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Infinera Corp. *(INFN)*

Q4 2011 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Fourth Quarter Year 2011 Investment Community Conference Call of Infinera Corporation. All lines will be on 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.

I would now like to turn the call over to Mr. Bob Blair of Infinera Investor Relations. Sir, you may begin.

Robert Blair

Head-Investor Relations, Infinera Corp.

Thank you. 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 of the company in the first 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 releases and SEC filings, including the company's annual report on Form 10-K filed on March 1, 2011, for more information on these risks and uncertainties.

Today's press releases, including fourth quarter and fiscal year 2011 results and associated financial tables and investor information summary will be available today on the Investors section of Infinera's website. 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 will also include certain non-GAAP financial measures. In our earnings release, we announced operating results for the fourth quarter and fiscal year 2011, which exclude the impact of restructuring other related costs and non-cash stock-based compensation expenses.

These non-GAAP financial measures are provided to facilitate meaningful year-over-year comparisons. Please see the exhibit of the earnings press release for a reconciliation of these non-GAAP financial measures for 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 Investors section of our website.

On this call, we'll also give guidance for the first quarter of fiscal year 2012. We have 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. With me are Chief Strategy Officer, Dave Welch; and CFO, Ita Brennan. I will spend a few minutes today commenting on the market, touch on our Q4 results and then provide an update on the reception to our new products before turning it over to Ita for a full review of our Q4 performance and Q1 outlook.

Internet bandwidth continues to expand with unabated growth driven by video, mobile and cloud computing applications. Simultaneously, we are observing the transformation of the Internet into the primary and mission-critical, telecommunications network of the future. We believe these trends are causing service providers to take a hard look at how they build and manage their next generation transport infrastructure.

This transformed transport infrastructure will need to scale smoothly to multi-terabits of optical transmission starting with the 100 gig and quickly moving to terabit capacities, efficiently accommodate more fluid, cloud-based traffic demands and support mesh networking, while maintaining the predictability and reliability of transport networks, and become simpler and more cost-effective, requiring significantly less human resource, power, cooling and space per bit of traffic carry.

We believe that our recently launched DTN-X is optimized to accelerate this important transformation. Our competitors are starting to ship a 100 gig and present concepts and demos of 200 gig on a line card. Customers are testing our DTN-X today with 500 gig super channel line cards and we've already demonstrated technology to go to one terabit super channel capacity on a single card.

The DTN-X is the step function that service providers and in particular Tier One carriers need to properly prepare their networks for the high-capacity future. We believe that our new DTN-X in conjunction with our enhanced DTN, and existing ATN, all with control plane unification software enable us to better address our traditional customer as well as a new set of Tier One customers across verticals and geographies.

In Q4, we saw an active market in the cable, Tier One and bandwidth wholesale segments. While, much of the industry conversation and our own go-to-market strategy centers around the 100 gig and greater than 100 gig super channel speeds, the 10 gig market remains strong. It is a consensus view among analysts that 10 gig will continue to grow in volume throughout the next several years, and we believe it'll remain robust for another decade. In fact, we believe the strength of the 10 gig market was a key factor enabling Infinera to achieve the number one share position to the North America terrestrial long-haul WDM transport and ROADM Market and advance to number three worldwide based on Infinera's data from the third quarter of 2011.

Our view continues to be that 40 gig will flatten out and serve as an interim solution as carriers continue to deploy more cost-effective 10 gig for lower capacity links and move to a 100 gig and 500 gig super channels for high-capacity links. Our opportunity is clearly defined, maintain leadership in the 10 gig market and repeat that success with a 100 gig.

We also continue to see an increasingly competitive pricing environment, which we expect to remain so as multiple vendors now compete with three DWDM transmission speeds: 10 gig, 40 gig, and 100 gig. We are also seeing market consolidation among our carrier customers reducing the universe of customers and increasing the leverage of each customer as they become larger.

Our better than expected revenue performance in Q4 reflects continued solid demand for DWDM equipment along with the benefit of some unanticipated year-end budget spending by a number of our customers. We recovered well from the disruption caused to the optical supply chain by the historic flooding in Thailand muting the negative impact to our performance that we had originally singled in November.

Our operations team and supply partners worked tirelessly to deliver on our disaster recovery plan and ensure that our customers were not hurt as a result of this catastrophe. Of the vast majority of our Q4 revenue was 10 gig related, we did achieve our first 40 gig revenue addressing pent-up demand from key customers. We saw a broad balance across our customer base in the fourth quarter with the top five customers accounting for approximately 40% of revenue.

Two cable companies were among our top five customers, including one in excess of 10%. I am also happy to report that one of our Tier One customers wins our top five for the second consecutive quarter. As a reminder, our strategy has been to demonstrate our value in the international and regional networks of Tier One carriers with the DTN and then to leverage the multi-terabit scalability, efficiency, and simplicity of the DTN-X to earn an insertion opportunity in the core backed on networks.

On the customer win front, we added five new customers in the fourth quarter. This gives us 16 customer additions in 2011 for a total roster of 98. Given that we were primarily shipping our 10 gig DTN for most of the year, the growth and stability of our customer base is a testimony to the importance placed on the Infinera value proposition; anchored, of course, by our differentiated Digital Optical approach to the network.

In another validation, we now have 36 network customers; customers who have purchased multiple products from us across multiple applications. On the new product front, customer interest in our new DTN-X since its launch has been very strong, which we believe is in recognition of the unique advantage Infinera's integrated platform brings to market. The only platform operating integrated DWDM and OTN switching functionality without compromise. As a reminder, this platform is fundamentally three products in one.

