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Infinera Corp. (INFN)

Q3 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon and welcome to Infinera's Fiscal Third Quarter 2019 Financial Results Conference Call. All lines will be in a listen-only mode until the question-and-answer session. Today's call is being recorded. If anyone has any objection, you may disconnect at this time.

I would now like to turn the call over to Ted Moreau, Head of Investor Relations for Infinera. Ted, you may begin.

Ted J. Moreau

Head-Investor Relations, Infinera Corp.

Thank you, Rocco. Welcome to Infinera's third quarter of 2019 conference call. A copy of today's earnings and investor slides are available on the Investor Relations section of our website. Additionally, this call is being recorded and will be available for replay from the website.

Today's call will include projections and estimates that constitute forward-looking statements, including but not limited to, statements about our business, plans, sales opportunities, manufacturing operations, products, technology and strategy, statements about the current status of our integration plans and synergies, as well as statements regarding our fourth quarter outlook. These statements are subject to risks and uncertainties that could cause Infinera's results to differ materially from management's current expectations.

Actual results may differ materially as a result of various risk factors, as included in our most recently filed 10-Q as well as the earnings release and investor slides furnished with our 8-K filed today. Please be reminded that all

statements are made as of today and Infinera 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.

Today's conference call includes certain non-GAAP financial measures. Pursuant to Regulation G, we have provided a reconciliation of these non-GAAP financial measures to the most directly comparable GAAP financial measures in our third quarter of 2019 earnings release and investor slides.

I will now turn the call over to our Chief Executive Officer, Tom Fallon.

Thomas J. Fallon

Chief Executive Officer & Director, Infinera Corp.

Good morning and thank you for joining us on our third quarter 2019 earnings conference call. Joining me today are CFO, Nancy Erba; and COO, David Heard. I'll start by briefly reviewing our Q3 financial performance, highlighting our execution on integration, and depicting our strengthening innovation pipeline and success in positioning our new portfolio with an expanding global customer base. I'll then turn the call over to Nancy to provide a detailed review of our Q3 results and give additional perspective on our financial outlook.

Looking back at the third quarter, my summary review is that we had a solid quarter. We made significant progress in three key areas. Aggressive execution on the Coriant integration has put us in a position to close this chapter of the combination in the fourth quarter and deliver on our second half 2019 commitments, including non-GAAP operating profit and positive cash flow in Q4. Our enhanced and integrated portfolio is being embraced by our customers as bookings for Q3 were at record high and we continued to win new strategic opportunities. And our innovation pipeline is robust with differentiated solutions that are exciting our customers and opening opportunities for future growth in both the top line and gross margins.

The financial results of the quarter demonstrate significant progress toward completing the integration of Coriant. Q3 non-GAAP revenue was \$328 million in line with our guidance, while we increased backlog for the fourth consecutive quarter. Non-GAAP gross margin came in slightly better than our guide midpoint, while operating expenses were at the low end of the range. This positive combination was partially offset by a negative foreign exchange impact resulting in non-GAAP EPS that came in at the midpoint of our guidance.

The highlight of the quarter was bookings, which grew significantly from a strong Q2, were a record for the company and it exceeded our expectations at the beginning of the quarter. Our pipeline in customer traction continued to build with the addition of three new Tier 1 customer wins which brought our year-to-date total to 10. Having recently passed the one-year anniversary of the closing of the Coriant acquisition, we are now in the final stages of integration and on track to substantially complete our integration office activity during the fourth quarter.

As we close this chapter, I'll remind you of the commitments that were made when we began this initiative. First, achieve significant cost savings through synergies to deliver a profitable business in the near-term. Second, increase scale from expanded customer traction with Tier 1s and ICPs enabled by a refreshed and integrated portfolio. And third, invest to be the innovation leader by leveraging our unique vertical integration capability over a broad end-to-end solutions portfolio to serve as a cornerstone of a differentiated business model.

Against these commitments, our execution highlights include, executing cost synergies, delivering two times our originally stated goal with the expectation of \$200 million in savings through 2019. Scaling a powerful end-to-end portfolio that fueled four consecutive quarters of substantial backlog expansion and helped us earn 10 new Tier 1 scale customer wins to drive future growth. And enhanced our leadership in optical technology as we successfully

launched 600-gig and remain on track for delivery of our 800-gig solution in 2020, while introducing XR optics, a new network paradigm.

While we must successfully complete the remaining integration work, our outlook remains that we expect to return the company to non-GAAP operating profit and positive cash flow in Q4. Our heritage as a leading optical innovator has been a significant value driver for our customers and we believe this capability becomes more important in the future. While we've reducing expenses this year, we'll have reduced – increased our R&D investment for our vertically integrated optical technologies by 20% year-over-year, building our pipeline with solutions that are aligned with the fastest-growing segments in the optical market.

We have clear insertion strategies to drive growth with the high bandwidth applications, data center architectures, and metro aggregation and distribution networks. On the innovation front, we are driving to differentiate in three distinct categories: optical leadership through vertical integration with differentiation in performance and cost; disaggregation with open platforms for both optical and IP solutions; and automation that delivers network operational efficiency and rapid service deployment.

