk about, are what caused this downtick in margin in Q4.

We believe that although there is going to be some volatility in our margins going forward, we can manage that give-and-take of commercial negotiations and concessions with other large customers as we move through time. I would just say that that is what gives us confidence that we can drive improved profitability next year. There's going to be some movements around the trend line, but we're going to grow our profitability over time

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Gary Smith - *Ciena Corporation - President & CEO*

Tal, let me address the broader strategic point that I think you are raising here as well about the dynamics and the cycle, et cetera. I think we have a very different environment than we had 10 years ago, both in terms of the industry structure and the opportunity for the industry structure moving forward. I think it's a much more expanded opportunity, and I think Ciena is a very, very different business.

And I think we understand the dynamics very carefully and very well, and we have been able to operate in them. And I think the -- it's important to note that these variables are, we believe, short-term in nature, certainly into Q4.

And I don't change our view of the fundamental dynamics of the market, the pricing impairment, or our ability, as Jim said, to improve on our business model. That's why we're absolutely confident in that. And I think the first half of 2015 will reflect a return to a more typical adjusted gross margin of the range of low to mid 40%s.

Tal Liani - *BofA Merrill Lynch - Analyst*

Got it. And what takes the margins higher? Is it volume, or you need to take cost out of the products?

Gary Smith - *Ciena Corporation - President & CEO*

It's -- well, cost is obviously -- the more obvious supply chain. But a lot of this is about technology moving forward and the fact that we have invested so heavily in this next generation technology. You've seen it with our coherent 6500 platform, which is absolutely leading the industry and has a long head start on it.

I think it's better delivering that technology into the marketplace, and I think it's also about the mix of the both markets and applications. The converged Metro applications, much bigger opportunity than long haul, NFV and SDN in the cloud-based architecture. It's really a mix issue. You've heard us say that before. That's what expanded our margin as we went through 2014. Q3 we were at 44% gross margin.

Tal Liani - *BofA Merrill Lynch - Analyst*

Thank you.

Gary Smith - *Ciena Corporation - President & CEO*

Thanks, Tal.

Operator

Jess Lubert, Wells Fargo.

Jess Lubert - *Wells Fargo Securities - Analyst*

Thanks for taking my question. I had new question on some of the new wins you referenced, several of which sound like they may be on the bubble of the end of Q4 versus the beginning of Q1. I want to understand if your Q4 guide assumes these deals don't fall into the current quarter. And given that dynamic, should we be expecting a better than seasonal performance in the first half of FY15?

Jim Moylan - *Ciena Corporation - CFO*

We've given a broader range of revenues than we typically give, Jess. And what I would say is that at the bottom end of the range, we don't expect much in the way of these big projects, but at the midpoint of the range, we do expect some.

But I don't want anybody to draw any numbers specifically about that because there is volatility, really across the board in these three variables that we've talked about. Some of them -- any -- all of them could move up or down, depending upon what happens in this quarter.

As to whether it affects Q1, this large project that we're talking -- set of projects that we're talking about -- by the way, it's a North American set of projects. And we -- it is going to be split between Q4 and Q1, and we're uncertain as to how it gets split. That's why we're giving this range that we're talking about.

Jess Lubert - *Wells Fargo Securities - Analyst*

All right, thanks, guys.

Gregg Lampf - *Ciena Corporation - VP of IR*

Thanks, Jess

Operator

Amitabh Passi, UBS

Amitabh Passi - *UBS - Analyst*

Hi, thank you. Good morning, guys. Gary, Jim, I wanted to clarify on revenue guidance again for fiscal 4Q. Just to confirm, are you saying that the bulk of the impact in what is typically a seasonally strong quarter for you is driven by some of the concessions to your large customer? Or is there also caution embedded around some of the pending M&A activity?

Is there any other caution embedded in your guidance? I'm just trying to clarify, is it purely related to the concessions that you referenced, or are there other factors that you factored in that might be driving some of the caution in fiscal 4Q.

