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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Ciena Corporation Second Quarter 2017 Earnings Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded.

I would now like to introduce your host for today's conference, Mr. Gregg Lampf. Sir, you may begin.

Gregg M. Lampf - *Ciena Corporation - VP of IR*

Thank you. Good morning, and welcome to Ciena's 2017 second quarter review. With me today is Gary Smith, President and CEO; and Jim Moylan, CFO. Steve Alexander, our CTO, will join us for Q&A portion of the call.

This morning's press release is available on National Business Wire and ciena.com. We will also post to the investor section of ciena.com an accompanying investor presentation, including certain highlighted items from the quarter being discussed today. In our prepared remarks, Gary will discuss management's view on the market and our momentum, and Jim will provide details on our financial performance as well as guidance regarding expected future results. (Operator Instructions)

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 on the most recent SEC filing. Our 10-Q is required to be filed with the SEC by June 8, 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 in the Investors section of our website. Gary?

Gary B. Smith - *Ciena Corporation - CEO, President and Director*

Thanks, Gregg, and good morning, everyone. Our strong fiscal second quarter results once again evidenced that we are benefiting from our unique position in the market and outpacing the competition in every dimension. We continue to deliver diversified growth, enabled by our global scale, industry-leading innovation and deep customer relationships across a broad set of market segments.

Notably, we are also the only industry player to participate in all key areas of the market, including systems, software and, now, components, all with best-in-class technology.

The net result is that we are consistently delivering differentiated financial performance, including faster-than-market growth and increasing profitability. In Q2, specifically, we delivered strong quarterly top and bottom line financial results, including 10% year-over-year revenue growth, adjusted operating margin of 12.5% and adjusted earnings per share of $0.45.

In addition, we experienced our largest ever quarter for shipment volume, and orders in the quarter were greater than revenue. This was an excellent quarterly performance by any measure. It was underpinned by several dynamics that are positively influencing our business and advancing our competitive position. These include continued diversification, strength in our core or traditional business, accelerated innovation and emerging opportunities in adjacent applications.

Firstly, let me talk to diversification. We continue to see strong contributions from outside of North America and an increasingly broad set of customer segments. In Q2, for example, we delivered more than $140 million in quarterly revenue in Asia Pacific, an all-time high.

In the region, we are benefiting from our position as a leading provider for all of the major network builds in India, including Reliance Jio, who, as many of you know, is experiencing unprecedented rates of customer growth for its services.

But other parts of Asia are also showing strength as well, including Australia and Japan, both of which are important markets for us where we have very strong momentum, really illustrating the multiple dimensions of our growth in this region.

We are building on our #1 position in the submarine upgrade market and are now complementing that success with new cable build opportunities. In fact, during the quarter, we secured a critical upgrade on a new open cable property with a global web-scale customer.

Our broader engagement with web-scale customers is expanding. With DCI still very much top of mind for them, the strong traction and increased adoption of our Waveserver platform is actually a useful proxy for the growth opportunity overall, and that we believe the growth that we see in this customer segment.

With that in mind, our success in this customer segment, including 43% year-over-year revenue growth, is reflected in Dell'Oro's latest DCI market share analysis, which puts Ciena at the top of every single category that they measure.

The second positive dynamic influencing our progress is that our business within our traditional areas of strength in terms of geographies, customers and solutions remain solid with room to grow. In North America, for instance, we are benefiting from our leading market share and capturing new opportunities for growth, in particular, with Tier 1 service providers.

In the quarter, we once again built on our longstanding strategic relationship with AT&T, extending the application of our Packet Networking portfolio in their network with a new award for 10G and 100G NTE solutions.

The global metro opportunity also continues to flow with many service providers, including an increase in metro-related revenue and orders from Verizon in the quarter, consistent with our expectation for a gradual ramp through the year.

The third positive dynamic is around our leading technology and innovation engine, which has been driving the momentum that I just described.

And looking forward, we're bringing to market additional new solutions ahead of the competition who, frankly, are struggling to keep pace with our increasing capabilities.

WaveLogic Ai, our next-generation Coherent chipset, will set new standards for reach and capacity, supporting rates up to 400G per wavelength, and allows users to employ a single module that can be programmed for optimal capacity in DCI, metro, long-haul or subsea applications, something that our competitors are struggling to offer. WaveLogic Ai remains on track to be generally available on both our 6500 and Waveserver platforms this summer.

Recently, we also announced new distribution channels for this technology, with leading component vendors, Lumentum, NeoPhotonics and Oclaro. These partnerships are designed to offer the market a compelling alternative to merchant modems whilst expanding our addressable market to include geographies such as China as well as new network operator and system vendor customers.

Leveraging that innovation lead with WaveLogic, we also introduced Liquid Spectrum, our approach to redefining really how optical networks are fundamentally built. This software-driven platform combines our Blue Planet software, WaveLogic Ai chipset and a reconfigurable photonic layer. This is a truly unique offering in the market. It is the first dynamic capacity on-demand solution that does not require pre-deploying hardware for peak periods of traffic.

And I want to be very clear, our success to date in the market does not take into account the technology advantages yet to come with WaveLogic Ai, which, when combined with our global scale and deep customer relationships, positions us extremely well to capture additional market share globally.

