Ciena Corporation

Preliminary Fiscal Q1 2022 Financial Results Conference Call

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Paul Silverstein, *Cowen and Company*

Tim Long, *Barclays*

Meta Marshall, *Morgan Stanley*

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Fahad Najam, *Loop Capital*

Samik Chatterjee, *JPMorgan*

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Jim Silva, *Citigroup*

PRESENTATION

Operator

At this time, I would like to welcome everyone to the Ciena Corporation Preliminary Fiscal Q1 2022 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.

It's now my pleasure to turn today's call over to Mr. Greg Lampf, Vice President of Investor Relations. Sir, please go ahead.

Greg Lampf

Thank you, Brent, and thank you, everyone, for your attention today regarding the announcement of our preliminary financial results for our fiscal first quarter ended January 29, 2022.

Our call today is scheduled for 45 minutes.

On the call is Gary Smith, President and CEO, Jim Moylan, CFO, and Scott McFeely, Senior Vice President of Global Products and Services.

We are providing this update in the spirit of transparency, sharing what we know today about our expected financial performance for the quarter. In addition to this morning's press release, we felt it would benefit investors to provide additional context for our expected financial results for Q1 and to describe in greater detail the specific reasons and contributing dynamics for today's announcement.

Today's discussion includes certain adjusted or non-GAAP measures of Ciena's results of operations. A reconciliation of these non-GAAP measures to our GAAP results is included in today's press release.

Before turning the call over to Gay, I'll remind you that during this call we'll be making certain forward-looking statements. Such statements, including in our expected quarterly results, annual guidance and long-term financial targets, discussion of market opportunities and strategy, and commentary about the impact of COVID-19 and supply constraints, are based on current expectations, forecasts and assumptions regarding the Company and its markets, which include risks and uncertainties that could cause actual results to differ materially from the statements discussed today. These statements should be viewed in the context of the risk factors detailed in our most recent 10-K filing and in our upcoming 10-Q filing, which is required to be filed with the SEC by March 10. 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.

We will open today's call to Q&A, focusing on the specific topics raised in our prepared remarks. Consistent with that, please also note that given the preliminary nature of today's announcement, we may not be able to fully address your questions today. On March 7, we look forward to discussing our complete Q1 results in more detail, including our GAAP results and a detailed reconciliation to those non-GAAP measures, as well as our outlook for the fiscal second quarter.

We're also planning to hold investor meetings at OFC on March 8 and 9. As in the past, we have reached out to the sell-side community for scheduling them. We look forward to seeing many of you there.

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

Gary Smith

Thanks, Greg, and good morning, everyone.

As you've seen from this morning's press release, we have announced preliminary financial results for fiscal Q1, as follows:

- Quarterly revenue in the range of $840 million to $850 million. Whilst this range reflects roughly 12% year-over-year growth at the midpoint, it is lower than our previous expectation of $870 million to $910 million.

- Adjusted gross margin for Q1 of 45% to 46% is at the high end of our previous guidance range.

- Adjusted operating expense of approximately $290 million is in line with our previous guidance.

With respect to our Q1 revenue, we experienced two specific types of disruptions in the supply chain in the quarter. These occurred late in the quarter and served to exacerbate an already challenging macro-supply situation. The first type of disruption included later than expected delivery of certain key components from a few suppliers and the second type involved some third-party manufacturing disruptions that took capacity offline for a period of time.

Ordinarily, we would have had the capability to successfully navigate through these challenges. However, as noted, these events manifested in the second half of the quarter, beginning, roughly, in late December and continued into January, and they occurred against the backdrop of a challenged logistics environment that was worsened by the Omicron surge in our Q1, which further constrained production and logistics due to workforce shortages. As a result, we simply did not have the typical flexibility to fully mitigate these additional disruptions in the quarter.

In considering the impact of these dynamics, I think it's important to place them in proper context. We believe it is unlikely that the same set of circumstances that occurred in our Q1, and the specific timing of them within the quarter, will occur in future quarters in the same manner and with the same results. Indeed, we already started to see the impact of these disruptions improve as we exited the quarter. Additionally, investments we've been making in supply chain capacity will provide us greater flexibility for the remainder of the year.

