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Infinera Corp. *(INFN)*

Q3 2012 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Third Quarter Year 2012 Investment Community Conference Call of Infinera Corporation. All lines will be in a listen-only mode until the question-and-answer session. [Operator Instructions] Today's call is being recorded. If anyone has any objections, you may disconnect at this time.

And I would now like to turn the call over to Ms. Jenifer Kirtland of Infinera Investor Relations. Jenifer, you may begin.

Jenifer Kirtland
Investor Relations, Infinera Corp.

Thank you, operator. Today's call will include projections and estimates that constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements address the financial condition; results of operations; business initiatives; views on our market and customers, our products and our competitors products; and prospects for the company in the fourth quarter of fiscal year 2012 and beyond and are subject to risks and uncertainties that could cause actual results to differ materially from such forward-looking statements.

Please refer to the company's current press release and the SEC filings, including the company's Annual Report on Form 10-K filed on March 6, 2012 for more information on these risks and uncertainties.

Today's press release including the results of the third quarter of fiscal year 2012 and associated financial tables and investor information summary will be available today on the Investor section of Infinera's website at infinera.com.

The company undertakes no obligation to update or revise any forward-looking statements to reflect events or circumstances that may arise after the date of this call. This afternoon's press release and today's conference call also include certain non-GAAP financial measures.

In our earnings release, we announced operating results for the third quarter of fiscal year 2012, which exclude non-cash stock-based compensation expenses. These non-GAAP financial measures are provided to facilitate meaningful year-over-year comparison. Please see the exhibit of the earnings press release for a reconciliation of these non-GAAP financial measures to the most directly comparable GAAP financial measures, and an explanation of why these non-GAAP financial measures are useful and how they are used by management, which will be available today on the investor section of Infinera's website.

On this call, we will also give guidance for the fourth quarter of fiscal year 2012. We've excluded non-cash stock-based compensation expenses from this guidance because we cannot readily estimate the impact of our future stock price on future stock-based compensation expenses.

I will now turn the call over to Infinera's President and Chief Executive Officer, Tom Fallon.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

Good afternoon and thanks for joining us on our third quarter 2012 conference call. With me are Chief Financial Officer, Ita Brennan; and Chief Strategy Officer, Dave Welch.

I will start by stating that we continue to make excellent progress as a consequence of the introduction of the DTN-X. Sales activity remains strong with the addition of six customers who have made purchase commitments to the DTN-X since our call in July for a total of 16. Furthermore, we began generating revenue from our DTN-X shipments this quarter as evidenced by our solid third quarter results.

Before turning it over to Ita for a full review of our Q3 financial results and Q4 outlook, I will talk about trends in the global transport market and provide a more detailed update on the market acceptance of our new DTN-X.

In regard to the market, Dell'Oro forecast that the total optical transport market will grow at a five-year compounded annual growth rate of 7%. However, not all markets are created equal. And when Dell'Oro further segments this market, they identify significant spending shifts. They show declining legacy technology segments such as SONET and SDH offset by rapidly growing next-generation technology segments.

Del'Oro predicts the 100-gig market will grow at an 80% annual rate and the converged optical packet transport market will grow at 25% annually over the next five years. The DTN-X platform is in the sweet spot of both of these fast-growing segments. This is consistent with our customer interactions where we are seeing a fundamental shift away from legacy technologies and a rapid transition to next-generation transport solutions.

The majority of our customer requests for proposals are now asking for both 100-gig and OTN switching. We believe this validates the market projections that there is a significant opportunity emerging for both 100-gig long-haul systems and a converged 100-gig WDM/OTN solution.

I believe Infinera is uniquely qualified and well-positioned to meet this need versus competitors who have exposure to both legacy technology and dated architectures. Infinera foresaw the need of this converged 100-gig solution well in advance when we designed the DTN-X and now we are delivering on that vision. We believe that customers would need to do an optical reboot to a cost-effective 100-gig network built for the next decade.

We believe that the most effective solution was not to incrementally upgrade a platform optimized for 10-gig or 40-gig with a 100-gig line card, but rather to deliver a platform optimized with forward scale to 100-gig, 500-gig and 1 terabit super-channel capabilities.

We also believe that in addition to delivering greater scale, we need to focus on reducing the operational cost of running a next-generation network while improving our customers' speed to market for new services. The DTN-X delivers on this vision with a converged WDM and OTN switching solution where both functions are integrated yet operate at full capacity without compromise.

To achieve this, we combined our unique 500-gig Photonic Integrated Circuit with our FlexCoherent processor to deliver the industry's highest density and lowest power WDM capability supporting the industry's first 500-gig long-haul FlexCoherent super-channels.