And lastly, there are some very exciting opportunities for our business on the horizon in adjacent applications. These include 5G for service providers and fiber deep for cable MSO customers. These longer-term opportunities are centered around the critical need for greater fiber densification of the network. As a market and technology leader in Packet and Converged Packet Optical, we are already partnering with customers today to help shape and support these strategic initiatives.

We've talked for some time about our belief that in this changing industry environment and structure, we will see winners and losers emerge, and that Ciena is positioned as one of the clear winners in this industry shakeout. As the only vendor able to address the system software and component markets, we are delivering innovations ahead of the competition that directly address the changing business and consumption models of our customers.

Our Q2 performance and first half momentum is strong evidence of our ability to capture that momentum and deliver increasingly differentiated financial performance. In fact, it's interesting to note that we are really the only systems vendor in our industry outside of China that is both growing and profitable.

With that, I'll turn over to Jim.

James E. Moylan - *Ciena Corporation - CFO and SVP of Finance*

Thank you, Gary, and good morning, everyone. We had an outstanding Q2 across all financial and operating metrics. As we've said before, we do believe that our consistent progress is best measured in the broader context of half and full year results. Combining our 2 most recent quarters, we delivered strong revenue growth and improved profitability in the first half of fiscal 2017. When compared to the same 6-month period last year, revenue is up 9.5%, adjusted operating profit is up approximately 25% and our adjusted net income is up approximately 43%.

Now turning back to the quarter's results, I'll provide more color on the regional view as well as financial metrics across our portfolio. North America continues to be a key region for us, where we have leading market share across an increasingly diverse set of customers and applications, including long-haul, metro and DCI.

In APAC, as Gary mentioned, India is currently a major contributor to our growth. We've driven nearly $100 million in revenue from India alone in the first half of fiscal 2017. And our #2 customer overall in Q2 was an Indian service provider. We believe that the current broad infrastructure build-out in India will be a long-term positive for Ciena.

We continue to see more stability in EMEA. The region grew 10% year-over-year in Q2, and we continue to make progress with key customer segments.

Lastly, catalyst performance in the quarter was consistent with our expectations as a number of significant bills from the last several years begin to wind down, particularly in Brazil.

And a few highlight across our portfolio. In Converged Packet Optical, revenue from our Waveserver platform is really beginning to accelerate, gaining 6 new customers in the quarter. As a result, we now believe that revenue from Waveserver will exceed our previous projection of $50 million to $100 million for the full fiscal year.

In Packet Networking, we reported strong quarterly revenue. In fact, we delivered record revenue for the first half of fiscal 2017. Specifically, in Q2, we added 6 new customers to our 8700 platform for a total of 49.

And in software and software-related services, revenue increased 24% year-over-year, led by momentum in software subscription as our focus continues on this increasingly important segment.

Turning now to our fiscal Q2 financial results. Total revenue came in at $707 million, driven by the growth factors we've mentioned, including Asia Pacific, submarine, metro, switching and web-scale. Q2's adjusted gross margin was 45.7%. Operating expense was $235 million. We achieved $89 million in adjusted operating profit in Q2, and we delivered a 12.5% adjusted operating margin.

We also continued to strengthen our balance sheet. In Q2, we refinanced our existing term loans, further reducing our debt by approximately $93 million and reducing our go-forward interest expense on the remaining term loan borrowings.

And just as a reminder, the remaining $185 million in outstanding principal on our 2017 convertible notes will mature in our fiscal third quarter. We expect to repay this amount with cash on hand. As a result, our diluted weighted average shares outstanding count used in the denominator of our diluted EPS calculation will be reduced by approximately 2.4 million shares in Q3 and 4.8 million shares in Q4 and going forward.

In Q2, we generated $72 million in cash from operations. We ended the quarter with just under $1 billion in cash and investments after the reduction in term loan borrowing during the quarter. And finally, adjusted earnings per share in Q2 was $0.45.

I'll now turn to guidance. For our fiscal third quarter, we expect revenue to be in the range of $710 million to $740 million. We expect Q3's adjusted gross margin to be in our target mid-40s percentage range. And we expect adjusted operating expense to be approximately $235 million.

Our first half performance was strong by every measure, including outperforming the midpoint of our revenue guidance in Q2 and exceeding our revenue projections for the first half of the year. As a result, for the full fiscal year, we now expect to achieve annual revenue growth in the range of 8% to 9%. In addition, we continue to expect to achieve the full fiscal year results that we indicated at the beginning of the year with respect to other financial metrics.

As a reminder, this guidance included adjusted gross margin in the mid-40s percentage range; adjusted OpEx to average approximately $235 million per quarter; and adjusted operating margin in the range of 11% to 13%.

In closing, we believe that our business and financial performance stands in stark contrast to that of the competition. We are growing our business and expanding our market share with a greater diversity of customer segments, geographies and applications, enabled by our global scale. And we are an innovation powerhouse that continually pushes the boundaries of technology development and brings purposeful invention to market faster than our peers.

As a reminder, our newest DSP, WaveLogic Ai, arrives later this summer and will set a new standard of performance for the industry. This foundation, coupled with strong demand drivers on our business, is enabling us to deliver consistent financial performance, including faster-than-market growth and additional operating leverage with greater profitability.

