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Ciena Corp. (CIEN)

Q4 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by, and welcome to the Ciena Q4 2020 Earnings Event. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions]

I would now like to hand the conference over to your speaker today, Gregg Lampf, Vice President, Investor Relations. Thank you. Please go ahead, sir.

Gregg M. Lampf

Vice President-Investor Relations, Ciena Corp.

Thank you. Good morning and welcome to Ciena's 2020 fiscal fourth quarter and year-end review. On the call today is Gary Smith, President and CEO; and Jim Moylan, CFO. Scott McFeely, our Senior Vice President of Global Products and Services is also with us for Q&A.

In addition to this call and the press release, we have posted to the Investors section of our website an accompanying investor presentation that reflects this discussion as well as certain highlighted items from the quarter and fiscal year. Our comments today speak to our recent performance, our view on current market dynamics and drivers for our business as well as the discussion of our financial outlook.

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

Before turning the call over to Gary, I'll remind you that during this call, we'll be making certain forward-looking statements. Such statements including our quarterly and annual guidance and commentary about our long-term financial targets 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-Q filing and then our upcoming 10-K filing. Our 10-K is required to be filed with the SEC by December 30, 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.

As always, we will allow for as much Q&A as possible today, though we ask that you limit yourselves to one question and one follow-up.

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

Gary B. Smith

President, Chief Executive Officer & Director, Ciena Corp.

Thanks, Gregg, and good morning, everyone. Our fourth quarter and fiscal year 2020 results really illustrate the extent of our market leadership and resiliency amongst the challenging market conditions we detailed last quarter, which are largely unchanged. And that is namely the combination of a slowing of business velocity and increased risk aversion amongst many global service providers is adversely impacting the short-term deployments of new architectures and network builds.

Despite this dynamic, today's results reflect the strength and durability of our business model, including continued strong profitability with adjusted operating margin of 15.8% in Q4 and 17.6% for the full fiscal year, which exceeded our forecast.

We also delivered strong free cash flow with our cash balance up $130 million from last quarter to approximately $1.3 billion. Simply put, we remain in the best financial position in the industry and we are extremely confident about our leadership position in the market.

We could not deliver this performance without the entire Ciena team which continues to persevere and perform at the highest levels. The Ciena family remains focused and dedicated even when facing new challenges associated with remote working and other COVID-19-related conditions.

I'm pleased that many have taken advantage of a wide range of new well-being programs, benefits and resources to support them and their families at this time. I'm also extremely proud of the way they are giving back to our communities throughout the globe, through their services and donations as a part of our Ciena Cares philanthropy program.

As you probably read, we're also collaborating with customers and partners through our digital inclusion commitment on innovative programs that help address the digital divide and promote broader opportunities, particularly for underserved students.

Turning to highlights from the fourth quarter and fiscal year. In our core business, we continue to see tremendous momentum for WaveLogic 5 Extreme. Through the end of Q4, we had orders from 65 customers around the world. And supported by our extraordinary supply chain, we're approaching 5,000 units shipped since general availability.

Looking ahead, our WaveLogic 5 Nano program remains on track. So, not only will we be ready to intercept the opportunity for pluggables when market adoption begins sometime in the second half of 2021, we will benefit from the advantage of integrating WaveLogic 5 Nano into our systems as well.

Our Packet Networking business had a solid year from an innovation perspective. However, revenue in this segment was impacted in largely by pandemic-related customer concerns around enterprise business, particularly SMB and some carrier managed services.

But as demand increases for services, applications and content at the network edge, the opportunities for this portfolio remain very strong, including advancements in IP optical convergence, virtualization, 5G and Edge Cloud. In fact, during the full fiscal year, we secured a number of awards for this portfolio including seven deployments of our new Adaptive IP solution, and we expect to monetize these wins as we move through fiscal 2021.

Within our Global Services segment, our network transformation offering is becoming increasingly strategic to our customer engagements. And we were very recently selected by two Tier 1 service providers for legacy to next-generation network migration projects.

We also had a strong year within our Platform Software and Services business which benefited from increased adoption of MCP which is our new domain control software platform, and including customers transitioning from our legacy NMS software as well as an uptake of advanced applications that are deployed on top of our MCP platform.

The number of customers adopting MCP grew by more than 300% in 2020, including large carriers such as AT&T, Deutsche Telekom and other Tier 1 operators.

With respect to our Blue Planet software which is primarily focused on service layer management, enablement and delivery, we are seeing increased engagement with network operators who are looking for ways to drive digital transformation through automation.

And, in fact, Q4 was our best-ever quarter for this business, including record bookings. We also acquired 11 new logos for Blue Planet in Q4 alone, including our recently announced strategic partnership with DISH, as well as a major win with a global systems integrator.

As for the overall market, demand for connectivity continues and the adoption of cloud architectures has accelerated and network traffic continues to grow. And while the pandemic has driven a shift in traffic patterns, largely towards the edge and access points and corresponding customer spend and resources, customer engagement and RFP activity for our core business and Blue Planet continues to be robust.

In fact, we are winning more than our fair share of new business, including several significant new strategic design wins during this time. This competitive success gives us confidence that we will continue to take share despite near-term challenges to monetize these wins within the current climate.

So as we look ahead to 2021, we have a clear action plan to execute on our proven strategy, focused on innovation leadership, diversification and global scale. This enables us to manage well through current conditions, and it positions us to continue leading as the macro environment improves, which we expect to happen in the second half of 2021.