Importantly, these specific circumstances certainly do not reflect a shift in overall network demand dynamics, which remain extremely strong. To that end, I want to speak in more detail about the demand environment, including some metrics about our quarterly order flow and backlog, that we typically do not provide. I will also review some of the proactive steps we've taken with respect to supply that give us confidence about Fiscal 2022.

Firstly, we continue to experience truly unprecedented levels of demand for our products and services, including extraordinary orders growth across key customer verticals and geographies. This growth is underpinned by an acceleration, overall, of cloud adoption and traffic growth, as well as some demand capture and security of supply activity. With our fourth consecutive quarter of orders outpacing revenue, we are clearly benefiting from significant momentum from what is undeniably positive long-term secular demand. As a proof point to this, our book-to-bill ratio in Q1 was in excess of 2.5 of our quarterly revenue. This ultimately resulted in significant backlog growth to more than $3 billion exiting the quarter, providing exceptional visibility for the full fiscal year as we now exit Q1.

Against the backdrop of that strong demand environment, the overall supply chain environment continues to be challenging, as we all know. As we sit here today, we are not assuming any significant improvement in component lead times through the remainder of the year.

With that in mind, and roughly nine months to go, we began to make considerable investments in the growth of our business. Specifically, we increased our component purchases, inventory levels and manufacturing capability, to establish sufficient capacity to support this increasing demand in the face of continuing extended lead times. We expect the majority of this increase in capacity to materialize in the second half of our fiscal year, positioning us for a stronger than typical second half, which you may recall is what we also delivered last year. As a result, we have greater visibility in supply and capacity coming online, which will facilitate more flexibility than we had in Q1. In summary, we have built a much larger ship going forward.

Overall, we are incredibly encouraged by the combination of a very positive demand environment aligned with an increasing supply chain capacity and increased visibility into the remainder of the year, based on our order flow and backlog. Together, they give us even greater confidence in our ability to achieve our Fiscal 2022 financial objectives and grow market share. Accordingly, we continue to expect our annual revenue guidance of 11% to 13% for FY'22.

We obviously remain very enthusiastic about our opportunities to address increasing bandwidth needs, the shift to the cloud and the focus on edge applications, as well as digital transformation and the growing need for network automation.

I also want to take this opportunity to thank the entire Ciena team for remaining focused and dedicated to our strong execution. The shared commitment to managing through supply chain challenges and supporting our customers is remarkable.

With that, we'll now take questions related to today's announcements.

Operator

Your first question comes from the line of Simon Leopold with Raymond James. Your line is open.

Simon Leopold

Great. Thank you for taking the question. I appreciate you guys doing the call today.

So, thinking about what we've heard from some of your suppliers, we knew that optical switching devices were constrained as far back as September, but it sounds like what was incremental, from a component perspective, was related to transmission products. I just want to understand if that's what you experienced, particularly in this quarter.

The second thing I wanted to see if you could address is—you've alluded to implementing some price increases. I wonder if you could give us an update on where you stand on that effort and if that's a factor that may be stimulating your customers to place orders before price increases. Thank you.

Scott McFeely

Thanks, Simon. It's Scott. Good morning, thanks for joining. Let me take the first one and then I'll ask Gary, maybe, to address the pricing one.

On the supply side, Simon, the components we're talking about, I would classify as being in the category of semiconductors, ICs and memory devices, all of which would be sort of commercial, low-value parts, "jellybean" parts, that have a pretty broad applicability across our portfolio. Those arrived late. They were intended to arrive in late December, they were pushed by a couple weeks. The quantity of components that was scheduled to arrived did arrive. They were just too late to turn into finished goods in the quarter.

Gary Smith

Simon, on the pricing, I would describe it as ongoing. Discussions are going well. In terms of order stimulation, yes, I think there's probably some. I don't think that's particularly material. Given the size and scale of the order flow in Q1, I don't think that's a really material factor. I don't think these discussions will have any material impact, really, on our financial performance, certainly in this year.