On the optical front, we are delivering 600-gig technology to the market with shipments scheduled for revenue this quarter. For 800-gig, our PICs are being demonstrated to customers and our DSP remains on track for delivery this month. This aligns with our plan for 800-gig product delivery in the second half of 2020. We believe our 800-gig product will deliver a significant cost and performance advantage, while our vertically integrated manufacturing capability, the most complete in the industry, will enable us to rapidly ramp at this fifth generation of technology into volume.

We continue to believe we'll be one of only a very small number of companies delivering 800-gig in 2020. In a continuation of our history of providing game-changing technologies, we introduced XR optics at ECOC in September and received a strong market reception. This is an innovative approach to drive radical simplification and step-function cost savings to aggregation network architectures and creates a new product category. The first coherent point-to-multipoint optical networking technology based on a network aware optical pluggable.

Network providers see XR as a compelling solution for applications such as 5G wireless, cable fiber deep and business service aggregation as it supports the evolution of bandwidth demand while greatly simplifying network operations. Infinera is committed to bringing this technology to market with a multisource strategy to enable a broad based adoption of this technology across network applications. Over the next few quarters, we expect to make further announcements as we position ourselves to deliver intelligent network pluggables.

On the open and disaggregated front, we are committed to leadership in two areas. In the optical space, compact modular platforms continue to experience double-digit yearly growth and are expected to be a \$3.6 billion market in 2023. Being adopted by both ICPs and CSPs, our Groove platform, supporting up to 600-gig waves today, continues to outperform from a market acceptance perspective. With the addition of over 40 new Groove customers year-to-date, including a significant ICP and a number of Tier 1 CSPs globally, our expectation is that our market share will show noted growth in the second half of 2019.

As we prepare to introduce 800-gig into our offering, we see the opportunity for continued market share expansion with our leading optical capability. With the advent of 5G and fiber deep, our customers are driving a fresh approach to metro aggregation and are looking to router disaggregation as a way to minimize vendor lock-in, speed new service deployment, facilitate faster innovation and assure cost-effective scaling.

As previously announced, Telefónica is currently deploying our DRX router for a 5G wireless network build in Germany. Our disaggregated DRX, XTM and Transcend wireless solution leverages our field-hardened cell site routing installed base while offering our customers a powerful transition to 5G. Our pipeline of activity continues to grow with the DRX and we expect revenue to begin ramping in 2020, what was expected to be a lengthy 5G investment cycle.

Transcend, our automation software suite is a key enabler to deliver an efficient network across traditional and desegregated network elements. Today, Transcend helps customers like AT&T, NBN and Verizon to manage their network assets with greater efficiency and improve customer responsiveness. It is instrumental in the purchase decision for our desegregated metro solutions as customers expect simplified operations and the rapid rollout of new revenue-generating services. And finally, it facilitates creation of new service offerings with Tier 1s, providing the intelligence required to migrate legacy circuits to next generation networks as evidenced by our previous Verizon announcement.

With the Coriant integration nearly complete, multiple proof points that our portfolio is being embraced by customers and innovation pipeline poised to deliver meaningfully disruptive solutions to the fastest-growing segments in the market and material progress in improving the bottom line of the company. We see the opportunity we envisioned a year ago starting to materialize. At the macro level, we see fundamental demand remaining strong as bandwidth-hungry services require new architectures that deliver dramatic cost reductions in transmission and networks.

Our leadership in vertical integration is core to our ability to continue to drive down costs, enable these new architectures and deliver technology in a narrowing group of viable technology sources. On the global front, we are well positioned to take advantage of growing concern over network security while having very limited exposure to the political uncertainty surrounding China. As we prepare to close 2019, I look back with appreciation at the significant transformation our company has achieved in one year. Looking forward, I'm excited and realistic about the opportunity ahead and the work required to complete the execution of our vision. I would like to thank our employees for their significant contributions toward enabling this transformation.

I will now introduce our new CFO, Nancy Erba. Nancy will share her initial observations about Infinera and then review our results and Q4 guidance.

Nancy Erba

Chief Financial Officer, Infinera Corp.

Thanks, Tom, and good morning, everyone. Today, I will provide my initial thoughts on the business, discuss our Q3 financial highlights, and provide our outlook for the remainder of the year. For your reference, we have posted slides with financial details to our Investor Relations website to assist with my commentary.

I became Infinera's CFO just over two months ago. What initially drew me to the company and what I've validated in my time here is the history of technology innovation and the potential for Infinera to emerge from the Coriant acquisition poised to increase shareholder value and the growing \$18 billion optical networking market. The organization has put forth tireless effort over the last year to integrate two companies at a fast pace.

As we entered the latter stages of the integration, we worked through the anticipated challenges of three significant structural business changes, first, the consolidation of three ERP instances into one. As we announced last week, the complexities of this integration resulted in the delay in announcing our financial results until today. We will continue to improve our close process and shorten the time to announce our financial results over the coming quarters.