The strength of our business model also allows us to continue investing strategically in our portfolio and go-to-market capabilities, even in the face of uncertain short-term market conditions.

Specifically, we will strengthen our technology and market leadership during the course of the year in core networks, particularly in DCI, submarine and long-haul networks, which are obviously under constant pressure to keep pace with ever-growing bandwidth demand.

We will also make significant incremental investments to address opportunities and increase our addressable market in fast-growing next-generation metro and access networks, specifically around expanding our IP and automation capabilities. And we'll also capitalize on the momentum we are seeing with Blue Planet to guide customers on their digital transformation journeys. These investments, as always, are a deliberate strategy to extend our leadership position and enable us to continue to take share over the long-term.

With that, I'll turn over to Jim.

James E. Moylan

Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

Thanks, Gary. Hello, everyone. We delivered a solid Q4 performance, which was certainly impacted by the effects of the pandemic. Total revenue in the quarter was $829 million. Q4 adjusted gross margin was 49.5%.

In addition to a higher percentage of software sales in the quarter, Q4 adjusted gross margin again reflects a high degree of pandemic-related dynamics. Specifically, we continue to see a quarterly revenue mix that is comprised of a larger percentage of existing business versus new design wins and early-in-life projects which tend to generate lower margins.

Adjusted operating expense in the quarter was $279 million. This was higher than expected due to an acceleration of investments in certain aspects of our business, including in our people and IT infrastructure, which we expect to continue. Q4 OpEx also included higher-than-expected variable compensation tied in part to our strong profitability metrics in the quarter.

With respect to profitability measures, in Q4, we delivered adjusted operating margin of 15.8%, adjusted net income of $94 million, and adjusted EPS of $0.60 per share. In addition, in Q4, our adjusted EBITDA was $154 million; and cash from operations was $188 million.

With respect to performance for the full fiscal year, annual revenue was $3.53 billion. This reflects a strong contribution from non-telco customers of a record 40% of total revenue in fiscal year 2020, up from approximately 37.5% in fiscal year 2019; also includes solid performance with MSO customers, growth with two of our major webscale customers and a very strong year in government.

While we saw significant quarterly variability as we move through the year, including a challenging operating environment in the second half, orders slightly exceeded revenue for the full fiscal year. In fact, orders in APJ and EMEA, in aggregate, were up 9% year-over-year. Orders in subsea were also up 9% year-over-year.

Moving to profitability. Adjusted operating margin in fiscal 2020 was 17.6%, and adjusted EPS was $2.95. And finally, free cash flow for the year was $411 million, which represents 66% of adjusted operating income. As Gary mentioned, we ended the year with approximately $1.3 billion in cash and investments.

Our balance sheet remains a significant competitive differentiator, particularly in the current environment in which financial strength and resiliency are critical. Our strong balance sheet and cash flow generation also affords us the flexibility to continue investing in our business for the long-term while returning capital to shareholders.

And to the last point, we will be reinstituting our buyback program in the first quarter of 2021 and are currently targeting repurchases in the range of $150 million during fiscal 2021.

Turning now to guidance. Given the uncertainty stemming from the pandemic and the resulting market and industry dynamics that we've described, we are not in a position to provide specific three-year financial targets at this time. However, our long-term financial goals remain unchanged. We plan to deliver additional operating leverage while growing faster than the market, as we've proven our ability to do over the years.

Setting aside the temporary challenges driven by COVID today, we see no change in underlying secular demand for bandwidth and automation that drives our business. As a result, we believe that as the impact of the pandemic ameliorates, the market is likely to return to the growth in the low to mid-single digits range, as we've seen for so many years. We also believe that we will continue to take share.

I want to emphasize here that this market view is really unchanged from our outlook pre-COVID. As Gary mentioned, we will continue to invest strategically in the business, and we expect to grow our OpEx at a rate below that of revenue growth for the next three years in aggregate.

And a comment about gross margin. We've talked a lot about gross margin and the effects of – on gross margin of the revenue mix caused by the pandemic. We have also said that we believe that our current run rate margin, once our revenue returns to a more normal percentage of new business, is between 43% and 45%. Based on what we are seeing, we now believe that our current run rate margin has increased a bit to the mid-40s.

On the point of long-term guidance, as visibility improves, we will revisit issuing these long-term financial targets.

With respect to fiscal 2021, we are providing our typical level of annual guidance. However, it is important to consider the key assumptions that underlie our current outlook for the year. Specifically, our 2021 guidance is predicated on a discernible improvement to the current industry and economic conditions, including a more balanced prioritization by our service provider customers of new architectures and deployments that enables us to operationalize and monetize the design wins we have secured with several key accounts.

With that context and set of assumptions, we expect to grow our annual revenue at or slightly faster than market in a range of 0% to 3%, with a stronger-than-typical second half as conditions improve. We expect continued strong adjusted gross margin in fiscal 2021 for the full year.

Specifically, first half adjusted gross margin is likely to be in the mid-to-high 40s range, driven by our revenue mix tilted heavily toward existing business. As conditions improve and we begin to operationalize new wins, our second half adjusted gross margin will likely come down from those levels and return to the mid-40s range by the end of the year. We believe that our gross margin for the full fiscal year will be between 45% and 47%.

With respect to OpEx, we are deliberately maintaining our investments in certain aspects of our business across people, operations and product development to ensure that we strengthen our leadership position and emerge from the current environment with an even greater competitive advantage than we have today.