Simon Leopold

Thank you.

Gary Smith

Thank you, Simon.

Operator

Your next question comes from the line of Paul Silverstein with Cowen. Your line is open.

Paul Silverstein

Thanks. Gary, I heard the numbers and the comments there, but I have to ask, was there any demand weakness whatsoever in any aspect of the business? I recognize the backlog and order book was just not in separately. What was the manufacturing issue and was that fully resolved? In Scott's comments, are you indicating that that component issue, the components were delivered, but they have been delivered, and that's been fully resolved? Thanks.

Gary Smith

Let me take the first part of that, Paul, and Scott can address the second question.

On the demand side, no, I think that we didn't see weakness anywhere, and I'm thinking sort of geos, applications, product sets. It's really across the board, you know, very strong demand, and I think it's a confluence of elements, for sure. There's some catch-up in there. There's some security of supply. Visibility, some players are giving us full visibility for the year. But, I think, as well, this is sort of underpinned by an increase in cloud adoption both at the consumer level and at the enterprise level in the multi-cloud. I think we're seeing a sort of step-function up in demand across the board, so I don't think there's any areas that I would think about of as sort of weakness. It's very general and across the board.

Jim Moylan

Yes, and the one thing I'd say, Paul, is the single largest contributor to the quarter itself was the fact that a lot of our customers gave us visibility into their full year of demand, and they did that, specifically, because they wanted us to work on our supply chain to get it ready for this demand. But, generally speaking, we now expect the full year to be higher in terms of orders than we did coming into the year. It doesn't affect our view on revenue, because we still have to deliver all that, but we do expect higher orders this year than we thought we would have at the beginning of the year.

Scott McFeely

Paul, on your supply chain-related questions, on the components, themselves, yes, they have all been delivered, and they were delivered in-quarter, just too late in the quarter. On the production disruptions, they added up to several days of production capacity, not exclusively, but partially related to Omicron staffing shortages. Really, in normal times, I would have said we could have mitigated either of those, and possibly both of those. The fact that it happened late in the quarter and we were swimming into an environment, both on the production and logistics side, that was hampered by Omicron, itself, just made it a too difficult task to recover in the quarter.

Paul Silverstein

Got it.

Greg Lampf

Thank you, Paul

Paul Silverstein

Thank you. Thanks.

Scott McFeely

By the way, both those supply component-related items and the production-related items are in the rearview mirror.

Paul Silverstein

Thank you.

Greg Lampf

Thanks, Paul.

Operator

Your next question is from the line of Tim Long with Barclays. Your line is open.

Tim Long

Thank you. Yes, two quick ones, if I can.

First, on the gross margin side, maybe, Jim, you know, narrowed that at the higher end, could you go into a little more detail why that's happening and is there anything to read into future quarters from that?

Then, second, just following up on, Jim, you comment about orders this year being better than what you thought a few months ago—obviously, the backlog number is huge here—maybe, Gary, talk a little bit about kind of the next few-year view. I'm assuming the overall view has to be more positive if you start looking into Fiscal '23 and '24. I know you don't want to go out that far, but maybe just at a high level what you think of kind of industry market growth and your position in that as you look out a little bit further.

Thank you.

Jim Moylan

Yes, Tim, we'll go into all the detail about our gross margin when we do our call on March 7. I can say that we had a good mix of software and services in these results, and you know mix is always very important to our gross margin. Our expectation for gross margin for the year still is based on a 43% to 46% range. That's our view.

Gary Smith

On the—again, a similar kind of answer. Obviously, today, we wanted to address sort of the specific issues and we're still sort of early into the quarter, so talking about the '23 and '24 is probably a little premature for us, but I think what we're seeing overall, as you sort of step back from it, we've had kind of two years of not strong growth in the industry, overall, and I think what you're seeing now is an increased adoption on cloud, both at the consumer and enterprise level, you know, the whole multi-cloud phenomenon, which really is all about getting higher capacity and bandwidth closer to the customer. That's really what all of that is. Whether it manifests in 5G, in fiber speeds to the home, it's all really about getting greater capacity close to the customer. I think we're in for a period of very strong sort of secular demand over the next, probably, couple of years, so feel very good about that.