Second, a supply chain transformation enabling the move from a fixed cost structure to an outsourced model that will allow for variable flexibility to better support our customers while optimizing our cost leverage. And third, the introduction of a new finance leadership team.

The complexity of these transitions was magnified by stronger than expected demand in bookings and an anticipated shipping shutdown recovery that extended longer than planned. The result was a heavily backend-loaded quarter in terms of shipping linearity, invoicing and collections. We anticipate shipping recovery to be accomplished in the fourth quarter.

I will now walk you through the financial highlights of our third fiscal quarter which illustrate the progress we have made toward executing on our strategic goals. Q3 non-GAAP revenue increased 7% sequentially to \$328 million was within our guidance range of \$320 million to \$340 million. As discussed, revenue was impacted by our planned ERP shutdown and delayed shipment recovery.

We recognized one 10% customer in the quarter and we experienced strength in the ICP vertical where we benefited from the growth in demand from a new customer that began deploying our Groove platform earlier in the year. As a result, our geographic mix skewed more towards North America with 49% of revenue coming from that region.

Non-GAAP gross margin of 33.1% came in above the midpoint of our 33% to 34% guidance range, even with our continued growth and footprint expansion for line systems in the quarter. With the flow through of our integration cost efforts, we're able to modestly offset these margin pressures.

Moving now to operating expenses, we continued to make solid progress driving down expenses, reporting Q3 non-GAAP OpEx at \$127 million below our \$130 million guidance midpoint and down 3.7% from \$132 million in Q2. While taking actions to reduce our overall non-GAAP OpEx spend, we are also ensuring that we invest in the right growth areas, such as increasing R&D and critical programs, as Tom mentioned earlier.

This diligent management of expenses affords us the ability to focus investment on innovation and provides us the ability to differentiate our solutions and improve our operating model through gross margin expansion over time. This is an investment versus spending mentality with the intense focus on the resulting business model. In aggregate, we recognized a non-GAAP operating loss of 5.7% and a non-GAAP net loss of \$0.17 per share, both metrics within our Q3 guidance range.

Turning to the balance sheet, total cash and investments finished the quarter at \$121 million. As a result of the disruptions we experienced with the ERP integration and the shipment linearity I described, our invoicing and collections for the quarter were also impacted. This is a temporal issue that will resolve during Q4 and into Q1. As a result, we drew down \$30 million on the ABL facility which was put in place during the third quarter for precisely this type of situation. The ABL provides flexibility to our working capital to support an increasing demand profile like we experienced in Q3.

I am keenly focused on improving our cash conversion cycle by measuring our working capital, prioritizing inventory turns and managing accounts receivable collections. While we have made progress over the past year, we believe there remain many ways to improve our operational efficiency. We believe that our cash, along with our existing credit facility, will be sufficient to meet our currently anticipated working capital requirements.

Now, to our guidance for the fourth quarter of fiscal 2019. As mentioned earlier, our Q3 bookings increased materially in the quarter, representing the fourth consecutive quarter of backlog growth. We continue to see a healthy pipeline and expect another solid quarter of bookings in Q4. For Q4, we currently anticipate non-GAAP revenue of \$355 million to \$375 million which would bring us to the target of \$1.3 billion for the year.

Based on the benefits of our new leverage supply chain model and as our product mix continues to normalize in the period, we expect non-GAAP gross margin to be between 34% and 36% for the fourth quarter of this year, in line with previous expectations. We anticipate additional cost benefits to flow through the P&L in 2020 when the full impact of the expected supply chain efficiencies will be reflected.

With regard to operating expenses, we have made tremendous progress driving down our expense levels, reaching our end of year target ahead of schedule. We will continue to manage expenses closely and anticipate Q4 non-GAAP operating expenses to remain in the range of \$125 million to \$129 million. This range includes the increased commissions expected with stronger bookings and revenue.

We expect our Q4 non-GAAP operating income to be between breakeven and 2%, slightly profitable, with anticipated non-GAAP EPS between a loss of \$0.01 and \$0.05 per share. The combination of stronger demand for our products as reflected by increased backlog and new customer additions and the impact of our synergy saving efforts has kept us on track for Q4 non-GAAP operating profitability and turning cash flow positive in Q4.

With the integration of Coriant coming to a close, we see the foundation in place for growth and improved operating leverage. We plan to share the metrics we will be measuring in 2020 along with the framework for our long-term business model during our Q4 earnings conference call next year.

With that, I will turn the call over to Rocco for the Q&A portion of the call.

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now begin the question-and-answer session. [Operator Instructions] Today's first question comes from Rod Hall of Goldman Sachs. Please go ahead.

Rod Hall

Analyst, Goldman Sachs

Q

Yeah. Good morning, guys. Thanks for the question. Good set of earnings. I just wanted to check I guess on 800-gig, Tom, and see if you could expand a little bit on where we are in that process? It sounds like you've finished tape out. Maybe let us know what the next milestone there is? And then, I have a follow-up.