Accordingly, we expect adjusted operating expense to average between $270 million and $275 million per quarter in fiscal year 2021, although it will vary from quarter to quarter as it always does. We are making these investment decisions because of the strength and durability of our business and operating model, as well as our confidence in future secular growth in bandwidth and demand for our products. Finally, we expect adjusted operating margin in fiscal 2021 to be in a range of 15% to 16%.

Finally, for our fiscal first quarter 2021 performance, we expect to deliver revenue in a range of $735 million to $765 million, adjusted gross margin in the 47% to 49% range, adjusted operating expense of approximately $265 million to $270 million. And we expect our adjusted tax rate will be between 20% and 21%.

In closing, we are performing well, and we are very confident in the future. Fundamental demand drivers are strong, and we are winning new business as the market leader, positioning us for even greater performance. Overall conditions begin to improve in the second half of fiscal 2021. Importantly, we are demonstrating that our scale, focus and financial stability are competitive advantages that enable us to meet our customers' needs, deliver strong profitability and return capital to shareholders.

With that, operator, we'll now take questions from the sell-side analyst.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Your first question comes from Rod Hall of Goldman Sachs. Your line is open.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Yeah, hi. Good morning, guys. Thanks for the question. I wanted to start off, I guess, with the OpEx question, since that came in a little bit higher. And I know, Jim, you had commented on that. Could you maybe dive into a little bit more detail on why you're deciding to invest now, given it's such a tough environment? And then, where are you investing? What types of people you're hiring? What is it that you're focused on from an investment point of view?

And then secondly, I thought I would go back to the visibility. You're talking about H2 of next year being stronger than H1. What is it that gives you confidence in that? And why don't we start to see some recovery in Q2? I know people are beginning to talk about, for instance, the accelerated 5G investment by midyear. So, could you talk a little bit about what sort of visibility you have? Or is this just a general assumption that COVID starts to slow by the second half and the carriers begin to invest again? Thanks.

James E. Moylan
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

Thanks a lot. And I assume your OpEx question really has to do with 2021, you're good on the quarter.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Well, no, I was really asking about the quarter just reported, Jim, and that – a little bit higher than usual, and then you're talking about spending a little bit more, it sounds like in the short term, 2021 is more or less in line with our forecast. So, I don't – I'm actually there, it doesn't seem like you're – it seems like it's more of a short-term first couple of quarter phenomenon we're looking at here and some investment, but I'm just not clear on what it is you're investing in exactly.

James E. Moylan
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

Fair enough. Well, a couple of things. One is that we've come through this year in a situation in which all of our employees basically are working from home. And through the year, we have made investments in their well-being, comfort and computer connections, personal computer connections. And we accelerated that a bit in Q4. It's really mostly about making sure that our people can operate comfortably and productively in the home.

Also, the variable comp, that has to do with the fact that our profitability for the quarter came in a bit higher than we thought it was going to. And our – many of our people, including salespeople have an element of their variable comp that's tied to profitability. So, that was another piece that came in.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

So, Rod, on the...

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Thanks.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

On the second part of your question, what gives us confidence, I guess, in the uptick in the second half, I guess, it's a number of elements. First of all, I think what we're seeing is that right now service providers generally are very risk averse for any sort of new business, rolling out new network, new architecture. They're running the networks hotter, that's for sure. And they're also, I think, to some extent, focused on access points as opposed to the metro and the core, which is understandable.

Things that gives us confidence are the wins that we've already had, that we've been much slower to monetize. Obviously, it's not binary. We are rolling out some of those but at a much slower rate. And the assumption is that the COVID overhang ameliorates during the course of the first half. And then, this pipeline that we've built up of new business activity begins to kick in because the secular demand, as you say, for things like 5G and all the rest of it, it needs this network infrastructure to be successful. And it's sort of – I'd describe the environment right now as somewhat bifurcated from the new business wins and deployment definitely slower. But the actual activity of RFPs, planning engagements and the rest of it have continued unabated.

And as I said in my comments, we're winning more than our fair share of that as you'd expect, given our technology, leadership and scale. So, as best we can tell, our business is normally fiscally second half loaded. But I think it's going to be a more extreme hockey stick this time around as best we can tell. So, those are the underlying assumptions and engagements with the customers that give us some confidence that we're going to see this uptick in the second half and sort of normal services is resumed kind of thing.

James E. Moylan
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

The other thing I'd add to that, Rod, is that many of our – or much of our revenue in any given quarter results from orders taken in the quarter before that. And so, we do expect a pickup in orders in our Q2. It just won't evidence itself in the form of higher revenue, we don't believe until sort of Q3. That's our view.

Gregg M. Lampf
Vice President-Investor Relations, Ciena Corp.

A

Great. Thank you. Thanks, guys.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Thank you, guys. That's helpful.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Thanks, Rod.

Operator: Your next question comes from George Notter of Jefferies LLC. Your line is open.

George C. Notter
Analyst, Jefferies LLC

Q

Hi, guys. Thanks very much. I guess I wanted to stay on the discussion of OpEx. And so, if I look at your selling and marketing costs, they were quite a bit higher than they were, for example, in the July quarter. And your gross margins are incrementally higher than July, not tremendously higher. So, I guess, I'm wondering if it's just simply profitability that's driving the increased compensation expense or if there is something else in there that's driving that. I guess I'm getting at is I'm wondering what bookings look like in the October quarter. Obviously, I think you guys incentivize your salespeople based on bookings as well, but what's the narrative there? Thanks.