Kayleigh, we'll now open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Patrick Newton with Stifel.

Patrick M. Newton - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP and Senior Analyst*

I guess, the first one I wanted to focus on was clearly a lot of strength out of India. You've been very consistent in talking about how this is going to be a multi-year tailwind. But a question I consistently get from investors is, how could this -- can this be and how long? So I guess, any commentary you can provide on both the near- and intermediate-term optionality from India.

Gary B. Smith - *Ciena Corporation - CEO, President and Director*

Yes, Patrick. Yes, I've had this question fair amount in the last few months. Our view on it is that it is multi-year. I mean, when you think about the big opportunity in India, you got 1.2 billion people who are coming online. And I think you've now got a political environment and a commercial environment that's really inducive to the kind of investment that we're seeing. You've got 3 -- I think you're ending up as 3 large players that are building out into the marketplace. And from our perspective, in all of the engagements with them, we believe this to be multi-year. Given the nature and scale of it, you have to draw that kind of conclusion. And obviously, we're privy to some of the plans -- the future plans of the rollout. So I think we're -- our perspective is that it is absolutely multi-year and I think it will be a very consistent business for us.

James E. Moylan - *Ciena Corporation - CFO and SVP of Finance*

The only other thing I'd add, Patrick, is that our Asia business is broader than India as well. We're growing in Australia. We're taking share in Japan. And so we feel great about APAC in general and India in particular.

Patrick M. Newton - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP and Senior Analyst*

And I guess, just shifting to the DCI opportunity. It's great to see that you'll now exceed the high end of your prior guidance range. I'm curious if you're benefiting at all from a major competitor seeing their product refresh slipped roughly a quarter. And then as we think about linearity of the business through the year, can you help us understand how we should think about Waveserver revenue contribution in the first half of the year versus second half?

Gary B. Smith - *Ciena Corporation - CEO, President and Director*

Yes. I think from a competitive dynamic, I think the interesting thing about that is we're seeing enormous demands for Waveserver, which is really the -- it's really the first specialist open architecture platform that was designed for that market. And I think we've seen very strong momentum in there. And I think the thing to bear in mind is, as Jim was talking about in the commentary, we haven't yet released it with the Ai chip in it as well. So we've got that to come. So we've already got a competitive advantage with the existing platform. And with a road map that we have to it, we're absolutely convinced that we can stay ahead of the competition on it. The other point I would make is that it's not just about the technology. It's really around the relationships and global scale with these folks, particularly the web-scale folks because increasingly, the business is not just North America. It's outside of North America. And to partner with the global web-scale folks, you have to have Tier 1 relationships in all the countries that they're moving into. And we're somewhat unique in that we have that. So it's a combination of leading technology and global scale that is really leveraging our growth in this space. So I think it's less about who's got the best product at the time and really more about the complete picture.

Operator

Our next question comes from the line of George Notter with Jefferies.

George Charles Notter - *Jefferies LLC, Research Division - MD and Equity Research Analyst*

I wanted to ask about gross margins. You guys are still kind of talking to mid-40s gross margin guidance. But obviously, there is a good amount of revenue growth here. You've got new products coming. What's the gating factor now as you look forward on gross margins? And how do you see the opportunity to grow that level above mid-40s?

Gary B. Smith - *Ciena Corporation - CEO, President and Director*

George, I still think that we're in that mid-40s range right now. You've got a lot of dynamics as we go into these new markets and new applications and new platforms where you've got some downward pressure on margins. But we've clearly grew up to the size that we are that we can deal with that. I still think we're in that range for the foreseeable future. Now to your question, what is the dimension that takes us up from there, I think it's our software business. And I think we're making good progress on that. But it's from a small number to impact the overall gross margin. I think, really, we don't move up from that until we get meaningful contribution from the -- from our software business.

Operator

Our next question comes from the line of Rod Hall with JPMorgan.

Roderick B. Hall - *JP Morgan Chase & Co, Research Division - VP and Senior Analyst*

So I wanted to ask -- I wanted to go back to the AT&T win, Gary, that you had talked about and just ask if you could just confirm that's incremental. It sounds like a new win. And also maybe Jim, you could comment on whether you still expect AT&T to be flat to down for this year. I think that's what you said last quarter. So does this new win change that at all? And then I have a follow-up.

Stephen B. Alexander - *Ciena Corporation - CTO, SVP and Member of Technology Advisory Council*

So this is Steve Alexander. I'll take you through the AT&T piece real quick on the product side. So the NTEs that Gary referred to, right, this is the move of the edge of the network away from kind of [giga] rates up to 10 gig and then 100 gig rates. And keep in mind, many of the platforms that we've put in market, 8700, in particular, were built in anticipation of this change, right, the increasing rate from the edge of the network up by -- effectively in order of magnitude. So to us, it is a further evidence of increasing importance into the provisioning of high-end services at the edge.

James E. Moylan - *Ciena Corporation - CFO and SVP of Finance*

And with respect to the second question, Rod, we do expect AT&T to be flat to down this year, as we've said. We do expect a strong second half with AT&T. And generally speaking, as we've often said, we have a great relationship with that customer. We're involved in many of their strategic initiatives. And I think they're going to be an important customer for us for a long time.