Thomas J. Fallon

Chief Executive Officer & Director, Infinera Corp.

A

Sure, Rod. Thank you for your time. Yeah. We remain on track, as I've said, to delivering our 800-gig product in the second half of next year. The next major milestone is delivery of our DSP that is scheduled for this week. So, we should have that in our hands this week. There is then a fairly significant amount of work that we will do to validate. Our history has been that the DSPs work, but until it works, you don't know. You should expect us to have announcements in regard to – I would call it, customer demonstrations in the first half of next year and then shipping for revenue in the second half.

The PIC, as we said in the call, is in good shape right now. We're demonstrating that to customers in our lab. We're doing emulation of the DSP. And so far, our customers have come back with the overall reflection that the performance is quite good.

Rod Hall

Analyst, Goldman Sachs

Q

Okay. Thanks, Tom. And then my follow-up for Nancy is regarding working capital. I guess, more bigger picture regarding cash flow, but cash flow was a little bit weaker than we expected, Nancy, and then if we dig into that, it's mostly in the working capital line. We see the inventory going up, which is probably a good sign I guess, and then accounts receivable is also up a little bit. So, I just wanted to see if you could talk us through some of those movements and what your expectations for cash flow are?

Nancy Erba

Chief Financial Officer, Infinera Corp.

A

Sure. So, as we talked about, we had the delay which we had expected in shipments with the cut-over to the combined ERP. I will say that that took a little bit longer than we had initially planned, which caused not only a delay in shipments, which then leads to all the follow-on repercussions in terms of invoicing and the ability to collect. So, you do see that increase both in the inventory and in AR because of that. What we expect and it is a temporal issue is now that we are back running, we will see those collections start to roll into Q4 and into Q1, and we would expect, as I said in my statement, to be cash flow positive in Q4.

Rod Hall

Analyst, Goldman Sachs

Q

And [indiscernible] (00:22:10) could you expand on that shipping issue a little bit, like why did the ERP system affect shipping, just so we can understand that in a little more detail?

David W. Heard

Chief Operating Officer, Infinera Corp.

A

Yeah. Thanks. There were actually two issues. So, one was certainly a cut-over of three SAP systems into one ERP. But the second is, as we discussed on prior calls, we moved our own fixed manufacturing from our own facility in Berlin to an outsourced partner in Thailand in Fabrinet. And so, all that happened all at one time. So, we cut over both systems and the supply chain.

And so, as Nancy mentioned, if you looked at invoicing and shipping on a weekly basis and divided out the number by the number of weeks in the quarter, instead of us only having a down period of about a week and a half that turned out to be about a three-week period. If you take that out to cash flow that's the delta in what we forecasted the cash and what we actually put out. Good news being we very rarely have a bookings cancellation and our bad debt is 0.15%. So, as Nancy said, we expect that cash to restore in the next two quarters.

Operator: And our next question today comes from Henry Needham of Needham & Company. Please go ahead. Mr. Needham, your line is open.

Thomas J. Fallon

Chief Executive Officer & Director, Infinera Corp.

A

Might be Mr. Henderson.

Operator: Oh, I apologize. And our next question today comes from Meta Marshall of Morgan Stanley. Please go ahead.

Meta A. Marshall

Analyst, Morgan Stanley & Co. LLC

Q

Great. Thanks. Maybe just if we could kind of isolate what amount of revenue might have slipped from Q3 to Q4 just as a result of this kind of three-week period as kind of a bookkeeping item?

And then, maybe as a second item, just progress made on kind of getting ICP customers that were Cloud Xpress customers converted over to Groove customers just to make that 800-gig transition process easier next year, just if there's any kind of traction being made on converting those customers? Thanks.

Nancy Erba

Chief Financial Officer, Infinera Corp.

A

Hi. Sure. So, I guess first, we should reiterate that revenue came in just below the midpoint of guidance. So, with all of the challenges that we had during the quarter, we were able to recover well and come back into the range. So, I want to make sure that we remember that as we're talking about this. So, you could then infer, right, that the bookings being as strong as they were in the backlog that we are now working through, there is additional opportunity. We see the improvement going into Q4, our range \$355 million to \$375 million in revenue through Q4 and another expected strong bookings quarter.

Thomas J. Fallon

Chief Executive Officer & Director, Infinera Corp.

A

Yeah. There was more than sufficient demand to hit our guidance window in Q3. We've kind of ran out of time with recovery, and as Nancy said, it's less of a revenue recognition issue, it's more of a linearity and invoicing and collections issue than a revrec issue.

In regard to ICPs, we're being very successful with the Groove. And if you think about the Groove, one of the advantages it has is it's a sled-based architecture which allows multiple generations of technology to be deployed. As the Infinera CX platform kind of runs through its normal course of life on the ICE4, we are being successful at introducing the Groove into ICPs that we historically had, but just as importantly, winning new ICPs with that platform, particularly the one we've pointed out a couple of times, a substantive ICP that is driving a significant amount of demand. But it's important not to just think about the Groove platform for ICPs, it is being exceptionally well received with CSPs around the world. They are using this platform for transmission as they look at building out 5G networks, as they look at building normal long-haul metro networks. It's being exceptionally well received in general.