In terms of our order flow, Jim talked to some of the reasons for that, but it's great to get that visibility, but if you look at the midpoint of our guide here, it's 12% growth, which means it's pretty healthy from an industry point of view. It also means that we're going to be taking share again this year. Even with the Q1 that we had, which was disappointing to us, and a little frustrating given the issues that we faced, we still grew 12% year-on-year, as well, so I think we feel very good around the future of the space.

Tim Long

Okay, thank you.

Gary Smith

Thanks, Tim.

Operator

Your next question is from Meta Marshall with Morgan Stanley. Your line is open.

Meta Marshall

Great, thanks. I just wanted to see, from a customer standpoint—I would assume that they were having their own labor kind of shortages during the quarter, and so just whether this has delayed, you know, your pause and ability to get them as much supply as they needed, probably combined with their own labor shortages, whether it just pushed back kind of their implementation plans, or have there been any more meaningful changes to, you know, "We're not going to do this implementation, we'll just do it six, nine months from now." I'm just trying to get a sense of has timing just been pushed back or have there been any notable delays from any customers on any projects. Thanks.

Gary Smith

Meta, I just want to be really clear. The completely opposite of that is what we're seeing. We're seeing customers wanting equipment more and more and more. There is absolutely no customer delays at all. This was all about our ability to supply them. Customers would take—if we could have greater capacity now, they would take more. That really is the dynamic. There's nothing around customer adoption or projects that's been delayed.

Jim Moylan

Meta, when we mentioned the logistics, it wasn't on the customer side. That was our ability to mitigate the lateness in the quarter. Typically, we would have put on more air flights, etc. This just wasn't available to us due to staffing shortages. That's what we were referring to.

Meta Marshall

Got it. No, the comment was just to say that I think everybody had staffing shortages for installation in kind of this last quarter period, and so just seeing if that kind of trickled through to customers, but it sounds like it didn't. Thank you.

Gay Smith

Thank you, Meta.

Operator

Your next question is from the line of Rod Hall with Goldman Sachs. Your line is open.

Rod Hall

Yes, hi, guys. Thanks for the question. I had a couple backlog questions for you.

The first one is, backlog growth, I think you called out backlog of $2.2 billion last quarter, and now it's $3 billion, so let me get this straight. You just added about a quarter's worth of revenue to backlog, the $800 million, and I wanted to see whether you expect that backlog to work its way down by the end of this calendar year, or are you expecting it to be roughly this level. I'm just kind of curious what the flow of that backlog through the next few quarters looks like to you.

Jim Moylan

Yes, thanks, Rod. It is true, our backlog is actually pretty much in excess of $3 billion, so we added more than a quarter's worth of revenue to our backlog, but remember that this is, in large part, because customers want to give us visibility into their demand, and we're seeing the duration of our backlog extended, as compared to previous periods. In previous periods, a large proportion of our backlog would be drained in the next quarter. That's not happening now, because people are giving us visibility into the longer term orders.

As far as we go through this year, I think it's going to depend upon how customers view the supply chain situation, is it still as constrained as it has been over the past six months or so. If that's the case, then, yes, I think we will exit this year with a pretty significant backlog, higher than we've seen in the past, but we'll just have to see how that goes.

Rod Hall

I guess, Jim, would you expect that to be a lower number than it is now? Some companies just told us that they expect their backlog to basically be unchanged from current levels as they exit the calendar year, and I don't know if you guys think the same, or do you (inaudible).

Jim Moylan

I think it'll totally depend upon customer behavior, Rod. Yes, as we go through this year, if customers are still concerned about the supply chain situation and want to give us visibility into next year's demand, then we could see a flurry of orders in Q4 higher than we've seen in previous Q4s. So, I think it depends upon their behavior, totally.

Rod Hall

Okay, great. Thank you, Jim, appreciate it.

Greg Lampf

Thanks, Rod.

