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CIEN - Q4 2016 Ciena Corp Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Ciena Corporation fourth-quarter 2016 and year-end earnings conference call.

(Operator Instructions)

As a reminder, today's call is being recorded. I would now like to turn the conference over to Gregg Lampf, Vice President of Investor Relations. Sir, you may begin.

Gregg Lampf - *Ciena Corporation - VP of IR*

Thank you, Shannon. Good morning and welcome to Ciena's 2016 fourth-quarter and year-end review. With me today is Gary Smith, President and CEO; Jim Moylan, CFO; and Francois Locoh-Donou, COO.

This morning's press release is available on National Business Wire and Ciena.com. We also will post to the investor section of Ciena.com an accompanying investor presentation, including certain highlighted items from the quarter and the fiscal year being discussed today.

In our prepared remarks Gary will discuss management's view on the market and our overall progress and Jim will provide details on our results as well as guidance. We'll then open 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 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-K is required to be filed with the SEC by December 28 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 GAAP 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 or website. Gary?

Gary Smith - *Ciena Corporation - President and CEO*

Thanks, Gregg, and good morning to everyone on the call. As Jim will outline in a moment, we saw in Q4 our best-ever quarter for revenue, our best-ever quarter for orders, which were significantly higher than revenue and enabled us to exit the year with the highest backlog we've ever had. And overall it was an excellent finish to a year that positions us extremely well for 2017. These strong Q4 results helped us post our seventh consecutive year of growing faster than the market and improving financial performance, helping to make 2016's adjusted net income the highest in Ciena's history.

As you know, we've always believed that winners and losers would emerge as our industry evolved towards converged solutions for the on demand world. Our strategic investments, our differentiated portfolio and customer experience, our diversification of the business, and our consistently improving financial performance have all positioned Ciena as one of the clear winners in this industry shakeout. We've done extremely well in this environment.

However, we are not content to keep running a race that has essentially already been won. Because as we've seen over the past year, the industry has begun to shift yet again, creating, if you will, a parallel race that is all about enabling greater choice for the buyers of network technology. And again, we have anticipated this shift and we are positioning ourselves to win this race, as well.

A little more context perhaps on what we mean about enabling the market with greater choice. For years now networks have experienced unrelenting growth in traffic and as a result large increases in network capacity have been required. Frankly, we don't see this changing any time soon, with end users increasingly requiring on demand services and a truly intelligent Internet taking shape over the next decade.

While these dynamics create an opportunity for service providers to rethink their business models, they also mean fundamental changes for their networks. So many of our customers are embracing IT tools, like software programmability and virtualization, essentially to better manage the changes that are occurring within both their network and their overall business.

And this is really at the heart of the next industry shift we're seeing develop. It's essentially the convergence of the telecom and IT worlds. And indeed, some of the largest carriers in the world are already merging their network and IT groups into unified teams.

This kind of convergence means that the network is increasingly influenced by an IT mentality that is shaping a new vision for network architecture, and one that is less about provisioning and monitoring and really more about orchestration and control.

For network suppliers, historically winning in the old telecom environment largely depended on their ability to protect the walled gardens, if you will, that had been built. But the IT mentality that is coloring today's network decisions means that there are new expectations for how network technologies will be deployed, purchased and implemented. Because of this, we believe that winning in the new environment will depend on a supplier's ability to deliver what the IT world has enjoyed for years, namely openness, co-development, and agility in how technologies are really consumed.

We're already seeing that different businesses are tackling this shift to IT-centric networks in different way, as you'd expect, really depending on their you unique business strategies. There's not necessarily a wrong way to make the shift, as long as it's made with market-leading technology. So Ciena is committed to becoming the leading enabler of choice in the new environment of open IT-centric networking, having the agility to work with customers no matter how they want to collaborate, innovate and consume network technologies.

And we will continue to do so with the underpinning of the best-of-breed technology. In fact, we've been learning, investing and preparing for the IT-centric network over the last several years and we've already established a strong leadership position.

Some examples of which, we have what we believe is the market's leading orchestration software in Blue Planet. We've developed a dev ops tool kit that enables customers to add network resources and program new services at cloud speed. And we now have over 25 customers for Waveserver. We've captured the market's attention with a new kind of network solution that leverages the open APIs and server-like management that IT buyers want.

Our emulation cloud provides an open environment for customers and third-party developers to create and test custom applications. We recently launched a new distributed NFV solution that includes full integration with third-party components, enabling greater choice and eliminating vendor lock-in. And, finally, with WaveLogic AI we're setting a new benchmark for scale, automation and analytics for a truly self driving network.

I think all of these developments really underscore our ability to unite software and hardware strengths for greater customer value. These are important first steps and they've created a foundation that already, frankly, separates us from our competitors. We are benefiting from first-mover advantage and a deep commitment to what the customer really needs. So, as this next shift in our industry gets underway in earnest, we are fully committed to being the leading enabler of choice, and we will continue to develop our business accordingly.