We combined this with WDM capability with a world-class 5 terabit non-blocking OTN switch and a GMPLS control plane to deliver the industry's most scalable, efficient, simple, and reliable converged platform. This integrated approach produces better results at a lower cost by more efficiently utilizing optical capacity on a network. Customers use fewer wavelengths, less space and less power to deliver the same set of services.

The integrated approach also enables customers to more quickly and efficiently scale their network by eliminating thousands of fiber interconnects, manual configurations and truck rolls.

Furthermore, through leveraging our automated control plane and operational innovation, the DTN-X helps our customers deploy services faster and compete more effectively in their markets.

Infinera's teams' execution of the DTN-X has been excellent. We launched a product in September 2011, began shipping to customers for deployment in June and now have live traffic running on networks across the globe. The DTN-X reception continues to be incredibly positive, reinforcing the value proposition that a combined super-channel and OTN platform can offer.

On our last earnings call I indicated that we had secured 10 purchase commitments and today I am pleased to announce that this number has climbed to 16. Of these 16 customers, five are new to Infinera and 11 are existing customers. These new customers validate that the DTN-X is allowing us to address larger bandwidth opportunities in new markets. The support from existing customers is based on our earned reputation for quality and performance and showcases the value of a combined DTN and DTN-X network running common software.

These customers span North America, EMEA and APAC and across each of our vertical markets including a Tier 1 domestic win and four Tier 1 international wins. We have also seen strong traction in the cable segment along with wins at bandwidth wholesalers, Internet content providers, research and education, and in the submarine market.

We recently announced two of these additional DTN-X customers: Telefonica International and PIPE Networks. These wins are complemented by strong trial activity and further significant opportunities in North America, Europe, India, and Russia.

Unlike competitor 100-gig upgrades, it is important to remember that the operators deploying the DTN-X are generally not upgrading a single route with a pair of 100-gig cards. Rather, they are building new networks for the next decade.

As a result, Infinera is shipping a significant number of 100-gig ports. I am pleased to announce that we have shipped over 1,000 100-gig ports for revenue through the end of the quarter. This compares to approximately 800 long-haul 100-gig WDM ports shipped by the rest of the industry in all of Q2 according to Dell'Oro.

We believe that this rapid market impact reaffirms the unique value proposition that the DTN-X offers our customers. We continue to see strong interest for the DTN platform and this quarter we added three new DTN customers for a total customer count of 106. Our ATN, DTN, and DTN-X now provide a broad portfolio that allows us to address multiple applications in markets with varying requirements.

We are also seeing DTN-X customers take advantage of some of the newer DTN capabilities, including 100-gig e-service interfaces. Both Eurofiber and Interoute recently announced their 100-gig e-offering on their DTN networks in Europe. The ability for our customers to adapt their existing Infinera DTN network to deliver these next-generation services demonstrates the inherent value of the Infinera Digital Optical Network architecture.

While we have seen a steep decline in 100-gig pricing over the past year, we believe that has started to flatten out. We believe that 100-gig is now a better economic solution than 40-gig for customers and we expect that this will drive significant volume in the high-capacity market.

We continue to compete aggressively to secure new DTN-X footprint and as volume increases, we will leverage the scale and cost advantages of our unique PIC-based vertically integrated model versus our competitors who are using less cost-effective off-the-shelf optical technology.

Finally, we now expect OSMINE certification to be complete at the end of Q4. This is an important milestone and is required to open up the North America Tier 1 market. We are executing well on our growth objectives and remain confident about our ability to continue to drive adoption of the Digital Optical Network. [ph] Build (10:32) activity is strong and we believe we are well positioned for a solid finish to 2012 and an opportunity to build on our strong momentum into 2013.

Now before turning the call over to Ita, I want to thank the Infinera team and supply partners for meeting our commitments and deploying the DTN-X in multiple networks across the globe. I would also like to thank our customers for their continued business and partnership as we move forward into the terabit age together.

Ita will now provide a detailed financial review.

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

Thanks, Tom, and good afternoon. This analysis of our Q3 results and our guidance for Q4 2012 is based on non-GAAP. All references exclude non-cash stock-based compensation expenses.

Total GAAP revenues in Q3 were \$112 million compared to our guidance of \$106 million to \$115 million. Our solid revenue performance in the third quarter was led by our DTN-X platform which contributed significant revenue from deployments with eight customers across multiple customer segments. We added a total of five new customers in the quarter, two of whom deployed the DTN-X. The remaining three new customers purchased and deployed Digital Optical Networks based on the DTN platform.

We had one greater than 10% customer in the quarter, which was a cable operator. The top five customers also included two other cable operators, a Tier 1, and a bandwidth wholesaler.

