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CIEN - Q3 2013 Ciena Corporation Earnings Conference Call

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PRESENTATION

Operator

Welcome to the third quarter 2013 Ciena Corporation earnings conference call. My name is Loraine and I will be your operator for today's call. At this time all participants are in a listen only mode. Later, we will conduct a question and answer session.

(Operator Instructions)

Please note that this conference is being recorded. I will now turn the call over to Mr. Gregg Lampf, VP of IR. Mr. Lampf, you may begin.

Gregg Lampf - *CIENA Corporation - VP IR*

Thank you, Lorraine. Good morning and welcome to Ciena 's third quarter 2013 review. With me today is Gary Smith, CEO and President; Jim Moylan, CFO; and Tom Mock, Senior Vice President, Corporate Communications. This morning's press release is available on National Business Wire and www.ciena.com. We have also posted to the Investor section of ciena.com an accompanying investor presentation, including certain highlighted items from this quarter being discussed today, as well as our historical results. In our prepared remarks, Gary will discuss management's view on the market and the quarter and Jim will offer some color on our Q3 results and provide guidance for Q4. We'll then open up the call to questions from the 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 context of the risk factors detailed on our most recent 10-Q filings. Our 10-Q is required to be filed with the SEC by September 12 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 our website. Gary?

Gary Smith - *CIENA Corporation - President & CEO*

Thank you, Gregg, and good morning, everyone, and thanks for joining us today. This morning we announce strong financial results highlighted by an 8% adjusted operating profit and another solid performance that clearly demonstrates Ciena's momentum in a rapidly changing industry. That momentum is evident in our revenue performance, which was up 6% sequentially and 14% year over year, as well as in our revenue expectations for the full year. In addition, it was another record quarter for orders, which continue to outpace revenue. With customers reporting continued growth and demand from strategic drivers, such as mobile data, business services and app driven machine to machine connectivity, Ciena's differentiated strategy as the network specialist is driving our faster than industry growth, as well as our steadily improving performance across the business. We made the strategic choice to focus on the evolving architectural needs of networks in support of dramatic changes in end-user behavior, and we've built the Company to address those needs. The markets acceptance of this approach, as well as our continued solid execution, gives us confidence in both our near and long-term prospects, as the industry shift to these new architectures.

But, as fast as the industry is changing, Ciena is changing as well. And the last time we spoke we outlined some of the ways that Ciena has already changed with greater customer and market diversification, greater portfolio breadth and increasing strategic importance to many of the world's largest networks. But, we're changing in other ways too. For example, with increasing packet optical convergence across our portfolio, we're seeing less direct correlation between our performance and that of the traditional optical ecosystem. And as more converged solutions with packet networking software and professional services ramp, we expect to see even more separation going forward. With our business opportunity now extending well beyond optical, we believe that viewing our performance through the historical optical prism is in fact no longer valid. So, today I'll spend some time discussing how we are tracking our progress in some of these other metrics.

As the industry shifts to new network architectures, we believe that the best indicators of our success relate to Ciena's expanding role and reach in the industry. Role being the types of solutions we sell and reach being where and to whom we sell them. I'll first touch on our role in the industry. One way to measure our expanding role is to look at customer and market adoption of our approach to building networks. We are tracking the markets adoption of our approach from several viewpoints, particularly the convergence of OTN and packet switching into an open and automated packet optical infrastructure. A few examples of our recent progress in the adoption of our approach would follow.

First, our overall packet business continues to grow in both revenue and market stature. Heavy Reading has named Ciena as number one globally in fiber -based ethernet access market share. And we are now reporting packet revenue that is roughly doubled since Q3 a year ago. Revenue from packet networking and OTN switching combined, when measured as a percentage of total revenue, grew by more than 20% year over year. And last month Delaro Group again named Ciena as number one globally in packet optical networking market share. And our network application software business also grew by more than 50% year over year for the first three quarters of fiscal 2013 versus 2012, albeit from a relatively small revenue base.

In evaluating our progress as we expand our reach a good yardstick is the continued diversification of our business. We believe that diversifying the vertical and geographic mix of our customers and expanding the types of applications we're addressing within our existing customer accounts will lessen revenue concentration due to any single application in a particular customer. In Q3 we saw several indicators of progress in these areas.

For instance, we expanded our presence with multiple tier one wins across multiple geographies, including Europe, Brazil and India. And in our vertical markets we have recently secured key wins with Internet content providers. And in terms of applications within our accounts, as of Q3 16 of our top 20 customers rely on Ciena in multiple applications across their business, such as Metro, long-haul, mobile backhaul, and ethernet business services. We believe this is a valuable measure of diversification and strategic value because it demonstrates our involvement in more elements of a customers' business.