A DWDM transmission system, that will support the world's first 500 gig super channels based upon 100 gig FlexCoherent channels upgradeable in the future to 1 terabit super channels unleashing highly efficient DWDM transmission capacity at the lowest operational costs. An integrated OTN switching system that will scale from 5

terabits in its first release to 100 terabits in the future. And will enable operators to efficiently tame these large pipes to a grooming of traffic down to 1 gig granularity.

And third, a system that is designed to be upgradeable to MPLS switching in the future, which will further enable convergence of the network for improved efficiency, reducing the number of interconnections between layers while preserving network investment.

Infinera pioneered the integration of OTN switching and DWDM with the DTN in 2005. Leveraging this unique learning from more than a decade of development in seven years of field operation, the DTN-X integrates three technology building blocks to deliver value and differentiate itself from the competition. 500 gig Photonic Integrated Circuits with FlexCoherent DSPs, custom switching ASICs and a multi-terabit non-blocking switch fabric and intelligent GMPLS control plane software that scales the thousand of nodes. The DTN-X design has been optimized to meet the needs of Tier One carriers and addresses their need to prepare for extremely high capacity in dynamic networks, opening up a large and new market for Infinera. Competitors are following Infinera's architectural lead, announcing integrated solutions.

However, unlike the DTN-X, design for this integration from day one, competitors are taking existing systems and adding DWDM or switching after the fact. This approach results in a compromise between the switching and transmission capacity of these systems. This does not occur with the DTN-X.

We believe the DTN-X will be the only platform on the market that will allow all components, including the optical functions based on our PIC technology to be consistent with Moore's law, delivering best of breed switching integrated with best of breed DWDM without compromise.

The DTN-X is on track with lab trials in Q1 and volume production starting in Q2. We have begun to scale the production capability and the 500 gig PICs have been released to manufacturing. On the trial front we have scheduled four DTN-X lab trials in our current quarter. All four of these trials are with Tier One carriers, reflecting mix of both new prospects and current customers with two located in North America and two located in Europe.

In addition to these trials, we've had numerous demonstrations of full DTN-X system. While we are pleased with the early interest by the carriers in our DTN-X platform, it is important to note that Tier Ones often have extensive qualification testing and that a lab trial is only one of several steps toward revenue. In the quarters ahead, we will be report to you on additional trials and DTN-X wins.

Infinera's mission is to transform the way telecommunications transport networks are built. Our first step on this journey was the DTN introduced in 2005. This platform delivered the world's only commercially available 100 gig Photonic Integrated Circuit. The world's first optical transport platform that integrated DWDM, OTN switching and a GMPLS control plane into one platform and the world's first digital optical network.

Our customers have validated this architectural approach of integrating photonic elements, platforms and network layers delivered network scale, efficiency, simplicity and reliability. We are now taking this decade of experience and are scaling and improving upon this architecture with the DTN-X. Infinera is delivering on a promise of the terabit age in 2012, and preparing our current and future customers to transform their networks to scale efficiently across the next decade. This is what the network will be.

Before turning it over to Ita for a detailed review of our Q4 performance and our outlook for Q1, I want to thank the Infinera team for their continued commitment to innovation and their focus on execution allowing us to make sure we deliver on the promise of helping our customers to be successful in their markets. I want to say a special

thanks to our supply partners that helped us navigate a uniquely challenging Q4 and I will close by thanking our customers for their continued business and partnership as we move forward in the terabit age together.

Ita will now provide you her review of Q4 and outlook for Q1. Ita?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

Thanks, Tom. I'll review our Q4 actual results and then follow that up with our outlook for Q1 2012. This analysis of our Q4 results and our guidance for Q1 2012 is based on non-GAAP. All references exclude non-cash stock-based compensation expenses.

As outlined in the September call, our revenue guidance for the fourth quarter had a wider range than normal due to uncertainty around the timing of revenue recognition on a number of large deals. The flooding in Thailand, which occurred just after our call, triggered notification from the supplier that they would not be able to achieve their previous supply commitments. This increased the uncertainty around our revenue guidance and required us to expand the range of potential outcomes in the subsequent press release.

As Tom mentioned in his remarks, we were successful in securing supply of impacted components and met most customer requirements. In addition, we completed and recognized revenue on all three large deployments that were targeted for completion at or around the end of the quarter. This included recognizing the first revenue from our 40 gig solution.

As often happens in the industry, we also had a number of customers approach us with some year-end budget money, and we were pleased to be in a position to accept and satisfy that demand in the quarter. All of these factors resulted in total GAAP revenues in Q4 of a \$112 million compared to our original guidance of a \$100 million to \$110 million and our revised guidance after the Thailand flood of \$85 million to \$105 million.

Our revenues were broadly diversified across our customer base with one greater than 10% customer in the quarter, which as Tom mentioned was a cable provider. We saw a healthy mix of new footprint deployments combined with continued strong TAM shipments.

International revenues amounted to \$34 million, or 30% of total revenues for the quarter. EMEA accounted for \$24 million or 21%, with APAC and the other Americas representing 5% and 4% respectively.

Our service revenues for the quarter were \$18.4 million, up from \$13.6 million in Q3, reflecting the completion of a number of large deployments and the renewal of some significant entitlement contracts. Services margins were favorable at 68%.