In closing my comments, it's been another excellent year for Ciena. We continue to deliver exactly what we've promised, taking share along the way, increasing our profitability, and positioning ourselves for the next wave of opportunities.

Finally, after such a strong year I'd really like to take a moment to say thank you, firstly to the entire Ciena team for your unwavering dedication to our customers, our technology leadership and our business. You truly continue to inspire me every single day.

To our customers, thank you for entrusting your agenda to us. We take that responsibility very seriously and we remain fully committed to being a customer-first partner to your business.

And, finally, to all of you on the call, we truly appreciate the support you've shown us over many years and we look forward to engaging with you in the year ahead.

With that I will hand over to Jim.

Jim Moylan - *Ciena Corporation - CFO*

Thank you, Gary, and good morning, everyone. The strong results we posted this morning for both our fiscal fourth quarter and the full year demonstrate Ciena's differentiated performance over the competition. We continue to grow faster than the overall market.

We are steadily improving our operating leverage, profitability, and cash flow. And we are extremely well positioned as the industry shakeout continues. Through leading technology, strategic investments, and the diversification of our customer base, we have truly transformed our business, and it is directly visible in our results.

It is also visible in the marketplace. Just this week analyst firm IHS released the results of its latest global survey on optical leadership, which measures network operators' perceptions of the vendor community. And in the eyes of the market Ciena truly hit its stride in 2016.

The report says that we once again took the number one overall position, claiming the top spot in six of nine categories, including technology innovation, R&D, product reliability, service and support, solution breadth, and management software. We reclaimed the top spot in transport SDN and control plane by a wide margin, displacing Huawei, underscoring our focus on the value of software as a driver of openness and choice.

And perhaps most importantly, the fact that we were named the overall leader, but not cited as the price leader, proves that we are winning on the total value that our technology and our people bring to the table. We believe this illustrates a high level of customer trust and strategic partnership.

Turning now to our results, for the full fiscal year revenue of $2.6 billion represents growth of 6.3%. For the year, some of our biggest growth drivers are directly attributable to our diversification efforts.

Globally, non-Telco sales for the year were 31% of revenue, representing an 11% increase year over year. Enterprise sales were up 34% for the year. Direct web scale revenue was up about 25%. And MSO sales were up 11%.

Additionally, revenue from our resale agreement with Ericsson was up about 20% for the year and submarine sales were up 9%. That is a vertical driven largely by web-scale demand.

From a regional standpoint, both APAC and North America, exclusive of AT&T, provided very strong growth at 31% and 11%, respectively. As we expected, AT&T was down slightly, coming off a record year in 2015.

EMEA was essentially flat for the year, but we are encouraged by that region's progress and we expect to return to growth in EMEA in 2017. CALA was slightly down in 2016 but we do feel good about our prospects going forward.

Adjusted gross margin for 2016 was in our mid-40%s target range at 45.5%. And adjusted operating expense was $887 million, resulting in adjusted operating margin of 11.4% for the year. We generated $290 million from operations in 2016 and $182 million of free cash flow. Adjusted net income was $215 million and adjusted earnings per share for 2016 was $1.38.

Clearly, our value proposition is resonating with customers and momentum is building. We are executing well and our business continues to gain operating leverage. By every measure, we delivered in 2016 what we said that we would deliver.

One of the reasons that we were able to achieve such strong annual results is our performance in Q4, which was an excellent quarter for our newer products in particular. With 14 new wins for Waveserver in Q4, we more than doubled the number of customers for that product for a total of 25. The market response to Waveserver has been very strong and our success with that product is one reason why Dell'Oro named Ciena the number one share leader in both the ICP market and the overall DCI market last week.

We also continue to be excited by the traction we're getting with Blue Planet. 2016 played out as we expected. Going into the year, we said that 2016 would be a year of gaining Blue Planet footprint and that we did not expect significant revenue contribution.

In Q4, we added five new Blue Planet orchestration customers, bringing our total customer count to 18. And we are encouraged that orchestration revenue began ramping in Q4, albeit from a small base.

And finally, we added another four customers for our 8700 Packetwave platform for a total of 40. We expect the 8700 to play an increasingly vital role as customers shift to IT-centric networks.

In Q4, total revenue came in at $716 million. Revenue was strong in part due to our best-ever quarter in APAC, which continues to be driven by strength in India and in submarine applications. We also had a strong quarter in EMEA which was up 20% year over year, and in North America which grew 11% year over year, exclusive of AT&T.

International sales made up 39% of total revenue in Q4. And direct sales to web-scale customers were in our expected range of 5% to 10% of total revenue.

Q4's adjusted gross margin was 45.2%, down a bit from a very strong Q3, largely due to the mix of customers and in various stages of deployment. Operating expense in Q4 was $234 million. We achieved $92 million in adjusted operating profit or a 12.8% adjusted operating margin.

And as Gary mentioned, orders in Q4 were the strongest on record, significantly higher than revenue. We closed the quarter with a record backlog of $1.5 billion, so we're seeing a lot of activity in the market.