International revenues totaled \$33 million or 30% of total revenues for the quarter. EMEA accounted for \$28 million or 25% with APAC and the other Americas representing 2% and 3%, respectively. Service revenues for the quarter were \$12.9 million down from \$15.1 million in Q2 as a number of service projects straddled the end of the quarter.

We expect to recognize a healthy deployment services revenue in the December quarter as these and other deployments are completed. Services gross margin for the quarter was strong at 69%. We expect services margin to decline in the fourth quarter as the mix of deployment-related services increases.

Overall gross margin in Q3 was 39% at the higher end of our guidance of 37% to 39% and up from 37% in Q2. Third quarter gross margin reflected the recognition of our first DTN-X revenues. As expected, these systems represented early production units and at a higher cost.

Product mix for the quarter was healthy with TAM and TIM units at levels consistent with prior periods. Our new footprint common equipment deployments increased as we began to ramp DTN-X deployments. Operating expenses for the quarter were significantly lower than expected at \$51 million compared with our guidance of approximately \$55 million.

Operating expenses were \$53 million in Q2. The primary drivers for the reduction in operating expenses in Q3 as compared to our guidance included a reduction in compensation accrual, a decline in payroll taxes as employees reached favorable tax caps, combined with careful cost control across all areas of the company.

Looking forward to the December quarter, we expect operating expenses to be approximately \$52 million reflecting lower compensation expenses through the end of the year and a continued focus on cost control.

Overall head count for the quarter was 1,235 versus 1,228 in Q2. Headcount additions were primarily related to direct labor for manufacturing.

Our operating loss for the quarter was \$6.9 million. Other income and expense for the quarter was unfavorable at \$0.4 million. Net loss for the quarter was \$7.8 million resulting in a loss per diluted share of \$0.07, better than our previous guidance, which called for a loss of \$0.09 to \$0.14 per diluted share and a significant improvement over a reported loss of \$18.6 million or \$0.16 per diluted share in Q2.

Now turning to the balance sheet. Cash, cash equivalents, restricted cash and investments ended the quarter at \$183 million versus \$210 million in Q2. We used \$29.3 million of cash from operations in Q3 versus \$22.7 million in Q2. DSOs came in at 74 days, up from 55 days in Q2. This increase is in line with our outlook on the July call as we expected DSOs to increase given the impact of the DTN-X ramp.

As we look forward to Q4, we believe DSOs will improve significantly as we experience better billing linearity and collect on the higher receivables balance outstanding at the beginning of the quarter.

Inventory turns were 2.3 times versus 2.1 in Q2. We experienced some improvement in inventory turns in the quarter, while overall inventory levels increased to \$118.5 million. This near-term increase in inventory is in line with our expectations for the initial DTN-X sales period. Our goal is to return to more competitive inventory metrics once our go-forward sales mix of DTN and DTN-X is better understood.

Accounts payable days were 48 days, up from 44 days in Q2. Capital expenditures declined to \$2.5 million compared to \$6.1 million in Q2. We intend to continue to manage capital expenditures to a run rate at or below \$20 million per annum.

We believe that these forecasted reductions in working capital and capital expenditures combined with our income statement guidance for the fourth quarter will result in an improved cash position for the end of the year.

Turning to our outlook for the fourth quarter and beyond. We continue to see strong interest in the DTN-X platform with a healthy pipeline of RFIs and lab trials. We received purchase commitments from 16 customers for DTN-X network deployments. Although we are seeing some decline in DTN revenues as some of our larger bandwidth customers migrate their deployments to DTN-X, we continue to win new customers and new deployments with the DTN platform.

Based on our current visibility, we believe that revenues for the fourth quarter will range from \$122 million to \$132 million, which when combined with our Q3 revenue performance is consistent with our prior guidance for revenues of \$230 million to \$245 million for the second half of 2012.

Looking beyond 2012, we believe that the DTN-X platform, we are well-positioned to grow market share and add new customers. Industry analysts have various views of forecasted market growth for 2013 and the state of which 100-gig footprint will be deployed.

Expected overall market growth rates for the year range from 7% to 10% with, as Tom mentioned, some technology segments growing rapidly and others in decline. We believe depending on the level of realized market growth that Infinera can achieve revenue growth in the 10% to 20% range for 2013.

And looking at the next couple of quarters, we believe that gross margin will be volatile as we ramp deployments and production of the DTN-X platform. We are seeing a faster than expected uptake of DTN-X, which will ultimately help our volume ramp and 100-gig cost structure, but will likely negatively impact margins in the near term.