Overall gross margin in Q4 were 42%, up from 41% in Q3 reflecting continued strong TAM shipments, improved volumes and a healthy services mix.

Operating expenses for the quarter were \$53 million in line with our guidance and compared to \$52 million in Q3. Looking forward to the March quarter, we expect operating expenses to be approximately \$54 million reflecting increased R&D testing and verification activities as the DTN-X product moves closer to final release.

Overall head count for the quarter was 1,181 versus 1,151 in Q3. Headcount additions primarily related to direct labor for manufacturing and some software verification adds for R&D.

Our operating loss for Q4 was \$6.3 million. Other income and expense for Q4 was favorable at \$0.1 million. Net loss for the quarter was \$6.7 million resulting in a loss per diluted share of \$0.06 compared with our original guidance, which called for a loss of \$0.08 to \$0.12 per diluted share and compared to a loss of \$9.2 million or \$0.08 per diluted share in Q3.

Now turning to the balance sheet. Cash, cash equivalents, restricted cash and investments ended the quarter at \$253 million versus \$276 million in Q3. We used \$5.1 million of cash from operations in Q4 versus generating \$4.1 million in Q3.

DSOs were 65 days, up from 60 days in Q3, mainly due to shipments occurring later in the quarter as we worked through supply issues.

Inventory turns were 2.9 times versus 3.5 in Q3. As a result of executing on our disaster recovery process some double sourcing occurred and we exited the quarter with higher DTN inventory levels. We expect to consume these inventories in the first and second quarters.

We also began production of components for the new DTN-X product and plan to ramp this production in the March quarter. As a result, we expect to drive increased inventory levels over the coming two quarters in advance of recognizing revenue on the DTN-X in the second half of the year.

Accounts payable days were 53 days, up from 43 days in Q3, again reflecting delayed receipts from suppliers in the quarter.

Capital expenditures of \$16.1 million in Q4 versus \$5.9 million in Q3 for a total of \$39 million for the year. As we look to 2012, we expect CapEx to average approximately 10 million per quarter for the first half of the year and then return to lower levels in the second half.

Now turning to our guidance for Q1 2012 and beyond. We may experience some seasonality in the first quarter as service providers typically take time to plan their annual budgets and deployments. As a result, we've been somewhat cautious with our assumptions around TAM shipment volumes for the March quarter. In addition, reflecting recent success in new footprint wins, we plan to take revenue on a number of significant deployments of both new and existing customers driving a stronger common equipment mix.

As mentioned above, we will ramp DTN-X related production in both our fab and module factories this quarter and depending on volume and yields, this may drive some gross margin volatility.

As we look beyond Q1 2012, we see good overall demand for our products and strong interest in the DTN-X platform. Revenues in the second quarter may be tempered by some existing customers choosing the DTN-X for their new footprint deployments. We expect that the shipment and acceptance criteria for these initial DTN-X deployments may push revenue recognition for this business into the September quarter.

With these factors in mind, the following guidance for Q1 is based on non-GAAP results and excludes any non-cash stock-based compensation expenses. Revenues of approximately \$102 million to \$108 million, gross margins of approximately 38% to 40%, operating expenses of approximately \$54 million, operating a net loss of approximately \$11 million to \$15 million, and based on estimated average weighted diluted shares outstanding of \$110 million, this will lead to a loss per share of approximately \$0.10 to \$0.14. Please note the basic share count is expected to be at 108 million for the quarter.

Operator, would you now please open up the call for questions? Thank you.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] . Our first question comes from George Notter of Jefferies. Your line is open.

George C. Notter

Analyst, Jefferies & Co., Inc.

Q

Hi, there. Thanks very much guys. I guess I wanted to just get updated on again the delivery of the DTN-X. Can you just lay out for us which milestones are still in front of us in terms of I don't know if it's software verification or just walk us through what's left in terms of development to get that shipping commercially?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Sure, George, this is Tom. We're in two phases right now, as we mentioned, we are in the process of doing customer lab trials. It's always a good way to validate the performance that you're expecting matches the market requirement. So that process has started, and I anticipate that we will both do well and discover things that we need to work on. The vast majority of the work is as you point out in the back end testing process and system validation testing, it's a product of magnificent scale and with that scale comes complexity. And we're going to make sure that when we introduce this platform, it comes with the reputation of quality that Infinera delivers. So the bulk of the remaining time is in system validation testing, making sure that the switching functionality works as planned, all the alarms on the system that are quite [ph] sensitive (20:32) all work as designed. And I suspect we will stumble across some bugs that need software fixes, so that's really the next major milestones. The development work is vastly done.

George C. Notter

Analyst, Jefferies & Co., Inc.

Q

Got it. Okay. So, I guess just to -- I guess more finely tune the delivery -- I assume the delivery then for trials is late Q1, is that fair to say?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

What we said is that, we have scheduled four for Q1 and that volume production will occur in Q2. We -- I am reaffirming that that's our current plan of the four trials we have scheduled, we've actually completed one. And so we are marching down the path.

George C. Notter

Analyst, Jefferies & Co., Inc.

Q

Great. And then, you mentioned earlier that there were some pent-up demand associated with the 40 gig line card delivery, and then certainly some budget flush also here in the quarter. Can you tell us how much that was relative to the \$112 million you printed here?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah. I mean, I think the year-end budget stuff was probably low single digit millions of dollars, it wasn't more than that, right? I mean, we executed on those large opportunities that we talked about in the original guidance and then we saw some upside kind of in that range.

