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Infinera Corp. *(INFN)*

Q1 2013 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the First Quarter Year 2013 Investment Community Conference Call of Infinera Corporation. All lines will be in a listen-only mode until the question-and-answer session. [Operator Instructions] Today's call is also being recorded. If anyone has any objections, you may disconnect at this time.

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

Jenifer Kirtland

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 second quarter of fiscal year 2013 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 5, 2013, for more information on these risks and uncertainties. Today's press release, including results from the first quarter of fiscal year 2013 results and associated financial tables and investor information summary, will be available today on the Investors sections of Infinera's website at infinera.com.

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

In our earnings release, we announced operating results for the first quarter of fiscal year 2013, which exclude 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 to the most directly comparable GAAP financial measures, and an explanation of why these non-GAAP financial measures are useful and how they are used by management, which will be available today on the Investors section of Infinera's website.

On this call, we'll also give guidance for the second quarter of fiscal year 2013. 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.

And with that I'll 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 thank you for joining us on our first quarter 2013 conference call. With me today are Chief Financial Officer, Ita Brennan; and Chief Strategy Officer, Dave Welch.

As we ended 2012, we had created significant traction with our DTN-X, gaining substantial share in a fast growing 100-gig market. In our first two quarters of shipping the DTN-X, we have secured over 20 customer commitments, achieving not only number one market share for 100-gig ports recognized for revenue in those two quarters, but also achieving 26% of all 100-gig long haul ports ever sold. In Q1 of 2013, we saw these positive trends continue.

Revenue growth on a year-over-year basis was 20%, reflecting the strength of our current DTN-X market momentum. During the first quarter, we received DTN-X purchase commitments from six additional customers, two that were new to Infinera for a total of 27 DTN-X purchase commitments to-date.

We exited the first quarter with increased backlog and strong bookings momentum. In addition, our pipeline remains robust with more RFP activities than we have seen for many years. As we continue to win new footprint and gain market share, we also started to see customers that begin to add 500-gig super channels and TAMs to their existing DTN-X network deployment. Continued growth in higher margin networks build sales, balanced with ongoing new footprint wins is critical to achieving our margins and business model objectives over time. On the DTN front, we announced wins with AKADO, a leading cable operator in Moscow and CyrusOne, a cloud provider in the U.S.

Further, we are seeing increased customer interest in 100-gig e-services on the DTN, a proof point of the investment protection that is provided by the DTN eight years after its first deployment. Architecting platforms that are ready to deliver services that may not be envisioned yet is a cornerstone of our approach. DTN customers are taking advantage of this today. We anticipate that DTN-X customers will take advantage of this tomorrow.

It is clear that a 100-gig offers customers a compelling economic value proposition, and it's proving to be the currency of choice for the new builds in the market today. After the recent unprecedented price compression on this new technology, we're seeing 100-gig prices flattening to more traditional industry norms. Today, a 100-gig

offers the optimal solution for long haul and high capacity DWDM applications for customers that are seeking to optimize their CapEx and minimize their operating expense.

Our shipments of 100-gig ports remain strong. According to Dell Oro data, Infinera was number one in 100-gig port shipped in the second half of 2012, the first two quarters since shipments of the DTN-X had commenced. And in the first quarter, we achieved another quarterly record for 100-gig ports shipped for revenue. While the industry likes to debate whether the future preference for transmission will be 400-gig or terabit, we are convinced that the standard today is 500-gig super channels, as they're being widely and rapidly deploying in production networks. And as the 100-gig market continues to ramp, we believe Infinera is well positioned to take share with our leading architectural approach and differentiated customer experience.

Infinera's commercialization of photonic integration has positively changed the cost structure of the optical transport industry. Today, that benefit is being realized by large-scale adoption of 500-gig super channels. We're now beginning to see the market explore the next cost step function in network design, convergence.

Convergence is becoming a reality as carriers seek additional improvements with integration of switching and DWDM transmissions to reduce the complexity of operating networks as they scale. Infinera, with our photonic integration advantage, is uniquely able to deliver convergence without compromise, ensuring the full capabilities of both DWDM and OTN switching, even with integrated into a single platform.

Leveraging this position, we are combining our architectural advantage with software intelligence, one of the more capabilities at the transport layer, and some of those functionalities previously reserved for higher and more expensive layers of the network. In March at OFC/NFOEC, we unveiled FastSMP, the industry's first hardware-based Shared Mesh Protection solution, offering customers protection against multiple failures, while lowering the total cost of ownership. This is one of the many features we have lined up to leverage our convergence advantage, helping service providers replace their current layered infrastructure.

Moving now to our first quarter operating performance, as I mentioned, we added six DTN-X customer purchase commitments in the quarter. Our 27 customer commitments represent a diverse cross-section of almost every significant vertical and geographic market that requires high bandwidth transport. Recent public announcements of several DTN-X customers include Pacnet, KDDI, TI Sparkle, MedNautilus, OTE and Interoute. We also continue to see our customers turn up new routes and networks built upon DTN-X very quickly. With our unique architecture and digital equipment model delivering ease of use and simplicity, time becomes a weapon.

This is part of what we like to call the Infinera experience. We have over 335 terabits of DTN-X capacity on live networks, up from 180 terabits in the fourth quarter, spanning 24 countries. We do not believe any of our competitors offer this type of differentiation and believe that we have in fact won opportunities because of this capability and commitment.