The progress in our financial performance that we've made to date is in large part driven by the success we're experiencing in these adoption and diversification metrics. Obviously, we don't expect to make progress in every metric each quarter and we may discuss additional metrics as helpful indicators of progress in subsequent quarters. But over time, we expect to gain ground in both adoption and diversification as measures of our expanding role and reach in the industry. With a very strong competitive position and significant market momentum, we're confident in our ability to continue to execute this strategy. In fact, we believe that by expanding our role in the industry and extending our reach within our markets we will be positioned to deliver higher profitability that is more sustainable over time. With that I'll turn the call over to Jim, who will provide greater detail on our financials for the period. Jim?

Jim Moylan - *CIENA Corporation - CFO*

Thanks, Gary. Good morning, everyone. I'll cover some of the highlights of the quarterly results that we published earlier today. I will speak only to non-GAAP results, so please refer to this morning's press release on our website for reconciliations to our GAAP results.

The market's ongoing shift towards new architectures continues to positively influence Ciena's performance, and we are staying true to our strategy of focusing on these critical new network requirements. As a result, we've had several quarters of strong financial performance and we expect to continue to grow as this network architectural shift progresses. Our customers are telling us that this is a rollout that will happen over years, not quarters. It's not necessarily going to be a straight line, but we do see a long-term opportunity for which we have strong momentum.

Throughout this period of network transition, our unique position as the network specialist is an important differentiator. Under our specialist approach, we are fully aligned, company-wide, with the new needs of the market and our engagement model has fostered highly trusted relationships with the world 's most progressive and most influential network operators. We are seeing healthy revenue growth, as customers increase their spending on new generation solutions. Revenue grew 6% over the previous quarter to $538 million in Q3, a quarter in which we experienced particularly good US revenues.

As Gary mentioned, we had another very strong orders quarter, with orders that again exceeded revenue and a solid mix of international orders coming from new tier one wins. At 43.6%, Q3 gross margin came in at the high end of our guidance range due to favorable customer and product mix. Operating expense in the third quarter was $109 million (sic-see press release, $190.4 million). Q3 OpEx was lower than we expected due to the deferral of several projects that we now anticipate will occur during the fourth quarter. With an adjusted operating profit of $44 million, Q3's adjusted operating margin was 8%. During the quarter we generated $42 million in cash from operations and at quarter's end our cash and investments totaled $493 million, up from $456 million at the end of Q2.

I'll now speak to guidance for the fiscal fourth quarter 2013. Absent any significant changes in exchange rates, our guidance is as follows. We expect Q4 revenue to be in the range of $550 million to $580 million. We expect Q4 gross margin to be in the low 40%s. As indicated, we experienced a favorable customer and product mix in Q3, which positively impacted gross margin. However, we anticipate that during Q4 we will start to recognize revenue on several large international network builds with tier one customers. As a result, we expect some downward pressure on gross margin in the near-term. Accordingly, we expect Q4 gross margin to be down sequentially from Q3.

With respect to operating expense, last quarter we told you that because of our strong business performance variable compensation would be higher in the second half of 2013 then previously anticipated. As a result, when combined with the Q3 expenses I mentioned earlier that are shifting to Q4, we expect Q4 's adjusted OpEx to be in the high $190 millions range. We continue to expect OpEx for the second half of fiscal 2013 to average roughly in the mid-$190 millions. With regard to other income and expense in the fourth quarter, we project an expense of approximately $11 million related to the interest on our convertible notes. We expect our tax obligation for Q4 will continue to be related solely to foreign taxes. As for share count, we estimate Q4's basic share count at approximately 103 million total shares. Diluted share count will vary depending upon your assumptions about our profitability.

In closing, we are confident that we have positioned and differentiated Ciena to be a market leader throughout this era of network and industry change. With the right architectural vision and the right portfolio of products and services to implement that architecture for the unique business needs of each customer, we expect to continue to expand our role and our reach in the marketplace and to deliver steadily improving financial performance over time. That concludes our prepared remarks. Lorraine, we will now open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Mark Sue, RBC Capital Markets.

Mark Sue - *RBC Capital Markets - Analyst*

Thank you. Good morning, gentlemen. If I could get a sense of how you're seeing the mix of the order trend growth from a regional point of view and from a [customer] point of view? And the thought here is that you are seeing very positive trends with the North American service providers and if we're seen similar continued growth in the international segment that would be helpful. And just kind of if you qualitatively, Gary, if you could kind of give us a sense of where we are in terms of the inning for some of the bigger deployments of converged networks in North American service providers and how far behind some of the international carriers might be as well?

Gary Smith - *CIENA Corporation - President & CEO*

Thanks, Mark, appreciate that. I would say on the overall mix of things it is going to fluctuate quarter to quarter. We're seeing strength in North America for sure and I think when you think about the architectural shift I think there the early adopters of that and so I think there's a great deal of linkage to our performance around that. I would say that we are beginning to see some of that architectural adoption internationally and, as I mentioned in our prepared remarks, we've had a number of tier one architectural wins internationally that we would expect to recognize revenue beginning in Q4 and as we go through next year.