George C. Notter

Analyst, Jefferies & Co., Inc.

Q

Got it. Okay. And then, I'm sorry the piece attached to the 40 gig delivery was that, I guess, that was also budget flush or --?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

We didn't put a number on that, but the 40 gig piece was planned, right? I mean, we had talked about that on the last call that we had some subsea 40 gig business that was kind of on the bubble from a Rev Rec perspective and that happened. So I don't think we've put a specific number on that, but it's a large subsea deal, so you can imagine that it's multiple millions of dollars.

George C. Notter

Analyst, Jefferies & Co., Inc.

Q

Got it. Okay. Hey and then, just as I look out over the balance of the year and I think about you guys ramping the DTN-X. I mean, how should I think about that in terms of the margin profile, safe to say that it'll come initially at lower margins, you're working through the yield issues and then over time the margins ramp, and how would that compared to the current margin profile of the existing DTN?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah. I mean it's tough to kind of plot it out on a quarter-by-quarter basis. We did -- we looked at the plan for the last call and we guided kind of to that 40%, approximately 40% range for the year. I think for the first quarter we put out a range of 38% to 40%, that's kind of just to do some, we haven't got a ton of visibilities of the TAMs yet for this quarter, hopefully they come. But as of right now, we wanted to be somewhat careful about what we included in that guidance. We did see a healthy mix of commons as well in Q1, which is probably maybe more than we might have expected initially. So we are winning new footprint and we are seeing customers putting in new line systems even in Q1, whether that gets filled out completely with DTN or DTN-X will depend on what the customer needs, but we are seeing kind of a heavy commons mix. So that's kind of impacting the margins in Q1. So I think depending on where revenues actually turn out for Q2, we could see some kind of lower margin impact there maybe and then in the back end of the year I think we start to ramp some volume and start to utilize some of the overhead that's already in the COGS number and we should start to see margins kind of improve, but averaging out to that 40%, is kind of what our current plan would say.

George C. Notter

Analyst, Jefferies & Co., Inc.

Q

Got it. Great. Thank you very much.

Operator: Thank you. Blair King from Avondale Partners. Your line is open.

Blair King

Analyst, Avondale Partners LLC

Q

Yeah. Hey Ita, a couple of quick questions, one for you and maybe one for Tom. When you mentioned in your prepared remarks about the revenue in the second quarter potentially being tempered by the DTN-X, does that imply or should we read into that, that the second quarter revenue should be down from the first quarter?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah, I mean it's hard to tell at this point, right? I mean we are seeing a dynamic where really just on the new footprint deployments – so I think the existing DTN business is continuing to transact as normal, but when customers are looking at new deployments, depending on when exactly they're going to need that capacity they'll either deploy DTN or they may want to start to deploy the DTN-X. If it's DTN-X in Q2 that may push out to Q3 from a Rev Rec perspective, because there'll be acceptance and some other criteria.

Blair King

Analyst, Avondale Partners LLC

Q

Okay.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Blair, this is Tom. The DTN and DTN-X are guided toward different markets. They are guided towards some different customers, some customer overlap, some customer end market overlap, but they're really specified to be two product lines or two products within one family. The issue that Ita brings to rise is as we introduce a new platform, my goal is that the customer base picks Infinera. And I don't have a preference quite frankly, if the DTN does that better for them, that's great, if the DTN-X does that better for them, that's great. And now we have that DTN-X tool in their toolbox.

Some customers who might have bought a DTN, might decide to go to the DTN-X because it has obviously more headroom. If that were to occur then at the end of the day, we're winning the footprint, we're going to enjoy that business for a long time. But it causes some volatility that we don't control right now and what we want to do is win footprint and help customers make the best choice for their long-term success. So she's just letting you know that there is an unusual dynamic afoot in Q2 that is new for our customer base.

Blair King

Analyst, Avondale Partners LLC

Q

Right. I understand that perfectly clear. Thanks for the clarity. The second question I had was, Tom, maybe you could just -- there's been questions in the past over the sort of the acceptance rate of not just Tier Ones, but just broadly the customer base in general over the 100 gig market, as well for the 500 channel, super channel product that you have coming to market. And that that acceptance rate is ultimately what determines the ramp within that product. So if there is -- you may not have a lot more clarity this quarter than you did a quarter ago, but to the extent that you do, maybe you could talk a little bit about how you see that market unfolding for you this year, a little bit more than just what you've done in terms of explaining the back half should be a ramp and then maybe think of --

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

I'm very optimistic that this platform, the DTN-X is going to be well received by the Tier One markets. We designed it for the scale of their networks, we designed it for the complexity of their networks. I think that they want to converge network layers, because they see that the way to reduce network costs over time, it's much less a

discussion around transponder costs, it's much more a discussion around network costs. And I think the DTN-X is uniquely ready in the platform case to do that. I think that the DTN and DTN-X, it's important that people don't confuse the DTN-X -- the DTN wasn't accepted into the core of Tier Ones. The DTN actually had fairly good receptivity into Tier Ones, just not into the core of their networks typically. And that's because, I firmly believe, we introduced the DTN which was a 10 gig wavelength platform seven to eight years after 10 gig was brought to the market. I think carriers need to make sure that as they're certifying new platforms, they're doing it on a relatively early end of the technology life-cycle to make sure they get full advantage of the investment they make.