In summary, Q1 was a very good start to the year for Infinera. The DTN-X continues to demonstrate strong traction in the marketplace and industry recognition is growing as more customers see the benefits that our 500-gig platform brings in terms of flexibility and total cost of ownership. We have a very active pipeline with large customers across multiple segments and geographies. The DTN-X was built for large networks and designed to meet the needs of Tier-1 customers.

It is opening up opportunities for us around the world and expanding the markets we can address. In Eastern and Western Europe, we're winning new business, contrary to what many would expect given the economic concerns in those regions. In North America, our business with Tier-1, cable and Internet content provider customers is robust and we're also seeing strong interest in Asia, which historically has not been a significant market for us.

Fundamentally, we believe that our strategy of building DTN-X product to address Tier-1s and other high capacity providers, combined with Infinera's scalable business processes, manufacturing and global support services is allowing us to achieve our growth objectives.

With our first quarter financial performance and positive momentum, we believe we are well positioned to achieve the priorities that we established for 2013. We remain focused on winning footprint and gaining market share, while balancing this with prudent financial management.

Once again, I'd like to thank the Infinera team and our partners for their commitment and hard work in delivering a great start to 2013. I'd also like to express my sincere appreciation to our customers for their support and confidence in Infinera.

Now, I'll turn the call over to Ita to provide a more detailed financial review. Thank you.

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

Thanks, Tom, and good afternoon. This analysis of our Q1 results and our guidance for Q2 2013 is based on non-GAAP. All references exclude non-cash stock-based compensation expenses.

Total GAAP revenues in Q1 were \$125 million, at the upper end of our guidance of \$115 million to \$125 million. We are pleased with our top-line performance in the first quarter with the revenue growth on a year-over-year basis at the upper end of our 10% to 20% growth outlook for the year.

While we experienced the typical first quarter's slow start to bookings, momentum built as we moved through the quarter. We exited the quarter with increased backlog versus the end of Q4, reflecting robust sales of our DTN-X platform combined with continued deployments of the DTN.

We recognized DTN-X revenue from eight additional customers this quarter, two of which were new invoice customers to Infinera. In addition, we added two new DTN customers, taking our total invoice customer roster to 115. We had one greater than 10% customer in the quarter which was in MSO. The top five customers also included an additional MSO, two competitive carriers and a Tier-1 customer.

International revenues totaled \$46 million or 37% of total revenues for the quarter. EMEA accounted for \$39 million or 31% with APAC and the other Americas representing 5% and 1% respectively. Service revenues for the quarter were \$16.3 million, down from \$18.6 million in Q4, reflecting unusually high levels of service activity in the December quarter.

Services gross margin was consistent with Q4 levels at 60%, reflecting ongoing deployments in various regions. Overall, gross margin in Q1 was 36% at the higher end of our guidance of 35% to 36%. Product mix for the quarter remains healthy with bandwidth fill sales consistent with recent periods. We continue to see higher levels of new footprint common equipment sales as we ramp DTN-X. This is due to the large number of new deployments completed in the period and is reflective of the significant amount of 100-gig footprint that we are winning.

While we're beginning to see some initial network fill sales on early DTN-X deployments, our product mix continues to have a strong rating to common equipment which will constraint our gross margin in the interim. This footprint however forms the foundation of our future business and allows for an ongoing profitable business model and long-term sustainable growth.

Our progress on yield improvements and cost reductions on the DTN-X platform remains on track. We expect to see initial benefits from these improvements in the June quarter, contributing to our improved Q2 gross margin outlook of 37% to 39%.

All things being equal, we'd expect cost reduction activities to continue and contribute to the financial on an incremental basis through the end of the year. These improvements are key elements of achieving our gross margin target for the year of 38% to 40%. Operating expenses for the quarter came in at \$52 million, slightly above our Q1 guidance and Q4 spending of \$51 million reflecting some increased sales expenses in the period.

Looking forward to the June quarter, we expect operating expenses of approximately \$53 million to \$54 million, reflecting increased R&D costs related to some prototypes to be delivered in the quarter and some increases in sales compensation expenses. Overall headcounts for the quarter was 1,219 versus 1,242 in Q4. The reduction in headcounts primarily reflects changes in operations and R&D resources as the DTN-X product matures.

Our operating loss for the quarter was \$7 million. Other income and expense for the quarter netted to zero. Net loss for the quarter was \$7 million, resulting in loss per diluted share of \$0.06, at the better end of our guidance which called for a loss of \$0.05 to \$0.09 per diluted share.

Now turning to the balance sheet, cash, cash equivalents, restricted cash, and investments ended the quarter at \$164.9 million, down from \$187.6 million in Q4. We used \$21.3 million of cash from operations in the March quarter, a significant swing from generating \$8.3 million in Q4. While we approached EBITDA breakeven on the income statement, working capital management this quarter was a challenge. There were a number of larger deals that booked later than expected in the quarter. This resulted in cash payments for inventory purchases that were not matched with collections in the period.

DSOs came in at 82 days, up from 76 days in Q4. Our aging remains current, however, the late timing of bookings resulted in delayed billings and therefore lower collections in the period. A strong opening backlog and good early bookings momentum should result in improved linearity and DSOs in the June quarter.

Inventory turns were 2.4 times versus 2.6 times in Q4. Inventory turns reduced to 2.4 times in Q1 as we positioned increased levels of finished goods inventory to support bookings received at the end of the quarter requiring shipments early in Q2. Our increased inventory reflects our outlook for near-term demand and the value customers place on time as a weapon, having said that, we do not anticipate the need to fundamentally grow inventory from here.