James E. Moylan
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

Our bookings came in close to what we expected, maybe a little bit better. But I'd say this, remember, George, that in the fourth quarter of every year is when people start hitting their accelerators, salespeople start hitting their accelerators. And that's really what drives the sales comp in Q4. We typically have higher sales comp in the fourth quarter as compared to other quarters as well. But it's just that the mechanics of the computation worked out that our sales comp was quite a bit higher in the quarter.

George C. Notter
Analyst, Jefferies LLC

Q

Got it. Okay. That's helpful. And then, just as, I guess, a follow-up on that. Did you guys have a backlog number or should we wait for the 10-K for that?

James E. Moylan
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

Backlog is just under $1.2 billion, $1.9 billion or something – I'm sorry...

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

$1.19 billion.

James E. Moylan
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

That's right.

George C. Notter
Analyst, Jefferies LLC

Q

Yes.

James E. Moylan
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

Okay.

George C. Notter
Analyst, Jefferies LLC

Q

Yeah, yeah. Perfect. Okay. Thanks, guys. Appreciate it.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Thanks, George.

Operator: Your next question comes from Simon Leopold of Raymond James. Your line is open.

Simon Leopold
Analyst, Raymond James & Associates, Inc.

Q

Thanks for taking the question. I wanted to see if maybe you could update us on your views of a long-debated topic around white box competition in the optical space. I know you've mentioned you plan on having your pluggable products out later this year. But just want to get a sense of what you're seeing there, particularly how it affects your thoughts on your web sale business in fiscal 2021? Thanks, and I've got a follow-up.

Scott A. McFeely
Senior Vice President-Global Products and Services, Ciena Corp.

A

Rod, it's Scott. The long-debated white box topic, yes. So, I'd put it this way, Rod, I don't see white boxes in the optical space as being a dominant deployment scenario for lots of reasons, primarily, which the economics just don't drive it like it has in some of the other segments of the marketplace. And having said that, there are places in the market that are pursuing that and our play there is a couple-fold. Number one is still an end-to-end system play even in that scenario because people have to deploy software in line systems and control this.

But also, the pluggable market, there are very few folks that I think are capable of delivering those high-performance pluggables and we're being one of them. So we would have exposure to that market as well. All of those dynamics, I'd say, are factored into our perspective of 2021. And by the way, I actually don't think it will be much of a dynamic in 2021 at all.

Simon Leopold
Analyst, Raymond James & Associates, Inc.

Q

Great. And just – sorry.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Sorry, Simon. Go ahead.

Simon Leopold
Analyst, Raymond James & Associates, Inc.

Q

The follow-up, hopefully, is pretty simple. Your top traditional North American operator customers, AT&T and Verizon, have been a bit softer. One topic I've heard debate on and I'd like your view is how their spending patterns with Ciena may or may not be related to spectrum auctions. And where I'm going with this is what will be the factors that lead them to come back to more normal spending patterns? Thanks.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

I think what you're seeing, if you look at the sort of the large Tier 1s, we order couple of the large Tier 1s in North America. We're very kind of front-end loaded in 2020. Some of that, I think, was also about supply chain provisioning and making sure that they've got that when COVID first happened. So to some extent, it's sort of normal ebbs and flows for that.

And our dialogue with them and engagement, as we get into 2021, I think you are going to see a stronger second half for some of those large carriers. And I don't think that's particularly affected by this whole sort of notion of the auction cost. I think what we're seeing is pretty steady visibility in terms of, now, we're engaged with these major carriers pretty much on all of their strategic platforms and across all of their business. And we see it pretty steady, but with a forecast for an uptick in the second half.

Simon Leopold
Analyst, Raymond James & Associates, Inc.

Q

Thank you.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Thanks, Simon.

Operator: Your next question comes from Meta Marshall of Morgan Stanley. Your line is open.

Meta A. Marshall
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thanks. You spoke to kind of conservatism around the planning around some of your customers. I just wanted to get a sense of whether you'd attempted to quantify maybe kind of international installation challenges or kind of slower lab testing just as kind of a drag right now as COVID specific drags?

And then, I know we kind of talked about last quarter that you still bought that open line systems or maybe a – we're not going to be a method of Huawei replacement and just kind of getting an update as far as what you're seeing as far as customers looking to kind of replace Huawei and what timelines that could be on? Thanks.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Okay, why don't I take the first part of that matter in terms of what we're seeing? From the initial impacts of COVID, it was really around just the velocity then of installation. That's largely being ameliorated with various protocols and stuff, stuff people can get to site, et cetera. But then what we saw was really a de-prioritization of new builds because they didn't want to risk messing around with the network at a time when you've got all this capacity going on it. So, really, I think they've made the decision to run it hotter for a little bit.

It's not completely binary. I mean we are deploying stuff. We are engaged in labs. We figured out ways of doing that. So that's why I said it sort of – it feels somewhat bifurcated. There's lots of planning going on and activity and RFP activity and awards, but it's just not being deployed very quickly. And we haven't really seen much of a change to that since last quarter really.

But you look at the – the demand continues to build, the engagement with them around new awards continues unabated. So that's pretty much the dynamic we've got. I mean, obviously, particularly in Europe, more recently, you're seeing more restrictions because of the COVID piece. That's not particularly impacting us somewhat perversely because we're not actually doing a lot of those new business deployments. So we're not seeing too much impact from that, if that answers your question.