Meta A. Marshall

Analyst, Morgan Stanley & Co. LLC

Q

Got it. So, your guys' stance is that really this three-week showdown just affected collections, not that more of the bookings that were booked in Q3 would have been recognized as revenue in Q3.

David W. Heard

Chief Operating Officer, Infinera Corp.

A

No. Yeah. I think Nancy was pretty clear in terms of – certainly, there was opportunity, but – and certainly we are positioned well with backlog as we enter Q4, but as any integration, you're going to go through the learning curve as we go and we've contemplated that into our guidance range for Q4.

Thomas J. Fallon

Chief Executive Officer & Director, Infinera Corp.

A

Yeah. Meta, as I said, we ran out of time. Had we had the ability to ship faster, we would have – we had the demand that we would have fulfilled...

David W. Heard

Chief Operating Officer, Infinera Corp.

A

More.

Thomas J. Fallon

Chief Executive Officer & Director, Infinera Corp.

A

...more. We ran out of time.

Operator: And our next question today comes from Michael Genovese of MKM Partners. Please go ahead.

Michael E. Genovese

Analyst, MKM Partners LLC

Q

Okay. Thanks. So, you've talked about four straight quarters of building backlog and the orders have been quite good for four straight quarters. My question is, do you think that that's a function of the industry demand or a function of share gain that you're doing or both?

Thomas J. Fallon

Chief Executive Officer & Director, Infinera Corp.

A

I think it's a function of a few things. One, as I said in my commentary, we see relatively strong and healthy demand. A lot of these new architectures that are being deployed to support next generation applications just require more bandwidth. So, I see a healthy bandwidth environment. Two, I see that the solution set that we are bringing to market as we've integrated this portfolio and tied together a number of various platforms into an integrated solution with Transcend is being well received. We are winning a number of new customers. So, when you win a new customer, invariably I figure – I look at it as winning new market share and we've won 10 Tier 1 scale opportunities with new customers this year.

In the first year of any of those, you typically don't do a huge amount of revenue, but it's a foundational spot that you can grow your business on over time. I also believe that while the industry continues to be broadly served by a number of competitors of ours, there are fewer and fewer people who can actually bring differentiated integrated technology to market. And I think we are leveraging the strength we have in that position to not only selling our portfolio today, but our roadmap tomorrow and people are appreciative of that capability.

Michael E. Genovese

Analyst, MKM Partners LLC

Q

Okay, great. And then, as my follow-up, I just want to check in with your language around the fourth quarter operating profit. Was that the same as what you were saying before when you're talking about EPS profit previously in the fourth quarter or was it always operating profit that you were discussing?

Nancy Erba

Chief Financial Officer, Infinera Corp.

A

It was always been operating profit that we've discussed.

Michael E. Genovese

Analyst, MKM Partners LLC

Q

Okay, great. Appreciate it. Thank you.

Operator: And our next question today comes from Simon Leopold of Raymond James. Please go ahead.

Simon Leopold

Analyst, Raymond James & Associates, Inc.

Q

Thanks for taking the question. I've got a question and a follow-up. First, on the vertical mix, I appreciate the slide you've included here. Just want to see if you could talk a little bit about how you expect the vertical mix to trend over, say, the next year or so, when you look at your pipeline, your product mix, the coming 800-gig, making an assumption that we should see ICPs rising, maybe cable falling, just if you could give us a little bit more color on how you see this evolving.

David W. Heard

Chief Operating Officer, Infinera Corp.

A

Yeah. So, again, I think as Tom mentioned, the compact modular space being a market that's growing at 29% towards that \$3.6 billion market, we think we're going to see significant traction along both ICPs as well as Tier 1s with that Groove compact modular platform with open line systems and us being in a – obviously in a take share position in terms of our aggressiveness towards the market. So, I'd expect to see both ICPs continue in a share gain mode. In Tier 1s, as Tom mentioned, we've closed 10 of them and that's planted the seeds. Those should be in growth mode as we look forward over the next year or so moving forward.

Thomas J. Fallon

Chief Executive Officer & Director, Infinera Corp.

A

My commentary would be the – our ICE6 will be first deployed with ICPs, they drive technology and I think we're well positioned there to gain market share. In ICPs, we are also seeing success with subsea, that's with ICE4 today, but also there is intense interest in ICE6. That growth will obviously come later than next year. In the cable space, we have a significant opportunity, though it's too early to call, you should keep your eye out on the DRX, disaggregated HDEA model that the cable guys are looking to deploy. It's later, obviously, than many had anticipated, but I think we are well positioned to grow in that space with the DRX platform. That will be a slow growth, but over time, I see significant opportunity.

Simon Leopold

Analyst, Raymond James & Associates, Inc.

Q

And then, just the follow-up to that would be, what are you thinking about the timing and effect of ZR and ZR+ pluggable on your business? Thanks.