Our gross margin guidance for the fourth quarter reflects solid footprint and DTN-X wins with significant common equipment deployments, combined with a higher mix of deployment services revenue, a lot of which carry a lower gross margin. However, this footprint is the foundation required to achieve an ongoing healthy business model and longer term sustainable growth.

We believe that with solid revenue growth our vertically integrated model can deliver significant leverage and allow for a healthy gross margin expansion in excess of that earned by the industry. In addition, over time, we would expect to see a more balanced mix of new footprint and network fill.

We will elaborate further on the margin profile of various network architectures over time and how this impacts our overall gross margin entitlement at our Analyst Day in December. As we think about operating expenses and CapEx for 2013 and beyond, management is committed to spending at levels that are supported by the business.

We believe that we can tailor spending to levels that support a consistent cash flow breakeven point by the second half of 2013. This must be done in a manner that supports a competitive roadmap and continued growth in new footprint wins. In the longer term, we'd expect that expense increases will be at a lower rate than revenue growth, allowing for improved profitability.

Now let's turn to guidance for Q4, which is based on non-GAAP results and excludes any non-cash stock-based compensation expenses. Revenues of approximately \$122 million to \$132 million, gross margins of approximately 35% to 36%, operating expenses of approximately \$52 million, operating and net loss of \$4 million to \$9 million and based on an estimated average weighted diluted shares outstanding of 115 million, this will lead to a loss per

share of approximately \$0.04 to \$0.08. Please note that the basic share count is expected to be at 112 million for the quarter.

Finally, before we open the call up for questions I wanted to remind you that we will be holding an Analyst Day in New York City on December 6, and we look forward to updating you then.

Now, operator, would you please open the call up for questions? Thank you.

QUESTION AND ANSWER SECTION

Operator: Of course. At this time, we will begin the question-and-answer session. [Operator Instructions] And our first question comes from Simona Jankowski with Goldman Sachs. Your line is now open.

Simona K. Jankowski

Analyst, Goldman Sachs & Co.

Q

Yes, hi, thanks very much, just wanted to follow up a little bit on the commentary around the customer wins with the DTN-X. I noticed you mentioned a North America Tier 1 customer and obviously you have been undergoing OSMINE and I believe couple months ago you had mentioned that you would announce this customer later this year. Can we still expect you to announce who that customer is? And is this something that at this point has been awarded to you as a design win? And if you can maybe just expand on what parts of the network or what applications it will be used for?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Yes Simona, this is Tom. This is the same one we have referenced for a period of time. Since the last call, two things. One we had said that OSMINE certification would begin in Q4 and complete some time in Q1. We have now pulled in the certification, to our expectation, is OSMINE certification will be complete by the end of Q4. We have been awarded a – this project. It is a long-haul application in a Tier 1 and we do intend to announce it this year with their permission.

Simona K. Jankowski

Analyst, Goldman Sachs & Co.

Q

Okay. Okay. Terrific. And then following up on Ita's comments on the profile of growth margins which are being impacted here near-term by a faster ramp of the common equipment for DTN-X. You know, to the best to have visibility at this point, when would we expect gross margins to come back maybe to the mid-40% which I would assume would reflect a more normalized mix?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

I think Simona certainly through the next couple of quarters we are going to have production ramps, impacts, plus a healthy common equipment mix. Once we get through that then we should start to see margins improve. And you're right, I think probably a mid-40% range is a good steady state with growth target. We haven't exactly pegged when that would be, but we should start seeing progress towards that through next year.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

I'll make an additional comment. Simona, as I mentioned in my script, right now we have the opportunity not to upgrade an existing network on a single wave of 100-gig, but our customers are deploying, upgrading their entire network with new platforms, new chassis, new line infrastructure. And that is going to allow it to be an Infinera 100-gig, 500-gig super channel network. The best thing we can do for now and for the near-term is to win as much footprint as we possibly can. We've been pretty clear that we are going to drive the company to have market share leadership, so that we have the opportunity to fill those chassis over a very, very long period of time.

While our absolute commitment is to create a company that has a margin premium to the industry based on our technology, over the next period of time, my absolute commitment is to grow our market share as fast as possible, while maintaining a good conservative view of cash use.

Simona K. Jankowski

Analyst, Goldman Sachs & Co.

Q

Sure. And then just lastly, I was a little bit surprised by the guidance for next year, 10% to 20%, which is a bit below where consensus is right now especially given the comments around the Tier 1 win and the stronger traction in DTN-X, and also some of the Dell'Oro forecast you were citing. So can you just kind of help bridge those numbers for us?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah. I think if you look at industry kind of growth rates right now they are somewhere in that kind of 7% to 10%. So that range of 10% to 20% is really saying we'll grow roughly 2X the market. I don't think there's any doubt that we are winning opportunities and gaining new customers. It's really a matter of timing and how those opportunities ramp and how the revenue ramps with those opportunities. So that's kind of our current visibility to that range. We'll obviously continue to update that as we move forward.