I think that our DTN-X platform with 100 gig is at the very earliest part of the 100 gig market, and we're quite frankly creating the 500 gig super channel market. I was very clear to point out that the four customer trials, lab trials, we have scheduled for Q1, they're all Tier Ones; two in Europe and two in North America. That's pretty darn good for a brand-new platform, that's still not released to market. So at the end of the day, Blair as you know, all this is interesting, POs will matter and wins will matter, and we'll be clear to you on what those are when they occur. But I'm pretty optimistic with the progress we're making to date.

Blair King

Analyst, Avondale Partners LLC

Q

All right. Thank you very much. I appreciate it.

Operator: Thank you. Ehud Gelblum of Morgan Stanley. Your line is open.

Ehud A. Gelblum

Analyst, Morgan Stanley & Co. LLC

Q

Hey, guys, I appreciate it. Thank you. Couple of questions, the four trial customers you have right now for the DTN-X, are they existing customers of your DTN or are any of them new people, new carrier customers?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

It's a mix of existing and potential new.

Ehud A. Gelblum

Analyst, Morgan Stanley & Co. LLC

Q

So in that four is at least one, possibly two new customers that are not currently Infinera customers.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

At least one.

Ehud A. Gelblum

Analyst, Morgan Stanley & Co. LLC

Q

Excellent. The -- when you look at your Q2, you were talking about again this concept of potentially stalling some of your DTN customers with the concept of the DTN-X coming out momentarily. I'm still a little unclear as to whether the concept is that we should be looking at Q2 as being a potentially down quarter or not, because then you additionally were talking about how they're marketed to different customer bases. So I'm just trying to correlate those two and how we should look at Q2 and the kind of the pacing throughout the rest of the year. Is it two scenarios and one scenario Q2 ends up being down, and the other scenario Q2 ends up being up, if you can just kind of walk us through how you're looking at that?

And then, what is the gross margin profile in both scenarios, if people hold out for DTN-X in Q2, what does that mean for gross margin, if they don't, what does it mean for gross margin?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah. I mean it's not that clear at this point exactly how it's going to play out, Ehud. I mean what we're trying to do is to kind of at least paint some of the boundaries around what we see could happen, right? I mean I think on the DTN-X the key is, the product is really -- and a lot of the opportunities that we're seeing with the product are with new customers, right, so that's back to Tom's comments. But obviously, there will be existing customers as well who have the capacity and will want to adopt the DTN-X. I think what we're seeing in Q2 is, we have customers who are deploying new footprint and they're putting in DTN to satisfy capacity and as soon as they can shift to the DTN-X if they require that capacity then they will look to do that, right?

How that plays out specifically in the quarter is tough. I mean I don't think we see the existing run rate DTN business being impacted, it's more the choice on new footprint deployments and the timing of those, and that's tough to call, right?

I think from a gross margin perspective, if there is a -- if volumes are higher we'll have better margins, if they're lower, if you take your revenues down, then you will see some impact to margin, right?

Ehud A. Gelblum

Analyst, Morgan Stanley & Co. LLC

Q

But does it matter, it doesn't matter though, the types of revenue that we'll see in Q2, in the different scenarios?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

I think either way I don't think we'll recognize revenue from DTN-X in Q2, right? So it's really going to be a DTN revenue base in Q2 either way. The question is do we impact kind of any growth that we would have expected to see in Q2, because we see people waiting to transition to the DTN-X or not, right? But I think the DTN base is there, we're not looking to -- there won't be a DTN-X impact in Q2 from a margin perspective.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

David, I'm going to add two comments. One, the backdrop to me is what's happening in the macro market for transport and we are seeing relatively steady demand across all of our markets. I think that that's a very healthy thing for our business regardless of whether people buy DTN or DTN-X. We're seeing a lot of activity, we're seeing a lot of activity in various markets, and I believe even the industry group is now saying that the long haul market should experience some relatively good growth this year. I think there's a question certainly in North America about AT&T and Verizon, but I don't have anything to add to that. But I can tell you across our customer base, we're seeing people making investment decisions.

So the backdrop is, I believe that the environment for this year should be reasonably healthy. Q2 adds a new dynamic that is new, because we are introducing a new platform and we believe that on the DTN-X, assuming we're fortunate enough to have the opportunity to sell to people, we'll have a longer acceptance cycle. A lot of our customers will allow us to accept upon shipment, these are people that have large installed base with us. We ship the product, we ship add-ons and they allow us to recognize revenue, because they've pre-certified it. The DTN-X probably has a longer certification system or process than recognized revenue on shipment, at least for the first bit

it will be through certification. That creates a revenue recognition dynamic that Ita is trying to in full disclosure share with you.

Ehud A. Gelblum

Analyst, Morgan Stanley & Co. LLC

Q

So for once it's actually a good thing that you don't have this Tier One exposure, you're actually seeing positive trends whereas a lot of your competitors are not. So as we look finally at Q3, how confident are you that you can actually recognize DTN-X revenue in Q3? Or do you think because of this revenue recognition issue on the new platform, it could push out into Q4 or possibly Q1 of 2013 in terms of when you can actually start recognizing DTN-X revenue?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

I think, Ehud, we're sticking to kind of the guidance that we have out there, which says revenue in the second half. We've ramped production in Q2 and then we'll just have to let to play it out, we'll update you, obviously, on the next call as to where we are, we'll be closer at that point and we'll have more visibility, right?

Ehud A. Gelblum

Analyst, Morgan Stanley & Co. LLC

Q

Okay. Very helpful guys. I appreciate it.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Thanks.

Operator: Thank you. [ph] Rod Stahl of JPMC. (33:52) Your line is open.

