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CIEN - Q2 2014 Ciena Corporation Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen and welcome to the Q2 2014 Ciena Corporation earnings conference call. At this time all participants are in a listen-only mode.

(Operator Instructions)

As a reminder this conference call is being recorded. I'd now like to introduce your host for today's conference, Gregg Lampf, Vice President Investor Relations. You may begin.

Gregg Lampf - *Ciena Corporation - VP of IR*

Thanks, Ashley. Good morning and welcome to Ciena's second quarter 2014 review. With me today is Gary Smith, CEO and President, Jim Moylan, CFO, and Tom Mock, Senior Vice President of Corporate Communications.

This morning's press release is available on national Business Wire and Ciena.com. We've 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 today Gary will discuss management's view on the market and Jim will offer some color on our results and provide guidance. 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 the context of the risk factors detailed in our most recent 10-Q filing. Our 10-Q is required to be filed with the SEC by June 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 the website. Gary?

Gary Smith - *Ciena Corporation - CEO & President*

Thank you, Greg, and good morning, everyone. This morning we announced another strong quarter and an excellent overall performance for the first half of fiscal 2014.

The market is evolving as we expected and our value proposition is resonating, and we are capitalizing on the opportunity. Over the past several years we've consistently executed well and as a result our financial performance has steadily improved.

All of this gives us confidence with respect to the second half of our fiscal year. With our market momentum, we expect a significantly stronger second half performance with better operating leverage.

Consistent with our strategy to expand our role and reach in the industry, we're driving continued growth in differentiated performance against our peers in three ways. First, as expected we are capturing a greater share of tier 1 carrier spending by addressing more applications beyond pure optical infrastructure.

Second, we are broadening and diversifying our customer base. And finally, by design, the solutions we are offering today are ideally aligned with the new requirements of an emerging on demand environment. I'll address each of these dynamics in a little more detail starting with the tier 1 carrier market.

Since our Q1 conference call, there has been some concern about near term carrier spending in the US. And although we've said it many times before, I think it bears repeating that we believe the shifts within CapEx budgets are a better indicator of our opportunity than the total envelope of carrier CapEx.

As packet optical is foundational for creating new revenue generating services, carriers are shifting their spend towards these solutions. And according to Deloro, Ciena is number one in packet optical worldwide.

The shift towards packet optical, coupled with our leading position, is allowing us to expand our applications within tier 1 accounts. And as a result we are now involved with multiple projects at many different carriers and at a more strategic level.

With more engagement at the front end of the business, we're helping customers driver service creation through models such as carrier managed services, and applications such as cloud services, data center interconnection and other applications that grow carrier revenues. Our expanding role means we're doing more kinds of business with tier 1s today than we've ever done, which is helping us establish a more balanced broader based business.

So clearly we hold a very strong position with tier 1 service providers, particularly in North America. But we've also designed our business to diversify into other high growth segments, which is the second dynamic that's fueling our success.

We continue to focus on extending our international reach, and in addition to our direct sales efforts in key geographies, we see our new partnership with Ericsson as an opportunity for greater long term international growth beginning in 2015. And that relationship is off to a good start and early indicators are very promising.

But to continue to expand beyond service providers as well; for the last four quarters our non-telco revenue has climbed from about 25 % to 30% of our total revenue, including government, financial services, healthcare and other enterprise verticals. One of the fastest growing non-telco segments for Ciena is Web 2.0, which includes customers such as internet content providers and data center operators.

We're now dealing with most of the major Web 2.0 players either directly or indirectly. Ciena now counts two of the top five Web 2.0 players as direct customers, and increasingly we are collaborating with traditional network operators specifically to support their Web 2.0 customers with both infrastructure and carrier managed services.

All of our customers, service providers, Web 2.0 players and private network operators of all kinds, are looking to leverage an open ecosystem of virtualized resources to enable the realtime analytics and network agility required to deliver on demand business models. And that is the third dynamic driving Ciena's continued strong performance.

We've discussed for several quarters now that a major market shift is just beginning towards an on demand model that's better suited to changing end-user behavior. Both consumer and enterprise end-users are consuming network resources today largely through network applications that require an on demand experience.

Our customers businesses depending on enabling that experience, making network performance more critical than ever. This shift to an on demand world is a fundamental market changer, and as we've said before there will be new winners and losers in this environment.

We have deliberately built our approach, our organization and our portfolio as the network specialist for this opportunity. Today Ciena is uniquely positioned for a market shift that is much more than just about the 100 gig.

Our OPN network architecture is all about transforming capacity into on demand capability. Additionally, we have key industry partners to help us drive an open ecosystem of virtualized resources.

As you know we're developing SDN control software with Ericsson, and we recently announced a joint solution with Brocade to enable on demand provisioning for both computing and network resources across data centers. By capturing a greater share of customer spend, diversifying our business and offering a compelling value proposition for the on demand environment, we are performing well and we see opportunities for continued revenue growth and margin expansion.