Simona K. Jankowski

Analyst, Goldman Sachs & Co.

Q

Okay terrific. Thanks very much.

Operator: And our next question comes from George Notter with Jefferies, your line is now open.

George C. Notter

Analyst, Jefferies & Co., Inc.

Q

Hi, thanks very much, guys. I guess I wanted to ask about the pipeline of DTN-X opportunities. I think you said you had 16 purchase commitments now total. Can you just sort of talk about what you see beyond that in the pipeline? Is there a larger number of customers presumably you are engaged with? Any way you could kind of quantify that or give us a sense for it? And if you have been turned down with particular customer opportunities, were there particular reasons why customers maybe are looking elsewhere relative to the DTN-X on 100-gig? Thanks.

David F. Welch

Director, Chief Strategy Officer & Executive VP, Infinera Corp.

A

Hey, George, maybe I can answer. This is Dave Welch. We're seeing a very robust marketplace for the DTN-X right now. We have a large number of engagements at various stages within the process from early demonstrations to trials to field trial deployments that are going on. There isn't a really an appropriate quantification of that to give any guidance in general to the market other than to say that it's being received very well. We're going to win our fair share of the business out there and we're seeing a lot of robust activity around it.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

I would just add that and we've said, George, that we're not going to comment on the number of trials that we are doing because we think it's a bit of a misleading indicator. I will comment that our pipeline of trials and demos is as big or bigger than it's ever been. So my view is the fact that we've already won 16 customers after basically shipping product for a little over a quarter in this industry is fairly remarkable. And the pipeline of activity is as big or bigger than it's ever been. We are extremely satisfied with the reception of the DTN-X into the market.

George C. Notter

Analyst, Jefferies & Co., Inc.

Q

Are you limited in terms of the number of trials or account relationships you can maintain right now on the DTN-X? Is there a sales and marketing challenge here?

David F. Welch

Director, Chief Strategy Officer & Executive VP, Infinera Corp.

A

You know, not really. We're pretty much full, but we're finding the appropriate hours and appropriate scheduling opportunities to make sure we do the right management for the expenses associated with the trials and making sure to qualify that customers are appropriate. So I would say, we're not turning anyone away, but we are definitely operating at a highly efficient operation right now for getting that out.

George C. Notter

Analyst, Jefferies & Co., Inc.

Q

Last one I had -

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

George, it sounds like you wanted to buy one.

George C. Notter

Analyst, Jefferies & Co., Inc.

Q

The last question I had was on OTN switching. Is that commercially available right now? Has it been deployed by customers? Can you talk about where you are with that? And then also would that provide you with some gross margin lift to the extent that you can deliver that to customers? Thanks.

David F. Welch

Director, Chief Strategy Officer & Executive VP, Infinera Corp.

A

Sure. The DTN-X has a – comes with it is both the DWDM system based on the super-channel, 500-gig super-channels as well as an integrated OTN switch. So all of our systems we deploy have integrated OTN capability. The feature set of that OTN capability is strong right now. And over the series of the next few releases over the coming quarters it will continue to fill out. So to – precision to your statement is, yeah, that what's shipping out right now

has an OTN capability to it and that's used to make the networks as efficient as possible. The OTN covers a wide range of specifications and you're going to see it continue to add on those specifications over a course of time.

George C. Notter

Analyst, Jefferies & Co., Inc.

Q

Thanks.

Operator: And our next question comes from Jeremy David with Morgan Stanley. Your line is now open.

Jeremy David

Analyst, Morgan Stanley & Co. LLC

Q

Hi. Good afternoon. I wanted to ask first about the mix that you saw this quarter in terms of 100G revenue versus 10G. And I have a couple of questions on 100G pricing.

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yes, we are not really going to break out the 10-gig versus 100-gig revenue streams. I mean it was significant though, if you can see with eight customers that would drive a significant piece of a revenue. So it did contribute well to the quarter, but we are not going to try to break those out as separate pieces of business.

Jeremy David

Analyst, Morgan Stanley & Co. LLC

Q

Okay. In terms of the pricing environment, how many of those wins have been based on price meaning the DTN-X was more competitive than other platforms that were being evaluated? And can you give us a flavor for what pricing is for your solution today versus alternative solutions in the marketplace?

David F. Welch

Director, Chief Strategy Officer & Executive VP, Infinera Corp.