Q

Yeah. Thanks for taking my question. I just had a couple of things to ask. Tom, I just wonder on the trials, if you guys could clarify what the pipeline for trials looks like, I mean, you've got these four people that are trailing, is that -- have you had to cut it off, you have other people in line who want to trial it, but you're just trying to limit it to those four Tier Ones or do you expect by next quarter, when you guys report to us, to be talking about a considerably larger number of trails and can you give us any idea how many we might be looking at?

And then I also just wanted to ask about the DTN-X, I mean, let's say it all goes well, let's say that the Tier Ones want to buy it. How are you guys fixed for production, I mean, are you feeling pretty good about your ability to serve demand? And what are you doing about distribution, let's say, if you get those headline customers, I guess you will definitely get a longer line of people that will want to come in and look at the product and potentially purchase it, do you feel like you've got the distribution in place to handle that kind of demand if it comes through?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Yes. So on the first one, on trials, we've very specifically had decided to just talk about the current quarter trials and I think that that's just a prudent thing to do. So we're only talking about the ones that we have scheduled in Q1. There is a pipeline of requests beyond our Q1 committed trials, but I'm not going to give you any more clarity

on that. My goal at every quarter will be to give you an update on previous trials, current trials for the current quarter and any activity of sales we might have achieved. So that doesn't completely answer question, but hopefully it gives you a flavor for our thinking.

In regard to the DTN-X fulfillment capability, I'll just I guess talk philosophically for a minute. If you remember last year, we said we're going to raise our sales head count, because we had spent a significant amount of money bringing what we think is a very significant platform in technology to market. And our view was, it would be inappropriate not to have invested in enough sales people to sell the product. That's in place, the sales guys are out, I think being productive, certainly the trials make me think that, and the interactions I have make me know that.

We're going to take the same philosophy to manufacturing. In our business, being a vertically integrated manufacturer, if you look back on the 100 gig market last year, it was forecasted at somewhere between a \$100 million and \$200 million, somewhere in the area of a 1000 wavelengths or so. If we are a successful at doing a 1000 wavelengths, even though that's a 100% of the market, that's insufficient for us to build the business model that we need. Our job is two fold, one, to deliver a compelling solution to the market based upon our 500 gig technology and cause the industry to adopt a 100 gig as a primary vehicle. And we are going to put the manufacturing capability and are putting the manufacturing capability to affect that.

Q

Okay. And then, I just want to clarify one thing too, maybe Ita is the right person to ask or maybe Tom, but these 5% and 10% of customers, would you expect the same ones in Q1 again or do you think that mix of top customers is going to change materially as we head into Q1?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah. I mean, typically if you look at that top five list, they do rotate in and out of there depending on whether we're doing new deployments et cetera with them, right? So there's always a good mix across the segments, but it tends to be different player on a quarter-over-quarter basis.

Q

Okay. Great. Thanks a lot, guys.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Thanks Rod

Operator: Thank you. Michael Genovese of MKM Partners. Your line is open.

Michael Genovese

Analyst, MKM Partners LLC

Q

Great. Thanks. I just have two quick questions. One, can you just comment on what you're seeing in the pricing environment? And then number two, I was going to ask using coated language, but Tom since you mentioned the

names AT&T and Verizon, I'll just come straight out and ask if either one of those are in these four trial customers that you have for the DTN-X? Thanks.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

So, I'll answer the first one first on pricing. You know pricing is a fairly distinct dynamic, because there's now 10 gig, 40 gig and a 100 gig all vying for footprint. We continue to see 10 gig come down at fairly significant pricing kind of unhistorical run rates of 10 plus percent a year. And typically this long in the cycle of a technology that starts tempering itself. It doesn't seem to be tempering, I don't think it's accelerating, but it's not tempering. So I think the 10 gig pricing is going to continue to be downward. 40 gig is I think trying to keep up with that downward trend. To the best of my view on 40 gig coherent, there really isn't a crossover yet. I think it's close to it, some people will say it's crossed over, some people say it hasn't, my view is it's roughly at parity and as long as it's at parity, unless have fiber constraints, or you want to make sure your network has more capacity in the future, 10 gig continues to be a fairly good economic answer. I believe that a 100 gig is still early on in its technology cycle. I think that my view is a 100 gig will achieve crossover with 10 gig at the same time, or approximately the same time as 40 gig, I think that's why we continue to believe that there is a 40 gig squeeze that will occur.

I think a number of people who have 40 gig and 100 gig today are selling a large installed base of 40 gig with the ability to upgrade to 100 gig because I think for them, allows them more margin and an upgrade path to 100 gig. I think that is not an unreasonable approach. Infinera's approach is going to be install with a 100 gig at good competitive price and be ready to upgrade to 100 -- to a terabit. And I think that if you look at Internet demand growth, I think going from 40 gig to 100 gig is an interesting step. I think going from 100 gig to a terabit or 500 gig to a terabit is really the problem set that needs to be solved. So I'm pretty compelled to believe the value proposition that we bring to the market, that we can do that competitively on a fair return and bring our customers great value.

In regard to the second question, which was are AT&T and Verizon within that fold of people on trials, we're not making any comment on who any of those four are.