Operator

Your next question comes from the line of Fahad Najam with Loop Capital. Your line is open.

Fahad Najam

Good morning. I had two questions.

One, Gary, if I heard you correctly, it seems like most of your challenges that you had in the first quarter have been addressed and it's likely that in Q2 you're going to recover most of that shortfall, and if I'm hearing your comments about the second half being stronger, consistent with last year, it sounds to me that you are actually, maybe, being more strict (phon) in your revenue outlook than 90 days ago. So, that's one, if you can help me understand that dynamic.

Two, for Jim, the question on backlog, can you just give us maybe some color on the duration? Because, obviously, backlog and duration are two factors that we need to understand. So, how far out of a duration visibility do you have? Do you have full year, you're going to have type of visibility? Can you just give us some more clarity there?

Gary Smith

Let me take the first part of that, Fahad. Yes, the issues that we had in Q1 were mitigated and, as Scott said, they actually were resolved before we got out of the quarter, but the timing was such that we couldn't take revenue on them.

So, yes, we got a much stronger order flow than we'd anticipated, but, as Jim said, a lot of that dynamic is customers giving us visibility for the year. We've built a much bigger ship, that comes online as we get into the second half, from both the components and a manufacturing capacity perspective. But, you think about what we've got to do in the second half to get to that 11% to 13%, that's also the big, you know, strong performance in the second half. Obviously, we've got great demand visibility for it and we think we've got the capability, both from a components supply and a manufacturing and logistics capacity, to deliver on that, and that's really, I think, blended into our forecast and guidance for the year at 11% to 13%. I certainly wouldn't change the outlook on that right now. I just think we've got greater confidence. Given the fact that we've got this demand visibility, which is quite extraordinary, I would describe it as greater confidence, and we're certainly—in the numbers that we're talking about here.

Jim, do you want to talk about the backlog?

Jim Moylan

Yes, on the backlog, a relatively small piece of our backlog is as a result of getting multi-year maintenance orders from some customers, that's a few hundred million dollars, and the rest of it are products and services and software with specific delivery dates, and in this case just about—well, almost all of the rest of our backlog specifies delivery dates in this fiscal year. There is some that extend into next year, but most of it is in this year. So, we have sort of total visibility into our demand for the year. It gives us great confidence. But, as Gary said, we still have to deliver these orders and the supply chain remains constrained. So, that's what I'd say.

Greg Lampf

Thanks, Fahad.

Fahad Najam

Gary, if I can just follow up on your response. Assuming that you made up for all of your lost revenue from 1Q into the second quarter, but then the second half outlook is just purely a function of how much capacity you can add and how quickly you can add that, and that's probably going to drive upside, I just want to make sure I understand the dynamic.

Gary Smith

Yes, I wouldn't necessarily translate all of the revenue into Q2. We'll give guide—obviously, we'll give guidance on that when we do our proper call. We just wanted to come out today and describe the issues in Q1, and we're very confident about the full year, but in terms of—I think the thing I would caution on is, we've built a much bigger ship in the second half, but we don't expect the actual delivery times of components to specifically improve in the second half. We've built a ship to deliver that 11% to 13% growth and to be able to withstand any of the normal challenges you get quarter to quarter, and give us some flexibility around that, so I think it's way too early to effect those numbers yet.

Fahad Najam

I appreciate the answers, thank you.

Gary Smith

Thanks, Fahad.

Greg Lampf

We'll take the next question, thanks.

Operator

Your next question comes from the line of Samik Chatterjee with JPMorgan. Your line is open.

Samik Chatterjee

Hey, thanks for taking my question. I have a quick one. I know you mentioned you started doing some work in securing supply and sort of longer (inaudible) commitments starting last year itself, that you expect to bear fruit in the second half. Just given the disruption that you had (inaudible), are you now taking a different approach to these components? Does that increase the cost of doing business or has an impact on gross margin longer term as we think about it, and is there then a need to sort of price that incrementally with your customers, if you can help me think through that. Thank you.