A

Yes, I think the – it's kind of impossible question to answer quite honestly. We sell networks. We don't sell transponders. We don't sell a commoditized item. We sell a fairly – highly sophisticated network. Everybody's network is different. Everybody's network utilizes a different degree of point-to-point network or a different degree of mesh network and there is no singular pricing around what a network costs in that. So I don't think there is an adequate answer. If I was a component company, which we are not, maybe I could go and I made a commoditized product maybe I could answer what that is. But as a network company that doesn't really fit our model.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

One comment I will make, certainly in the market 100-gig pricing has come down quite significantly over the past year. We have seen that level off a great deal. I think that that was necessary. This market, this technology has experienced a price curve that I think is fairly unprecedented in this industry, as people are trying to capture market share. I do think that it is leveling off.

The second comment I will make is we have not been the lowest price offering in each of the ones. We have lost some that we are not the lowest price and we have won some that we have not the lowest price. So it is a very competitive market out there. But I think, as Dave said, the value proposition of the network, the reputation that we bring, or rather our quality and reliability, has value to our customer set.

Jeremy David

Analyst, Morgan Stanley & Co. LLC

Q

Thank you and then just the last one if possible. Looks like you have more of a focus on cash, other things that you have decided not to pursue in order to get breakeven faster and if so, what are those things?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

I think it has always been our intention to kind of come back and focus on cash once we got the DTN-X product to market, right. For the last number of quarters we have been very focused on the need to do that and kind of maybe relax some of our normal operational controls around some things in order to make sure that that happens. So you'll definitely see us shift back to just normal operational focus around various things. First, it was CapEx, now it's going to be around inventory, receivables and driving the working capital metrics and ultimately on the P&L as well.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Let me add just one flavor to that. I think we have been very clear over the last two years that our goal line of success was bringing a world-class product, the DTN-X, to market as soon as humanly possible. And we did that. I think we spent the necessary money. We brought the necessary people on board. We created the appropriate technologies to do that. Our next goal line, as Ita mentioned, is consistent cash flow generation. We're going to move the energy of our company toward focusing on that, while not forgoing a continuation of delivering great products to customers or customer care.

Jeremy David

Analyst, Morgan Stanley & Co. LLC

Q

All right. Thank you very much.

Operator: And our next question comes from Alex Henderson with Needham. Your line is now open.

Alex Henderson

Analyst, Needham & Co. LLC

Q

Thanks, guys. A couple of questions. First can you digress a little bit and talk about what's going on in the 10-gig segment of the market in terms of pricing? I think you talked about it being extremely competitive and sharply discounting over a prior period, is that also starting to level out as the market starts to solidify around 40-gig, 100-gig coherent?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Well, I think in 10-gig, 10-gig is experiencing relatively normal price curves. Sometimes in a long technology cycle, the technology cost will flatten out, the price will flatten out. 10-gig continues to have reasonable price erosion, partly driven by the fact that our customers are experiencing price erosion in the 10-gig services they offer. So we're seeing, I would say, normal price erosion.

I think that, talk about 40-gig, I really do believe 40-gig has been and we call it the 40-gig squeeze, we're going to see that. 100-gig is more cost effective than 40-gig, 10-gig is more cost effective than 40-gig and the market's been

waiting for an opportunity to go to a next generation technology that will afford both the capacity and the dollar-per-bit that the market needs.

It's not 40-gig; it's not going to be 40-gig; it's 100-gig. 10-gig is still going to have a long life. It's still going to serve a lot of purposes. It's still a good economic answer if you are out of capacity. I think that 10-gig is going to last a long time and I think 100-gig is going to scale magnificently.

Alex Henderson

Analyst, Needham & Co. LLC

Q

Just so we're clear, normal pricing curves, that sounds less pressured than what you had been describing in the past I believe. Am I correct in reading that that may have started to stabilize – the rate of decline may have stabilized a little bit as people actually got their 100-gig products out and coherent products out so they are no longer scrambling, trying to stem the incursion of the market by dropping 10-gig? Is that the right way to read it?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Yeah. I think we've been – I think I've tried to be clear on two things, one, 100-gig has gone through a rapid price reduction and we are seeing that stabilize. The other thing I commented on historically is that until we had a 100-gig solution, we were making economic trade offs around our 10-gig solution to allow customers a fair economic solution until we had 100-gig. So there is a difference between market price of 10-gig and some of the commercial arrangements we made to make our 10-gig compelling while people waited for the 100-gig.

Alex Henderson

Analyst, Needham & Co. LLC

Q

So, it has stabilized though?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

For us, yes.

Alex Henderson

Analyst, Needham & Co. LLC

Q

Got it. And – but what about in the broader industry that you are competing – the backdrop you are competing in? Do you think the pricing of 10-gig is still coming down hard, or do you think it's stabilized?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

I believe it's stabilized into kind of normal technology curves. I believe that a couple things are necessary to make a market; one is economics and two is enough viable competitors selling a technology. This year is the first year that there's been a number – an appropriate number of viable competitors selling 100-gig solutions.