Meta A. Marshall
Analyst, Morgan Stanley & Co. LLC

Q

Yeah. That's helpful.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Okay. Scott, do you want to take the line system?

Scott A. McFeely
Senior Vice President-Global Products and Services, Ciena Corp.

A

Yeah. I mean the open line system concept and an approach to actually take, I say, next generation optics technology and run it over a legacy system is not new. You want to think about it in its purest form when we got into the submarine business by doing exactly that, overlaying line systems. And we were doing that for a decade – close to a decade. So that's not new.

As it applies to Huawei, and our comments in the past I think were that's not necessarily the trigger. The trigger is twofold. Number one is just the list of actually moving operationally all those circuits that may be sitting on the Huawei network to touching the customers, touching the back-office system is a heavy lift for our customers and that will take time.

The other thing though is their prioritization around moving away from Huawei, a lot of press around the RAN network. And that is getting the priority that we see around the world as opposed to, I'll say, the core infrastructure – the core optical infrastructure with possible exception we are seeing some activity in India.

Meta A. Marshall
Analyst, Morgan Stanley & Co. LLC

Q

Got it. Appreciate it. Thanks, guys.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Thanks, Meta.

Operator: Your next question comes from Paul Silverstein of Cowen and Company. Your line is open.

Paul Silverstein
Analyst, Cowen and Company

Q

Thanks. Jim, can you comment on pricing environment? Are you seeing a change for better or worse? And can you, like, comment on what you're seeing from webscale customers, in particular any concerns about Amazon's project progress and impact from a longer-term standpoint?

James E. Moylan
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

That was more than one question, Paul. But I'd say that the pricing environment really is not meaningfully changed. We do have one company that's been a very significant price aggressor in the industry. It's a company that – it doesn't have an 800-gig product. And so, I think they're using price to try to maintain or gain market share in some cases.

So, I'd say, it really hasn't changed very much. But I think that at the margin, we have improved our gross margin slightly because of all the things that we're doing to take cost out of our systems.

And with respect to the webscale, we still think that their spin this year is a bit lower than we ended the year, its difficulty in getting data centers built and all that sort of thing. But by and large, we're doing well. We think, essentially, we retain share with them.

And with regard to specifics about any one customer, we just can't do that. But we do know that certain webscale customers are experimenting with some, I might say, grow-your-own technology. We think we've adequately captured that in our guidance for the year.

Paul Silverstein
Analyst, Cowen and Company

Q

I appreciate it.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Thanks. Thanks, Paul.

Operator: Your next question comes from John Marchetti of Stifel Nicolaus. Your line is open.

John Marchetti
Analyst, Stifel

Q

Thanks very much. Jim, in regards to your outlook for 2021 you talked about the second half being better. But I'm just curious if it – we've often seen the first quarter still be the trough of the business and then it moves up from there. And I'm wondering if at least that seasonal pattern you expect to hold true, as you're going through fiscal 2021.

James E. Moylan
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

The pattern is going to be the same as it has always been. Our first quarter has always been lighter, and then we've strengthened as we move through the year. Second half has typically been better than the first half. We expect that trend to be the same. However, because we will have meaningfully lower first half, then maybe our trend line has been the difference between the first and second half will be more exaggerated this year.

In fact, if you just do the numbers, John, and I'm sure you have, it's pretty obvious. Our second half is quite a bit higher than our first half.

John Marchetti
Analyst, Stifel

Q

Right. And then, maybe just on a different topic, Gary. As you're looking at a lot of the interest or the activity around the new WaveLogic chipset, for the service providers, how much of that is through 800-gig focused versus improving performance of 400 and maybe even 100-gig or 200-gig systems in terms of increasing the distance in their efficiencies and whatnot? I'm just curious, how we think about that dynamic playing out, as we're looking more into the second half of next year, maybe even into 2022.

Scott A. McFeely
Senior Vice President-Global Products and Services, Ciena Corp.

A

Hi, John. We've talked about this before. We use 800-gig as an easy handle for basically twice the performance of the previous generation, and that performance we use in various different applications.

And actually, it's quite difficult for us to even keep track of how much of that is going to be dialed up at 800-gig versus 750-gig versus 700-gig, et cetera, because you can set the dial to wherever you need it to be to get the maximum price per bit performance. That's one of the value propositions around the technology.

I will say this and this may help sort of as a surrogate to it. Up until now, about two thirds of the volume that Gary talks about has been on a 6500 platform, one-third on Waveserver, that may give you some idea of the split between service providers and webscales, not perfect but that's an indicator.

John Marchetti
Analyst, Stifel

Q

Thanks very much.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Thanks, John.

Operator: Your next question comes from Alex Henderson of Needham. Your line is open.

Alex Henderson
Analyst, Needham & Co. LLC

Q

Thank you very much. I was hoping you could focus a little bit on the India market and talk a little bit about what you're seeing there in terms of their reopening, the implications of the China – the Chinese vendors all being banned. My estimate that that's about somewhere between 30% to 35% market share opportunity in that geography and you guys are the number two player. If you split Huawei, ZTE, and FiberHome, and to what – how long do you think it will take for that to open up?

And then, I know one of the vendors, one of the service providers there has the vast majority of their network on that, how do they approach or how do you think they'll approach the replacement process? And any timelines for those decisions and implications hitting your P&L would be extremely helpful. Thank you.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Okay. So, Alex, yeah, the India market has been, obviously, very challenging in the last sort of 18 months or so, initially from just the economic issues there and some of this issue around the taxation of the service providers, et cetera.