Roderick B. Hall - *JP Morgan Chase & Co, Research Division - VP and Senior Analyst*

Okay. And then -- and also Steve -- and then my follow-up was with regards to linearity in the quarter. You guys had -- I know there'd been some concerns about book-to-bill exiting the last quarter. But then, that doesn't really seem to have played out. You guys have reported a very strong revenue number here, I think, being the most people's expectation. So just wondering, how good an indicator is book-to-bill? And can you comment on linearity in the quarter?

James E. Moylan - *Ciena Corporation - CFO and SVP of Finance*

Yes, we -- as we said, we did have a greater than 1 book-to-bill in the quarter. We had strong order flow. And we expect strong order flow for the rest of the year. I know there was some concern last quarter about a statement made. But we're going to have -- in the first quarter, we're going to be lower than trend and then later quarter is going to be higher than trend. So we expect a very strong quarter on -- year on orders.

Operator

Our next question comes from the line of Jess Lubert with Wells Fargo Securities.

Jess L. Lubert - *Wells Fargo Securities, LLC, Research Division - Director and Senior Equity Analyst*

I wanted to squeeze 2 in here. First, for Gary, I was hoping you could update us on what you're seeing with Verizon, how close they were to being a 10% customer and how the metro build there is progressing and should progress through the second half of the year. And then for Jim, it looks like total inventory was up sequentially after seeing a pretty big jump in Q1. And it sounds like you saw record shipments. So I was hoping you could help us understand how much of your inventory jump is a function of equipment sitting in customer networks waiting approval where you have high visibility versus a continued buildup in anticipation of future demand.

Gary B. Smith - *Ciena Corporation - CEO, President and Director*

Jess, let me do with the Verizon one. The answer -- the quick answer to your question is they were very close to 10%. And in fact, if you look at the first 6 months, I think they came in at about 9%, so very close to it. In fact, there was an India customer was actually our second-largest customer in Q2 and then Verizon. So very close to it. So normal ebbs and flows with Verizon, but basically, specifically on the metro side, both revenue and orders were up in the quarter. And we expect that to continue to be a steady ramp during the second half of the year. I think deployments, this is a very large project that we think will go out to 2020. Size of the opportunity could be extremely large. We measure it in hundreds of millions. And the sort of split between us and the competition, we seem to be getting more of our fair share on the initial rollout here. And it's a mix of large and small metros. The thing that I would also remind folks of is our engagement with Verizon, and everybody is focused on the metro for understandable reasons, but we actually have quite a broad relationship with them that's long-haul, that includes now Packet for the first time and also switching.

James E. Moylan - *Ciena Corporation - CFO and SVP of Finance*

And on the inventory question, yes, a bit of it is off site. But I think, generally speaking, our inventory levels reflect the fact that we expect a strong second half. And we have to build inventory in anticipation of that. My guess is that our inventory will be down by the end of the year, though.

Jess L. Lubert - *Wells Fargo Securities, LLC, Research Division - Director and Senior Equity Analyst*

And Jim, just -- would it be fair to say visibility coming into the second half is better than the first half given some of the orders and the inventory you're looking at right now?

James E. Moylan - *Ciena Corporation - CFO and SVP of Finance*

What I'd say there is that we've had very good visibility in our business for a long, long time, really, the last couple of years because our backlog has been growing. So I'd say, marginally, could it be better, yes. But we've had good visibility for a long time.

Operator

Our next question comes from the line of Tim Long with BMO Capital Markets.

Timothy Patrick Long - *BMO Capital Markets Equity Research - Senior Equity Analyst*

Question and a follow-up. On the -- talking about WaveLogic Ai out in the summer, I think Jim and Gary both talked about some potential market share gains there. Could you give us a little color on where you think those gains will come from, what applications, what products, where do you think you'll get the most bang there? And then on the follow-up, just on the software line, it did tick down a little bit in the quarter. Last quarter was pretty strong. So was there anything else to the sequential move a little lower in the software line?

Stephen B. Alexander - *Ciena Corporation - CTO, SVP and Member of Technology Advisory Council*

Yes, sure. So this is Steve Alexander. I'll address the Ai piece of it, right? So to the points that were made earlier, all the success we've had in the market, the share gains and stuff were really done off of the prior WaveLogic 3 platform with Ai. There's a number of improvements that come into place, right? It's -- so you would expect it to have impact across the entire portfolio. First 400 gig per wavelength chip, it has a whole series of features that we've talked about in the past with regards to the ability to have software control throughout the entire photonic layer. It produces a number of the analytics information necessary for the automated network that we're enabling for the future. So Ai will have broad-reaching impact on the portfolio. And again, it's the first in market with 400 gig per wavelength, so it does represent an entire new level of performance.

James E. Moylan - *Ciena Corporation - CFO and SVP of Finance*

And on software side, I'd note first that we're up 20% over last year in the quarter. We had a particularly strong quarter in Q1. And there's -- this is a very nascent market, and there are going to be movements up and down. But over time, we do expect this segment to grow.

Operator

Our next question comes from the line of Vijay Bhagavath with Deutsche Bank.