So, I think the overall balance of the business, over time, will continue to be a healthy mix between North America and international. But I do think we're seeing the early adoption come from the North American carriers. So, we see a good balance going forward. The point I would make about sort of innings, I guess you're referring to a baseball parlance, I would say we're in the very early stages of this. So, we're in the first or second innings here and I think it's going to run to a fair amount of overtime, frankly.

Operator

Tal Liani, Bank of America.

Eric Ghernati - *BofA Merrill Lynch - Analyst*

Yes, hi, this is Eric Ghernati on behalf of Tal. Just following up on this, Gary, North America has obviously been a big source of strength all this year and you seem pretty confident that it's going to kind of run overtime per your comment. What kind of visibility that you have into next year 's project and if you can't pinpoint particularly at what you think that overtime will look like in terms of strength? Is there more strength versus what you've seen right now? Is it just continuation of what you have seen or is there something new that we should expect? And I'm talking specifically about 2014. Thank you.

Gary Smith - *CIENA Corporation - President & CEO*

Let me address overall. I mean our backlog continues to grow. We had record order flows in the quarter and that's both international and in North America in terms of orders. So, it's going to fluctuate between the two, but we're encouraged by what we're seeing internationally across all of the major theaters. Europe, I would say, we're definitely seeing it stabilizing and those opportunities we're seeing are actually turning to wins. Latin America I think we're seeing strong traction among some of the tier ones there and new wins and also in Asia. So, I feel good around the balance of demand and the fact that our backlog continues to grow.

Don't want into guidance for 2014, we haven't finished '13 yet, but I think this momentum that we're seeing is really anchored in a fundamental architectural shift that I think is a multiyear opportunity for us. So, yes, you're going to see fluctuations. It's not always going to be a complete straight line in every dimension, but I think we're seeing very strong momentum and I think we're well-positioned for steady growth over a long period of time.

Gregg Lampf - *CIENA Corporation - VP IR*

Thanks, Eric

Operator

Amit Passi, UBS.

Amit Passi - *UBS - Analyst*

Hi, thank you. Jim, I was hoping maybe you can help us understand what you think the positive impact was to gross margin this quarter just from mix? I mean, international was down, so, I presumed that helped margins. Just trying to understand how we should think about normalizing for the puts and takes this quarter as we look to the next quarter?

Jim Moylan - *CIENA Corporation - CFO*

Yes, Amitabh, as we've talked about many times before, gross margin is -- consists of a lot of different moving parts. Not just individual segments, but within each segment you can have different products, you can have customers in different stages of deployment and all of those things can cause margin to move up and down. I will say that 43.6% was at the high end of the range that we expected.

We've been saying really low 40s for a couple of quarters and that's what we expect our current state of the business is. I can't be a lot more specific than that. I can just say that it is difficult for us to model. We feel good that the long-term direction of margins is going up over time. I think this next quarter we are going to see a little bit of downward trend as a result of a number of international projects that are going to be hitting revenue in Q4. So, that's what I'd say. We're going to be in the low 40s and -- but it will be down from the 43.6%.

Operator

Simon Leopold, Raymond James

Simon Leopold - *Raymond James & Associates - Analyst*

Great, thank you very much. I wanted to see if you could talk a little bit more about what's going on with product mix, both in the current quarter as well as the outlook. Specifically, I'm looking at the strength of the legacy products, at least sequentially. Trying to understand what's happening there. And then within your converged packet if you could talk about the contribution from switching and then go into a little bit of color as to how you see the mix evolving, at least in your October quarter? Thank you.

Gary Smith - *CIENA Corporation - President & CEO*

Simon, let me start with that and then maybe hand over to Tom. I think we are seeing growth in all of the segments. Converged packet optical was up, packet networking, if you look at that significant growth in that it's sort of doubled sort of year on year. The optical transport, which is really the non- converged elements of the portfolio if you will, we also saw some growth. But although you can see if you look at the line overall compared to sort of Q3 last year it is down, as you'd expect. So, I think we're seeing the growth in the right places. Tom, any commentary on our?

Tom Mock - *CIENA Corporation - SVP Corporate Communications*

Yes, in terms of the switching piece, if you look at our switching business for the first nine months of this year versus last year, we're up pretty significantly over last year in terms of revenue. And we also continue to see OTN switching show up as a component in our optical in our 6500 product line. So, that trend that we talked about earlier in terms of convergence is something that's continuing. We're also continuing to add customers in both our transport and switching product lines. We added about 12 new customers in the last quarter on transport and we added a couple of new customers on the switching side. I think you're going to continue to see growth in both of those areas.

Gregg Lampf - *CIENA Corporation - VP IR*

Thanks, Simon

Operator

Kent Schofield, Goldman Sachs.