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Jim Moylan - *Ciena Corporation - CFO*

Very clearly that the concessions that we've talked about are affecting the quarter. I'm just going to say again that without the impact of the three variables that we're talking about, if we just had a normal quarter, we would've guided in Q4 at or even perhaps exceeding expectations. It really is these three things which are hitting the quarter.

Gary Smith - *Ciena Corporation - President & CEO*

On the broader point around the M&A activity, I touched on it in my comments, Amitabh, I think we are not seeing a slowdown generally. I think there is some customer specific dynamics going on.

Amongst a couple of the larger ones, there are some architectural choices people are making, clearly, the main being one of them. But we're also seeing in other very large tier 1 accounts, both in North America and outside, moving full steam ahead. Overall, whilst we're not immune from some of the larger carrier dynamics, we're are able to get through this transition better than most because we are more diversified.

Amitabh Passi - *UBS - Analyst*

Gary, as a follow-up, are you able to give us an update on trends in Europe? Last quarter, I think you referenced Vodafone Spring, didn't really hear you talk much about it.

Are you starting to recognize or see the benefit of that project? And maybe just an update in terms of overall trends in Europe and your opportunities out there.

Gary Smith - *Ciena Corporation - President & CEO*

Europe obviously covers a large geography. We're obviously seeing some specific challenges that you'd expect around Russia and some of that Middle East challenges, which are geopolitical elements.

But outside of that, it's been fairly steady in Europe for us. And I think some of those wins around Vodafone and the rest of it are helping with that stability. And we're actually seeing some increased opportunity out of the British Telecom win, which really expands our opportunity into the more packet-based technologies, which we've not done before in that account.

Europe, as we turn the corner into 2015, notwithstanding the geopolitical issues, we actually feel increasingly confident around some of these opportunities there.

Amitabh Passi - *UBS - Analyst*

Thank you.

Operator

Catharine Trebnick, Dougherty & Company.

Catharine Trebnick - *Dougherty & Company - Analyst*

Thank you taking my question, good quarter. Two questions. Could you give a little flavor on the federal government opportunity? And then the other one is the 8700 was just released, and how are those opportunities helping you going forward? Thank you.

Gary Smith - *Ciena Corporation - President & CEO*

Let me take the first part of that, Catharine. Yes, as Jim alluded to, they are North American, and one of them is government related. We are seeing some good opportunities, both in North America and outside of the US, in government education and research.

We've expanded our footprint there pretty dramatically over the last couple of years. And so we are -- we believe we've been selected, it's a matter now of, what is the timing of revenue recognition and all of those kinds of things and our ability to ship. We're excited about that. The couple of opportunities there are both with the government and the DoD.

And on the 8700, Tom do you want to?

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

Yes, the big thing the 8700 brings to the product line is it lets us move more -- move closer into the core of the network from the edge of the network. 8700 is a much bigger switch than the ones we've been supplying in the ethernet arena to date, so it lets us have a broader portfolio in terms of being able to deliver services.

It's also well positioned, as we start looking at more on-demand type services which are going to be driven by ethernet access ethernet aggregation. I think it gives us the opportunity to participate in a number of different areas in traditional telcos as well as other areas like MSOs as a way of being able to provide ethernet services or provide ethernet as an infrastructure for other types of services like video.

Catharine Trebnick - *Dougherty & Company - Analyst*

Thank you very much

Gary Smith - *Ciena Corporation - President & CEO*

Thanks, Catharine.

Operator

Brian Modoff, Deutsche Bank

Brian Modoff - *Deutsche Bank - Analyst*

Good morning, guys. I want to beat on this a little longer, but on the margin side, so you are saying that the improvement will be mainly mix as we get into next year, mix of customers, mix of contracts. It won't be anything in terms of, you've got some better cost integrations on the product side. That's the first thing.