In the second half we will be introducing new application software on an entirely new product platform targeting opportunities that expand our addressable market in a way that makes strategic sense for both Ciena and our customers. Given the increasing diversification of our products and our customer base, I would stress that our business today correlates less with the overall spend of a handful of North American carriers, and less with the forecast from optical component suppliers.

We are capitalizing on segments that are growing faster than the traditional Telco market and we're taking share in those segments. All of these factors help drive another strong quarter and first half for Ciena, and we view them as critical underpinnings for our continued differentiated performance going forward.

We have built a broad and balanced business for the significant multi-year opportunity in front of us, and as a result Ciena is in a position to not just win in the new environment, but to drive increased operating leverage in our business in 2014 and beyond. I'll now turn the call over to Jim.

Jim Moylan - *Ciena Corporation - CFO*

Thank you, Gary, and good morning, everyone. I'll cover some of the highlights of our results and I'll speak only to non-GAAP results.

Please refer to this morning's press release, which you can find on our website, for reconciliations to GAAP numbers. Given the quarter-to-quarter fluctuations we sometimes see in our results, we emphasize that you should view our performance not solely on what we do in the quarter, but also in the broader context of half-year and even full-year results.

We have now completed the first half of FY14, and so my comments will address both the quarter and the half. Q2 revenue came in at $560 million.

We had strong order flows in the quarter and orders were meaningfully higher than revenue. For the first half of 2014 revenue was $1.1 billion, a 14% increase over the first half of last year.

At 43.1% adjusted gross margin in Q2 was consistent with Q1's gross margin. For the first half of 2014 adjusted gross margin was 43.2%.

Adjusted operating expense in the second quarter was $206 million. For the first half of 2014 OpEx was $406 million, in line with our guidance of an average of approximately $205 million per quarter for the full year with some quarterly fluctuation. As a percentage of revenue, OpEx was 37% in the first half.

Q2's adjusted operating profit was $35 million, and we posted an operating margin of 6%. For the first half adjusted operating margin was 6% as well.

We ended the quarter with $430 million in cash and investments. We said last quarter that we expect the business to benefit from a strategic investment we made in converged packet optical inventory. And indeed we are already seeing some of that benefit.

We have reduced delivery lead times. We have improved velocity, which is helping us win new diversified business, particularly with customers like the Web 2.0 players Gary talked about earlier.

And we can increasingly book and ship more orders in the same quarter, converting backlog to revenue faster, which will in time benefit our cash flow. And as we have said before, this investment did result in some short-term cash use. We still expect, however, to generate free cash flow for the full fiscal year.

Turning now to guidance. For the fiscal third quarter of 2014 our guidance is as follows. For Q3 we expect revenue in the range of $585 million to $615 million.

We expect Q3's adjusted gross margin to be in the low to mid-40%s, similar to Q2's result. We expect Q3's adjusted OpEx to be approximately $210 million.

We remain committed to our OpEx plan, and we continue to expect that the quarterly average for OpEx throughout the fiscal year will be approximately $205 million. We also remain committed to driving down OpEx as a percentage of revenue going forward toward our target of the low to mid-30%s as a percentage of revenue. In the second half of this year, we expect it to be in the mid-30%s as our revenue grows.

With regard to other income and expense in the third quarter, we project an expense of approximately $11 million related to the interest on our convertible notes. We expect our tax obligation for Q3 will continue to be related solely to foreign taxes.

And as for share count, we estimate Q3's basic share count at approximately 106 million total shares. Diluted share count will vary depending upon your assumptions about our profitability.

Before we go to questions, I'd like to comment on the year as a whole. At the beginning of this year we expressed enough confidence in our visibility, our backlog and the overall strength of our business to provide annual guidance for adjusted operating margin for the first time.

We continue to have that confidence today. We built a balanced diversified business that is aligned with high growth segments of the market, and we continue to execute very well.

As a result, we're delivering steady improvement in operating leverage, and we remain confident that we will achieve the low end of our current target range of 7% to 10% for adjusted operating margin for the full FY14. Ashley, we'll now open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from Amitabh Passi of UBS.

Amitabh Passi - *UBS - Analyst*

Hi, thank you, good morning guys. I had a question for Gary and then a follow-up for Jim.

Gary, you talked about diversified customer base, yet I think your largest customer was almost 22% of sales this quarter. Revenues there I believe grew 20%, outpacing overall US sales growth as well as international sales growth.

Just wanted to get your thoughts. When do we expect momentum across the rest of your customer base to start picking up? Because I suspect going forward the investors will likely be a bit concerned in terms of the concentration around your largest customer.

Gary Smith - *Ciena Corporation - CEO & President*

Thank you, Amitabh. I think here we've built into the guidance for the rest of the year the various fluctuations and changes that we see within that. And the couple of things I would stress. One, relative to where we were, we've diversified with our top customers the overall percentage of business pretty considerably over the last two to three years. So it is much more balanced.

We're continuing to do well with those large customers, and we're continuing to expand the applications that we're driving in all of those large customers. And so we continue to diversify our business in both our role and the reach dimensions of it, and our international business as well. You know diversification into other customers is going extremely well, and I would expect that to show into the numbers as we move forward.