Kent Schofield - *Goldman Sachs - Analyst*

Great, thank you. I was wondering if you could touch on the international wins that you're expecting to come through in the October quarter. Are we looking more at the optical transport side. Are we looking at the converged side of things? Any color you could provide there would be helpful

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Gary Smith - *CIENA Corporation - President & CEO*

Sure. Kent, I think I'd characterize them overall as new architectural wins. Many of them are new customers to Ciena. They are architectural wins in terms of the shift that's going on and therefore I think, as I think about all of the key ones there, they are multifaceted, converged platforms that we're putting into market with them. So, I think it's consistent with this view that we're starting off in North America with this sort of shift to a converged multiservice type platforms network.

We're beginning to see that internationally, both with our existing international customers and with new customers as well. I think the fact that we're able to get multiple new tier one customers internationally, I think it's a very healthy sign for the spread of the adoption of this architecture. And I think continues to strengthen and broaden and diversify our customer base going forward. So, I would absolutely characterize them as new, converged architecture wins.

Jim Moylan - *CIENA Corporation - CFO*

And just a word on the, we made about gross margin. These are converged architectural wins. We're very pleased that our network vision is having success internationally, but these are new customers to us. And, as we said in the past, new customers typically involve some startup cost, early discounts, those kinds of things. We are attacking internationally and so we are going to see, as we attack internationally and as we bring on new customers early, we'll see lower than average margins. Over time we expect those gross margins to get to around the Company average.

Gregg Lampf - *CIENA Corporation - VP IR*

Thanks, Kent.

Operator

Brian Modoff, Deutsche Bank

Vijay Bhagavath - *Deutsche Bank - Analyst*

Hi, guys, it's Vijay Bhagavath on behalf of Brian. So, a two-part question. The first part is on the 100 gig product cycle with AT&T, any qualitative color you could give in terms of how is AT&T looking at 100 gig toward the network? That is the first part.

Gary Smith - *CIENA Corporation - President & CEO*

Vijay, I don't think we -- our policy is not to, obviously, comment on specific customers. If you're looking at the 100 gig overall, part of our sort of converged platform, Vijay, I think we're continuing to see adoption there. I think as Tom mentioned, we had a number of new customers in the quarter on the converged 6500 platform with 100 gig, both good order flows internationally and domestically.

Vijay Bhagavath - *Deutsche Bank - Analyst*

And then the second part of the question, Gary, is on the packet networking product cycle. I see two levers there, one is the optical business broadband and the second is optical fiber access for 4G. Any thoughts on the longevity of those product cycles? Like, how many quarters ahead do see the optical business, broadband, the 4G fiber access data cycles continuing? Thank you.

Tom Mock - *CIENA Corporation - SVP Corporate Communications*

Vijay, it's Tom. We see ourselves participating in the 4G market to the extent that some of the aggregation needs increase there in existing sites, as well is in some cases in some of the new 4G sites that are created. As I talked about before, we see one of the real strong growth engines in our packet business, though, being business ethernet services and that's been a driver of some of the increases you've seen in the last couple of quarters.

We're beginning to expand the customer base. We've got enough space and we are actually, as we mentioned earlier, in two of the bigger ethernet service providers here in North America, AT&T and Comcast, today deploying across their networks. So, we're bullish on that as a growth engine for the packet networking business. We would not necessarily say that we don't see wireless as being a growth engine moving forward, because we do. But on the other hand we see packet networking as been probably a stronger growth engine at this point in time.

Gary Smith - *CIENA Corporation - President & CEO*

And the other thing that I would add is when you talk about sort of cycles and those kinds of things I think we view it much broader than just isolating to 100 gig or even some of the packet stuff. I think this converged architecture we see as a multiyear opportunity and we have strong momentum across very broad range of converged packet optical architecture

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Tom Mock - *CIENA Corporation - SVP Corporate Communications*

One of the things we're just starting to see the effects of, too, as we've added a lot of this packet capability now to our optical transport products. So, that too will be driving packet penetration in the business, although it ends up being reported in converged packet optical.

Gregg Lampf - *CIENA Corporation - VP IR*

Thank you, Vijay.

Operator

Michael Genovese, MKM Partners.

Michael Genovese - *MKM Partners - Analyst*

Great, thanks a lot. Let me just start with a couple of clarification questions. The 10% customers, sorry if I missed that, but can you give us the 10% customers? And also, I think a metric on 100 G. I think you give us a metric on 40 and 100 G last quarter. If you would sort of update it this quarter how that went? Thank you

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Jim Moylan - *CIENA Corporation - CFO*

Yes. We don't necessarily disclose who our 10% customers are in any given quarter, but we have two. They are large. So, I think you could probably get a good idea of who they are. Tom, you want to deal with --?

Tom Mock - *CIENA Corporation - SVP Corporate Communications*

Yes. On the 40 and 100 G, we added one new customer for 40 G for a total of 132 customers. On 100 G we added 11 customers in the quarter for a total of 91. And we typically also talk about coherent as a percentage of our WDM revenue and it's in the 60% to 70% range today.