And then can you talk a little bit about how you see your mix of product going into next year? Obviously, Metro ethernet seems to be doing better, the 8700 should help you.

How is that doing versus OTN versus transport as we look into 2015? Give us a flavor of what you see the mix looking like and how that might impact margins next year. Thank you.

Jim Moylan - *Ciena Corporation - CFO*

Thanks, Brian. Just to make it clear on the Q4 gross margin piece. One piece of the margin downtick in Q4 is the fact that we have these several international projects that have the typical margin profile that we see in a large international project. That will go away, there is no question about that.

And as we move through time, what we will do is we will fill those networks with cards and the margin profile will get better. That's just the typical profile that we see with these large projects.

On the AT&T deal, just to be clear, there are disproportionate effects in our Q4 as a result of the way the deal came together. That is as clear as I can be in terms of the explanation. The disproportionate effect will go away. It is -- perhaps will have some impact on the first quarter, we're not sure about that yet.

But by the time we get into the second quarter, we are out of this period of disproportionate impacts. It is not so much a mix issue, it's the fact that this negotiation led to this structure. And Gary, maybe could deal with the product mix.

Gary Smith - *Ciena Corporation - President & CEO*

Yes, why don't I take the element around the going forward gross margin element. I think it's a mix of customers and stage of evolution, to Jim's point, that we're at with some of those customers.

We've always got some new customers that we're in the investment stage in, but I think we've gone through a significant element of that over the last two to three years as we've expanded our footprint. I think that mix of customer evolution gets better. And yet, there's also cost reductions which are ongoing as we develop our supply chain.

There's also, as I said, the significant impact of a lot of the new technologies we're bringing into market that significantly reduce the costs for our customers and provide additional functionality as we move more towards software-orientated networks. You look at all those investments that we've made and the blend of them which really enabled us to drive our gross margin improvements over the last couple of years. Those things are still very much in play, and we're very focused on them.

I think you've heard me say this before, our longer-term objective here is to get a gross margin that is consistently in the mid-40%s. We've said we're not at that point yet, and unfortunately, we're amply demonstrating that in our guidance for Q4. That being said, you look at the trend lines here, we are absolutely improving our gross margin.

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

Just a couple of data points on what Gary was saying. We announced BT is a new customer for ethernet, and that's going to be a way in which we expand our ethernet service delivery capabilities outside the US.

We also talked a bit about the fact that we're beginning to deliver application software to our customers in support of on-demand type activities. We think that's going to have a pretty strong impact on our gross margin.

And finally, we've also started really seeing the take up of packet capabilities in our traditional transport portfolio. That, too, we think will help improve gross margins.

Jim Moylan - *Ciena Corporation - CFO*

And I would just close by saying that we have said all along that our progress toward our targets is not going to be linear quarter to quarter. Our progress should be viewed through a wider lens, when we look at half years or full years or longer-term commercial or financial progress, which we have shown and we will continue to show.

As I said, 2014 overall is a good year for us. We had a confluence of items that will, we think, will affect Q4, and that's why we're seeing a down dip, frankly, below where we'd like to see it. But we do believe that as we move through these projects in particular, we're going to get back to a more normal course of gross margins.

Brian Modoff - *Deutsche Bank - Analyst*

Thanks, Brian. Thanks, guys. If I could slip in real quick, was cloud in -- the cloud providers in the 2.0 players as a percent of your revenue this quarter? Thanks.

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

We've talked about it really in terms of percentage of our 100G [board] shipments, but we haven't talked about it as a percentage of revenue. But we do think that we're getting a good market share in that space; in fact, we think we're a leader, if not among the leaders in that space.

We are very comfortable with our position, and we think we've got a compelling offering. And we also think that it's going to be a growth area for us as we move forward.

Gary Smith - *Ciena Corporation - President & CEO*

The only stat that I'd talk about with that, Brian, is the context of more than 30% of our revenues now are attained from non-carrier infrastructure-type revenues. A large portion of that is the Web 2.0 guys, both directly and indirectly.