Also diversifying the business, 30% of our business now comes from non-traditional infrastructure business. That's up from 25% last year. So you can see we're making good expansion in terms of our overall diversification.

You take someone like an AT&T for example, we're now providing them metro applications, we're in the core of their backbone, we're in submarine, we provide global mesh, we're in mobile backhaul, we're in their business services, we're in their fiber to the building VIP program, we do carrier managed services with them, layer one and layer two and provide consulting services as well. So I think we need to view the word diversified in both of its dimensions of both role and reach. And I think in that context I think we have a much more balanced business than we've had previously.

Amitabh Passi - *UBS - Analyst*

Thanks for the color, Gary. And then Jim, just for you I think you snuck in a very subtle change in gross margin guidance, low to mid-40%s. I think it's the first time in the last two years that you're actually guiding up to the mid-40%s.

Just curious, what's changing? And as we look at gross margins sequentially fiscal Q2 to fiscal Q3, should we expect gross margins to be relatively flat? Could you do better in Q3? Would love to get some incremental insight there.

Jim Moylan - *Ciena Corporation - CFO*

Yes, the one thing I added to the changed guidance was I said we expected to be similar to what we did in Q2. One thing I'd say about our gross margin is that because of all of the changes and addition of software content to our products and the increasing role and diversified reach that we have across customers, we are seeing good things happen in our gross margin.

So I'd just say that we feel good about it. I think they are going to continue to be movements around gross margin because we have big items flow through our results, which can impact our margins up or down. But overall I think our gross margin trend is good.

Gregg Lampf - *Ciena Corporation - VP of IR*

Thanks, Amitabh.

Operator

Our next question comes from Mark Sue of RBC Capital Markets.

Mark Sue - *RBC Capital Markets - Analyst*

Thank you. Good morning gentlemen.

Jim Moylan - *Ciena Corporation - CFO*

Hello, Mark.

Mark Sue - *RBC Capital Markets - Analyst*

A question on just how you feel about linearity and predictability in your diversified order trends. Just how that feeds through in terms of your working capital requirements, subsequently your cash generation, and how we should think about cash generation and working capital over the next several quarters. That would be helpful.

Jim Moylan - *Ciena Corporation - CFO*

We've seen really over the past three years very strong order flow and a growing backlog as we've talked about, Mark. A feature of the growth in our business as we've diversified internationally, is that we have gotten into the business of building out complete networks which require installation on our part and require the entire network to be lit and accepted by the customer before we can book revenue, and for the most part before we can collect.

So a natural feature of that business is that it has used working capital. And so really this year we, for the first part of this year a big part of our use of cash has been building this off-site inventory for these projects and this strategic investment that we've talked about several times, about trying to get enough converged packet optical inventory on hand to handle the new customers, which are really focused on lead time.

So having said all that, my feeling is that we're going to start to generate cash nicely. I think we've gone through this bulge of having to put inventory on our balance sheet. I do, again, have to put out another word which is we do tend to have quarters which are back-end loaded and that means that at the end of a quarter our receivables tend to be higher than they are during the rest of the quarter. And so you don't see the inner workings of a quarter and what happens to our receivables balance. But I think we're going to now turn to generating more cash than we have, particularly over the last couple of quarters.

Mark Sue - *RBC Capital Markets - Analyst*

And subsequently how should investors think about your cash, and should we think of deleveraging? Should we think of debt repayment? Any thoughts on just the long term use of cash as you generate more and more?

Jim Moylan - *Ciena Corporation - CFO*

Well, I think that's going to be a great problem to have, Mark, but what I'd say is this. We know that we've got a convertible which is coming due in the first part of next year, $187 million. I'm confident, frankly, that that's going to convert to equity and so I don't think that's going to be a cash need.

But having said that, given our current cash position and the fact that we do expect to generate cash for the rest of this year and next year as well, we're confident that we have the liquidity to manage our business, including the repayment of this debt. And once we get through that repayment or conversion or whatever it is, I do think we're going to have options on cash and we'll deal with those as they come up.

Gregg Lampf - *Ciena Corporation - VP of IR*

Thank you, Mark.

Operator

Our next question comes from Ehud Gelblum of Citigroup.

Ehud Gelblum - *Citigroup - Analyst*

Hi, guys. Good morning. So a couple questions to dig a little bit in. Clearly [passing out] your largest 21% customer, in the past there were obviously a number of other customers that were close to 10%, but haven't quite made it.

Can you give us a sense as to what the next collection of customers look like? Are they clustered around the 8%, 9% range? Or from there does it drop off? How many have you had in that range and does it drop off a little bit? Just to give us more of a spectrum view of what your customers look like and the diversification from there.

And then Gary, you mentioned a lot of different areas that were driving growth from wireless backhaul, you had a whole list. You gave us a sense as to how much your revenue is driven by each one of these types of deployments, whether it's fiber-to-the home, the Web 2.0 guys, the data center build, things like Google general, Google fiber. If you could just give us a sense of what the drivers are that we can get our arms around so when we see increases and decreases in spend in those particular areas, as opposed to the crutch we've had in the past which is just spending from the large North American providers overall, we can get a sense as to what areas of your business are doing well.