Vijay Krishna Bhagavath - *Deutsche Bank AG, Research Division - VP and Research Analyst*

So yes, I'd like to get your view, Gary, on how speed transitions impact your business. Where I'm coming from is if Verizon, or whoever else, starts to roll out 200 gig versus 100 gig prior, would that mean more ASP for you, better margins versus 100 gig? And a similar thought process on the cloud guys, as they go to 100 gig, 400 gig and on and on, how do these speed transition impact pricing and margins? Help us understand.

Stephen B. Alexander - *Ciena Corporation - CTO, SVP and Member of Technology Advisory Council*

So Vijay, let met -- this is Steve. Let me give you some insights. Similar to when we've had conversations in the past, historically, we've seen the web-scale folks be the first adopters of the higher-rate speeds, right? So we've shipping 200 gig for several years now. Every time we do that, we're able to provide better economics for our customers, right? So if you can double the rate for the same basic platform, you're cutting their effective cost per bid in half. And so you would expect, as you go 200, 400, as things go faster and faster, we'll continue to produce better economics for our customers. We look at it, again, on kind of a platform basis. And these chips more and more are programmable. And so the customers are free to set them to do the type of application that they need. And with the introduction of Ai later this year, they'll actually become much more capable of automatic operation and letting the systems basically signal as fast as the physics allows. So we view it as providing a programmable platform. That's the way we view this. And we think that plays very well into the way we see the customer demand evolving.

Vijay Krishna Bhagavath - *Deutsche Bank AG, Research Division - VP and Research Analyst*

Perfect. A quick follow-on for Jim. Packet Networking, software platforms both down quarter-on-quarter. How should we think of gross margins, in particular, product gross margins heading into the back half since software and Packet Networking is what drives margins?

James E. Moylan - *Ciena Corporation - CFO and SVP of Finance*

Yes, Vijay. The one thing that we've often said is that quarter-to-quarter movements can be misleading. And if you look year-over-year, our first half to first half, or anything that's longer duration, you're going to see nice upward and to the right movements. So I guess, in general, what I'd say is that those 2 segments do have high -- or those 2 products or segments have higher gross margins than our average. And over time, as they grow as a percentage of our business, we will see higher gross margins on average.

Gary B. Smith - *Ciena Corporation - CEO, President and Director*

The cautionary note on that, though, if you just take this quarter as an example, both were slightly down in the quarter, and our gross margin was up. So I'd caution you on that.

Operator

Our next question comes from the line of Dmitry Netis with William Blair.

Dmitry G. Netis - *William Blair & Company L.L.C., Research Division - Equity Research Analyst*

My question is kind of goes back to kind of North America and AT&T. And if I'm doing my math correctly, you had about a $15 million to $20 million, maybe close to $15 million headwind from AT&T as it kind of came down to a 15%, I'm being presumptuous here, correct me if this isn't AT&T, but I presume it is. And so that headwind, what helped overcome that headwind? Was the pickup almost entirely outside the North America, markets like India you discussed? Or was there also strength outside, say, Verizon, AT&T? Verizon seems to have stayed pretty flat here quarter-over-quarter. What are you seeing outside those 2 accounts with -- vis-a-vis the CenturyLink and the Level 3s and some of the consolidation that happened? How did that, if at all, help overcome the headwind?

Gary B. Smith - *Ciena Corporation - CEO, President and Director*

Yes, I mean, I think it goes back to the fundamental strategy that we're executing on, which is around global scale and diversification. And so AT&T and Verizon, particularly great customers for us and have grown over the years. But really, the company is growing faster than that. And if you look at the example in North America or outside of AT&T, it was actually up about 13%, if you take that out. So you've got very good strength in North America. I know some other competitors are saying softness and CapEx changes. We are not seeing that, and that's because we are way more diversified, both in terms of customer and in application even in North America. So we're benefiting from that strategy and approach in North America. And obviously, because we've got global scale, the examples that Jim was giving around Asia Pacific, in general, the submarine market was strong for us, Australia, Japan, India. Europe was up 10%. So it's a broad base. And so I think that really has been a fundamental tenet for the strategy of the business, and that's how we're able to withstand these kinds of ebbs and flows.

Dmitry G. Netis - *William Blair & Company L.L.C., Research Division - Equity Research Analyst*

All right. Well, can I jump one quick follow-up here? That was very well presented. My follow-up is on the web-scale side of things. Is that still in that 10%, 15%? Have you kind of crossed that threshold at all? Or is it still in that range? And you have discussed a major project expansion with a top 5 operator. It wasn't part of the -- it wasn't in the 10% category, so I would just love to get some thoughts around where that customer is. Was that the same customer that you'd mentioned the submarine expansion with? And what's your thoughts on the web-scale and kind of how it's tracking?

James E. Moylan - *Ciena Corporation - CFO and SVP of Finance*

We're doing great with the web-scale customers. They're important part of our business. And as we said earlier, #1 in all aspects of the DCI market. So that's just sort of indication of how well we're doing with them. They like our technology. And they remain in the 5% to 10% range on a direct basis. And they remain in the sort of 15% to 20% range in terms of both direct and indirect. As far as the big win that we talked about last quarter, not a ton of revenue from that win as of yet. We do expect that to come on strong as we move through the rest of the year.

Operator

Our next question comes from the line of Tal Liani with Bank of America Merrill Lynch.