Gregg Lampf - *Ciena Corporation - VP of IR*

Thank you.

Operator

Ehud Gelblum, Citi Research.

Stan Kovler - *Citigroup - Analyst*

Hi, good morning. It's actually Stan Kovler in for Ehud, thanks for taking my question. I wanted to ask about software a little bit more. Really, growth there, especially sequentially in software and services, and you mentioned some of the wins there.

Are those customers effectively buying the software in at one time perpetual license? Or can you help us understand the dynamics of you selling your software to the customer and how that's going to impact the longer-term line item and margin effects there over the course of perhaps even 2015?

And if you think about it as a percentage of revenue, how that will trend with customers? If it's just embedded in the products or that standalone software that I'm referring to, that's really the key?

And the other question is really on OpEx and how we think about OpEx going into the following year. It's been pretty steady over the past couple of quarters.

And as you get some of these new customers, how does it typically trend? Especially early on with some of the customer deployments, if you think there's going to be a more significant uptake or if you can keep that under control at current levels. Thank you.

Gary Smith - *Ciena Corporation - President & CEO*

Why don't I take the first part of that? If you think about our software, very simply, to NMS it's embedded software that you get, there's a large part of embedded software with the platforms. That shows up either directly and more widespread now within a subscription software-type model, which is why a lot of it is included in the services and we don't break that out. That's -- a lot of that is shown within that segment.

Increasingly, we're also providing NMS and the various complexities -- increasingly complexities around NMS, given open architecture, et cetera, and application software, which are specific purchases that are made to do certain things on the network. We are expanding our activities there, which is where you would include things like the SDN-type applications as well.

But you would expect us to talk more about that and over time, to separate them out as well as a way of indicating our progress. But relative to the overall size of the business right now, still fairly small but has a disproportionate impact in terms of gross margins. And I think equally importantly, embeds intrinsically the Company in the business models of our customers because a lot of this software is actually at the front end of their business and actually is success based, driving a lot of the network monitoring and analytics and this delivery -- instant delivery of the network.

And I think -- we're at the early stages of all of this, but it's very encouraging, what we're seeing. We've invested significantly over the last few years in this, and I think we're getting to see the benefits of that investment. We'll be calling that out as we go through 2015 a little more discreetly.

Jim Moylan - *Ciena Corporation - CFO*

As you noted, that 44% margin was heavily influenced by the fact that we had a very good software quarter and over time, we expect software to continue to grow as a percent of our revenue.

On the OpEx question, here's what I say about OpEx. Over the past, at least three years, maybe longer, we have demonstrated that our targets for OpEx are set at the beginning of the year, and we drive to those annual targets. Because we have projects embedded in our OpEx, we are going to see some quarter-to-quarter variability in our OpEx.

But I can say that, again, look back over the last three years. We have hit the targets that we've set for ourselves and will continue to do that.

If we look ahead into 2015, we haven't even begun to really drive our 2015 plan yet. But what we have said consistently is that this is a business in which you must continue to invest to innovate. And sometimes you have to invest with customers and sometimes you have to invest in the back office.

We're committed to driving operating leverage through growing our revenue faster than we grow our OpEx. And as we head into our 2015 plan, which is just now beginning, that is a concept which is deeply embedded in the Company, and we will deliver that.

Gregg Lampf - *Ciena Corporation - VP of IR*

Thank you.

Stan Kovler - *Citigroup - Analyst*

Thank you.

Operator

Mark Sue, RBC Capital Markets.

Mark Sue - *RBC Capital Markets - Analyst*

Thank you. Gary, in the world of optical components, every year we see a big step function down in terms of annual price cuts. Is this something that we should also think about for optical systems as well or is it nonrecurring?