Our balance sheet continues to improve and, in fact, has become a differentiator against the competition. In Q4 we generated $137 million in cash from operations and we ended the year with $1.14 billion in cash and investments. Adjusted earnings per share in Q4 was $0.44.

I'll now turn to guidance, first for our fiscal first quarter. We expect revenue to be in the range of $615 million to $645 million, consistent with the seasonal reductions in order volume and customer deployment activity that we typically experience. We expect Q1's adjusted gross margin to be in our mid-40s percentage target range. And we expect adjusted operating expense to be in the range of $220 million to $225 million.

For the full fiscal year, we continue to believe that we have the strongest position in the industry. And we believe this momentum will translate into another very strong year for Ciena in 2017.

We expect to continue to grow revenue faster than the overall market, which we believe is growing at mid single-digit rates. We expected adjusted gross margin for the year to be in the mid-40s percentage range. We expect adjusted OpEx to average approximately $235 million per quarter over the fiscal year. And we expect adjusted operating margin to be in the range of 11% to 13%.

Looking beyond 2017, we continue to believe that we can achieve the next stage milestone for profitability that we set last year. As a reminder, at that time we targeted an adjusted operating margin of 15% within the next three to four years. To achieve this milestone, we need to continue on our path of gross margin expansion as a result of increasing software, packet networking and solution sales, elevating the overall business value Ciena offers to a broader set of customers.

We also expect to continue to take market share and to grow revenue faster than operating expense. Of course, the exact contribution of each of these factors will vary quarter to quarter. But we are confident that over time the cumulative effect will result in greater value for both our customers and our shareholders as we position Ciena as the leading enabler of choice in our marketplace.

Before I close, I want to make a clarification to something that I said earlier. I believe I said that we had $1.5 billion in backlog at the end of the year. That was a misstatement. We have $1.15 billion in backlog at the end of the year. Sorry for that misstatement.

Janet, we will now open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from Jess Lubert with Wells Fargo. You may begin.

Jess Lubert - *Wells Fargo Securities, LLC - Analyst*

Hi, guys. Thanks for taking my question. Congrats on a nice year. I want to squeeze two in. First for Gary, I was hoping you could help us understand, when you look at the upcoming year and some of the opportunities you're positioned to address in metro cloud, the submarine market, what you think are likely to prove most impactful in the short term, which are likely to take a little bit longer to get to the point where they're really moving the numbers.

And then for Jim, I was hoping you could touch on the pricing environment, some of the factors that drove the sequential down tick in your gross margins despite what appeared to be a pretty good quarter for both the packet and the software business. Is this a sense that as some of these metro builds ramp up, we should expect lower gross margins? If you could help us walk through that, that would with helpful. Thanks.

Gary Smith - *Ciena Corporation - President and CEO*

Hey, Jess, I'll take the first one. Think about it in product segmentation and market segmentation in the short term what's going to drive growth, I think you've seen it in this open multi-haul architecture around metro and even some long-haul rollouts. We've got a number of those already secured and we'll be rolling those out during the course of the year.

Markets that continue to grow are really the ICP, Waveserver type markets. We've got a lot of new platforms in there. The 8700 and packet business continues to do well, and, encouragingly, outside of North America, as well.

From a geographic point of view, I think we feel much better about Europe. You saw a very much improved performance in Q4, up about 20% year on year. I think we've turned the corner with our particular challenges in Europe.

And as Jim articulated, Asia-Pacific particularly very strong growth and we see that as we go through 2017. India I would call out as a specific very positive market for us where we're very well positioned and I think we'll see excellent growth in 2017.

I think from a financial impact point of view, and Jim referenced it, we're very encouraged by what we're seeing on Blue Planet. Obviously that market is nascent and will take a little while to develop and really have a big impact on our bottom line. But I do think you'll see many some progress in 2017 in our overall software business.

Jim Moylan - *Ciena Corporation - CFO*

On the pricing environment and gross margins, you know, Jess, that we have often said there are a lot of different variables that impact our gross margin. And you'll recall, and when we guided for Q4, we did say that we expected gross margins to come back to the mid-40%s range, which they did. Overall, the pricing environment has not significantly changed.

What I would say is that some of the competitors who have lost market share continue to be very aggressive, particularly some of the smaller companies, but in overall form the pricing environment has not changed significantly. And I would say this, that as we move forward, here and as we guided, we think our gross margins are going to be in the mid-40%s this coming year. And, yes, we are going to get we think a little help from software. We think our software business is going to be up $20 million to $25 million, in that range.

But we do have number of early-stage tier 1 next-gen metro deployments. And it's a number of them, it's not just one. So that's why we're guiding to the mid-40%s for this coming year. I don't believe our margin for this year is going to be significantly different than it was for 2016.

Jess Lubert - *Wells Fargo Securities, LLC - Analyst*

Thanks, guys.

Operator

Our next question comes from Doug Clark with Goldman Sachs. You may begin.