Daniel Bartus - *BofA Merrill Lynch, Research Division - Research Analyst*

This is Dan Bartus on for Tal. The first one, I just wanted to understand the submarine market a little bit more. So what has changed there that has put you guys in such a good competitive position? Is it more at-bats, fewer competitors? Just trying to get a read on that a little bit more. And how much should that be a second-half driver for you guys? And then second question is on EMEA improvement. So there, again, I just wanted to dig in more. Is it market stabilization? Is it more the sales restructuring that you guys did that's bearing fruit? Partnership with Ericsson? Just trying to get a read on what you guys are seeing in the region.

Stephen B. Alexander - *Ciena Corporation - CTO, SVP and Member of Technology Advisory Council*

So let me take the -- this is Steve Alexander. I'll take the submarine piece of it. The single biggest determinant in the submarine space is the technical performance, how many bits you can get down the cable, right, so if it plays right into the strengths that we've had all along with the WaveLogic family. And again, I'll point to the fact that all the wins to date have been off of the WaveLogic 3 platform. Clearly, our customers know what's coming with Ai, but the results you're seeing have all been off of the WaveLogic 3. The second piece after technical performance is the relationships, and to the point Gary made earlier, on a global basis, you have to be talking not just to the web-scale folks, but also to the Tier 1 operators because they all have roles in these large cable deployments.

Gary B. Smith - *Ciena Corporation - CEO, President and Director*

On EMEA, I would say, really, it's a confluence of things. Some of it is the changes that we made about 18 months or so ago to focus really the -- on customers that appreciate the value proposition. And I think then it's a combination of the technology. As Steve talked about, we clearly have not missed a technology cycle here at all. And I think the European market appreciates that. And also, I think we've got some very deep relationships in Europe. We go back a long way. And I think it's the confluence of these things that have enabled us to both stabilize and start to grow the business, again, I mean, it's people like Vodafone, LGI, British Telecom. Then we're seeing the sort of spend as they build out their metro networks.

James E. Moylan - *Ciena Corporation - CFO and SVP of Finance*

Just one other point on the submarine market. Remember that the early days of our participation in that market were in the upgrade piece of the business. And we achieved #1 market share, and we've stayed at or near the top in terms of market share in that market pretty much since the last 3 or 4 years. But what is coming now is a series of new cables. And as a result, in part, due to our sort of proof that we have the best technology, the builders of cables want to have best in breed on both the cable laying side and on the optical gear. And we've started to place very well in that market as well. We've announced our partnership with TE SubCom, so that's going to be, I think, an extender of our business in the submarine market going forward.

Operator

Our next question comes from the line of Greg Mesniaeff with Drexel Hamilton.

Gregory Mesniaeff - *Drexel Hamilton, LLC, Research Division - Senior Equity Research Analyst*

I wanted to ask you guys about your -- you mentioned customer diversity and wondered if you can give us any color on your dealings with the cable MSOs and particularly, if you have any products in the pipeline designed for their industry interfaces.

Gary B. Smith - *Ciena Corporation - CEO, President and Director*

Greg, it's a good question. We've increased, over the last few years, our relationships into the cable space, principally in North America, but, obviously, some of that plays as well and to some other parts of the world. I mentioned LGI. So we're in all of the real major cable operators in North America. And we're actually seeing -- over the last 18 months, we're seeing good, steady growth in there. Probably, Comcast is the -- is our largest customer there. And we've got pretty much all of our portfolio, including Ethernet business services, in with Comcast. So we're seeing very good, steady, healthy growth there. I think the big opportunity with these folks is, really, as they look to put fiber deeper into the network, densification of the fiber closer to the network, and that we're already seeing activity in that space. And we're collaborating closely with most of the cable operators in North America.

Gregory Mesniaeff - *Drexel Hamilton, LLC, Research Division - Senior Equity Research Analyst*

So what about products specifically geared towards cable interfaces, like DOCSIS?

Stephen B. Alexander - *Ciena Corporation - CTO, SVP and Member of Technology Advisory Council*

So -- and DOCSIS clearly plays on the -- what -- effectively is the co-ax side of it. And we see a lot of growth in the fiber end of this thing, right? In terms of the fiber deep opportunity, to Gary's point, is densification, and the great common denominator in all this generally tends to be Ethernet-formatted packets. Everything is being carried which is IP, but there's tremendous amount of commonality now in terms of how they're building and actually in deploying equipment out into the field. So when we look at how technologies like WaveLogic play, they match very well into what cable operators want to do, which is increase the capacity per fiber out closer to the customer. So we think we're very well placed for this.

Operator

Our next question comes from the line of Jeff Kvaal with Nomura.

Jeffrey Thomas Kvaal - *Nomura Securities Co. Ltd., Research Division - MD*

I was hoping that we could unpack the gross margin performance a little bit. I think if we look historically, when you post a strong quarter in North -- in Asia Pacific and a little bit of a lighter one in North America, that would be a negative on the margin structure. Similarly, if you, in the past, posted a slightly down quarter in software, that would be a negative on the gross margin. But yet, your gross margin was up nicely, so I'm wondering what that tells us about some of the underlying assumptions that we might have had historically and what that tells us about where the gross margins might go over time.