Accounts payable days were 48 days down from 56 days in Q4. Capital expenditure were \$4.9 million, compared to \$3.2 million in Q4 and in line with our guidelines for capital expenditures of approximately \$20 million per annum.

Although, we invested more cash into working capital in the first quarter than anticipated, we believe we're making the right decisions about the timing of inventory purchases to support this key growth pace for the business. We expect to see some incremental improvement in cash metrics in Q2 and believe that we will exit 2013, having increased our cash balance on a year-over-year basis.

Now, turning to our outlook for the second quarter and beyond. We continue to see strong interest in the DTN-X platform with good bookings momentum and a healthy pipeline of RFPs and lab trials. We're pleased with the level of purchase commitments driven by the platform to-date, and especially with the number of new customers

the DTN-X platform has generated. Although most of the new network builds are DTN-X based, we continue to see new customers and new deployments with the DTN platform.

As outlined in our February call, we were concerned about seasonality associated with Tier-1 and its impact on the timing of bookings and revenue in the first quarter and for the year. Q1 revenues came in at \$125 million, at the higher end of our guidance for the quarter and in line with the higher end of our revenue growth outlook for the year.

Based on our current views, we believe that revenues for the second quarter will range from \$130 million to \$140 million and we are becoming increasingly comfortable with a higher end of our revenue growth outlook of 20% for 2013.

We expect some improvement in gross margins in Q2 as we benefit from DTN-X related cost reduction activities. Our guidance for Q2 2013 calls for gross margin levels of 37% to 39%. This assumes continued footprint and DTN-X wins in the quarter, with higher levels of common equipment driving lower initial gross margins.

We remain committed to our 2013 gross margin outlook of 38% to 40% with expected incremental benefits in cost reductions and product mix improvements later in the year. We believe that with solid revenue growth, our vertically integrated models can deliver significant leverage and allow for a healthy gross margin expansion. In addition, over time, we expect to see a more balanced mix of new footprint and network fill. These factors allow for gross margin expansion towards our mid-term target of 45%.

As we look at operating expenses, our outlook in Analyst Day in December calls for operating expenses in 2013 of approximately \$201 million to \$205 million, depending on our projected revenue attainment. We now believe that with revenues at the upper end of our outlook, operating expenses could range from \$205 million to \$210 million. This increase in spending for the year includes some assumptions around accelerated R&D costs related to customer specific features and a refinement of our sales commission estimates as customer mix and requirements become clearer. This increase would only be executed on as our confidence increases around the improved revenue outlook.

As we go forward, we intent to grow operating expenses at a lower rates and revenues in order to support profitability and achieve our mid-term business model. In summary, our guidance for Q2 which is based on non-GAAP results and excludes any non-cash stock-based compensation expenses is as follows. Revenues of approximately \$130 million to \$140 million, gross margins of approximately 37% to 39%, operating expenses of \$53 million to \$54 million, operating and net income loss of approximately \$1 million income to a \$5 million loss. Based on estimated average weighted diluted shares outstanding of 120 million, this would lead to an EPS range of \$0.01 income per share or \$0.04 loss per share. Please note that the basic share count is expected to be 117 million for the quarter.

Now operator would you please open the call up to questions. Thank you.

QUESTION AND ANSWER SECTION

Operator: And with that we'll now begin the question-and-answer session. [Operator Instructions] One moment please for our first question. Our first question will come from George Notter with Jefferies. Your line is now open.

George C. Notter

Analyst, Jefferies LLC

Q

Hi, guys. Thanks very much. Congratulations on a very strong quarter and guide. I guess I wanted to ask about the DTN-X, and it feels like the pace at which you guys are adding customers and seeing revenue growth maybe is a bit ahead of where you guys had previously expected. And I guess I'm just trying to understand what's new here. Is this the addition of certain particular customers that could be sizable? Is it more broad-based? I mean is there any kind of root cause analysis you guys can point us towards to talk about sort of the inflection in this DTN-X business?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Hi, George, it's Tom. First of all, thanks for the congratulations. Second of all, certainly the DTN-X progress is at the upper end of what we were driving for. We're a pretty aggressive group of people. So, we're trying to, quite frankly win as many opportunities as possible. But from a more balanced perspective, I would say, we are winning customers at a clip that is to me very impressive and the size of the deals is also impressive both for an initial footprint and opportunity over time.

I think that where I am looking at, where are we being pleasantly, not surprised but on the upside, Europe has really been a great place for us while most of the world talks still about the challenges of Europe and there are many – there are clearly a significant number of networks being built in Eastern and Western Europe that I think that we are benefiting a great deal from that.

Our outlook for the future I think has been enhanced with more comfort toward the top end of the range because the DTN-X is being very well received by potential Asia customers. We won't win all of them, but the interest is very significant. And I'm confident that we're going to win at least some of them. And in our home base where we kind of always had an established leadership role, cable, Internet content providers, wholesalers, they're putting in networks.

Capacity is certainly – requirements are certainly growing. It is clear to me that anybody building a new network today is going to build with a 100-gig. I feel very comfortable that we have the best 100-gig solution on the market. Our reputation for quality, time-is-a-weapon and customer support is unparalleled. So I just think we're seeing an investment period after a dearth of investment. I'm seeing a 100-gig being standardized as the right answer for today and tomorrow, and Infinera is just executing well.