Doug Clark - *Goldman Sachs - Analyst*

Maybe to follow up on one of those latter points, you mentioned the multiple tier 1 deployments ramping, can you talk about some of those, where they are geographically, in particular the one in North America that we're all familiar with? Can you talk about how that's coming in line relative to expectations?

And then a slightly different topic, you talked about Web 2.0 having basically double the number of customer adds, I think 14 in the quarter. Yet it sounds like if we just do the quick math on direct Web 2.0 sales they came down from about 12% in that 5% to 10% range. Can you talk a little bit about the mismatch in terms of timing and sequential pullback on Web 2.0 business in particular?

Gary Smith - *Ciena Corporation - President and CEO*

Doug, let me take the part around deployments. They're characterized as next-gen metro. But I think the lines are blurring, let me first of all say, between metro and long haul, particularly as we roll out various features on the 6500 platform that really are a much more open architecture. What folks are looking at is a platform that will blur into both the convergence of long haul and metro.

As you know, we've had a number of those wins in North America, pretty much a clean sweep across all of the tier 1s, and they will continue to roll out during 2017. So, strong in North America.

But I'd also point out you've got various activity in Brazil where we continue to do rollouts. Similarly in Europe, we've had a number of wins in Q3 and Q4 that are translated into revenues during 2017. I highlighted India earlier. Very large buildouts in India at fairly early stages. And also I would also highlight Australia, as well, as another geography.

So very diverse, very broad spread. I know that the financial community particularly focused on North America but I would really encourage a broader view around the global markets as we roll this out, specifically around one or two of the metro deployments in North America.

And let me go to Verizon metro, which I think Doug is your question. We did take some initial shipments in 2016 and we continue to expect a gradual ramp across 2017. I would say, though, that in general I think the investment community got a little bit ahead of this, because I think, by and large, that project is on, track and I think they will gain momentum throughout 2017, 2018 and through to 2019. So from our perspective, completely on track.

To your second question on Webserver ICP type market, was down a little bit from a direct point of view, but in fact was up from an indirect point of view. Remember, we have various manifestations of the ICP business where we have a direct relationship with them. Order flow was actually very strong. And I think you'll see just the normal ebbs and flows in the quarter, was slightly down directly, but indirectly was actually up for the quarter. Francois, you want to --?

Francois Locoh-Donou - *Ciena Corporation - COO*

Doug, just you said there was a contradiction between the increasing number of customers and the percentage of revenues for web-scale. Just to clarify, we did double the number of customers on Waveserver to 25 customers. More than half of those are actually ICPs or web-scale players. There are a number of customers for Waveserver that are not in the web-scale market, in media, enterprise, and also in the traditional telco space.

So, we're incredibly excited about Waveserver as a platform. It has broad applicability across a number of segments, including in the web-scale space where we're seeing a number of tier 2 web-scale players start to adopt the technology because of its programmability and performance. So, it's generally very strong in the ICP but also broader application range.

Jim Moylan - *Ciena Corporation - CFO*

And we did reference Waveserver in a comment about ICP. But that's not the only product that we sell into that market. And I will remind you that Dell'Oro named us top share leader in ICP and overall DCI market just this past week. We're doing very well with that customer set.

Doug Clark - *Goldman Sachs - Analyst*

Thank you.

Operator

Thank you. Our next question comes from Dmitry Netis with William Blair. You may begin.

Dmitry Netis - *William Blair & Company - Analyst*

Thank you very much. Good quarter, guys, and nice way to finish the year. On the M&A side, we have been watching closely here, can you guys just give us some color about any impact you may see or if there's anything maybe as a result of CenturyLink, Time Warner Cable, XO and all the hoopla that we see throughout the year and you how that may project into the 2017 time frame? Certainly the guidance isn't reflecting some of that maybe here or including some of that here, so I'd love to hear your thoughts there.

And then, secondly, if you could talk a little bit about the optical layer disaggregation that's going on and the effort that AT&T is leading to disaggregate, and maybe some of the ICPs, as well. But for the most part we've been waiting for AT&T to get this into 100-gig long-haul project. And maybe there's a completely different RS deal, completely different way of approaching that. So, if you could comment on how they're going to go to market with that and how they're going to roll that optical layer and disaggregation, how you are positioned for that, that would be great. Thanks.

Gary Smith - *Ciena Corporation - President and CEO*

Dmitry, let me take sort of the overall environment around, and I think specifically around customer M&A. First of all, I think it's been as facet of this space globally for a long time. And we've seen a lot of it internationally and we're seeing considerable amount of it in North America.

I would say, of the announcements so far, I would overall say that generally we view them very positively for Ciena over time. I think we're very well-positioned in virtually all of those announcements and with excellent relationships with them.

We are not seeing really any impact to us at this time in any way, shape or form. The order backlog is probably the best example of that and the visibility that we have is the best that we've ever had.

I would say a couple of other dynamics around it that we've seen historically during this is that bandwidth demand continues to grow. So, this notion of really pausing for a long period of time as they come together is not one, frankly, that we've witnessed in some of our historical M&A activities with customers. You're bound to see a little bit of that, but I think the point that I would make is Ciena is now very diversified with global scale, expanding customer base and application set. And I think we're extremely well equipped to deal with any ebbs and flows that may come.