Jim Moylan - *Ciena Corporation - CFO*

That's a long and involved question. (laughter)

Ehud Gelblum - *Citigroup - Analyst*

You'll break it down.

Jim Moylan - *Ciena Corporation - CFO*

But first part I'd say this. Over time we've seen less concentration and more diversification just numerically in our top customers. And just to give you an example, if you look at the second quarter of this year just over 60% of our revenue came from our top 10 customers, and that was almost 65% last year. So that's just an indication that we're getting more and more diversified.

And you can take that and sort of get to the amount which the other nine contribute as a piece. And of course there's a declining of the percentage as you go down the top 10, but that gives you some indication. If you look at the top 20 you see a similar trend. And we've seen this trend continue over time.

So I know people tend to be focused on two big US customers, and they are very, very important to us. But we do think that with the fact that we are much less concentrated as a company than we were two and three years ago overall, then people should feel much more comfortable about our prospects being more diversified.

Gary Smith - *Ciena Corporation - CEO & President*

And let me take the sort of second part of that which is really around sort of the questions around market perspective and try and answer that in a couple of different ways. And first of all from a sort of an application point of view and then I'll talk about market segments.

The network's moving more to be from the traditional view of the network segmentation to be more about either connecting content to content or content to users. And I think in the content to content we're seeing good growth around that, particularly as one would describe that as data center to data center connectivity, and that market is clearly extremely strong.

But I would think that the -- I would say that the content to the users piece is where really a lot of the diversification of our applications and a lot of growth is coming. And that's really manifested in older segmentation terms as sort of growth within the metro and at the edge of the network and around things like carrier managed services. Ethernet business services, seeing very strong growth there as evidenced by our performance. And overall the move towards a converged single network as opposed to multiple networks, which is why the converged packet optical segment is growing so fast for us. That's the bet that we placed, and I think you're seeing that now show up in the network architectures and in our financial results.

To take another sort of perspective of it, I see very good growth in international, both from our direct efforts, you have a number of large opportunities and large existing accounts there, and we're broadening out within those accounts. I think the relationship with Ericsson, although very early days, looks very promising and we're building a nice pipeline of business there. And also from a segment point of view I think the Web 2.0 market segment we're seeing very good traction there, both directly and indirectly where we're providing carrier managed services through our partners into those Web 2.0 players both in North America and outside.

The other segment that we're also diversifying and seeing very good growth is obviously submarine. That's a market that we had zero share in two to three years ago. We now have the number one market share in about 30% of that total market. And that continues to grow nicely.

So when we step back from all of that, we think about the expansion in our role and our reach and we're diversifying in each of those dimensions. So hopefully that gives you a little more color, Ehud, in terms of where we see the growth for the Company.

Gregg Lampf - *Ciena Corporation - VP of IR*

Thanks. We do need to move on to others.

Operator

Our next question comes from Scott Thompson of FBR.

Scott Thompson - *FBR Capital Markets - Analyst*

Good morning, guys. Remember the days when you had to worry about stringing three quarters together? (laughter) I'm not sure I do anymore, but nice quarter.

Gary Smith - *Ciena Corporation - CEO & President*

Thank you.

Scott Thompson - *FBR Capital Markets - Analyst*

Let's dig into the web scale opportunity a little bit. The Web 2.0 guys. It sounds like those guys are building out data centers in maybe some of the top 30 cities as a group, maybe well beyond that into next year.

I would assume there's some services opportunities as well as some equipment opportunity around that. But what's the magnitude and the timing around that? How would we start to build that source of demand into our models? Thanks.

Gary Smith - *Ciena Corporation - CEO & President*

That's a good question. I would say that by way of sort of context, two years ago, Scott, we really didn't see any of this business. It was non-existent to us. We've now got two of the top five internet content providers as direct customers, and an increasing opportunity with both them and the others. And I think it's an increasing number of leading exchanges and data center operators. So it covers a number of them.

I would say if you were to take an estimate of that, Scott, in terms of the total optical market, I would say it's less than 10% now but growing to sort of 15% over the next year or so. And we're addressing that both directly and indirectly through our various carrier partners. So I would say it's becoming a very high growth part of the market.

Gregg Lampf - *Ciena Corporation - VP of IR*

Thank you, Scott.

Operator

Our next question comes from Vijay Bhagavath of Deutsche Bank.

Vijay Bhagavath - *Deutsche Bank - Analyst*

Yes, hi guys. Vijay on behalf of Brian. Hi Gary, hi Jim.

Jim Moylan - *Ciena Corporation - CFO*

Hi, Vijay.

Vijay Bhagavath - *Deutsche Bank - Analyst*

So a conceptual question. I'd like for us to better understand the Web 2.0 opportunities in terms of ASP margin profiles. You see them comparable to the big telcos in the US, you see them giving you a better price point? So enhancing a better gross margin profile for sales into the Web 2.0 versus the big telcos.