George C. Notter

Analyst, Jefferies LLC

Q

Do you think – just expanding on that, do you think there is anything that's more germane to the marketplace itself that's going on, would it be just the pure economics of a 100-gig as they improve? Do you think people start to come off the sidelines and launch more RFPs and more deals and deployments? Do you think its may be the presence of more vendors in the marketplace? It's getting people off the sidelines. Could it be the presence of Infinera certainly that was previously an overhang in the 100-gig space, and now that overhang has come off as

you guys have shipped product. I mean it seems like there is just more activity out there right now and I guess I'm trying to understand why that is above and beyond just you guys now having a product?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

I think it's all of those things George. I think that even as recently a year ago, there was a grand debate on whether it was going to be 40-gig for how long and then a 100-gig or is it going to go to a 100-gig. The 100-gig supply base was too narrow to be standardized upon. A 100-gig pricing did not offer a compelling economic choice to 10-gig. I do believe just like we did with 10-gig, Infinera entered the market and catalyzed rapid growth. Other people have also entered the market. I think that's – the customer base today use a 100-gig as a best economic choice and a broad enough supply base that there is not a great deal of risk. I also think that and just like we've said for a long time 40-gig squeeze is happening and nobody is going to be wrestling with is it going to be 40-gig or is it going to be a 100-gig. It's 100 gigs today. It's 500 gigs today and we have a great platform. Great installed base, and there is a pent-up demand for transmission capacity around the world.

George C. Notter

Analyst, Jefferies LLC

Q

Got it. Great, and then one just last qualification, you guys threw out a couple of numbers earlier, I missed, 335-terabits and then I think you compared that with 180-terabits in the prior quarter. Was that the amount of 500-gig super channel adds in aggregate each quarter Q1 versus Q4?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

No, it's the cumulative amount let me go look at the numbers real quick. It's the cumulative amount, basically, we sell an AOLM, it has – if people buy the whole thing, it's got 500-gig on it. If people buy it by bandwidth by channel, we have one channel that accounts for that and we're collectively adding up all of the capacity that is cumulatively deployed in the world.

David F. Welch

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

A

And there is a slight difference between bandwidth product purchased and product deployed. So this represents the amount that's gone through the acceptance and the deployment cycles.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

And it's 335-terabits versus 180-terabits, George.

George C. Notter

Analyst, Jefferies LLC

Q

Got it. Great, thank you.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

And obviously that number should grow every quarter, don't view it as an incremental – that 335-terabits is incremental, it's the cumulative amount of capacity.

George C. Notter
Analyst, Jefferies LLC

Q

Got it. Thank you.

Operator: And our next question comes from Rod Hall with JPMC. Your line is now open.

Ashwin X. Kesireddy
Analyst, JPMorgan Securities LLC

Q

Hi. This is Ashwin on behalf of Rod. Tom, could you elaborate on the 100-gig pricing comment that you made? I think you said that your 100-gig price is, it's probably flattening versus the industry. Does that mean that you are seeing less pricing pressure and is it specific to Infinera or to the market wide phenomenon? Can you elaborate on that?

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

A

Well, I specifically said, it's no longer falling at the rate it has fallen at the last two years and it is now approaching more traditional industry norms. Usually, when you introduce a new technology it takes a number of years typically greater than five, before that technology will offer price per bit parity. And with the 100-gig that's been about two years and it's already much more cost effective than 40-gig at a price per bit and it's actually, quite frankly, at this point less than 10 on a price per bit basis. That's a very rapid degradation of pricing. That's good in one way. It helps the market adopt that technology as a standard, and ramps that volume in the industry much more rapidly.

As a vertically integrated manufacturer, we have more benefit from that ramp than the traditional competitors do, because the more volume we create, the lower price or cost of each device. We are not trying to drive that price curve, and the market drives the price curve as people enter the market and are interested in the establishing footprint. There are several of us in the market now and any – on any given day, some customer might be viewed as strategically important, one of the competitors and for that it drives a market price down. The markets will typically respond, the competitors will typically respond. We've seen that behavior over the last year. And what we're seeing now is less of that behavior. There is a kind of a market price that's been set, and with a small range around that. And that doesn't mean that for some strategic customers, somebody won't do something what I would consider out of common sense practice, that's part of the business world. But I do see that the natural degradation of pricing is going to be slower.

I think that's very important because our industry needed to have the opportunity to recoup our R&D through fair margins, and that's a challenge in our industry. As you can see, as Ita pointed out, we believe that our margins are starting to up tick, so we believe that we're taking advantage of the volume that we are trading in the market, and that should help us over the next, both several quarters, and several years.

Ashwin X. Kesireddy
Analyst, JPMorgan Securities LLC

Q

Fair enough. Thanks. Shifting gears to the general business environment, I mean, obviously, we saw a lot of negative news around CapEx in last few weeks. How do you characterize the business environment out there in the market now?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

I'm going to put some fidelity what I am hearing you say, negative news on CapEx over the last few weeks, what it specifically is, is negative news on CapEx from a couple of Tier-1s. Not negative news in general in the market is that correct assertion or incorrect assertion?

Ashwin X. Kesireddy

Analyst, JPMorgan Securities LLC

Q

Yeah. Maybe we can start there.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

That's – so I continue to be somewhat defuddled by what I consider a fairly narrow view of the world of CapEx as being defined by a couple of Tier-1s in North America. We're growing business obviously not with the people who are publicly saying your CapEx is going down. We're picking up market share. We see incredible opportunities with cable, with wholesalers, with international Tier-1s, with content providers and as long as the industry views, one or two people as defining the market, I think there is going to be a disjoint of reality of who is going to do well and who is not going do well. Our job, as a company, is to get into those markets because they are important markets, but I do not believe they define the market.