Operator

Rod Hall, JPMorgan.

Rod Hall - *JPMorgan Securities Inc. - Analyst*

Hi, guys. Thanks for taking my question. Just a couple of questions for you. One is on the international deals you are talking about, I just wonder if you guys could say whether those deals are expected to grow into fiscal Q1 and Q2? So, do we expect continued pressure on gross margins as those mature or is Q4 really the peak of impact on the gross margin? If you could comment on that. And then secondly, pricing [in front of] it a little bit. It feels like pricing remains pretty stable here. So, just curious to hear your thoughts on what's going on with pricing and then I might have one follow-up.

Jim Moylan - *CIENA Corporation - CFO*

Yes, Rod, let me deal with the margin situation. This year has been a strong North American year where we have established incumbency and we have a very, very broad product set sold to a number of customers. We are gaining momentum in the international business, we're attacking there. We're going through a new series of wins here. We talked about that really a year ago about the momentum we then had on the international side and we -- what's happening now is that we're starting to win more of these international deals. They are large, they are multi- product and, so, I do expect there to be a bit of pressure on margins both this quarter and as we go into the first part of next year.

Gary Smith - *CIENA Corporation - President & CEO*

Let me add overall the business continues to grow internationally and domestically. So, the impact of those in the shorter term is probably less than it would have been. And I would also say we do expect them to grow over time, but what we've seen is they would be more in line with the overall margins of the Company. And I think that also talks to the sort of pricing environment. I think we're seeing a sort of fundamental shift in architectures.

We're also seeing a shift in the competitive landscape, I think, as you move away from these end to end legacy conglomerates into more specialist focused players that have open architecture, I think we are seeing a degree of stability in the solutions that we're bringing into market. Still, a competitive environment, but I think we're confident that over time we can get to our goals of a mid- 40s gross margin over time, particularly on the back of the expanding role in reach that we're playing in the industry.

Tom Mock - *CIENA Corporation - SVP Corporate Communications*

And just to reiterate something we've said in the past, Rod, relative to 100 G pricing. We saw pretty sharp price declines in the early stages of that largely because the technology was becoming mature. And now that we've gotten into more mature -- the technology has become more mature and we're now in volume production, you're seeing less and less of those price declines.

Rod Hall - *JPMorgan Securities Inc. - Analyst*

Okay, thanks, Tom. Just maybe one follow-up and that is could you guys comment -- these new customers I know you mentioned several different regions, but where is the bulk of them? Is the bulk of them in Europe or are they in LatAmaNesa or can you just give us some idea of regionally where most of this new revenue is coming from?

Jim Moylan - *CIENA Corporation - CFO*

We're actually seeing a good spread. If you take this last quarter as an example, we had tier one wins in Asia, Europe and Latin America. And these were new tier ones for Ciena. So, they're pretty significant and they're across the regions. Now, we're very careful and selective around the markets that we're in and the customers that we choose. These have been long sales campaigns that [worked on], but I think it also, I think, talks to our improving position and momentum globally. And also the solutions that we're bringing into market and the overall architectural shift that we're seeing

Gregg Lampf - *CIENA Corporation - VP IR*

Thank you, Rod

Operator

Paul Silverstein, Cowen.

Paul Silverstein - *Cowen and Company - Analyst*

Yes. Guys, before I ask the question just a couple of household numbers I'm hoping you will provide. Tom, did I hear you say 11 new 100 G customers for 91 total. Was that the number?

Tom Mock - *CIENA Corporation - SVP Corporate Communications*

That's right, Paul

Paul Silverstein - *Cowen and Company - Analyst*

All right. If we --?

Tom Mock - *CIENA Corporation - SVP Corporate Communications*

Paul are you trying -- these don't count as questions? Is about your position?

Paul Silverstein - *Cowen and Company - Analyst*

Exactly. Too obvious. If you look at your tier one customers today versus a year ago, two years ago, can you characterize one -- can you quantify how many tier ones do you now have in total? How is that compared to 12 months ago, two years ago? And finally, I trust by the numbers you given us both in (inaudible) and visibility that relative to the concerns about some customers being perhaps further on in their deployments and the risk that the revenue generation slows down, that doesn't appear to be a significant issue.

But I guess my question to you is are there any one or more significant carriers, significant tier ones where that would be the case. And finally related to that I'm trying to get you to quantify visibility. If you look at your visibility today versus 180 days ago, 360 days ago, Gary, can you quantify that or Tom can you quantify that?

Gary Smith - *CIENA Corporation - President & CEO*

All right, let me try to address those multiple questions, Paul. Let me start with the last and probably the highest level one. Our visibility is improving. And I would say across the board. And that's really driven by -- some of the manifestations for that. That backlog is at the highest it's ever been. We had record order flows last quarter. We have multiple tier one wins internationally into the quarter. So, we have better visibility than we've had and it continues to improve. The point I would make is that we've got now multiple large carriers that we're at the early stages of deployment of these multiyear converged networks.