Gary Smith - *Ciena Corporation - CEO & President*

I would say it varies by application, not too dissimilar from the overall telco market. I mean it's whether we're providing wholesale capacity to them or whether we're at the edge of the network with sort of carrier managed services type applications.

They're at the very early stages of deployment and buildout, but we're seeing it as a constant theme again, both directly and indirectly. I would say that my assessment right now is I would say similar margin by application.

Vijay Bhagavath - *Deutsche Bank - Analyst*

And then a follow-up would be on the metro opportunities at your US telcos. Do you see an early inflection point in 100 gig in the metro in the US heading into the back half? Or is that still too early to make that call?

Gary Smith - *Ciena Corporation - CEO & President*

I mean I think we talked about that last quarter. We are beginning to see metro deployments. Tom, do you want to give some additional color on that?

Tom Mock - *Ciena Corp - SVP Corporate Communications*

Yes. We've started to see a couple things happen in the metro space, Vijay. The first one is we are beginning to see 100g happen in the metro. It was a significant portion of our 100g shipments in the quarter was kind of in the 20% sort of range that were going to those shorter distance applications.

But probably a more important point that we're seeing in the metro space is the fact that as you get closer to the end-user you have to be more involved with service delivery. So the capability of those boxes is becoming more diverse. So you end up with a greater need for OTN switching and a greater need for packet switching. Gary alluded to a platform that you're going to see coming up from us in the latter part of the year, and that's really about more tightly integrating packet and optical together and being able to deliver that packet capability closer to the end-user.

Gregg Lampf - *Ciena Corporation - VP of IR*

Thank you, Vijay.

Vijay Bhagavath - *Deutsche Bank - Analyst*

Thank you again.

Operator

Our next question comes from Georgios Kyriakopoulos of Raymond James.

Georgios Kyriakopoulos - *Raymond James - Analyst*

Yes, thank you. This is Georgios for Simon.

Gary, how should we think about your US customers outside AT&T for the remainder of the year? Clearly you seem very excited about AT&T spending, so I was wondering if you could discuss how your business trends with other big US customers, especially given this quarter revenue from these customers excluding AT&T, actually declined 6% sequentially?

Gary Smith - *Ciena Corporation - CEO & President*

So you're talking about large -- let me just understand the question, you're talking about large telcos in North America excluding AT&T? Is that the question, around what do we see the dynamic around that?

Georgios Kyriakopoulos - *Raymond James - Analyst*

(multiple speakers) Yes, so your --

Gary Smith - *Ciena Corporation - CEO & President*

Yes. Within the quarter you're going to see fluctuations within the quarter. We expect to have a strong second half with most of the major tier 1 carriers in North America.

We don't expect to see a drop off with people like Verizon, for example. You got Century Link, you got Sprint, you got Comcast, you got Bell Canada, so I think we're going to continue because of our diversification in that customer base as we are in more and more applications with them. So I would expect a strong second half for that segment within North America.

Georgios Kyriakopoulos - *Raymond James - Analyst*

Okay. And then you mentioned that your business is less correlated to the forecast from optical component suppliers, which was rather weak this quarter. Can you expand a little more on this? Is it you that holding less inventory, perhaps less optical content in your systems, maybe some vertical integration or favorable component pricing? Thank you.

Jim Moylan - *Ciena Corporation - CFO*

Let me take a stab at that, Gary. Here's what I'd say about that. There's no question that over the long term as spending on telecom goes up, we are going to be somewhat correlated to those guys. But what's happened if you look back over the past three or four, at least two or three years, is that as we've diversified our products, the percentage that we represent of their business and the percentage that they represent of our purchase has changed.

And if you actually look at the quarter-to-quarter correlation between our results and theirs, it just doesn't correlate. I mean you can be fooled by making judgments about what we're going to do based on what those fellows are saying. To me, the best thing you can do is listen to what we're saying about our results, because we have the best view into our business.

Gary Smith - *Ciena Corporation - CEO & President*

And to take another cut on that, if you look at our portfolio we've diversified with our open architecture, it's increasingly about software which we develop ourselves. You're not going to see that show up in any supply chain metrics. It's increasingly about our own degree of ASICs and vertical integration where we're choosing strategically to own that technology. It's increasingly about consulting and services, and it's increasingly about packet, which does not necessarily show up in the optical ecosystem.

So you know you put all of that together, and to reiterate Jim's comments, I think you are seeing we're moving into a different environment now around these converged technologies. And I'd encourage everybody not to keep looking at us through this pure optical filter of our history. I mean yes, we've got market leadership in 100 gig, et cetera and we are absolutely going to continue with that, no question. That's a core part of the underpinning of our architecture and our strategy. But we're much more diversified than that.

And back to my point, when you see dislocations in the market as we're seeing as we move to these on-demand networks, you're going to see winners and losers and you're going to see a different set of players both decline and emerge, frankly. So I think it's very important that as an industry we understand the sort of context of the dynamics that we're dealing with.

Georgios Kyriakopoulos - *Raymond James - Analyst*

Thank you.