Thomas J. Fallon

Chief Executive Officer & Director, Infinera Corp.

A

Yeah. The ZR, we view that as is certainly impacting a small portion of our market. I wouldn't call it meaningful. I don't like to lose any type of opportunity, but it's not meaningful. We are actually going to plan on using the ZR in our applications. We have no intention of using our kind of scarce DSP and PIC resources to create commodities. We're going to enjoy the cost structure of commodities and we'll incorporate that where it makes sense into our platforms.

In regard to the ZR+, it's still uncertain. There's still no standard. I'm intent upon using our XR portfolio to really offset what the ZR+ could do. Our XR provides not only cost-effective transmission, probably at better reaches than the ZR+, and it also provides the ability to build intelligent networks, not just point-to-point transmission service.

Simon Leopold

Analyst, Raymond James & Associates, Inc.

Q

Great. Thank you.

Operator: And our next question today comes from Tim Savageaux of Northland Capital Markets. Please go ahead.

Tim Savageaux

Analyst, Northland Securities, Inc.

Q

Hi. Good morning and congrats on the results and outlook. First question is on kind of customer profile. You mentioned you had one 10% customer in the quarter. I wonder if you can kind of characterize that customer around Tier 1 or traditional type customers, and maybe provide a little more color as you have in the past on who – beyond that who some of your key customers were by vertical, and then I've a follow-up.

Thomas J. Fallon

Chief Executive Officer & Director, Infinera Corp.

A

Sure. Yeah. Our largest was a North American Tier 1. It's a customer that's often our number one customer. We continue to enjoy significant business with them, as we've talked about I think the last quarter, they deploy a

significant amount of new footprint this year. We continued to do not only long-haul with them, but also some metro and some [indiscernible] (00:34:10) in subsea with them. As I've talked to you before, that business, there will be some challenges as they move, for the long-haul, into a complementary direction with 400-gig. That is not where we are targeted, but I see a substantive amount of opportunity, short, medium and long term with this customer. It's continued to be an exceptionally healthy relationship.

I think the next largest customer was our new ICP that we won based upon the Groove in North America. That's a new relationship this year. It's one of our Tier 1 scale customers. They were not quite a 10% customer, but they had a substantive amount of business in Q3 and I forecast that to continue to remain fairly strong business. Though in the ICP space, as you know, it's a little lumpy, so you can't count on that every quarter, but we do anticipate a strong Q4 and we also anticipate that our ICE6 is well positioned within that market. One of our other large customers was a European Tier 1, building a new network for long-haul. It's been a long term customer that's doing a technology refresh and they've upgraded to our latest technology. So, that's a smattering of the largest customers that drove some good opportunity in Q3, Tim.

Tim Savageaux

Analyst, Northland Securities, Inc.

Q

That is great color and I appreciate it. Moving on to that, I know the question was asked about verticals over time, but as you look specifically into Q4, I guess you sort of mentioned it, Q3 was heavily driven by ICPs. Do you expect that to remain the case? And if you could provide any commentary on the cable vertical, that remains week. Obviously, historically you've had a very significant customer there. Maybe you could offer some commentary similar to what you've done on your traditional Tier 1 about any expectations for cable in particular or that large customer [indiscernible] (00:36:16) cable in general or that large customer in particular? Thanks.

Thomas J. Fallon

Chief Executive Officer & Director, Infinera Corp.

A

We actually have more than one large customer in cable. People talk about our North America large customer like it's the only cable guy we have. It's just not a correct reflection. We actually have a pretty strong presence in Europe in cable also. But to your specific question that customer, as we said, is working through a significant inventory position. You will see that business growing Q4 off of a very soft Q3 as they start bumping into capacity type of limitations that we are happy to help them with. I'm excited about the cable space in general.

The DRX is now well positioned in a number of labs and we won't see any real demand out of that in the early part of next year. But our success in cable over time I think has a real opportunity [ph] after having an (00:37:13) inflection up based upon the receptivity of the DRX. So, it's something to pay attention to. Our portfolio is being well received by the cable space and they are one of the top segments that are interested in the XR technology as you can imagine. I mean, it's ideally positioned for 5G and cable distribution. So, I think that the richness of the conversations, that the engagement between executives and people below executives has probably not been stronger than it is today, that has to turn into bookings and I'm – I think Q4 will be stronger than Q3.

Tim Savageaux

Analyst, Northland Securities, Inc.

Q

Thanks very much.

Thomas J. Fallon

Chief Executive Officer & Director, Infinera Corp.

A

Yeah.

Operator: [Operator Instructions] Today's next question comes from Samik Chatterjee of JPMorgan. Please go ahead.

Samik Chatterjee

Analyst, JPMorgan Securities LLC

Q

Hi. Good morning. Thanks for taking my question. Tom, I know you mentioned a couple of times the adoption of the DRX router that you're seeing. I just wanted to ask more broadly if you can quantify for us in terms of your order book, how much of your order book is kind of open disaggregation products, like your open line systems, et cetera? What are you really seeing and if you can quantify that and maybe compare that to what you had maybe a year ago, so that we get some milestones in terms of tracking the adoption there? And then, I have a follow-up.