Francois, do you want to?

Francois Locoh-Donou - *Ciena Corporation - COO*

Dmitry, on the question of AT&T and what you termed the optical layer disaggregation, it is, in a way, very exciting for us because it is a manifestation of what Gary talked about earlier, which is the shift towards more openness and programmability. And AT&T's open ROADM is one example of that. But we're seeing it in other parts of the industry.

For example, Waveserver running over foreign line systems is a manifestation of that. The 400-gig announcement we actually made with AT&T for their network in the metro is a manifestation of that. And the big shift we're seeing in the industry is a shift from closed architectures and closed and proprietary systems towards more open systems. And you're seeing that in the results of performance of different vendors.

As Gary mentioned, we have been preparing for that for a long time around openness and programmability. And what we're doing with Waveserver, open interfaces, Blue Planet and WaveLogic AI are examples of technologies that enable that shift. So, generally a trend that we feel very excited about and we think will accelerate in 2017 and beyond.

Dmitry Netis - *William Blair & Company - Analyst*

Great. Do you guys expect the AT&T business to be up from 2016 in the 2017 time frame?

Jim Moylan - *Ciena Corporation - CFO*

We think it will be flat to slightly down for this coming year. But we're doing very well with that customer and we look for a strong customer from AT&T for a long time.

Dmitry Netis - *William Blair & Company - Analyst*

Thank you.

Operator

Thank you. Our next question is from George Notter with Jefferies. You may begin.

George Notter - *Jefferies LLC - Analyst*

Hi, guys, thanks very much. I was curious about your backlog. I think you said $1.15 billion. In the past you've talked about shippable backlog, also -- IE, shippable within a year. Can you give us that number by any chance?

Jim Moylan - *Ciena Corporation - CFO*

No, we won't give that number, George. But the vast majority of it will be shipped during the next year. We do have, as we've said, a number of long-term maintenance projects in our backlog which are delivered over several years. But by far the vast majority of it will be delivered in 2017.

George Notter - *Jefferies LLC - Analyst*

Is it fair to say the year-on-year growth in backlog, then, was driven not by longer-term services contracts but --.

Jim Moylan - *Ciena Corporation - CFO*

That is fair to say, yes. We have a very strong hardware backlog.

George Notter - *Jefferies LLC - Analyst*

Okay. And then also just curious about 2016 [Quam]. I think in prior quarters you've given us a customer update on 16 Quam. I was just curious if there's a number you can give us for this quarter. Thanks.

Jim Moylan - *Ciena Corporation - CFO*

Yes, we'll look that up and we'll give it to you in just a moment, George. It's 56, correct?

Gregg Lampf - *Ciena Corporation - VP of IR*

Yes, that's right.

Jim Moylan - *Ciena Corporation - CFO*

56. Thank you.

George Notter - *Jefferies LLC - Analyst*

Great, thank you.

Operator

Thank you. Our next question is from Paul Silverstein with Cowen and Company. You may begin.

Paul Silverstein - *Cowen and Company - Analyst*

I have two questions, if I might. Jim, was there a currency impact both on revenue and on margins? And with respect to 2017, when you look at the revenue composition is there a shift in terms of chassis versus line card, given the coming metro buildouts and some of the other stuff you all referenced in the call?

Jim Moylan - *Ciena Corporation - CFO*

There was not a significant FX impact on revenue in the quarter. There are always puts and takes, but there was not a significant impact. As you'll recall, the quarter ended before recent important political events in the US.

Francois Locoh-Donou - *Ciena Corporation - COO*

Paul, in terms of chassis versus line cards, I would say we do have in 2017 a number of early-stage deployments in tier 1, next-generation applications. We call them multi-haul applications because increasingly, as Gary mentioned, there's a blurring between metro and long-haul boundaries, and this shift implies that most customers want to define the behavior of network in software, rather than hardware. So, we have these early-stage deployments across the board that are somewhat shifting the mix a little bit towards chassis. But, overall, it's driven by a number of new wins we've had this year and we expect to have in early 2017.

Paul Silverstein - *Cowen and Company - Analyst*

Jim, just a clarification, if I may. On the comment about FX, when you said it didn't have a meaningful impact, are you expecting it to have a meaningful impact going forward?

Jim Moylan - *Ciena Corporation - CFO*

No. And just to be clear, when I said that, I was referring to against our expectations when we gave guidance for the quarter. The quarter's results were not significantly impacted by FX effects. And as we look into the coming year, again, I don't see a significant change from FX.

Now, if foreign currency movements move about, then, yes, we might could. But for now, we don't expect FX to be a significant part of the puzzle for us in 2017.

Paul Silverstein - *Cowen and Company - Analyst*

Thank you.

Operator

Our next question comes from Patrick Newton with Stifel. You may begin.