Ashwin X. Kesireddy

Analyst, JPMorgan Securities LLC

Q

All right, great. Thanks.

Operator: Our next question comes from Ehud Gelblum with Morgan Stanley. Your line is now open.

Kimberly Anderson Watkins

Analyst, Morgan Stanley & Co. LLC

Q

Thank you. This is Kim Watkins in for Ehud today. Just wanted to first ask you about your large Tier-1 in North America, actually the U.S. It looks like, just looking at the revenue trends for domestic versus international that they're relatively similar. So just wanted to get a sense of when you're expecting to see a ramp from CenturyLink specifically? How you expect that deployment to occur? Does it happen in one quarter suddenly? Are we going to be surprised to see the domestic number tick up pretty significantly? Just your expectations there would be helpful.

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah. I mean, I think it's hard to derive that from looking at the split – geographical split. And we are seeing a lot of strength internationally and a lot of, kind of, the new customers that we added have actually been international customers. So that's going to mask what you will see as shifting revenues in North America. I would point you to our top five customers and the fact that there is a Tier-1 customer in there, and that's a major Tier-1 customer, an important customer to us. I'm not sure that we can say very much else about them, about CenturyLink at this point, but that is – we are seeing that growth in that Tier-1 customer be in the top five.

Kimberly Anderson Watkins

Analyst, Morgan Stanley & Co. LLC

Q

Got it. Okay, that's helpful. And then the comment about – Tom, you made a comment about some opportunities in Asia. Could you just comment on the number of 100-gig RFPs right now, in China specifically? Are you involved in any of those and if so, would that result in any additional margin pressure, i.e., this flat, the prices that you are seeing on a global basis. Is there any differences on a regional basis?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Yeah. You're going put me on a little bit of a soap box for a second, and I apologize. I see all of the news about the big builds in 100-gig coming in China, and you'll notice that they're all Huawei and ZTE oriented.

I want – my view, and it is a biased view, the China market is not an open market to non-Chinese supplier for long-haul transmission. We are involved with zero RFPs. We have, I believe zero opportunity to win any RFPs. It is a closed market. Where we're seeing opportunities around the world, we are seeing them in Japan, we are seeing them in Hong Kong, we are seeing them in New Zealand, Australia area, we're seeing them in India, we see them – we're seeing them in Korea. We're seeing broad based ranges of opportunity, Vietnam, whether we win those or not, I don't know but DTN-X is viewed as cutting edge technology with a history of large scale deployments around the world with other carriers, and we are being invited very aggressively to both RFPs and our earning opportunities for shortlisting. I think that the tale will still be told later this year, that we have not seen this amount of broad activity in Asia ever and I am expectant of success in that area, though it's starting off at pretty small base.

Kimberly Anderson Watkins

Analyst, Morgan Stanley & Co. LLC

Q

Got it. Just to my question specifically about pricing, the comment about pricing relative to, it's turning back to industry norms, which I think is somewhere around 10% to 15% declines per year. Is it any – are there any differences on a regional basis that you're seeing?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

It's – I would say, it's fairly the same around the world. There are some areas in the world that have historically seen shocking areas, better pricing, some of it sometimes is due with I would consider to nationalistic pride. If there's a supplier in that region, they typically will make sure they are the provider of choice for the telecom company in that region, and they'll get unusual price.

But in general, the pricing and the pricing expectations are relatively the same. The biggest difference in pricing will come from how big is the opportunity, obviously a guy buying \$10 million or \$15 million a years, it's probably going to get a better price than a guy buying \$1 million a year.

Kimberly Anderson Watkins

Analyst, Morgan Stanley & Co. LLC

Q

Yeah. Got it. One last question, just want to explore the service gross margin line, I realize it's been a little bit weaker because of the deployment mix in the services side. Ita, how are you thinking about the services margin specifically, shaking out throughout the year, and I guess really I guess we need to talk about revenues, because it seems like you've got quite a lot of activities, so I'd expect deployment revenues to be – continue to be strong, but just want to hear your thoughts there.

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah. I mean, I think we expect to see the deployment revenue stay strong and that – that kind of high 50%, 60% gross margin is probably a good place to think about services margins being for the rest of the year, because we will – we're doing a lot of deployments, we're doing some deployments in new regions, et cetera. So, we will – we will see increased activity and some of the new activity which will need to optimize over time. So, I think kind of high 50%, 60% is the good place to be.

Kimberly Anderson Watkins

Analyst, Morgan Stanley & Co. LLC

Q

Great. Thank you very much.

Operator: Our next question comes from Mike Genovese with MKM Partners. Your line is now open.

Michael Genovese

Analyst, MKM Partners LLC

Q

Great. Thanks a lot. Congratulations again guys on a great quarter and great guide. But speaking of the guide, did you think about not necessarily tightening the range, but lowering the bottom end or even just raising the entire guide? Seems like your second half would have to be pretty terrible for you to come in the lower end of this 10% to 20% for this year?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah. I mean, I think based on my comments, we're saying we're pretty comfortable with upper end of the range at this point, right. If you think about the backend of the year, I mean our visibility has improved, but we still don't have visibility at a bottoms-up basis to the second half, even though we think there's good momentum there and there is a lot of RFP activity there. So, I think our messages is more that we're comfortable with the upper end of that range at this point, and then as we get more visibility on the next call we'll provide some more fidelity through the end of the year.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

The other thing to avoid Mike is getting into the habit of kind of giving a year outlook on every quarterly call. We gave the original year outlook if you remember at Investor Day and what we're trying to do is update our view of that guidance at that time versus reset guidance on a quarterly call that extend beyond a quarter.