Alex Henderson

Analyst, Needham & Co. LLC

Q

Super. Thank you very much on that. Let me ask a second question if I could. As you are looking at the mix of chassis to line cards any thought on given the 16 customers that you've now seen commitments from, how long it will take to start to see a mix shift back to getting some blades into the mix to get the margins up? Is that going to take 12 to 18 months from the time the chassis ship, or do you think that it might be longer than that?

David F. Welch

Director, Chief Strategy Officer & Executive VP, Infinera Corp.

A

Excuse me – I'd say that there's two dynamics going on. One is there is a relatively short-term transition in order to ramp our manufacturing capabilities and it's you can comment more on that if you appropriate. There is a – what we have typically experienced with a customer when they deploy a network, is we get a bump and sometimes about six months into that, then they start going into more of a full distribution of fill after the initial deployment of – assuming it's a reasonably large network or so.

So I would put it certainly inside of the 12-month period, you see a reasonable distribution of line to fill. Now these systems have 8 terabits of capacity versus our prior systems, which had 1.6 terabits of capacity. So we should see the life of that fill last longer, certainly from a bandwidth perspective it lasts subsequently longer. So that those ratios will be more dominant over time going-forward.

Alex Henderson

Analyst, Needham & Co. LLC

Q

Just if I could follow-up on that. So when you're shipping your initial box out, at this point, it's going out with what percent loaded?

David F. Welch

Director, Chief Strategy Officer & Executive VP, Infinera Corp.

A

It varies again by customer base, but on a relative basis it's lightly loaded or certainly there is a fair amount of growth to go in that system, so multiple 100 gigabits going out, you know it's got a – in that.

Alex Henderson

Analyst, Needham & Co. LLC

Q

Does it also go out with a similar amount of trib cards in it?

David F. Welch

Director, Chief Strategy Officer & Executive VP, Infinera Corp.

A

It depends on the customer. It depends on the application that you are looking at. The fill of the tribs in general are less than the fill of the line modules. However, in an OTN enabled network, the line capacity is more fully utilized. It's not a point-to-point network that you're dealing with.

Alex Henderson

Analyst, Needham & Co. LLC

Q

Okay. Thank you very much.

Operator: And our next question comes from Michael Genovese with MKM Partners. Your line is now open.

Michael Genovese

Analyst, MKM Partners LLC

Q

Thanks very much. In the next quarter's guidance, I mean, how do you expect the 10-gigabit DTN business to trend in the fourth quarter?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah. I mean, I think although we're not going to break it out, just directionally we are seeing more of our existing larger bandwidth customers transition to the DTN-X. So we will see some fall off on the DTN as the DTN-X ramps and the DTN-X will ramp for two reasons, right. Obviously there's existing customers moving and then there is new customers adding to the overall revenue number. But we will for a period of time here we will see kind of the DTN new footprint with these larger bandwidth customers start to decline.

Michael Genovese

Analyst, MKM Partners LLC

Q

So...

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

We did add three DTN customers this quarter. We added two new DTN customers last quarter and in customers who break up their markets by region, within those customers, we continued to win new regions within the DTN. We have a very large installed based of DTNs and a lot of those are not at capacity. So, I certainly agree with Ita's commentary that as far as new business goes they'll be more guided toward the DTN-X. We anticipate that the DTN-X is going to have a good lifecycle for a long time.

Michael Genovese

Analyst, MKM Partners LLC

Q

Good. What I'm trying to get at is the guidance is up \$15 million sequentially at the midpoint. So, I'm basically trying to ask, do we think that the new product, the DTN-X is going to be up more than \$15 million sequentially in revenues?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah. I mean we're not really going to break that out, but we will tell you that the DTN-X is ramping strongly in Q4.

Michael Genovese

Analyst, MKM Partners LLC

Q

Okay. And then one other question. Going back to the statement – correct me if I'm wrong, but I think you said that in the third quarter you shipped 1,000 100G line cards, and the whole industry shipped 800 in the second quarter. Can you flesh that out a little bit more?

And I know in the 10G, you guys became number one overnight in terms of line cards. But if you'd asked your competitors, they'd say there is a difference in the system and how they were counted. And you are guys are getting a 10 to 1 kind of advantage on that counting. What's your view on that?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Yes. So we didn't say it was 1,000 line cards. We said 1,000 100-gig ports. Each one of our line cards has 500-gig on it. And, so I know our competitors like to say that that's not an apples-to-apples. I can tell you that the next

100-gig port that's going to be bought by that customer or fulfilled by that customer is an Infinera port, because they've pre-provisioned it. It's in place, and all they have to do is insert a TEM.