And just one thought there, if we could look at your customer diversification, your Web 2.0 customers, for example, are they more inclined to pay for a premium for your optical switching and transport? Just trying to get a sense of their purchasing behavior versus the traditional telcos

Gary Smith - *Ciena Corporation - President & CEO*

I think the correlation between us and the optical supply chain is diminishing over time. When you think about that, increasingly more of our business is packet-based.

More of our business is software and services-based. Therefore, the correlation and the dynamics around that are diverging.

Whilst we have our own pricing dynamics within that, I think the industry is evolving as we get to a more solution-based industry where the opportunity for margin expansion is greater. And let me express that very simply. The optical industry basically grew up moving bits from A to B.

If you are moving bits from A to B, that is generally viewed as a, I'll use -- it's not the right expression, but I'll use it as a commodity-type thing. It is the price per bandwidth bit that you are moving.

We know how to ride that curve with our vertical integration that we've done strategically which allows us to both innovate, lead the market, and capture more of that value. We know how to move bits around and lead the industry in terms of innovation and capturing margin out of it.

But I think the broader picture is increasingly, we're doing more with those bits. It's back to the earlier conversation around software. It's a bit of a proxy for, you are actually doing more than just moving bits from A to B.

I think as the Company moves through this transformation of becoming more of a solutions player of convergence of not just optical moving bits, but packet optical and doing something with them, in simplest form. I think that creates the dynamic that we've been able to expand our margins over the last couple of years, and we're only at the early stages of that.

Mark, you've heard me say this before, I think, and I understand it, that people look at us through this lens of history as an optical player. We are very different Company in a very different industry than we were 10 years ago. I think the dynamics are different to that.

In regard to the -- sorry, go on.

Mark Sue - *RBC Capital Markets - Analyst*

The divergence between you and your competitors, the others are struggling, Alcatel-Lucent, for example. Maybe just speak of the widening gap between you and some of the other vendors that are out there.

Gary Smith - *Ciena Corporation - President & CEO*

I think what you've seen in the industry, without going too specific around a particular competitor, what you've seen is historically, the industry has grown up as very broad-based vendors because basically, they were was spin-offs from the traditional phone company that used to manufacture everything that phone company needed domestically. I think there was this notion that you had to be an end-to-end provider in the industry to be successful, and I think that notion has turned out to be incorrect.

The industry is moving towards one of wanting best of breed in each area and an open architecture. I think that's demonstrated by AT&T's domain 2.0 approach to the architecture.

I think you are seeing a dislocation from an industry structure point of view. It's been a slow one over the last 10 years, but you've seen even the bigger players are having to get focused and be the best in the world in certain areas.

Our strategy has always been to be a specialist and be the best that we can be in the space that we are in, and I think that is driving some of the divergence of performance. You look at our growth this year, last year and the year before.

We're growing way faster than you would think about the traditional market because we've diversified our business and we're in a very different place. But I think it also talks to strategic choice, and the fact that we're a specialist is resonating within the industry structure. Thanks, Mark.

Operator

Simon Leopold, Raymond James

Simon Leopold - *Raymond James & Associates - Analyst*

Thank you. I wanted to get two quick clarifications and then go to a question. In terms of clarification, if you could maybe give us some sizing of the contributions from the switching products, the CoreDirector and 5400 which in -- within the converged packet segment. I'm guessing it was pretty good, given the good gross margin.

The other clarification I wanted was, you talked about the nontelco business now being over 30%. Within that, I believe you include your cable TV segment. If we could get a sense of how you view the cable TV market.

And in terms of the longer-term question, I understand that between long haul and Metro, it is certainly more of the spectrum than binary. But if you could speak to the trends and opportunities as we believe the market will start spending more on coherent in Metro regional applications as opposed to long haul, maybe the timing, sizing. Any thoughts you could give on that particular trend. Thank you.

Gary Smith - *Ciena Corporation - President & CEO*

Do you want to start with that?