And they'd also done large builds in the previous couple of years, so it definitely was a lull and then the impact of COVID I think has been disproportionately affected on there, they're rolling out the new network, so it's been a very down market for the last sort of couple of years. Though, as you say, there's still – the activity is continued around new architectures and build-outs, because it's still got a long way to go.

I think specifically as it relates to Huawei, I mean what we're seeing in India is, if you compare and contrast it to EMEA, Europe, India have moved much faster, I think, to really mitigate their exposure to Huawei which is about, as you say, roughly about 25% to 30% of the total infrastructure is with Huawei.

Now, it's like anything, it takes time because you've got back-office system, et cetera, but they seem to be approaching this more aggressively than the European carriers. I think that's for sure. Unclear exactly how that'll play out, Alex, but we've seen a couple of opportunities on the packet side that we've won, that won't get deployed until the second half of this year, but we are beginning to see that movement and we do see that as a tailwind for us.

Particularly, if we think that the effects of COVID ameliorate little in the first half and then the India market begins to move again. And then, there's really sort of two to three carriers there. And as you say, the third carrier is very dependent on Huawei, and they're all making plans to migrate away from that, always takes longer than you think. But we're actually quite bullish around the Indian market as we move forward into the second half of 2021 and into 2022.

Alex Henderson
Analyst, Needham & Co. LLC

Q

Thank you. And just going back to the point, it's obviously a very large decision process for some of these vendors.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Yeah.

Alex Henderson
Analyst, Needham & Co. LLC

Q

Can you give us any sense of when you think that wholesale network deployment decisions might be made in that geography? I mean, taking that one example of one customer with, what, 80% of their net worth, or something of that sort on Huawei, obviously, that's a huge decision. And then, the other piece of that is you have seen Jio raised some $20 billion. What do you think the impact of that is? Thanks, and I'll give the floor.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

I think, we ought to be clear, we've already seen some of that movement. We've won some of that business, we have not deployed it yet, but we've seen some of that migration away from Huawei in India, more aggressively than we've seen it in Europe. And even during the course of the last couple of quarters, we've won business, specifically around the Huawei replacement. Now, always takes longer than you think and you asked me for a timeline, it's one to three years before you really play that through, but it's moving, and decisions are being made now by all of these carriers around mitigating their exposure to Huawei. Some have more exposure than others, but those decisions are being made, and we are winning more than our fair share of that business.

Alex Henderson
Analyst, Needham & Co. LLC

Q

Thank you.

Gregg M. Lampf
Vice President-Investor Relations, Ciena Corp.

A

Thanks, Alex.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Thanks, Alex.

Operator: Your next question comes from Amit Daryanani of Evercore ISI. Your line is open.

Amit Daryanani
Analyst, Evercore Group LLC

Q

Thanks for taking my questions. I guess, the first one, could you just maybe touch on how should we think about the webscale growth in fiscal 2021 versus expectation? I think overall it's 0% to 3% growth. And then, very specifically within that segment, I think lastly you talked about a new customer win in the webscale side, how is that ramping up and any way to dimensionalize how bad revenue stream could look like in 2021?

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Yeah. Let me...

Gregg M. Lampf
Vice President-Investor Relations, Ciena Corp.

A

Gary? We may have lost Gary there.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Let me take that – around driving the data center expansion, et cetera, just logistically more than anything else. We expect that...

Gregg M. Lampf
Vice President-Investor Relations, Ciena Corp.

A

Gary, we lost you, Gary, you might want to restart your answer, I apologize.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

I'm sorry?

Gregg M. Lampf
Vice President-Investor Relations, Ciena Corp.

A

I apologize. We lost you there for the beginning. You may want to restart your answer.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Okay. Yes. All right. So if we look at the webscale – let's start at the top – we think the webscale market in 2021 will grow in [Technical Difficulty] (00:45:46) digits. And we expect to maintain market share with 50% plus and grow basically in line with the market this year. We've got – as we've talked about, it's largely dominated by four main players. And we've now, as we've said, got the fourth player, of which we're beginning to roll out, and we are beginning to deploy during the course of this [Technical Difficulty] (00:46:11). It'll be second half of [Technical Difficulty] (00:46:13) good visibility to that. We'll see that wrap up, and we'll see a pretty good movement across all of the webscale players during 2021.

Amit Daryanani
Analyst, Evercore Group LLC

Q

Perfect. And then, can I just follow up on the pluggables discussion that we're having earlier? Can you just – how do you – how would you think about the revenue opportunity on the pluggable side? And then, importantly, do you think the gross margin structure there is any different versus what it is for overall Ciena? Thank you.

James E. Moylan
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

I guess I'll take the revenue question. First of all, from a 2021 perspective, we don't see this as being a significant market opportunity, not only for Ciena, I think for anybody. I think just timing wise, the industry has moved to the [Technical Difficulty] (00:47:05) right? It won't necessarily be like [indiscernible] (00:47:07) event. I think specifically pluggables in the coherent space, I think of it in three different ways. One is that very specific application around a very short reach metro/campus DCI. And that would be substitutive to some of our dedicated [ph] transfer (00:47:29) wave services business. I think of it as a coherent moving into access, which is net new business for all coherent players. That'll take some time, that won't be a 2021 event. And then, I think of it as just the natural miniaturization of the technology still embodying the system business, and that was no different than the other previous generation of technology.