James E. Moylan - *Ciena Corporation - CFO and SVP of Finance*

The first thing I'd say there, Jeff, is that there are lots and lots of variables that can affect our gross margin, the maturity of the -- of a certain rollout. Early days, we're going to have lower gross margins. Later days, we're going to have higher gross margins. The mix of the products. The sort of stage we are in market. When we're attacking, we tend to have lower, and higher when we're mature and incumbent. But all of those go into this calculation. And some are more important in some quarters than others. Having said all that, we've had extremely good gross margin performance now for 3 or 4 years. And coming from the 42% up to the 45% range, plus or minus, we think that's where we are today. We think there are going to be fluctuations in our gross margin this year as we move through the year. But we think mid-40s is where we are as a company. We have said a few times that in order to get to the 15% operating profit margin, we do need to show consistent gross margin improvement, and we've estimated that in 100 to 200 basis points. And we still believe that, that's going to happen. We think that it's not a feature of this year. We think that, as we grow our software revenue, in particular, and to some extent our Packet revenue, then we are going to trend toward that slightly higher than mid-40s range that we've talked about for this year.

Jeffrey Thomas Kvaal - *Nomura Securities Co. Ltd., Research Division - MD*

Okay. And then secondly, you talked last quarter about XO as a part of Verizon. You didn't mention it this time in talking about Verizon, but if there's anything to add, we'd be all ears.

Gary B. Smith - *Ciena Corporation - CEO, President and Director*

I believe that is now closed and is a complete part of Verizon. I mean, we've got big footprint at XO, which they're going to continue to build on now as part of Verizon. They're going to integrate it into the network and a lot of that is based on Ciena technology.

Jeffrey Thomas Kvaal - *Nomura Securities Co. Ltd., Research Division - MD*

Okay. So that is share gain opportunity for you. Or should we expect it to be...

Gary B. Smith - *Ciena Corporation - CEO, President and Director*

Well, I think they were both -- they're both customers, so I would say it's sort of neutral for us overall.

Operator

Our next question comes from the line of Michael Genovese with MKM Partners.

Michael Edward Genovese - *MKM Partners LLC, Research Division - MD and Senior Analyst*

Just 2 quick questions. First of all, it seems like it's already encompassed in your annual quarterly OpEx guidance, but just could you quantify for us -- or help us understand the OpEx commitment for the merchant silicon and component initiative that you're doing? And then secondly, just any comments on the federal demand, what you're seeing in the federal market right now.

James E. Moylan - *Ciena Corporation - CFO and SVP of Finance*

Yes. We did say that the merchant modem business was going to add to our OpEx by single-digit millions of dollars, and it definitely is encompassed in our guidance for OpEx for the year. We've said just now that our OpEx for the year is going to be exactly what we said at the beginning of the year, which is that we're going to average sort of $235 million a quarter.

Gary B. Smith - *Ciena Corporation - CEO, President and Director*

On the Fed question, Mike, I think, like everybody, we're seeing some weakness. We're very well positioned with the multi-facets of the Fed over time. But I think it also talks to this fact that we're a much broader-based company of global scale and diversified. And we can deal with these ebbs and flows like we can, the M&A activity of our customers, and that's a good example of that.

Michael Edward Genovese - *MKM Partners LLC, Research Division - MD and Senior Analyst*

Jim, just the single-digit million, is that per quarter? Or is that an annual number?

James E. Moylan - *Ciena Corporation - CFO and SVP of Finance*

No. No, that's an annual number.

Operator

Our next question comes from the line of Meta Marshall with Morgan Stanley.

Meta A. Marshall - *Morgan Stanley, Research Division - VP*

A couple of questions. You mentioned orders being greater than revenue this quarter. I just wanted to get a sense of -- do you already have orders coming from products that are based on WaveLogic Ai that will just come out in the next quarter and you already have those purchase orders? And then kind of the second question is just the pace of metro RFPs. Are we getting into the stage where now, we are getting towards more deployment? Are you still seeing kind of a pickup in metro RFP activity?

Gary B. Smith - *Ciena Corporation - CEO, President and Director*

On the first one, Meta, we may have some orders for Ai. But I think it's absolutely de minimis. So we're not seeing the -- another way of saying it is we're not seeing the benefits of the Ai platform from an order point of view, I think that's fair to say, in the order flow so far. In terms of metro activity, I think you can parse it a little bit by geography. Basically, the North American choices are already made. That would -- that boat sailed couple of years ago. And we're in deployment mode. The highest profile of which, I guess, is probably Verizon, but you can say the same thing with AT&T, say it at Comcast, say it at CenturyLink, et cetera. They've chosen their players, and that's all done. You are seeing opportunities in 1 or 2 different geographies. But even that, I would say, most of the players of this made their choices and they are deploying. So we're very much into the deployment phase, and that will be a multi-year -- given the nature and scale of this thing, it will be a multi-year deployment. Places like India -- and I think a key element behind this metro -- one of the elements behind it is getting ready for 5G. It's basically densification on fiber of the network, getting it closer to the user. We're already seeing many networks around the world begin the planning for that.

Meta A. Marshall - *Morgan Stanley, Research Division - VP*

Got it. And is there any different reception or change surprises that kind of came out of your OFC announcement that kind of your partners, Lumentum or NeoPhotonics or anybody who kind of came back with different feedback after the OFC announcement about enthusiasm or excitement about that announcement?