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

I'll start with the Metro one then, Simon. Your observation that the lines between Metro and long haul are blurring is indeed a true observation.

One thing we are seeing is people are moving to make deployments in the Metro space is they are actually looking at their boxes to do more things. For example, the incorporation of packet switching or OTN switching might be more important in a long haul market -- I'm sorry, in a Metro market than it might be in a long haul market.

That said, we're starting to see that market begin to emerge. As we've talked about, we've begun to do deployments with these integrated capabilities in a handful of North American carriers. And we expect that to continue, and we expect that to spread beyond the United States.

Jim Moylan - *Ciena Corporation - CFO*

On the margin piece, we had good quarter on switching and packet. It was not an extreme growth rate in those compared to last year.

Frankly, I would say there were three elements in our gross margin this quarter. One which was earlier pointed about is we had strong software quarter, and we know that software is a higher margin product.

Secondly, we had a good services margin, and you will see that when you get into the details of our results. And then finally, as I've said the past two or three quarters, we've seen very nice progress in our gross margin, particularly this year.

We've had a nice mix of cards, we've had a nice mix of solutions and switching, embedded and transport and all those kind of things. And so I -- that's frankly what gives me confidence that we can get back on our track on gross margin as we move through the impact of these variables that we're talking about in Q4.

Gary Smith - *Ciena Corporation - President & CEO*

I think the other part of your question about MSOs, yes it has been a relatively small market for it, we don't have great share there. We see a lot of opportunity there. Comcast is going extremely well for us. I would highlight that.

And also, we see opportunities both in North America and internationally, actually, in the MSO space. We see that as a upside to us, and we're making good headway in that space.

Simon Leopold - *Raymond James & Associates - Analyst*

And what portion of sales are you getting from MSOs historically?

Gary Smith - *Ciena Corporation - President & CEO*

We haven't pulled that out as a percentage, Simon, but it's fair to say that it's been relatively small, certainly less than 10%.

Jim Moylan - *Ciena Corporation - CFO*

The thing about the 30% that we've disclosed is -- 30% or so which is nontelco, the components of that are MSOs, the enterprise and the domain 2.0, as well as the government. It's -- they're all combined in there, so not one of them is 20% of our revenue or anything like that.

Gregg Lampf - *Ciena Corporation - VP of IR*

And we have time for one more quick question.

Operator

Alex Henderson, Needham & Company

Alex Henderson - *Needham & Company - Analyst*

Wow, sneaking in after the bell (laughter). I'm really pleased to get another question in, but given we're after 9:30, I'll make it really quick. Just broadly speaking, if I take the AT&T announcement and the upfront concessions, does that increase your expectation for revenue and profit in 2015 and 2016 fiscal years? Is it a net substantial positive to the longer term outlook?

Jim Moylan - *Ciena Corporation - CFO*

I would say for the longer term, it is a positive. As far as 2015, we're just developing our thoughts about 2015.

I'd just reiterate that we're going to show leverage, operating leverage. That's our goal as we move into our plan. And even if we don't show margin progress beyond the low to mid 40%s, we will drive it through OpEx being -- growing more slowly than revenue grows.

Alex Henderson - *Needham & Company - Analyst*

Let me restate that, just to make sure we hear the question clearly. Is the deal that you did with AT&T specifically net positive for 2015 and 2016? I'm not asking for your forecast for the full year, I'm just asking, is that an incremental positive to your revenue and earnings outlook for the out -- for that -- for those two out years?

Gary Smith - *Ciena Corporation - President & CEO*

I think if you expand the two years together, the answer to your question is yes.

Alex Henderson - *Needham & Company - Analyst*

Thank you.

Gregg Lampf - *Ciena Corporation - VP of IR*

We do have to end this conversation. We appreciate everybody attending this morning. We look forward to reaching out and connecting with everyone over the next few weeks. Thanks very much, everyone. Have a good morning.

Operator

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