Michael Genovese

Analyst, MKM Partners LLC

Q

Great. So, along those lines with the order strength, could you just give us a sense of the backlog expansion? I mean is there any just goal post you can put around? How much bigger the backlog is now than it was at the end of 2012?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah. We're not going to give kind of quarterly backlog numbers, we put it in the K once a year and that we're probably going to stick to that, but it's up a significant amount, right. I mean it certainly helps us to have comfort around the guide for Q2.

Michael Genovese

Analyst, MKM Partners LLC

Q

Okay. And just your advantage on kind of order to time to build the network to time taking revenue, could you just give us, again, I mean, versus the competition, the typical competitors you have out there. How much faster do you think you're turning orders into revenues than they are?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

I mean, I think from a pure rev rec perspective, it's going to vary significantly customer by customer. From a network turn up perspective, I think we believe we do that significantly faster than the competition.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

I know for a fact in Q1, we won a deal when one of our competitors could not execute to requested timeline, I think that quite frankly we're going to be number two on the deal, we ended up winning it. That – that network was taken in the quarter, it was delivered in the quarter, it was turned up in the quarter, it was turned over in the quarter. I think our culture, our DNA says time is a weapon. Our architecture is a digital architecture. You can deploy services and equipment very quickly and that's I think it's a big advantage to some customers some other time. What other competitors do? I don't really know, our customers just say, if I need it fast, I know I need to get it from Infinera.

Michael Genovese

Analyst, MKM Partners LLC

Q

Okay. Just hopefully a couple of more quick ones. The seasonality Tom, I mean now that your customer base is broadening out more, do you think that seasonality is a factor and that now that we are past 1Q which is the – should be the seasonally weakest quarter in the year, do you have any view on industry seasonality? And I realize that we're not talking about just AT&T and Verizon, we are not really talking about them, we're talking about everybody else. But do you have kind of an updated view on seasonality now with the customer counts up to well over 20 approaching 30 for DTN-X?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Yeah, there's still other impact of seasonality depending on which industry there is. Certain industries buy more in the first half of the year, certain industries buy more in the second half of the year, I think as we expand our customer base beyond 27 in more and more both geographies and industries, it will become more moderated, but I would not assume at this point that we are going to escape seasonality clearly in Q1 now which is typically a very tough quarter for both the industry and us, we came through it pretty well. But I think that the industry would itself say that Q1 had some seasonality. And I think Q1 will continue to be a slower quarter for our industry in general and I don't think that we're going to be immune from that moving forward.

Michael Genovese

Analyst, MKM Partners LLC

Q

Okay. And then finally Ita, you mentioned a mid-term margin target, I think you said on the gross margin, 45%, but I also – I think there's a long-term target out there at 50%, unless I'm wrong about that?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah. I mean, we pretty much reset to the mid-term view at the Analyst Day. And we haven't really updated a long-term model beyond that. I think our – we're more focused on achieving that 45% and then providing some further color after that.

Michael Genovese

Analyst, MKM Partners LLC

Q

Is the 45%, is that with the 10% operating margin? Am I remembering that correctly?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Correct, yeah.

Michael Genovese

Analyst, MKM Partners LLC

Q

Okay. Great. Thanks – thanks again, and congratulations guys.

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Thanks, Mike.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Thank you.

Operator: [Operator Instructions] Our next question will come from Alex Henderson with Needham. Your line is now open.

Alex Henderson

Analyst, Needham & Co. LLC

Q

Thank you very much. I was hoping you could talk a little bit about the mix between the existing customers and the new customers in terms of, not just simply the number of orders, but rather what degree the existing customers are already showing up – excuse me, the new customers are showing up as revenue or are the larger new customers still longer time to deploy and revenue recognition? The – looking at the orders that you've had announced on your website and tracking them against existing customers with the exception of KDDI and too small customers, virtually all of it announced contracts on the website for the last two quarters for existing customers. And I'm assuming that there are a couple of larger orders underneath the surface from new customers that are going to take a little longer to come through. So, can you give us in terms of magnitude of what you're seeing in terms of new customers in the current quarter and what we should expect that go towards as the year progresses?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah. I mean, I think if you look at the number of new customers that we've invoiced right, I mean there is a good percentage of those that our new customers, and our new customers are all driving significant revenue amounts, because you can't – you're not going to turn up a DTN-X network with an acceptance that's better without driving meaningful dollars, right?

So, I think every new DTN-X customer that we've talked about our goals, that we can't talk about are driving meaningful revenue and has potential to drive further revenue, but DTN-X initial deployment is still multimillion dollar of revenue at any point in time.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

I also think it's important not to focus just on the names we announced. As Ita said there are a number of very significant wins we both had, and recognized revenue on from very significant market segments that are, they just don't allow you to talk about it, and that's Internet content space, it's the Tier 1 space, it's the cable space. So be cautious of assuming that if we announced somebody that you think doesn't drive a lot of revenue that that's representative of the entire suite of customers we are winning and delivering for revenue DTN-X.