Margin wise, across those three things, I don't see a discernible different than the margin versus our system business. The revenue opportunity on that first application, I talked about, obviously are smaller because you're not selling the whole system, you're selling [Technical Difficulty] (00:48:18) would be similar.

Gregg M. Lampf
Vice President-Investor Relations, Ciena Corp.

A

I think we can move on to the next question, operator?

Operator: Okay. Your next question comes from Fahad Najam of MKM Partners. Your line is open.

Fahad Najam
Analyst, MKM Partners

Q

Thank you for taking my questions. I have two questions. First, on the OpEx outlook, it seems like a pretty healthy increase. I suspect most of it is in R&D. Does that suggest maybe a step-up in cadence on your part, especially in light of – if it checks up correct, that Acacia is going to likely announce a 1 terabit solution in the first half of 2021? Are you seeing an increase in design cadence in the industry overall?

And then, on the question related to Huawei. If I'm not mistaken, it sounds like a $700 million to $1 billion total revenue opportunity for you. So why not give up a two or three-year outlook as to what your revenue growth would be potentially, given it's such a substantial opportunity for you? Why don't you kind of give us a three-year outlook on what your revenue trend could be?

James E. Moylan
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

Okay. Thank you, Fahad. On the OpEx situation, just to remind everybody, we went into 2020 and guided OpEx to be $270 million to $275 million average for the quarters for 2020. That's exactly the number that we have posted this year as guide for the year. So it's not really a step-up, generally speaking, but it is a higher number than 2020 – the 2021 number is higher than 2020, because we didn't spend in some areas, including travel, including medical, et cetera, as a result of the pandemic.

So, generally speaking, this is not a big increase. It's flat to what we expected for 2020. We are stepping up some investments in R&D and not spending in other areas. That mainly has to do with the edge and access portion of our portfolio.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

On the Huawei comment, listen, I understand that it's getting a lot of geopolitical attention and a lot of publicity to that. This is not particularly a new dynamic to us. This has been in play for a couple of years now. And it's going to take a while because, first of all, you talked about in Europe. They've got massive amounts of installed base. It's integrated into all of their back-office systems. It's very expensive for these carriers to make those kinds of wholesale moves. And the operational issues associated with that are very large.

So even though many governments, et cetera, would like that to go faster, it also costs a lot of money. And so, you factor all of that in and the reality is, yes, it's a great tailwind and will happen we think over a period of time, but not as fast as folks will think, possibly with the exception of India, as I talked about earlier.

And overall, your number around – the share that they have in Europe and then India, is it a $0.5 billion to $1 billion total market, something like that? Yes. But it's already feathered into forecasts for the year and has been for the last couple of years. So I don't think it'd be appropriate to call that out. And apart from which having visibility to that degree of granularity three years out is certainly challenging.

But it is a tailwind. It's a very positive dynamic for us. We are winning business there. We just won some in India. We've won some business in Europe that we are now deploying. You look at people like Deutsche Telekom, Vodafone Group, BT, those are existing customers that we are expanding with because of this dynamic, and that is happening. But it's feathered into our overall business now.

Fahad Najam
Analyst, MKM Partners

Q

Thank you. Appreciate the answers.

James E. Moylan
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

Thank you.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Thanks, Fahad.

Operator: Your next question comes from Samik Chatterjee of JPMorgan. Your line is open.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Hey, guys. Thanks for taking the question. Just wanted to start off with asking you about the edge and the access part of the network where you're obviously talking about investments. But as some of the discussions around 5G picks up and Nokia being very large incumbent there, how should we be thinking about the opportunity for share gains over the next few years in that part of the network? And I have a follow-up.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Scott, do you want to take that?

Scott A. McFeely
Senior Vice President-Global Products and Services, Ciena Corp.

A

Yeah. Yeah. So, first of all, our edge and access piece, our next-generation metro included in that. 5G is one driver there. Also, the evolution of enterprise business services in general is another driver. I think we've talked in the past around our existing businesses very strong in those areas, wireless backhaul and enterprise services in North America and India. And [ph] I'll just and distributed to the (00:53:54) rest of the world partially because historically us not playing in the IP space.

The investments that we're making there is really around a next-generation IP capability with a ground-up IP OS, integrated with our optics, integrated with our multi-layer domain controllers and a series of products optimized for things like 5G, Fiber Deep and the next-generation sort of aggregation networks for converged traffic. All of those things, we think, is an opportunity that will show up in our metro in our packet business, and we expect that to grow faster than our aggregate part of the business going forward.

Now, 5G specifically, I think what's going on right now is sort of augmentation on their existing architectures. That will benefit us where we have wireless backhaul installments today. But our real opportunity longer-term is as they start to look at stand-alone architectures and make architecture decisions, that will allow us to expand our addressable market beyond our historical installed base of wireless backhaul.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Got it. And if I can follow up with a question for Jim. Jim, just if you can give us some color on – you talked about the investments that are kind of probably going to be elevated for a bit here, but how long is that kind of going to run for? Primarily because if I think about what you said for your three-year outlook and you ended the year with 17.6% margin, which is higher than your long-term range, if I think about gross margins moderating a bit, but you also guided to of having OpEx leverage sort of three years, do we end up kind of three years out above the long-term range that you've provided of 16% to 17%?

James E. Moylan
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.