David W. Heard

Chief Operating Officer, Infinera Corp.

A

Yeah. It's actually a good question in terms of percent of portfolio and something we'll think about depicting for you maybe in our next call in a better respect. Here is what I'll tell you, the compact modular platforms allow for an insertion into existing footprint at great ease along with open line systems and we're seeing that as a much larger portion of our portfolio. The last three quarters we've had a ton of new footprint as well as more and more open line system insertion, both with our existing products as well as with the Groove product. So, that has been an increasing, I'd say, by a factor of two over the last couple of quarters in terms of the importance which allows us to position ourselves to gain share on a go-forward basis. But really, really good question and that's, again, a great part of what we're seeing in this open and disaggregated world.

In addition, we announced a trial with Telefónica, a network deployment with Telefónica first in Germany. That was publicly announced. Obviously, that's a nice global property, and as we see this open DRX disaggregated router, it marries up quite nicely with our products on the Edge offering Layer 2 with our XTM Series to really offer both solution for mobile fronthaul and backhaul, which we call Xhaul, as well as what Tom referenced for the cable industry in deep fiber solutions. And so, we see both the pipeline for those products increasing as well as bookings for those products increasing on a quarterly basis as we go forward. And as Tom mentioned in his prepared comments, the 5G market is going to be a multiyear investment curve for the company and for the industry.

Thomas J. Fallon

Chief Executive Officer & Director, Infinera Corp.

A

Yeah. A real quick color on open, Infinera has unfortunately been labeled as a closed/proprietary type of supplier and it's never been further from the truth. They say because of our PIC, we're proprietary. I think our customer base in the market is finally understanding that the technology of the PIC has nothing to do with open and disaggregated. We are working very hard and growing market share in open line systems. The Groove is an open disaggregated transponder platform and the DRX is an open disaggregated IP solution.

We're not doing it just to be good sports in the industry, however, we believe in an open world, the advantage comes to whoever delivers the best transponder, and we are convinced that our technology with our vertically integrated PIC and our vertical DSP, we create an unfair advantage for ourselves by executing on the optical platform and deploying [ph] net across (00:41:30) open line systems, ours or others. It's another reason that you'll hear us talking a lot about our investment in Transcend.

Transcends starts playing a more strategic role as customers deploy disaggregated platforms, because carriers are still looking for one neck to grab around operational execution and efficiency, our automation platform provides that one neck to grab. So, you'll see us continue to talk about open desegregated optical leadership and automation. Finally, I would pay attention to the TIP announcement today. TIP, we've made a press release and you'll see us, a customer and TIP talking about our role, the DRX is playing in its new architecture in the industry.

David W. Heard

Chief Operating Officer, Infinera Corp.

A

You had a follow-up question as well?

Samik Chatterjee

Analyst, JPMorgan Securities LLC

Q

Yeah. I'm sorry, more on the cost side, obviously, there seems to be more move towards outsourcing. How should I think about that impacting your longer-term targets in terms of 50% gross margin, like does that lower the revenue base that you now need to get to that target? How should I think of the overall implications here in getting to your long-term margin targets from more outsourcing?

Nancy Erba

Chief Financial Officer, Infinera Corp.

A

Sure. Yeah. So, I mean the outsourcing model as it relates to the system manufacturing is really designed to give us flexibility to allow us to serve our customers and our customers' needs more effectively and more efficiently. It's one of the examples that I spoke of in terms of how we're looking at growing and scaling the business in 2020 to be able to address this increasing demand that we're seeing from the customers and then the market growth.

So, certainly, the supply chain transformation that we're undergoing does enable us to offer that and as well gives us an opportunity to get to the OpEx levels that we need to. In addition to that, it impacts our margin efficiency. Certainly, we're very focused on bringing that margin up to what I will not preview in terms of what that margin range is, but certainly with our Q4 results, we will talk about both our expectations for 2020 and also the leverage and efficiency that we think the business model can achieve in the next two years.

David W. Heard

Chief Operating Officer, Infinera Corp.

A

Yeah. Overall, it positions us for margin expansion as we go forward. The particular actions we took this year, again we took over the summer, as we mentioned what was supposed to be a slow summer and it turned out not to be. We expect that to scale in full effect in 2020 which will afford some margin expansion.

Samik Chatterjee

Analyst, JPMorgan Securities LLC

Q

Thank you.

Operator: Our next question today comes from Jim Suva of Citi. Please go ahead.

Jim Suva

Analyst, Citigroup Global Markets, Inc.

Q

Thank you very much. My question is, first of all, for Nancy. You've only been in the CFO seat a few weeks and you're working through a lot of ERP issues. It sounds like you're having, if I hear your comments correctly, pretty

much fully under control as you exit the December quarter for implementing all three ERP systems. Am I right on that or is it taking a little bit longer, because that is part of the cause of the delay for the Q3 earnings and why we're talking today?