So, I think the sustainability of this is no longer hostage to one or two customers in one or two areas of their network. If you take the top 20 tier ones that we've got, 16 of them are taking multiple platforms and applications for Ciena's. So, it's in ethernet business services, wireless backhaul, Metro applications, long-haul, packet optical, so their converged. So, I think we've got a broader reach and visibility into multiple carriers, Paul, and I think that was the design point of the business, particularly when we acquired the Nortel assets.

And it's taken, I think, longer than we would've thought given the recession, et cetera, but I think we're now seeing the clear signs of the shift in architecture by these carriers. And I would mention and highlight again, we do not see an overall increase in carrier spending. What we're seeing and we're the beneficiary of is a shift in how they're spending that money from legacy Sonet SDH networks to converged multiservice networks

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Tom Mock - *CIENA Corporation - SVP Corporate Communications*

And the other thing I'd say is specifically to the question of do we see a loss of momentum in any of our major customers, we do not. We see this as a multiyear opportunity as they continue to build out their networks. So, that's how we feel about our outlook

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Jim Moylan - *CIENA Corporation - CFO*

Yes, I think one of the things that maybe leading to that conception that things may be nearing completion in North America is that a lot of the guys who are building out, particularly in things like 100 G, are reaching a point where that technology has touched a large part of their footprint, but that's only the first bit of capacity they put in at that rate. There's plenty of capacity to be added past that as needs for additional capacity on their network tend to grow. Just because, for example 100 G has touched a particular region does not mean there's not continued growth in that region.

Gary Smith - *CIENA Corporation - President & CEO*

And also if you take North America as an example, we've got multiple carriers in North America. All of the major carriers, including CenturyLink, Sprint, Comcast, Level 3, XO, et cetera, that are all at the early stages of this kind of shift.

Gregg Lampf - *CIENA Corporation - VP IR*

Thanks, Paul.

Operator

Scott Thompson, FBR.

Scott Thompson - *FBR Capital Markets & Co. - Analyst*

Hi, good morning, guys. Just a couple points of clarification here. First of all you talked on the call quite a bit about being a network specialist. But we also talked a little bit about having a broader range of products this upgrade cycle and that's going to translate into more stable revenues and possibly better margins. Can you give us a little more idea of why the focus on specialist, but then the broader packet portfolio? And then secondarily, as packet networking continues to ramp, should we expect it to accelerate and help support margins? Or are these new customers in Europe, Latin America and Asia more focused on packet optical rather than networking?

Gary Smith - *CIENA Corporation - President & CEO*

Scott, why don't I take the first part of that, which is sort of strategy and industry structural. Ciena chose a different path than a lot of the typical common wisdom in the early 2000s was around this industry was sort of end to end with large legacy players. We chose to focus on the convergence of packet optical and to specialize in that and all the aspects of it. And I think what you've seen from an industry structural point of view over the course of the last ten years or so is really a sort of a shift towards this kind of more focused players.

And a move away from this sort of end to end players, such as we've seen it with Nortel, Marconi, Lucent, Alcatel, you're seeing it more recently in the sort of MSN moves over the last few months. And so, from an industry structure point of view we placed bet fairly early on that to be a focused player with global scale was really going to be the most appropriate way to position for this industry move over the next five to ten years. And I think largely from a strategy point of view, that is bearing out. From a product point of view, Tom, do want to touch on that?

Tom Mock - *CIENA Corporation - SVP Corporate Communications*

Yes. When we talk about being a specialist we really specialized, as Gary said, in converging packet and optical. Now that doesn't mean that that technology can't be used in multiple applications, which is exactly what you're seeing today. You are starting to see packet optical infrastructure become the backbone of a lot of networks. You are also seeing it become the way in which traffic is allocated amongst users and you're also seeing it become the way in which people access the network in a generic sense. The fact that we've specialized from a technological standpoint doesn't necessarily mean we can't address multiple applications and still remain focused on our particular strength and technology area.

Gregg Lampf - *CIENA Corporation - VP IR*

Thank you.

Operator

Sanjiv Wadhwani, Stifel.

Sanjiv Wadhwani - *Stifel Nicolaus - Analyst*

Thanks. Just a quick clarification and then a question. Wondering if you could talk a little bit about the deferral of several projects that you talked about early in the call. Any color on whether these are related to some operational issues or some other nuances there? And then, looks like you've won a lot of tier ones international market that customers that are new to Ciena. Any vendors stand out against whom you might be gaining market share? Thanks

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Jim Moylan - *CIENA Corporation - CFO*

Yes, on the first one. As we've said in the past, a number of our areas of OpEx do spend money on large projects. R&D has projects, IT has projects our real estate activities have projects and the timing of those projects getting to expense is not always easy to predict, because things move around. The reason that we spoke to that detail was because we had said last quarter that we thought we'd average in the mid- 190s for OpEx for the last half of the year.