Patrick Newton - *Stifel Nicolaus - Analyst*

Good morning. Thank you for taking my questions. First one us just trying to pars out the 2017 revenue potential. You talked about mid single-digit growth for the industry, share gains for Ciena, incremental revenue from Blue Planet that I think calcs to about 1% year-over-year growth, strong backlog and then benefits from the Verizon metro rollout. If we put this all together is it fair to assume a high single-digit growth rate for Ciena in 2017?

And then the second question would be on Blue Planet. What is the time frame for when you think you could start to see meaningful revenue beyond the $20 million to $25 million you talked about in 2017?

Jim Moylan - *Ciena Corporation - CFO*

I think the inference that you've made is a fair inference. We've given you a lot of points of guidance for 2017. As you back into a revenue growth rate, then that's where you get to, absolutely.

Gary Smith - *Ciena Corporation - President and CEO*

Patrick, let me take the Blue Planet piece. As Jim talked about, we added a number of new customers in Q4. We're seeing very good traction -- still nascent, still early days, multiple pilots, trials and awards, you've characterize the market. I think we began to see some single-digit million revenues as we came out of Q4, and I think that will continue to scale during 2017.

My own view is I think, given what we're seeing, as we turn from 2017 into 2018 it will turn into tens of millions of dollars. And I think over a course of time you can get into that $50 million to $100 million range over a couple of years, and that then becomes to be very meaningful, both from a market share point of view in a fast-growing early market, and also the financial impact on Ciena. As Jim said, getting to our next target goal of 15% operating margin, that's going to be a key element in helping us get there.

Patrick Newton - *Stifel Nicolaus - Analyst*

Great. Thank you for taking my questions. Good luck.

Operator

Our next question is from Tim Long with BMO Capital Markets. You may begin.

Tim Long - *BMO Capital Markets - Analyst*

Thank you. Two questions, if I could. First, on the Ericsson partnership, if you can just update how things are going there, particularly in light of the management changes that are going on at the company. And then, secondly, on the OpEx, it looks like the guide for next year is a mid single-digit increase. Anything out of the ordinary there or is that just growth in the Company and investing into new technologies? Thank you.

Francois Locoh-Donou - *Ciena Corporation - COO*

Yes, on the Ericsson relationship, things have been progressing well, as we said. Our revenue with Ericsson year on year was up 20%. We've done very well with the Telstra relationship with Ericsson, and that continues to expand into new applications beyond the initial application that we came into Telstra with Ericsson for.

And then around the globe there's been a number of new wins this year with Ericsson, typically in geographies where Ciena doesn't have a physical presence and Ericsson has a strong in-country presence and relationship. And we've been able to work together to compete in those countries and win new business. So, overall we continue to be pleased with the progress with the relationship.

Jim Moylan - *Ciena Corporation - CFO*

And with respect to OpEx, the guidance that we've given is consistent with what we've done in our annual plan for 2017. And we have a very disciplined approach to establishing OpEx. We look at the opportunities for investment, whether they be R&D or in the field or even in the back office. And we make our of choices and prioritize, based on the fact that we're going to spend where we need to but we're also going to continue to increase our operating leverage.

If you look back over the past five years, we've grown OpEx about 5% a year. We've grown revenue 2 or 3 percentage points higher than that. And I think that's the kind of forward view you can expect from us.

Tim Long - *BMO Capital Markets - Analyst*

Okay. Thank you.

Operator

Our next question is from Vijay Bhagavath with Deutsche Bank. You may begin.

Vijay Bhagavath - *Deutsche Bank - Analyst*

Thanks. Hi, Gary, Jim. It's great to hear on the order backlog strength getting into your new fiscal year. Please helps us out here in terms of color on new optical networking projects here in the US. In particular I'd like to hear how do you see fiber to the home playing out? Do you see that as a stronger rollout cycle versus metro? Or do you think both metro optical and fiber to the home would be approximately the same in terms of rollout intensity? And then also quickly on hyperscale clouds and metro, do you see (inaudible) 200-gig products in the new year? Thanks.

Francois Locoh-Donou - *Ciena Corporation - COO*

Vijay, it's Francois here. I'll start with the 200-gig question. If you'll look at 200 gig, we have shipped several thousand ports of 200 gig already in 2016. And that's one of the competitive differentiators for Ciena because we're seeing some of our competitors getting excited about potentially shipping 200 gig in 2017. And, frankly for us, that's a little bit of yesterday's news because we've been shipping 200 gig for several months.

And in 2017 we're going to start shipping 400-gig ports. And that's really where we think, certainly where the market is moving in metro. And we're also extending the 400 gig distances into regional networks. That happened in the ICP and the web-scale space, as you mentioned, but also in the carrier space, increasingly we're going to be shipping 400 gig in 2017.

As it relates to fiber to the home, yes, we do see more -- basically, the general trend is that both in the carrier space and in the MSO space customers want to push more capacity to subscribers and end users. And, increasingly, to do that they need to push fiber further out at the edge of the network. Whether in all cases fiber will reach the home is not decided, and a number of our customers are looking at a number of architectural choices to get that done.