Nancy Erba

Chief Financial Officer, Infinera Corp.

A

Sure. So, as anyone and you guys have followed a lot of companies who've gone through integrations, both as a result of an acquisition, but also companies who just simply are upgrading and integrating their ERP, this was a very complex integration, three different instances, two from the core end side of the house and the Infinera instance, bringing those all together was a very significant effort. We did complete that. We have closed our first quarter on the combined and integrated system.

I will also say that it's an ongoing process to gain all of the efficiencies that one instance will bring. So, we will continue to work to improve our close time as well as the benefits that this system can bring us in terms of how we work, working smarter, closing better, having better analytics and all of the benefits that that will bring to support the business. So, first quarter closed, we will continue to evolve over the next several quarters as we get all of the benefits out of that one system.

Thomas J. Fallon

Chief Executive Officer & Director, Infinera Corp.

A

I'll just add, converting three ERP systems is challenging, you throw into that mix moving your entire supply chain to an outsourced model at the same time, it's a monumental task. I'm extraordinarily pleased with the work of the team. And I would say it's as an important part, those items are the most substitutive operational risks of this integration and they're now behind us. To Nancy's point, we're not done. I would say we're probably 90% done. We have things to improve and to continue to learn from. But I do believe that the close represents a significant milestone, also the discoveries that we made, we won't have to make again, and that's a big milestone.

Jim Suva

Analyst, Citigroup Global Markets, Inc.

Q

Great. And then, my follow-up question is on the ERP system, typically when we implement two into one or in your situation, three into one, there is extra operating costs and operating burden from that. Is that contemplated and included in your Q4 guidance or will you have even more cost savings in the March quarter as far as kind of operating margin – or are operating expenses coming down? I don't know again if you have extra costs associated with this integration also that we should be thinking about.

Nancy Erba

Chief Financial Officer, Infinera Corp.

A

Yeah. Certainly, we will gain efficiencies through having one ERP and we have been thinking through our integration efforts and the plans for the year included benefits from that. I will also say that as we go into 2020, there are other efficiencies that we can gain that will enable us to leverage this model and to leverage our new supply chain. And all of the actions that were taken in 2019 are positioning us to be able to scale more effectively and efficiently in the 2020 timeframe.

Jim Suva

Analyst, Citigroup Global Markets, Inc.

Q

Thank you so much.

Operator: And our next question today comes from Dave Kang of B. Riley. Please go ahead.

Dave Kang

Analyst, B. Riley FBR, Inc.

Q

Good morning. A couple of questions. Regarding your fourth quarter EPS outlook, what's your FX assumption? And my follow-up question is, with all the momentum you have, how should we think about first quarter seasonality?

Nancy Erba

Chief Financial Officer, Infinera Corp.

A

So, for Q4 or I should – let's back up for Q3, we did see a more significant FX impact than we had anticipated coming into the quarter. It's a result of everything that we've talked about today. The significant movement of our intercompany resources to the new European distribution center, in addition to the outsourcing of our supply chain for systems manufacturing. The level of transactions and the number of transactions and movement of materials caused a larger impact than we had originally anticipated. For Q4, we would expect to be on a more normalized range. We're not anticipating anything unusual in the Q4 timeframe.

Thomas J. Fallon

Chief Executive Officer & Director, Infinera Corp.

A

In regard to Q1, as you well know, our industry typically experiences Q1 that is about 15%, 14% softer than Q4 and that is driven by customer demand where they just get their new budgets and start planning for the year. I would anticipate our Q1 to be sequentially down from Q4. It's certainly too early to call, but unlike most years, we are carrying a significant backlog into our Q1 as we had talk about growing backlog for four quarters in a row. When we look at our current bookings outlook for Q4, we anticipate that Q4 backlog will grow yet again. So, we will go into Q1 with a stronger backlog than usual, but we do expect to see a somewhat softening of Q1 bookings. So, that's about all I can comment on a quarter from now.

Dave Kang

Analyst, B. Riley FBR, Inc.

Q

And my last question is, on last quarter's call, you talked about being approached by a couple of DSP customers, any closure there?

David W. Heard

Chief Operating Officer, Infinera Corp.

A

We continue to see more and more opportunity and I think the scarcity in the market of – and how difficult it is, not only on the DSP side, but obviously integrating that into an open optic, whether it be a DCO and obviously in the future, a pluggable. So, we continue to have lots of activity, and as we see more progress and we're ready to announce, we will make that public, but very, very good engagement and activity there.

Dave Kang

Analyst, B. Riley FBR, Inc.

Q

Got it. Thank you.

Thomas J. Fallon

Chief Executive Officer & Director, Infinera Corp.

I'd like to thank all of you for joining us today and I look forward for us to having the opportunity to give you updates as we continue on this exciting journey. To the veterans, I want to thank you the day after Veterans Day for your service to the country. Have a great day.

Operator: Thank you, sir. This concludes today's conference call. You may disconnect your lines at this time and have a wonderful day.

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