And we wanted to address the reason why we were a little bit below the mid- 190s in Q3 and point to the fact that those projects will likely occur in Q4. So, we'll have a little bit higher OpEx in Q4. There are no operational issues or anything like that. It strictly refers to the fact that the timing of some of these projects and their completion is difficult to predict.

Gary Smith - *CIENA Corporation - President & CEO*

Sanjiv, let me take the second part of that. What we're seen internationally from our sort of very much a changing competitive industry landscape as you move towards these converged multiservice networks that really are based on open architectures and more focused specialist players, I think we are largely taking share against, as you'd expect, the larger legacy vendors in the various packet and optical spaces. So, I don't think it will be any surprise given the shift that's going on in the industry.

Gregg Lampf - *CIENA Corporation - VP IR*

Thanks. Sanjiv.

Operator

Subu Subrahmanyan, The Juda Group

Subu Subrahmanyan - *The Juda Group - Analyst*

Thank you. One clarification. Could you tell us what the optical switching revenues were both independently and as part of 6500? And then, Gary, I wanted to ask about kind of operating margin goals. How you hit kind of a high single digit operating margin goal. There's still some moving parts, obviously, given mix and your OpEx itself, but how should we think about goals going into 2014?

Jim Moylan - *CIENA Corporation - CFO*

Let me deal with the second part. Remember we said a couple of years ago that we thought a near-term goal was 7% to 10% and we got there this quarter. We're at 8% adjusted operating margin. We said longer term 10% to 12% is our longer term goal. That remains our longer term goal. And we also think that, while it's not going to be a straight line upward in any of this, we think that over time we're going to improve our profitability, deliver sustained profitability and deliver cash. So, we feel good about the future. We think people are going to see some good results from us over time. On the question of switching?

Tom Mock - *CIENA Corporation - SVP Corporate Communications*

On the question of switching. In 6500 that's accounted for roughly 10% of our revenue on the 6500 platform. And then in terms of just overall switching growth, we talked a moment ago about the fact that switching is up over 50% for the first nine months of this year versus the first nine months of last year.

Gregg Lampf - *CIENA Corporation - VP IR*

Thank you

Operator

Mark McKechnie, Evercore.

Mark McKechnie - *Evercore - Analyst*

Great, thank you. A question for Jim and then one for Gary, if I may. First on the gross margin guidance, you're talking down sequentially. Can you give us some better granularity or detail? Will it be closer to the 42.5% seen in April or the 43.6% in July? And then second for Gary, you talked about a win at an Internet content player. I think that's new. Is that the same product or are you going to have to do any custom builds or custom tweaks? And what are you replacing there for that player? Thanks.

Jim Moylan - *CIENA Corporation - CFO*

Yes, Mark, on the question of gross margin. As I have said gross margin is a difficult thing for us to model and to predict because there are so many moving parts. We do believe that because we will be seeing some revenue from some of these international projects in Q4 that there will be downward pressure and that's -- I'm afraid that's all the detail I can give you right now. We are -- I don't think you can look at any one particular quarter and say that's a trend for our margins. I think what you should believe is that we believe that the low 40s is sort of the run rate of our margins today.

We've actually done a little better than that throughout this year and we've done better than we thought we were going to do as we came into this year. We've had some very favorable mix experience and that's good. So, yes, I believe we're going to be down from Q3 to Q4 and as I said earlier we're probably going to see some pressure over the next quarter or two because of these international builds. But again don't look at any one quarter, we're low 40s now we're driving towards the mid- 40s and that's going to happen over time

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Gary Smith - *CIENA Corporation - President & CEO*

So, Mark, on the Internet content. We actually had a couple of key new wins in the quarter. I think we've got -- we're gaining sort of momentum in that space. It is with Packet-Optical. So, it's a converged solution. They are new builds and they're principally what's going on with the sort of content delivery folks, generally, is really between data centers. So, it's very high-speed connectivity and additional intelligence between the data centers and we're seeing more and more applications for that

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Gregg Lampf - *CIENA Corporation - VP IR*

Thanks, Mark

Operator

Michael Genovese, MKM Partners.

Michael Genovese - *MKM Partners - Analyst*

Great, thanks very much. Can you guys just qualitatively outline for us at 100 G how much of the market roughly is long-haul these days, how much is Metro, how you see that shift occurring, what's the time frame and eventually when do you think the crossover point, what happened to Metro is larger than long-haul for you guys and for the industry?

Tom Mock - *CIENA Corporation - SVP Corporate Communications*

One of the things that is happening with convergence, Mike, is that sometimes it gets hard to tell the difference between whether it's used in a Metro application or in a long-haul application. In fact, for us, the platforms are largely the same. There may be some different options and different sizes that are used in the Metro area. All that said today, as you might imagine, because the traffic cross-sections are larger.