But I think what you're going to see over the next few years is the fundamental rethink of access networks. And you're seeing that in the access networks of our carrier customers.

AT&T, for example, in their Domain 2.0 architecture have projects where they're really reinventing their access networks. They've announced things like core central office reinvented as a data center. That's really about leveraging network function virtualization to reinvent their access network.

But MSOs are also going to push fiber deeper in their networks. And over a period of time that's a great opportunity for Ciena on our packet and optical platforms.

Vijay Bhagavath - *Deutsche Bank - Analyst*

Perfect. Just a quick bigger picture question for Gary. Gary, do you see Ciena as a share taker in 2017 or is share stable a more reasonable assumption? Thanks.

Gary Smith - *Ciena Corporation - President and CEO*

Thanks, Vijay. Absolutely a share taker. We've taken share in the last seven years. Whatever the market rate has been, we've been almost double the revenue growth.

I think on a global basis now with our scale, I think we're very well-positioned to continue with that in 2017. So, I expect us to take market share in 2017, et me be really clear.

Vijay Bhagavath - *Deutsche Bank - Analyst*

Perfect. Thank you.

Operator

Our next question is from Rod Hall with JPMorgan. You may begin.

Rod Hall - *JPMorgan - Analyst*

Hi, guys, thanks for taking the question and good morning. I wanted to ask about North America. We understand that the deployments there are going really well. I had two questions on this. One, can you comment on your performance in the deployments so far and what you think your potential for share gains is share shifting from where the deal started? That's one question.

Another is, we understand more cities are being added to that deployment plan over time. Can you comment on that or confirm that's happening or you think it's likely to happen in the near future?

And then I also wanted to go back to this comment on software, Jim, you made. You said you think it's up $20 million to $25 million. That's a significantly better growth rate on software than we had anticipated. So, can you give any more color on that number? Is that a single customer driving that? Are there multiple customers driving it? Thanks.

Jim Moylan - *Ciena Corporation - CFO*

Okay. On the software question, we've invested a lot of money in our software applications. And this kind of growth, $20 million to $25 million or so, is within our range of expectation for the business. And, remember, when I said that, I was talking about FY17.

Now, there are a number of elements to our software business. We have the applications business, which includes our network management software, and we have software support which is a service. And it's the combination of those elements which we think leads us to the $20 million to $25 million number.

Francois Locoh-Donou - *Ciena Corporation - COO*

And, Rod, on your question on specific Tier 1 metro deployments I think you were referring to the Verizon metro deployment first. Generally, we're on track with that deployment. As it relates to our performance, there were several milestones that were agreed with Verizon around initial lab trials and field office applications, and then starting commercial deployments. And we've basically hit all of these milestones on track.

As it relates to the number of cities, there were a number of cities that were assigned to each vendor a few months ago. That assignment hasn't fundamentally changed. I think, as we said on the last call, we're really pleased that we're getting our fair share of these deployments. And we expect a gradual ramp in 2017, as per the plan.

Rod Hall - *JPMorgan - Analyst*

Great. Thanks. Could you guys comment real quick on the Waveserver customer adds, how exposed are you guys to greenfield builds on Waveserver? Is it a majority of your exposure or are a lot of those adds are customers in existing builds?

Francois Locoh-Donou - *Ciena Corporation - COO*

Interestingly, one of the unique aspects of Waveserver is it's a platform that works on four-in-line systems. It can be installed on line systems from other vendors.

And a number of our deployments actually are brownfield, so they're going over other vendors' deployment, largely because the performance characteristics of Waveserver are, frankly, highly differentiated in the marketplace. Of the 25 customers that we announced, if you want to look at it numerically, I would say probably around 40% of those would be over what we call foreign line systems, so other vendors installed base and then the other ones are on more greenfield deployments.

Rod Hall - *JPMorgan - Analyst*

Thank you, guys.

Operator

Our next question is from Simon Leopold with Raymond James. You may begin.

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

Great. Thanks for taking my question. First, another clarification on the comment Jim made on the software revenue. I want to make sure I've got the appropriate baseline. When you referred to the $20 million to $25 million of software, that is growth above and beyond the FY16 roughly $49 million of software sales? Or are you talking about the software and services combination that you're comparing that to?

Jim Moylan - *Ciena Corporation - CFO*

Yes, I was talking about software and services combination. But it's also true of the software piece, as well.

By the way, if you look at that number, it was $125 million in 2016, it was $100 million in 2015. So, we showed that kind of growth in 2016. Very consistent with what we expect in 2017. Mostly Blue Planet is what's driving that growth in 2017.

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

Great. Thank you for that. I wanted to talk a little bit more about where you see the web-scale customers going in that you this quarter talked about being in that 5% to 10% range again. And you did mention also good exposure for submarine applications. How do you see that particular group of customers trending in your FY17 expectations? Can we see them in a range of 10% to 15% of revenue? And how should we think about the applications beyond the submarine comment? Thank you.