Operator

Our next question comes from Kent Schofield of Goldman Sachs.

Kent Schofield - *Goldman Sachs - Analyst*

Great, thank you. I have to admit that I was sitting here struggling a little bit with how to formulate this question. But kind of the bottom line, and maybe it's just comparing it and contrasting, but if we think about international -- and I know that's a broad bucket and that's the reason I struggle with this a little bit -- but if we think about that, it's undergrown your domestic piece and sometimes that's driven by AT&T or not. But it's undergrown your domestic piece for more than kind of a full year.

And so can you just help us understand is there a different level of cycle deployment? Is there an inflection that we're waiting for? Do we need Ericsson to come on line to get that growth ahead of the domestic side of things? Just trying to understand with that being kind of the more I think of your domestic business as being kind of the more mature piece that maybe the growth opportunity isn't quite as large there, that you may have more room on the international side, but we just haven't seen that really happen yet. And I know it's a long question but any color would be helpful there.

Jim Moylan - *Ciena Corporation - CFO*

Sure. Let me take a stab at it and I'm sure Gary will have a comment or two as well. The first thing I'd say is that if you think back a couple of years ago, as we talked about the network architectural shift we said that it was likely to happen in the US first. And so we thought that we would actually for a couple of years see faster growth in North America than we would in the rest of the world. And that has played out fully.

Secondly, we are growing internationally in our engagement with customers around the world. We're well positioned with many customers. In many cases this growth is about these big networks, where we're building out complete networks as we talked about that have to be lit before we can recognize revenue. And so what you've seen is that our deferred cost of sales has grown. And you can think about that as if it were on a normal revenue, or I shouldn't say that, revenue cycle like that of North America, then we would already have booked that revenue. And that sort of masks the growth that we have.

If you look at our backlog overall, with that deferred cost of sales and other business that we have in our backlog, it is much more heavily international than it is US. So I do expect over time that international will grow to a larger percentage of revenue than we have seen.

And Ericsson is just another item that's going to help us grow internationally. So we feel good about our international business. You're going to see growth there.

Kent Schofield - *Goldman Sachs - Analyst*

Thank you.

Operator

Our next question comes from Rod Hall of JPMorgan.

Rod Hall - *JPMorgan - Analyst*

Yes good morning, guys. Thanks for taking my question.

I just wanted to see if you guys could -- Gary, you've commented on the second half of the year momentum, confidence in the US. And I then think in your prepared remarks you said it's going to be better than the first half. I mean it feels like you're indicating maybe better than normal seasonality there or a little bit at least. And I just wonder if you could comment on that, and also on what gives you that sort of confidence visibility point seasonally?

Is it Europe do you think is going to pick up more, the US and Europe, and what exactly drives that? And then secondly, I wonder if Tom brought along his coherent and 100 gig customer numbers? Maybe just update us on the counts there, thanks.

Gary Smith - *Ciena Corporation - CEO & President*

Rod, let me take the second half question first. I think what we've seen actually is over the last two to three years as we've executed on our strategy, the second half has consistently been better than the first half. And I go back to the point that Jim was making, I would encourage people to look at us -- if you're looking for trends, put the halves together. Things can fluctuate in any given quarter, but I think the halves really kind of tell the story. And the second half has been consistently better than the first, so that's one piece of data that I would offer.

Secondly, the reason that we're confident, it's a combination of things. It's backlog, it is the order flows that we're seeing, it's the engagement, the pipeline, the conversations with the customers. Very broadly based as well I would say, Rod, to your point, we're seeing it internationally, to the comment that Jim made, we're seeing it in North America, to the diversity of customers that we've got across both international and North America. We're seeing it across the diversity of applications that were in as well.

So I think you step back from that and look at it and that gives us confidence for the second half. And I think we're still at the early stages of the shift, which is a sort of multi-year shift into this on-demand type architecture.

And I think the carrier space broadly is really beginning to move now. And as Jim said we saw it in North America first over the last 18 months, we're beginning to see that internationally now as well. Some examples of that are people at places like [Caler] and Brazil particularly putting a lot of investment in infrastructure.

So we look at all that, Rod, and we feel pretty confident about the second half. Tom, do you have your coherent numbers at hand?

Tom Mock - *Ciena Corp - SVP Corporate Communications*

Yes. I do have my numbers to hand here. (laughter) Couple things before I actually get into the details.

This was a great quarter for us from 100g perspective. It was a record quarter for us. We announced six new customers for a total of 129 now. That was six that were publicly announced. We had 15 new customers in the quarter.

We also had some new customers in terms of 40g as well, and there are a total of 100 40g customers as we sit here today. So if I look at overall coherent customer count, we're at about 182 customers, 140 of which are 40g and 129 of which are 100g.

One of the other things that I think hasn't really been fully appreciated is that we're now putting 100g ports on our switching gear as well. So if I look at our 6500 -- I'm sorry our 5400 platform, we're now beginning to put a number of customers, or number of units in the field with customers that also have 100g optics integrated into our switching platforms.