Michael Genovese

Analyst, MKM Partners LLC

Q

If I could just get a quick follow-up here on the margins, realizing the pricing environment. With the outlook this year for 40% gross margins and it's obviously a transition year, in the product portfolio, but is it still reasonable to assume a long-term target of 50% gross margins. I believe that's probably still the guidance that's out there for the long term margin?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

And I mean that is the long term business model. I think as we look out we've guided kind of the 40% through 2012 and then into 2013, you start to see that margin expand as you start to get more volumes around the DTN-X and more balanced kind of commons versus fill in the networks. I think that will expand out into 2013 and then beyond you start approach that higher kind of 50% range. So it is kind of an expansion over time as you grow kind of the top line.

Michael Genovese

Analyst, MKM Partners LLC

Q

Thanks.

Operator: Thank you. Simona Jankowski of Goldman Sachs. Your line is open.

Simona K. Jankowski

Analyst, Goldman Sachs & Co.

Q

Hi, thanks so much. Just to clarify first of the four trials, are those customers who are committed to buying the product at this point or are they still more evaluating, so you could still -- they could still not convert to customers?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Any time that somebody is doing a trial, I think the intention is to evaluate whether they -- it solves a problem for them in their network. As I tried to explain on the call, trials are a first step of a many step process toward a customer deciding that it is something that they want to put in their network. I think that companies are far too busy to send people to our labs for several days of testing just to be entertained in the California sun. So I think that it's an indication to me that what we're bringing to market represents a solution to a problem set they either have or have in the future. But it's just a first step in a many step process toward a purchase decision.

Simona K. Jankowski

Analyst, Goldman Sachs & Co.

Q

Based on your historical experience, what percent of trials typically convert into customers?

David F. Welch

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

A

Yeah, I mean, we don't have that -- we don't give out that type of statistic. The best way of looking at the people that are trialing our gear have a serious need for DWDM bandwidth. They are in a purchasing cycle. They're evaluating our products seriously for those considerations.

Simona K. Jankowski

Analyst, Goldman Sachs & Co.

Q

And you mentioned that some of your competitors have a 40 gig system that is upgradeable to a 100 gig. Among carriers who have adopted such a 40 gig system, do you feel like they've effectively committed to that competitor's 100 gig road map or are any of them trialing your product and do you still feel like you have an opportunity to convert them to the DTN-X?

David F. Welch

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

A

So, I think any time you have a current customer, you have a certain level of incumbency, there isn't a -- in this space, there isn't a hard lock in that inhibits that business from going to another competitor as well.

Simona K. Jankowski

Analyst, Goldman Sachs & Co.

Q

Great. And then just lastly, can you just clarify what you meant about the segmentation of the DTN and the DTN-X, because clearly they both can sell into the Tier One customer base. So did you just mean more that within a single customer, they can target different parts of the network or if you can just expand on kind of the tiering that you are referring to?

David F. Welch

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

A

As we've talked about before, our DTN product for national Tier One markets really hasn't been fully appropriate for large Tier-Ones. The DTN-X is, does meet their maximum fiber capacity, their density and now the integrated OTN switching that satisfies a lot of key tech sectors. So by bringing the DTN-X to market, we substantively improve our accessible market from that. So there will be a new market addition on the DTN-X as well as some overlap with our current DTN customers as well as a bunch of our -- a significant amount of our DTN customers are perfectly happy at the capacities and positions we've been at. As we've talked about North American share in the past, we have developed a number one position within North America without the existence of the largest Tier One customers in North America. We think by bringing a DTN-X on board to complement that market position, that will broaden out our accessible market.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

If you also look at the DTN versus the DTN-X, a single card on the DTN-X comes with 500 gig of capacity, that's more capacity than the entire DTN chassis handles. So it's a -- they can certainly work in the same application, but if you need significant scale, you're going to go with the DTN-X. If you don't need something that goes up to that capacity, the DTN is an exceptionally affordable and proven platform to achieve simplicity, efficiency and scale.

Simona K. Jankowski

Analyst, Goldman Sachs & Co.

Q

Great. Thank you.

Operator: Thank you. [Operator Instructions] Nathan Johnsen of Pacific Crest Securities, your line is open.

Nathan Johnsen

Analyst, Pacific Crest Securities LLC

Q

Yeah, hi, thanks for taking my question. You talked some about crossover points between the various speeds. I was wondering as you guys look at the, I guess yield roadmap for DTN-X and kind of what you're assuming for price reduction on the DTN, just wondering where you guys actually see a potential crossover point for DTN-X versus the DTN, I mean is that a 2013 event or is that maybe not the right the way to think about it?

David F. Welch

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

A

I am sorry. A crossover point from --

Nathan Johnsen

Analyst, Pacific Crest Securities LLC

Q

From a cost per bit.

David F. Welch

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

A

We think that the DTN -- you got to look at it from a network point of view as opposed to, people try to take systems companies and push them down into a transponder market, it's not, it's a network market. From a cost per bit, if I have large mesh network with integrated OTN, the DTN-X is a better performer out there just strictly because of the integration of the OTN switch. You know you've absorbed a lot of gear that would have otherwise

sat in another chassis next to your DWDM platform. Now for a guy that, you know has a non large mesh network, but is really looking at a singular point to point type of network, and is happy with capacities in the terabit or less range, DTN is going to be a preferred economic solution for it. And say at a network level, if you measure these things at a network level you're going to come up with a different answer. If you try to push both of these products into a transponder equivalent pricing, you're not going to come up with the right answer, because it's not a component, it's a system.

Nathan Johnsen*Analyst, Pacific Crest Securities LLC*

Q

Got it. That's very helpful. And then, looking at yields of I guess the key DTN-X components, I guess particularly the PIC, was wondering how the current yields for that product compare to the previous PIC generation, just whether those are on track at this point?