More of that capacity is likely going into the long-haul part of the network, but we are beginning to see some deployments in the Metro. We haven't talked about specific customers in that case excepting CenturyLink a little while back. But we do see the Metro business increasing and over time we believe the Metro market will be a larger market than the long-haul market for 100 G

Gregg Lampf - *CIENA Corporation - VP IR*

Thanks, Mike.

Operator

Catherine Trebnick, Northland Securities.

Catharine Trebnick - *Northland Securities - Analyst*

Hi, thanks for taking my question. Could you provide some more details on the data center interconnectivity? Also, not only with the content providers, Gary or Tom, or with perhaps the carriers and what they're doing with their cloud applications? Thanks.

Tom Mock - *CIENA Corporation - SVP Corporate Communications*

A couple of things that we have seen there, Catherine, that are interesting. I mean, the first thing is that as a lot of IT infrastructure providers have started virtualizing their infrastructure, they have centralized a lot of their assets and as a result the need for connectivity has grown up and specifically that is driving things like 100 gigabyte ethernet connectivity between data centers.

Now, another thing that's happening and this is probably more related to cloud is we're beginning to see interest in making that capacity dynamic and on-demand between different locations at different times. And in fact we've demonstrated some things to customers and also in our annual vectors event up in Ottawa that show that that technology is feasible and can be integrated with applications that run in the data centers. So, it actually becomes automated. So, we do see that as a chance for differentiation in the infrastructure and data center connectivity space

Jim Moylan - *CIENA Corporation - CFO*

And that's why we've highlighted, Catherine, the content delivery network wins that we have had because we are getting some momentum in that space.

Gregg Lampf - *CIENA Corporation - VP IR*

Thanks, Catherine. Operator, we'll take one more question.

Operator

Alex Henderson, Needham

Alex Henderson - *Needham & Company - Analyst*

Thank you, just under the wire. I was hoping you could give us a little bit of a read on the mix of your coherent line cards versus coherent chassis? One of the key variables in gross margins has been that you've been selling more chassis then line cards. And could you talk a little bit about that mix and how it's shifting? I think you were running around 5% line cards last quarter. And then can you put that in context with the rate of growth in those line cards versus the rate of decline in the old Sonet line cards from the legacy stuff so we can get a ratio there?

Tom Mock - *CIENA Corporation - SVP Corporate Communications*

Maybe one way to look at the legacy versus NextGen stuff, there are a couple of studies out now that show that Sonet SDH stuff has been down 20% per year for the last couple of years. So, that decline actually is well underway. And you have seen a little bit of that too in our performance. You have seen our optical transport segment decline a bit year on year as people have migrated to some of the new platforms.

In terms of what the average fill in the shelf is, it's pretty hard to tell, although one thing I can say is that we're in, as Gary mentioned, we're in early stages of deployment with a lot of our customers. So, as a result of that you wouldn't expect the shelves to be terrifically heavy loaded. And as Jim pointed out, we're also beginning to start some new deployments. So, at this point I don't think you're really seeing the shift begin to favor line cards over chassis. Anything you'd add to that, Jim?

Jim Moylan - *CIENA Corporation - CFO*

No, I think you said it well. As we've said in the past, the mix of chassis versus cards is going to vary depending upon where the customer is in his deployment cycle and our overall mix is going to depend upon how many newer customers sort of new deployments we have as compared to fills. And that's very, very difficult to measure and predict because customers change their minds about where they're going to deploy this equipment. But I'd just say overall that the momentum we have on all of these deployments, some new architecturals, new architectures around the world is strong and so we're going to continue to win internationally and domestically.

Tom Mock - *CIENA Corporation - SVP Corporate Communications*

The other thing I'd add, by way of a sort of caution is we talk about cards and chassis and historically when you talk about the optical industry that has been a reasonable sort of determinant. If I look at the overall margin mix that we've got across a broader portfolio, there's a lot of other dimensions to our business that are incredibly impactful and a lot of this is around software, around applications, around services.

And so, it is not as defined as just cards and chassis any more, particularly to get it more into the sort of Metro applications. You get further out into the ethernet business services and the rest of it. So, it's not the absolute determinative of margin. For example, we can have a fairly high chassis quarter and still have good margins, depending on what happens in these other areas. I just say that by way of caution and really back to I think we have to be careful not to view Ciena through the sort of optical prism of sort of the early 2000.

Alex Henderson - *Needham & Company - Analyst*

Thank you, Alex. And thank you everyone for joining us --.

Operator

Thank you

Gregg Lampf - *CIENA Corporation - VP IR*

Go ahead, Loraine.

Operator

Thank you, sorry. I will now turn the call over to Mr. Greg Lampf for closing remarks.

Gregg Lampf - *CIENA Corporation - VP IR*

Thanks, everybody, we appreciate your time today. We look forward to connecting with a lot of you folks in the next few weeks. Thanks very much. Have a good day.

Operator

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