Alex Henderson

Analyst, Needham & Co. LLC

Q

I just trying to get a handle on the pig in the python problem with a lot of your first half 2012 customers deferring into the back half and it looks like it continued into the first quarter. The substantial amount of delay to wait for the DTN-X to be available and then you ship into them and then you can recognize revenue very quickly versus if you were to bring in say a Tier 1 service provider, it could take four quarters, five quarters for that customer to show up his revenue. And when I'm trying to get a handle this, is the mix that we're seeing in the first half mainly existing customers that are coming on and that that mix starts to shift towards newer customers in the back half. Can you just qualitatively talk about that mix shift?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah, I mean, it's tough, right. We are – we certainly see a good strong representation of our own customers in the Q1 and Q2 revenue numbers, right. But at the same time there is very a meaningful number of customers who will ramp a little more slowly than an existing customer right. So, for sure our existing customers are more likely to take larger dollars and have shorter rev rec, right. But the – there is a recent fair representation of new customers there and they are ramping meaningful dollars pretty quickly. We haven't had customers that have taken four quarters or five quarters or six quarters to come to revenue, right. We just don't have that phenomenon, right. A long turn up time for us with a customer to get to multimillion dollars is two quarters or there about. So, I it's – now we don't see that long tail that you are describing.

Alex Henderson

Analyst, Needham & Co. LLC

Q

One last question, one more – one last crack at it. And then I'll cede the floor. So if I were to look at your lead book, if you look back at the customers you've had over the years versus the customers that are new, is there a higher percentage of new customers in your lead book, than there has been in prior periods?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yes, absolutely. I mean we are getting access to customers that we didn't have access to before for sure, and those customers have a different profile. They are definitely larger customers, Tier 1 type customers that we can, that we didn't have access to before.

David F. Welch

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

A

I'll just – I'll just add on very quickly there. What we've talked about before is the DTN-X brings out a variety of new features and I want to emphasize we're winning because of those added features, the integration of the OTN, the value of the 500-gig super channels capability network, in that, it's features that allow us to expand the market space to a greater set of new customers. In that we're seeing the benefits of that market expansion in the new customers.

Alex Henderson

Analyst, Needham & Co. LLC

Q

Thank you.

Operator: And our next question comes from Subu Subrahmanyam, with The Juda Group. Your line is now open.

Subu Subrahmanyam

Analyst, TheJudaGroup

Q

Thank you. My question is on market growth versus share gain. I know you talked about it partly, Tom but are you thinking that the market growth is also towards the higher end of the range you had earlier expected? Is there a broader inflection point in 100-gig that we're seeing or is a lot of this upside in terms of share gain?

David F. Welch

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

A

So, let me define market growth. If I define market growth as the 100-gig or in our case the 500-gig market sector, I think that is growing at a good – very strong clip. It's coming at the negative consequence to 40-gig markets that have existed out there, and that's clearly made a transition. So, it's quite a wide range of predictions and what the growth rate was for the 100-gig market sector, but I would say that from our experience, we're seeing that that market sector doing very well.

Subu Subrahmanyam

Analyst, TheJudaGroup

Q

I think more in terms of long-haul DWDM market not necessarily the 100-gig.

David F. Welch

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

A

Yeah. So, if I expand to look at 10-gig, 40-gig and 100-gig as an aggregate, I would say that, it's probably on target for what the growth is, I'm not sure that the market growth is a little hard or not, not a lot harder from that.

What we're seeing is a – we think there's a substantive market share gain. It's coming about one, we didn't really participate in the 40-gig market sector, and so now it's out 100-gig- now that has moved towards 100-gig, we're see market share gains for ourselves on that.

So, it's the mixture of both. We think the – again, the market expansion for us, new customers we haven't gotten to before. The 100-gig market is doing very well. The total long haul market sector is doing reasonably well. There seems to be good business out there, but in kind of in that order, it's what driving our growth.

Subu Subrahmanyam

Analyst, TheJudaGroup

Q

And if you could talk about margin, I mean the last time, you were at \$130 million in revenue, couple of years ago, obviously, margins, EPS are much higher. Can you talk about kind of what kind of targets from a revenue perspective should need to be to in to think about your long-term operating margin? Obviously, part of that is gross margin improvement from a revenue direction, if you could speak about that?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah. I mean, I think the margins phenomena that we're seeing right now and through the end of 2013 is pretty unique and that it's really – it's going to be largely driven by two factors, right, one is product mix right and getting to a balanced new mix level on the DTN-X. And the second piece of it is that we're – we have – we just have a cost curve that we need to work through, right. So that's why – if you look at the guidance even for 2013, by the time you get to Q4 you do start to see margin expansion to hit that 38% to 40%, right? So, I think the two biggest drivers in the near term are going to be, get down that cost curve which we see, and we're seeing ongoing progress towards that, and then have some product mix and sale on the DTN-X, which we're also starting to see, which is the positive sign.

Beyond that obviously, as revenues grow, we will get some gross margin flow through, et cetera, as well, what the revenue number is to hit 45%, it's somewhat more than where we are in 2013, but it's really more driven by those two factors than it is necessarily going to be the top line in the near term.

Subu Subrahmanyam

Analyst, TheJudaGroup

Q

And I meant on operating margin, Ita, to get to your target operating margin ranges, what kind of revenue number?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah. I mean, it's going to be depended on the growth, right. I mean if you get the gross margin up to 45% and thereabouts and you get – you start to drive towards that 10% bottom line, right, but key is the gross margin.

Subu Subrahmanyam

Analyst, TheJudaGroup

Q

Thank you.

Operator: Our next question comes from Simona Jankowski with Goldman Sachs. Your line is now open.

Simona K. Jankowski

Analyst, Goldman Sachs & Co.