So whether it's an accurate measure of a point in time, I can't tell you. There is different points of view. I can tell you it's an accurate reflection of market share of 100-gig capacity over time.

David F. Welch

Director, Chief Strategy Officer & Executive VP, Infinera Corp.

A

I will add one other thing in there. George, you need to keep in mind that – I'm sorry – Mike, that their 100-gig port is a muxponder. Right. They are deploying 100 gigs of bandwidth on the line side, and they are deploying some amount of 10-gig interfaces into that line card. So the only fair metric and fair comparison is how much line side bandwidth are you shipping for revenue, and then you'll figure out what the fill capability of that is over time. We shipped the equivalent of 1,000 100-gig line side bandwidths for revenue.

Michael Genovese

Analyst, MKM Partners LLC

Q

Okay. Great. Thanks a lot.

Operator: [Operator Instructions] And our next question does come from Rod Hall with JPMC. Your line is now open.

Rod B. Hall

Analyst, JPMorgan Securities LLC

Q

Yeah, hi, guys. Just a couple quick questions from me. So you mentioned this Tier 1 customer that you're going to announce in Q4. I wonder if you could talk about whether you're going to be the first or second supplier on that customer? I mean are you going to have the primary position or would you be following someone that's already there? So that's my first question.

The second one is, just on pricing again, the gross margin guidance obviously pretty weak but yet you're talking about 100-gig pricing declines leveling off and I just wonder if you can kind of put those two things together for us, help us understand are we talking about declines leveling off post this quarter we're in now or are they already leveled off and other things are driving that gross margin? Can you just talk a little bit about what's going on with the pricing environment, it would be helpful?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

With regard to the customer until we officially announce it I'm not going to give any more clarity on it. I'm going to respect their desire to not talk about it until we can officially talk about it. In regard to cost, Ita, I'm going to ask you to start and then I'll finish.

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah. I think Rod if you look at the Q4 margin guidance, I mean what we're really seeing is we have some production ramp issues that are still happening and we clearly have a very strong mix towards new common equipment deployments in that quarter, right. So I don't know that it's necessarily that pricing has gotten any worse than what we were seeing before. It's more just the dynamic of us moving through kind of ramping production on a new product set. We've got that replacing some DTN margin product at the same time, so there is

a lot of dynamics there from a gross margin perspective. On top of that we also have – we'll have kind of our highest deployment services number in Q4 that we've ever had and that also carries a slightly lower margin. So when you look at all those things combined, they are really more operational ramp issues than they are anything that was necessarily related to a change in pricing on a quarter-over-quarter basis.

Rod B. Hall

Analyst, JPMorgan Securities LLC

Q

Okay. Ita, could I just – and just following up on that then if it's mostly mix that's impacting the guidance, could you still – you have the benefit of seeing more detailed data than we do, so could you still talk a little bit about what's going on with like-for-like pricing? Is it – when you say it's leveling off, do you mean it's still coming down a little bit or do you mean it actually is kind of looking pretty flat now quarter-on-quarter?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

I think what we saw was if you look back over the last year on 100-gig, we saw some very aggressive price declines, very competitive as new vendors moved into the market and now I think it's really reached a point where it can't continue that way and we really are starting to see it level off, right. And I don't think it levels off forever, right, and that there will be further technology driven declines out into the future, but I think in this time period people have kind of reached a point where it really does have to level off, so that we can catch up from a cost structure perspective to support the pricing that's been in the market already.

Rod B. Hall

Analyst, JPMorgan Securities LLC

Q

Okay.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

We have seen it kind of level off over the last quarter. So we are pretty much seeing the same type of pricing from a quarter ago. So I do believe, as Ita said, the industry is coming to a point where the value proposition of 100-gig is sufficiently better than 40-gig. It provides the capacity required for next generation networks and people are comfortable with the pricing that is in the market. I will go back and talk about commons again. The most important thing we can do right now is win new footprint and new customers. Commons bear approximately 0% margin. The best thing we can do is assure that our commons are everywhere so as people fill up, as Dave said 8 terabits of capacity, it's with Infinera capacity.

Rod B. Hall

Analyst, JPMorgan Securities LLC

Q

Yeah great. Thanks a lot guys.

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Thanks Rod.

Operator: Thank you. And I will now turn the meeting back over to Tom Fallon for closing remarks.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

Thank you very much for joining us this afternoon and for your questions. We look forward to staying in touch in the months and quarters ahead with reports on our continued progress. Have a great day.

Operator: Thank you. This concludes today's conference. You may disconnect at this time.

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