Rod Hall - *JPMorgan - Analyst*

Great. Could I just follow-up quickly, Gregg?

Gregg Lampf - *Ciena Corporation - VP of IR*

Sure, one quick one and then we'll have to move on.

Rod Hall - *JPMorgan - Analyst*

Just a quick one. Gary, what I was saying is that it sounds like you were saying second half would be better than normal seasonality.

So we know that the second half is always better, but it feels like you guys have maybe more confidence there than you have had in past years. That's what I was asking.

Gary Smith - *Ciena Corporation - CEO & President*

Okay. I would say consistent with previous years. I wouldn't say we're -- I think we're seeing very good progress and we have good confidence in it, but I wouldn't -- we've had a steadily improving financial performance and I think that's going to continue.

The sort of growth rates we are talking about, we were up the first half this year, on the first half last year was up 14%. I mean we're seeing pretty significant growth here. And if we can keep that up then the operating leverage that we can deliver over the next few years looks very encouraging.

Rod Hall - *JPMorgan - Analyst*

Okay, thank you.

Operator

Our next question comes from Mark McKechnie of Evercore.

Mark McKechnie - *Evercore - Analyst*

Thank you. Congrats everybody. But so the first is on the Web 2.0.

I think there were a lot of questions on the call. My question is are you breaking into some of the do-it-yourselfers, i.e. these folks used to buy components directly and now they're buying systems? To whatever extent you can answer that.

And then also what do you attribute some of the wins that you're getting at Web 2.0? What products are they, what application are they, and why is it that they might be moving from do-it-yourself to buying systems from Ciena?

And then the second question is, if you can remember it's your international business actually there was an earlier question, I thought it was pretty nice. It was up 9% sequentially and so. From Jim's answer it sounds like that's some of the deferred revenues potentially coming through.

But could you give us an update on the strategic deal with Vodafone I guess? Are you running some trials there, would we expect similar to what happened at Verizon to play out there? And any kind of commentary you can tell us on your content with the project Spring, thanks.

Gary Smith - *Ciena Corporation - CEO & President*

Okay so let me take those, Mark. I think from a -- and I understand you're -- the Web 2.0 market is still early days, but I think it's evolved from a very basic point to point kind of need of just addressing content centers to content centers.

Now it's about better performance, about distance, capacity, subsea network. So the degree of sophistication and complexity that they're now dealing with has increased. Therefore to your point, Mark, their requirements are for more sophisticated systems to go and do that.

And I think as they spread out from just linking content centers from content to users, their requirements are exponentially going up, which is why that market space is increasing so much. So I think it's just natural maturation of requirements.

And I think we're dealing with them both directly, as I said, and indirectly as part of a sort of broader ecosystem. And some of it they're building themselves, I mean in terms of building the network themselves and owning part of the network. But still, a large, you know the vast majority of their spend is actually coming through traditional type carriers. And I'd expect that to continue, just the reach that they've got to have.

In terms of the applications, I would say converged packet optical. I think there's opportunities with them as they get more into the user delivering into the user space would be more in our packet and ethernet orientated. We're just beginning to see that now.

In terms of international, as you said our international business was up, so we are beginning to recognize some of those projects and we've got more to come. Don't want give too many specifics about particular customers, but Vodafone, we've announced a strategic relationship with Vodafone which we started last year.

And we confirm that we are involved with as part of that is project Spring as that rolls out as they invest in their infrastructure. And we think we're well placed for the converged packet optical elements of that. And I think they're going to be a strong customer as we go through 2015.

Mark McKechnie - *Evercore - Analyst*

Great, thank you very much.

Gary Smith - *Ciena Corporation - CEO & President*

Thanks Mark.

Operator

Our next question comes from Dmitry Netis of William Blair.

Dmitry Netis - *William Blair & Company - Analyst*

Thank you very much. Nice quarter, guys. Couple of quick questions here.

On the switching side of the business, has that grown faster than the transport? Can you give us an update? What's sort of the growth been in that business has been this past quarter? I think it grew pretty fast last quarter, some 74% rate. So I'm just curious how fast it's growing again this quarter.

Tom Mock - *Ciena Corp - SVP Corporate Communications*

One of the things we're seeing, Dmitry, this is Tom by the way, is the switching business is growing, but I think you need to look at it in the context of the fact that it's across a bunch of different platforms. We did talk about the fact that we added 5400 customers in the quarter, but equally important is the fact we are now putting more switching across more of our optical transport platforms.

And part of our value proposition in the market is that we can connect these big centrally located switches with distributed switches that are embedded in the transport network. So OTN switching broadly is becoming a bigger part of how traffic gets managed in the network, in much the same way as packet is as we were discussing earlier around the new platform.

Dmitry Netis - *William Blair & Company - Analyst*

Okay. That's helpful. On the Web 2.0, I know we've beating this horse to death, but just as you look at your cross section of Web 2.0 customers, just curious from a technology perspective are they the ones that are more attuned to integrate optics into the routing platforms? Or are they going actually the telco route where they take maybe some of the packet technologies and integrate those onto the optical transport boxes and use them that way? So I'm just trying to get the perspective there of which route those guys are going.