A

Without giving a specific number, I would say that we would expect operating margin to increase from what we're going to deliver in 2021 if we hit our plan. So, yes, we said that we are going to grow OpEx more slowly than revenue. We'll grow in the two years beyond 2021. We did indicate that our gross margins, we think our base rate of gross margins have improved a little bit. So, yes, we do expect our operating margin over the next couple of years to increase and what we're going to focus in 2021.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Thanks, Samik.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Thank you.

Operator: Your next question comes from Ryan Koontz of Rosenblatt Securities. Your line is open.

Ryan Koontz
Analyst, Rosenblatt Securities, Inc.

Q

Hi. Thanks for the question. As we look ahead to the impact from ZR on the DCI segment, as soon as you're able to retain share with your incumbent customers there, how should we think about the deflationary price per wavelength there? Seems like pretty disruptive impact to pricing, and when we think about that deflating the market there a little bit. Thank you.

Scott A. McFeely
Senior Vice President-Global Products and Services, Ciena Corp.

A

Yeh, Ryan. Here's how I think about it, if you drive sort of the typical price erosion curve over the last decade in the optical space, and you think about the timing of ZR and some of the price points that we sort of see in the marketplace, you get – you can easily extrapolate that curve. It's the natural price erosion that we see from technology introduction.

So, I don't see that being any different than we've had to deal with for years in this industry and as we sort of demonstrated, you can survive and flourish in that space if you actually lead from a technology innovation and actually control the vertical integration of your supply chain, and that's what we intend to do on ZR as well.

Ryan Koontz
Analyst, Rosenblatt Securities, Inc.

Q

Okay. Helpful. And just a quick follow-up on Q4. The soft packet number there, how should we think about that in terms of – such as lumpiness and customer concentration kind of impacting our business or is there any kind of secular demand change in packet? Thanks.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

I think it was impacted by the sort of – some of that business is around at the edge delivering sort of Ethernet type services, and I think that was impacted by the challenges in enterprise, SMB and the carrier managed service piece. And then probably a little bit of ebbs and flows, we had a couple of large customers built out heavily in the first half of last year, some of it a little bit around sort of COVID planning pull forwards, but normal ebbs and flows to that. But we expect to have a pretty good year as we go forward. Now, we've got a lot of the new technology we developed in market, and as I said, and some of that Adaptive IP. We've got seven installations now and scaling. So, we actually think that packet business will do well during 2021.

James E. Moylan
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.
A

And over the next three years.

Ryan Koontz
Analyst, Rosenblatt Securities, Inc.
Q

Okay.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.
A

Yes.

James E. Moylan
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.
A

Will grow faster than our base business, we believe.

Ryan Koontz
Analyst, Rosenblatt Securities, Inc.
Q

Okay. Thanks so much.

James E. Moylan
Senior Vice President-Finance & Chief Financial Officer, Ciena Corp.
A

Thank you.

Scott A. McFeely
Senior Vice President-Global Products and Services, Ciena Corp.
A

Thank you.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.
A

Sure, Ryan.

Ryan Koontz
Analyst, Rosenblatt Securities, Inc.
Q

Yes.

Operator: Your next question comes from Jim Suva of Citi. Your line is open.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you. And I just have one question. When you mentioned in your prepared comments that the carriers are kind of sweating their assets in the useful life and bandwidth. You mentioned that you expect them to come back to spending on the metro and the core. Is there any risk that they continue to spend more on the edge, and actually just continue to sweat those assets in the metro and core a lot longer? And the reason why I ask is maybe you have some contracts in place, or you have some agreements where you actually have the visibility into where it will come back? Or is it just more of the hope of continual bandwidth you used to believe it's going to come back? Any comments on that that'd be great.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Yeah, that's a good question, Jim. I mean, I think what you did see were the initial traffic flows go to the edge. Obviously, the carriers then focused on just making sure that those access points, mainly our homes, are sufficiently supported which is what they've kind of been focused on. But when we look at our model and our forecast for the year, it takes into account a number of things in terms of what we've got as visibility.

Some of it is project plans and engagements with our customers, some of it's orders, it's pipeline, it's RFP activity. It's executive engagement with those customers around what they're planning to do and obviously we've got pretty deep and long-term relationships with many of these service, large service providers. So, we have pretty good visibility into that.

Now, the things that are unknown there are what happens with COVID and the economy at large. The overriding assumption, I think, of all of us is that that begins to ameliorate during the course of the year. And the dynamics around the traffic flows are such that they'll be under a lot of pressure to build out their metro and their core. And it's not that they don't want to do that right now, it's not really even a budget issue.

It is really about just risk aversion of – and focus of messing with the network for those kind of upgrades during this kind of time when they can't deploy all of the people and support that they would normally do for those kinds of activities.

So, it's really a combination of all of those elements and the visibility that we have that give us some confidence that as Jim said, if we're right about that, we will need to see an uptick in orders as we go through Q2. And that'll be a big test of that assumption. But based on what we see right now, that looks like a pretty good assumption. We always have a stronger second half of than first. And it's just going to be more accentuated, we believe, this year.

Gregg M. Lampf
Vice President-Investor Relations, Ciena Corp.

A

Thanks, Gary.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you so much for the details and clarifications.

Gary B. Smith
President, Chief Executive Officer & Director, Ciena Corp.

A

Thank you, Jim.

Gregg M. Lampf
Vice President-Investor Relations, Ciena Corp.

Grazie. Thanks, everyone, for joining us this morning. We appreciate your time. We look forward to following up with everybody today or over the next few days. Hope seeing everyone well at least remotely, over the next few weeks. And happy holidays, happy new year, everyone.

Operator: Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.