Gary Smith

I'd say the answer to that is no. What's happened is that—and it's happened over the last six months—is that lead times have extended and we've seen price increases, but all that was factored into our guide that we gave for the year. We're not seeing incremental price increases from here. So, no, we don't expect any different gross margin this year than we indicated earlier, which is 43% to 46%.

Samik Chatterjee

Thank you.

Greg Lampf

Thanks, Samik.

Operator

Your next question comes from the line of Tim Savageaux with Northland Capital Markets. Your line is open.

Tim Savageaux

Hi, there, good morning, a couple questions.

You had mentioned a couple times now that the primary factor in driving the order strength and the backlog increase was kind of this customers getting in line a bit early. I wonder if I could as you to be a little more specific about that. Is that three-quarters of what you saw in terms of demand growth? It sounds like it's the majority.

The follow-up would be any difference in customer behavior across segments; specifically, are you seeing similar type of behavior from your cloud and carrier customers?

Gary Smith

Tim, I would say that, as Jim said, I think a large portion of the stuff in Q1 was visibility for the year, but it is a little bit difficult to parse it out, to be honest. You've got sort of all this catch-up, where a lot of carriers have run their networks very hot for the last 18 months or so, and you've got catch-up on both capacity. You've also got catch-up on network modernization. Many of the wins that we've had 18 months ago are now beginning to flow through as orders. Then, you've also got this dynamic around security of supply, I would say, particularly amongst the North American carriers, where they're looking to secure supply chain, so you've definitely got that. Underpinning sort of all of that, then you've also got this step-function, I think, in traffic growth, as well, from the expectation that folks had, really, by the adoption of the cloud and its various forms. So, you've got all of those three elements in the pot of the order flow. It's difficult to really parse all of that out and put sort of clear percentages on it.

Having said that, I would say that Q1, we saw some very specific large carriers, analysts, so the webscale folks looking to secure supply for the year, we absolutely did see that, and you're obviously seeing all of the other demand characteristics around 5G now beginning to be a reality and building that out. You're seeing an increase, again, from all of the webscale folks globally in terms of their data center buildouts. I think the secular demand dynamics around all of this, I think is very, very positive.

Jim Moylan

I think it is also a very strong event, that our expectations for orders for this year is higher. Even with this pull-forward of orders on the part of certain customers, our expectation for orders is higher than it was at the beginning of the year.

Tim Savageaux

Jim, if I could squeeze a follow-up in on that. To the extent that order expectation is higher, can you point to any particular customer segments or developments that are driving that?

Jim Moylan

Broadly based, it's broadly based.

Tim Savageaux

Okay, thanks.

Jim Moylan

Customer types and verticals, geographies, it's very broadly based.

Operator

Your next question comes from the line of Jim Silva with Citigroup. Your line is open.

Jim Silva

Thank you. I just have one question. While you talked about the supply chain and kind of the push-out to those orders, the bigger question I have is I'm still trying to grasp the impact to margins in the future. If customers are giving you longer visibility and longer lead times, and bookings and more visibility, are they locking in today's pricing or is there some of type of indexing that is, because I assume that your suppliers and shipping costs and raw materials are all going higher, so is that going to be a margin headwind as we look further in the year. As you mentioned, the sales growth is an impact, but I'm more interested in the margin impact. Thank you.

Jim Moylan

Yes, on the cost side of that, Jim, we've been dealing with increased component costs and increased logistics costs for a period of time, and that's been factored into our guidance range for 2022. I'm not seeing an improvement and I'm not seeing a deterioration of those.

Jim Silva

Great, thanks so much for the clarification, and we appreciate the call today.

Gary Smith

Thank you, Jim.

Operator

There are no further questions at this time. I will now turn the call back over to Mr. Greg Lampf.

Greg Lampf

Thank you, and thanks again, everyone, for joining us on short notice. We look forward to speaking with you again on March 7, and after a long period of time and not seeing people in person, we're also looking forward to seeing you at OFC on March 8 and 9. Thank you, and have a good day.

Operator

Ladies and gentlemen, thank you for your participation. This concludes today's conference call. You may now disconnect.