David F. Welch*Director, Chief Strategy Officer & Executive VP, Infinera Corp.*

A

So specific on numbers, we don't put out numbers on either. When we define production, we define our ability to meet entitlement yields, which would mean I can get to a proper economic solution for DTN and DTN-X. And I'd say it's comparable in that range.

Nathan Johnsen*Analyst, Pacific Crest Securities LLC*

Q

Got you. And last one from me, just you guys have talked about the future integration of MPLS capabilities. I'm just wondering if you could provide an update on when you guys expect that to be added as a capability? And whether you see that future capability being important for purchasing decisions now?

David F. Welch*Director, Chief Strategy Officer & Executive VP, Infinera Corp.*

A

So we've talked about that the DTN-X is a system that's compatible with upgrades to include MPLS technologies in it. We are absolutely marching down that path. And we think the [ph] complement of all beta with (49:01) management technologies, which -- at the optical level at the OTN level, the MPLS level on a common platform is what's required in the marketplace. And the DTN-X offers that or offers the migration to include that. We haven't put a date on the integration on the MPLS and I don't think we're at the stage where we want to do that just yet, but we've got a fair amount of expertise in-house that understands that problem, it's safe to say we are working down that path. Let's see, I apologize, I forgot your second question.

Nathan Johnsen*Analyst, Pacific Crest Securities LLC*

Q

Well, I was just curious, whether that's being thought about in purchasing decisions now or if that's something you guys will start pushing to customers later?

Thomas J. Fallon*President, Chief Executive Officer & Director, Infinera Corp.*

A

Yeah. I'd put it in the area of an interesting topic for architecture teams, but not in a decision-making topic. They like to hear on where my -- where their network's going to go several years out. They like to -- they need to have a vision that says, my network level that my cost per bit and my power per bit et cetera are all decreasing, and they understand that later convergences is part of that solution forum, but their decisions now are not being dictated by a need for an MPLS today.

Nathan Johnsen

Analyst, Pacific Crest Securities LLC

Q

Very helpful. Thank you guys.

Operator: Thank you. Kevin Dennean of Citi. Your line is open.

Kevin J. Dennean

Analyst, Citigroup Global Markets (United States)

Q

Great. Thanks very much. Just a few random questions. I guess Ita for you, should we think about the investment in sales force ahead of the DTN-X, should we think about that as being largely complete or do we need to think about bringing more head count on board mid-year?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah. No, I think we deliberately ramped it ahead of the revenues last year and we feel like we're pretty well-positioned from a head count number and expense right now.

Kevin J. Dennean

Analyst, Citigroup Global Markets (United States)

Q

Okay, thank you. And I know you're not giving the mix of 40G, but within the gross margins this quarter specifically product gross margins, was there any noticeable impact from 40G given that it's a non-PIC merchant-based solution?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

There's a little bit of a difference, but not enough to kind of impact the corporate margins, the mix of it is not significant enough that it would drive corporate margin impact.

Kevin J. Dennean

Analyst, Citigroup Global Markets (United States)

Q

Is that a function of it not being a substantial difference or it not being a big enough part of the mix?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Probably a little bit of both, right? I mean if the impact is not, is not that significant and it didn't drive enough revenue to kind of move the needle on that basis, right?

Kevin J. Dennean

Analyst, Citigroup Global Markets (United States)

Q

Okay. Thanks. And last one from me, Dave Welch was just talking about eventual development of MPLS capability, what -- do we need to think about some point in 2012 or 2013, a step up in R&D expense to support that effort or is that process underway now and it's already in the numbers?

David F. Welch

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

A

It's baked into the numbers, we're not -- we staying within consistency with our R&D burns that we've communicated to you. We've been working on the problem and we think we've got some good things that we can add in that space and you'll start to see maybe we'll start talking about that maybe towards the end of the year or whatever what our product plans are.

Kevin J. Dennean

Analyst, Citigroup Global Markets (United States)

Terrific. Thank you.

Q

Operator: Thank you. Sanjiv Wadhvani from Stifel Nicolaus. Your line is open.

Sanjiv R. Wadhvani

Analyst, Stifel, Nicolaus & Co., Inc.

Thanks so much. Just two quick questions on the DTN-X. First question is I know you've highlighted trials with four Tier Ones, any color at least in North America whether they are just regular Telcos or MSOs or Internet companies, any color over there would be helpful?

Q

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

We're not going to comment on any more clarification of that.

A

Sanjiv R. Wadhvani

Analyst, Stifel, Nicolaus & Co., Inc.

Okay. And with the trial sort of starting this quarter, what's sort of the -- the next step is probably [ph] a first office (53:23) application, is that sort of something that happens in Q2, is that a Q1 event, any timing on that or any clarity on whether that is a next step indeed?

Q

David F. Welch

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

I think, it's all consistent with what we've said repeatedly is we're trialing and engage customers this quarter, we are going to ship volume products in Q2 or have manufacturing capable of shipping volume products, and we are going to realize revenue in Q3. And so -- different customers have different processes, some are faster than others, some are slower than others. And I'm not what else -- what other detail you want to get into.

A

Sanjiv R. Wadhvani

Analyst, Stifel, Nicolaus & Co., Inc.

That's helpful. Thanks.

Q

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

Thank you 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. That does conclude today's conference. Thank you for your participation. You may now disconnect from the audio portion.

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