Gary Smith - *Ciena Corporation - President and CEO*

Let me take the last part of that first, Simon. In terms of the overall growth, I would expect them to continue to see very healthy growth. I'd remind you, as you alluded to, we have various manifestations of that growth. We have the direct relationship where we're selling to where they can get direct fiber, for example, and we have indirect. And particularly as they expand indirectly, their ability to get their own fiber is more and more challenged. So, we have more of an indirect three-party relationship.

I would continue to see growth both at the direct level in terms of dollar terms growth; dollar terms growth in terms of indirect that we can track, as well, in submarine, in international deployments, as well. I think we feel very good about that segment, particularly with a lot of things like Waveserver, and even Blue Planet and other applications coming onto them that we can support them with. Francois?

Francois Locoh-Donou - *Ciena Corporation - COO*

To the latter part of the question, specifically in the submarine space, increasingly they have a lot of influence, the web-scale players have a lot of influence on what capacity gets deployed where. We think they're going to be probably exceeding this range of 10% to 20% overall. But in the submarine space they're driving increasingly a significant portion of the overall submarine capacity that's installed out there. And we see that trend continuing in 2017 and beyond.

Jim Moylan - *Ciena Corporation - CFO*

And I'd just bring you back to our new announcement on WaveLogic AI. This is a set of technologies which we believe fits very well with the web-scale customers in their submarine applications, in their metro applications, and in their long-haul applications. And, by the way, it's not just a web-scale product but it's going to drive market share gains, we believe, in that segment.

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

Great. Thank you.

Operator

Our next question comes from Michael Genovese with MKM Partners. You may begin.

Michael Genovese - *MKM Partners - Analyst*

Thanks very much. I think most of the questions have been asked. I'll just circle back on gross margins one more time. Maybe you could talk about the pricing environment you're seeing from carriers versus what you're seeing from suppliers. I think particularly on optical components there's probably some tightness ands possibly even price increases in key products, so if you could comment on that.

And then how is the strategy? Can you keep gross margins at their current levels and possibly a little bit better and make sure they don't get worse from here in that type of environment?

Gary Smith - *Ciena Corporation - President and CEO*

Sure. Let me take the first part of that and then I'll ask Francois to talk particularly about the supplier context of that. As Jim said, the ebbs and flows on the pricing environment, not really seeing anything appreciably change. You're seeing some of the smaller players get desperate, but I think that's fully recognized and subsumed into the marketplace at this stage.

I think you've also seen over a number of years our ability to expand our gross margins, and I think that's through essentially two main elements. One is just efficiencies and global scale of the business. And the second one is the technological innovation that we brought into the marketplace, essentially putting more and more software delivered into the platforms.

So, I think we have a very good road map. WaveLogic AI is certainly a key part of that. But we can continue to do that, I think also aided and abetted over time by the Blue Planet software, as well, which I think they are key elements, all of these, in us getting to our 15% operating margin. We have a very good view around the steps that we need to take to get there.

Let me ask Francois to talk specifically around the supply chain.

Francois Locoh-Donou - *Ciena Corporation - COO*

Mike, your observations about potential tightness on suppliers, it's a relevant question. I think there's two aspects of that. One is around lead times, in large part driven by a significant build in China. As you know, a number of our suppliers have had a full book of business and maxed their capacities on factories. So, we've had to do a few things to make sure that we were maintaining good lead times and be able to maintain great customer experience.

To your point on margin, our suppliers have a long-term view of the relationship with us. So, even though there may be a buildout in China at the moment, I think they think long-term about that. So, we've been able to work with them on that.

And the other piece of that is they see us as a share gainer. You've seen a number of reports showing that we're number one in the various market segments in which we play. That allows us to have, I would say, significant leverage in our discussions with our suppliers.

The last point I'd make is, where we think it's relevant for us, especially in terms of control our forward technology road map, we have made steps towards vertical integration. The TeraXion acquisition was a manifestation of that. But we've made some important bets in that space that are helping the differentiation of the platforms overall. Jim?

Jim Moylan - *Ciena Corporation - CFO*

Just to repeat some of what was said, but to add to it, we feel really good about the progress that we've made in our gross margins. We've come from low 40%s to mid 40%s and that's due to a number of factors. Our guidance for this year would imply that we're not going to see a lot of progress this year in our gross margins. But we do think that it's going to be around where we were in 2016.

We're going to get some help from software. We're going to have some new deployments that are going to be a little lower margin. But, again, I would repeat, we do expect to get to our 15% operating margin. And I've told most of you that the way to get there is some operating leverage, but we do think we're going to have to get some improvement in gross margin to get to that 15% and we see that it's on the way.

Michael Genovese - *MKM Partners - Analyst*

Thanks very much for taking the question and for the well thought out answer. Thanks.

Gregg Lampf - *Ciena Corporation - VP of IR*

Thank you all. We appreciate you taking the time to connect with us today. We look forward to connecting with you over the next period of time here, the next weeks. Happy holidays to everyone. And we will see you soon.

Operator

Ladies and gentlemen, this concludes today's conference. Thanks for your participation and have a wonderful day.