Gary B. Smith - *Ciena Corporation - CEO, President and Director*

No. I mean, I think we -- there's, obviously -- we've been working on this for quite a while with these partners, so I'd say it's well researched from our point of view. It's very well researched from their point of view. These are probably the premier component players in our space with deep and long relationships. And so they've done their homework extensively, so I think we're in a good place with them. As we've said, we don't think this is a really second half of '18 impact to us. And I think we're making good progress towards that.

Operator

Our next question comes from the line of Simon Leopold with Raymond James.

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

First, I just wanted to get a clarification on the services gross margin. If I've done my math correctly, it was just over 50% this quarter, which looks like the highest level we've seen and kind of breaking out. If you could clarify what, if anything, was unique or special about services this quarter and how that's trending. And then in terms of -- question I want to ask was whether or not you're seeing any kind of pause, which is not evident in your revenue guidance ahead of the release of WaveLogic Ai, just wondering if maybe there's some pent-up demand or customers waiting, which could lead to better than seasonal behavior once the product is out in the market. Anything you could give us to help us understand the product cycle transition.

James E. Moylan - *Ciena Corporation - CFO and SVP of Finance*

On the services margin, Simon, as I said earlier, there are lots of variables that go into the computation of our gross margin. It so happened that we had a very good quarter in services. We have spent a lot of time and effort improving our cost structure in services, and that's a piece of it. That improvement has certainly factored in to our view that we're in a mid-40s kind of range today. I wouldn't read a lot into it, except that it was great, and we're proud of it. And we'll see what happens going forward.

Stephen B. Alexander - *Ciena Corporation - CTO, SVP and Member of Technology Advisory Council*

And Simon, as far as the Ai, I mean, clearly, our customer are in the labs with it. They're looking at it, right? All lights are green, right? It's on schedule. We expect it out in the summer time frame. But all of the impacts of that are basically built into what we've been saying.

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

But I guess, what I'm trying to understand is could we see a better pattern once Ai is available in the market? Does that lead to some kind of inflection where there's pent-up demand that might become more evident in October or January? That's what I'm really trying to understand.

Gary B. Smith - *Ciena Corporation - CEO, President and Director*

I think -- Simon, I think we've got a pretty close relationship with those folks and they're very aware of the road map. And I think that is mapped into the performance that we're predicting for the second half. So we're seeing a nice uptick in the second half, and some of that is due to the Ai beginning to appear on the street.

James E. Moylan - *Ciena Corporation - CFO and SVP of Finance*

And certainly, Ai is a factor in our confidence in our future. We're saying this is not just a 2017 performance. This is a multi-year performance. We're going to continue to grow. And we believe we'll continue to increase our profitability.

Operator

Our next question comes from the line of Fahad Najam with Cowen and Company.

Fahad Najam - *Cowen and Company, LLC, Research Division - Associate*

So my question is -- 2 questions for me. One on the gross margin. If our checks are right, the new AT&T win includes a significant software components. Why shouldn't gross margin be greater than the mid-40s? Help us understand what is gating that. And then regarding your long-term 15% operating margin guidance, do you think, against the backdrop of all the positive trends you are seeing, do you think you'd get to that milestone sooner than what you were previously anticipating?

James E. Moylan - *Ciena Corporation - CFO and SVP of Finance*

Yes, Fahad, on the gross margin. Just to remind you, we -- typically, when we're in early stages of deployments or when we are taking market share, we're going to enjoy less than corporate average gross margins on those kinds of deals. And we have been taking share. And we do have a fair amount of early-stage deployments in our results this year. So yes, software is doing well and I think it's going to continue to do well. We've got a lot of other positive things going on in our gross margin. But we are in early stages of deployment with a number of projects and customers. So that's the offsetting piece. I think, over time, as we said, we'll see improvement in our gross margins as software continues to grow. But we strongly believe, this year, we're a mid-40s gross margin-type company.

Operator

Our next question comes from the line of Catharine Trebnick with Dougherty.

Catharine Anne Trebnick - *Dougherty & Company LLC, Research Division - VP and Senior Research Analyst*

Quick question on subsea. At the TCI conference this year, they talked about over 12 of the new subsea systems coming online are funded by the content providers. Any possibility publicly you could state how many of those you're involved in that are coming online from the end of this year into 2019?

Gary B. Smith - *Ciena Corporation - CEO, President and Director*

Catharine, yes, we're involved with a number of those. I wouldn't like to put the exact specification to it. I think we've called out a couple of them that we've already secured. And we're working on the others. Some of them are -- they're at different stages of evolution and maturity. But we're incredibly well placed for them. And I think it also talks to this fact around a lot of the web-scale folks are really very focused now on growing outside of North America. And so partnering with them, not just on the submarine, but on where they land and then getting network capacity in their DCIs pulled up in these various countries, we're partnering with them as well. And so I think our ability to have global scale and Tier 1 customer relationships is actually helpful in pulling through our submarine business as well. So we're seeing a pretty aggressive expansion from these folks, not on just submarine cables, but on also growing outside of their North American base.

Gregg M. Lampf - *Ciena Corporation - VP of IR*

Thanks, Catharine. And thanks, everyone, for joining us today. We look forward to catching up with everyone today and over the next several weeks.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone, have a wonderful day.