Q

Hi. Thank you very much. And I joined the call a bit late, so apologize if you've already addressed this. But as far as whether you are on the yield curve in terms of your pick for the DTN-X, can you just comment on that. And

perhaps if you are able to quantify, if we were to kind of magically be at the ultimate goal of your yields, how much would that contribute to gross margin in terms of points or dollar amount?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah. So, I don't know that we're going to talk specifically about the yield in the fab, but I think if you look at our gross margin guidance for the year and kind of the expansion that has to happen in that margin to get to that annual number, it gives you some idea for how we see those cost reduction efforts impacting and helping gross margins through the end of the year.

Simona K. Jankowski

Analyst, Goldman Sachs & Co.

Q

Maybe just to try to ask it another way, if you look at the upside to margins from the kind of the blade versus chassis shift and compare that to the potential upside from improving yields, which one is the larger factor for us to look for in terms of driving upside?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

I think through the end of the year we are relying more heavily on the cost optimization and cost reductions because we think we will still be shipping heavier mix of commons and then as we move into next year and expand beyond that it will come mainly from mix as we start to see the fill on existing networks.

Simona K. Jankowski

Analyst, Goldman Sachs & Co.

Q

Okay. That's helpful. And then second question is, what percent of your sales roughly at this point are coming from customers who are using that new revenue model that introduced the quarter or two ago where you can sell chunks of capacity kind of de-coupled from the actual TAMs.

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah, I mean the percentage of revenue at the point is still pretty low, right, and I know we had – we talked about this a little bit but it's a model that will be used by, particularly our customer set as opposed to being broad based, right. So, we're seeing it in some key accounts where it fits customer needs, but it's not driving a significant proportion of revenue.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

To me the importance is it whether or not it's a big part of the revenue. Infinera is passionate around being on the same side of the negotiating table as our customer. Some people want 500-gig at a time, some people want a 100-gig or think they want a 100-gig, we offer that, they have the choice of what makes the best economic sense to them. Sometimes they end up buying the 100-gig at a time and sometimes they come back and say no, I just want the 500-gig. Our job is to help them build a successful business. We are creating tools that allows them to do that in there in their markets, and it allows us the flexibility of building a good business model and a fair return for our shareholders.

Simona K. Jankowski
Analyst, Goldman Sachs & Co.

Q

Is there a larger percentage of backlog for you versus what's in the run rate revenues?

Ita M. Brennan
Chief Financial Officer, Infinera Corp.

A

No, I mean I think, it still – it's a tool to be used kind of in the sales process, but it's not driving a significant portion of our existing Q1 and Q2 revenues, but it may do in the future depending on the customer, but for right now it's not driving a major portion of that revenue.

Simona K. Jankowski
Analyst, Goldman Sachs & Co.

Q

Got it. Thank you very much.

Operator: And we do have time for one final question. That question comes from Sanjiv Wadhvani with Stifel. Your line is now open.

Sanjiv R. Wadhvani
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Thanks. Congrats on a great quarter, guys. Tom I had a question on gross margins and sort of wanted to get your thoughts around strategy going forward. I mean it does seem that you guys are starting to take some share and I'm just fast forwarding, let's say, two quarters to three quarters from now, and let's say your share gains accelerate. I'm trying to figure out if some of your larger competitors then decide to use pricing as one of mechanisms to sort of stem those gains, are you sort of going to be participating in that and just curious to see whether you would sacrifice sort of gross margins in the short-term just to gain those footprints but pricing as an element?

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

A

Yeah. First of all thank you for the congrats on the quarter. Your observation is if we are winning market share now, in the few quarters from now, people might want to truncate that by having a pricing war. My view is that the market cannot become more competitive than it's been over the last year, as this new technology is absorbed into the market. And the market share winners for the long-term are going to be defined over the next few quarters and years. There is intense competition today for that market share. I think that once we or somebody else is into a customer to dislodge that competitor as a primary supplier is very difficult to do just around pricing. It has to be more of a value of network, a value of service, quality experience.

So I think that in my view is that the vast majority of the competitiveness we're already in the midst of it is rationalizing itself. I think that candidly as I watch Huawei begin to have challenges on the world stage and extract themselves, I guess, at least what I'm reading is they have stated that they are not interested in the U.S. market any more that helps the market. I think that Huawei, they weren't winning in the market anyway, certainly in the United States, they didn't have a differentiated solution. Their customer service and support, I think was inferior. I think their business practices were inferior, and they did not receive acceptance. Having said that a number of people have used them as a pricing lever to bring down competitive pricing. I think that there is a more rational view on that and as people, companies exit from that – certain markets, there is less abnormal behavior to drive irrational pricing. So, I am more comfortable that the future will have more rational pricing, not less rational pricing.

David F. Welch

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

A

Yeah. If I can add a couple of points here also. You need to understand that the – this transition that, that's going on right now it's not just a transition to 100-gig, it's a transition to an intelligent transport network. And when you have features such as Fast Shared Mesh Protection, which as Peter Paul indicated in one of his talks that was almost a factor 2 – could be as much as a factor 2 benefit in the cost structure of his networks, it's far more valuable than the price pressure on the transponder basis. It's the added intelligence that goes into a transponder network with integrated OTN switching with a big super channels in there that creates a better total cost of ownership when looking at the network in entirety and not looking at the historical point-to-point transponder market, it's not a – it's no longer a 10-gig market as per se. It's an intelligent transport market that takes big pipes in there to make it efficient.

Sanjiv R. Wadhvani

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Got it. That's helpful. Thanks.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Thanks Sanjiv.

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: And with that we will conclude today's conference. Thank you very much for your participation. You may disconnect at this time.

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