And then if you could at least talk about that, if you could just give us an update on your maybe future R&D initiatives? I'm not asking for the road map, but clearly what are some of the things you guys are working on and investing effort in going forward?

Tom Mock - *Ciena Corp - SVP Corporate Communications*

The kind of things that we're seeing in that space do have to do with convergence, but often times it's more about Layer-2 convergence than it is about opti routing convergence. Because if you think about what they're trying to do, particularly in the context of connecting content centers to content centers, they really don't need the complexity of routing.

What they really need is the ability to be able to establish virtual channels between locations, and Layer-2 happens to work pretty well for that. Most of the deployments we've seen to date have not necessarily integrated those technologies together, although you may see that happen over time.

And that's one of the reasons when we are building -- looking at how we build out our road map, we put more and more focus on how we integrate packet and optical together, putting optical switch -- I'm sorry packet switching inside our optical platforms as well as coming out with larger packet platforms that include optical transport [explorer outline].

Gregg Lampf - *Ciena Corporation - VP of IR*

Thank you.

Operator

Our next question comes from Sanjiv Wadhwani of Stifel.

Sanjiv Wadhwani - *Stifel Nicolaus - Analyst*

Thanks, question for Jim. I think you addressed a little bit of this.

Just wanted talk about backlog, and I understand it's going to be variable, but you obviously built significant backlog exiting 2013. Given that you're now halfway through the year, I was just curious to get a sense of what you thought backlog would be exiting 2014? And if you could give us an update on what the backlog trend was quarter on quarter that would be helpful, thanks.

Jim Moylan - *Ciena Corporation - CFO*

All of the comments that I'd make about backlog are in the context of we expect strong order flows for this year for the second half, just as we've seen for the last several years. But one of the things that our investment in converged packet optical inventory was meant to do was to move -- increase the velocity of our supply chain and move items from order to revenue and hopefully to cash more quickly.

And so in that context, even with strong order flows we would not be surprised to see backlog come off a little bit this year. That to me that would be a positive because it would mean that we were successful in getting our lead times down, increasing velocity and hopefully getting to cash faster. That's my feeling about backlog this year.

Sanjiv Wadhwani - *Stifel Nicolaus - Analyst*

Got it.

Jim Moylan - *Ciena Corporation - CFO*

One other thing I want to mention here is this. We look at a metric inside the Company of how much of our revenue comes from orders which were placed in the given quarter.

And with the investment that we made in inventory with some other improvements we've made in our supply chain, that metric, and we call it book to revenue by the way, is a metric that has shown really strong growth over the past year. It's grown by 50% or 60%.

So that's a real positive for our business because it means we can move through the cash cycle more quickly. That's mainly a North America type of phenomenon. Internationally we tend to have the same sort of completed projects type of accounting.

Gregg Lampf - *Ciena Corporation - VP of IR*

One more question.

Operator

Our next question comes from Catharine Trebnick of Dougherty.

Catharine Trebnick - *Dougherty - Analyst*

Oh, thanks for taking my question. Nice quarter.

Could we go dig into this 30% non-telco? Not so much the Web 2.0, but more on the indirect or direct channel into healthcare, federal and finance. Can you give us some more background on that and maybe a better idea on how we can do some of our channel checks or think about our models? Thank you.

Gary Smith - *Ciena Corporation - CEO & President*

Thank you, Catharine. Yes, we've talked a lot about the Web 2.0 and the other segments, as you rightly point out in there as we diversify it into these other segments you've got broadly speaking enterprise and carrier managed services where typically they finance healthcare energy and we go both direct and indirect there with our channel partners.

And really it's about building private packet optical networks, and they are migrating to cloud based architectures. And we've really leveraged over the last couple of years our customer engagement model to basically, I think we've doubled our sales in enterprises through the carrier channel in the last 18 months or so. So it's pretty significant.

Government and research and education, we've expanded that within state and local agencies, international governments and particularly the sort of national research and education networks. Their demand for enormous amounts of capacity and switching has really fed some nice growth in that market. Submarine, talked about that, we've now got number one market share from nowhere about two years ago.

The other market segment, which we haven't touched on is cable and MSOs, which again is showing good growth for us. In fact, I think we have three new customers in MSOs last quarter alone, and that's really been driven by the growing opportunity not just for infrastructure, but more around ethernet business services as well, which we're well suited to. So you look at that in total and that's -- we're seeing growth in all of those elements, which is how we're able to move up from 25% to 30% and really have a much more diversified business.

Catharine Trebnick - *Dougherty - Analyst*

Okay, thank you.

Gary Smith - *Ciena Corporation - CEO & President*

Thank you, Catharine.

Gregg Lampf - *Ciena Corporation - VP of IR*

Thank you, everyone, for joining us today. We look forward to connecting with you again over the next several weeks. Everyone have a good day.

Operator

Ladies and gentlemen thank you for participating in today's conference. This concludes today's program. You may all disconnect. Everyone have a great day.