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Infinera Corp. *(INFN)*

Q4 2012 Earnings Call

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MANAGEMENT DISCUSSION SECTION

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

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

Jenifer Kirtland

Head-Investor Relations, Infinera Corp.

Thank you, operator. Today's call will include projections and estimates that constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements address the financial condition; results of operations; business initiatives; views on our market and customers, our products and our competitors products; and prospects for the company in the first 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 6, 2012, for more information on these risks and uncertainties. Today's press releases, including fourth quarter and fiscal year 2012 results and associated financial tables and investor information summary, will be available today on the Investors section of Infinera's website at infinera.com.

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

In our earnings release, we announced operating results for the fourth quarter and fiscal year 2012, 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 first 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 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 thank you for joining us on our fourth quarter and year-end 2012 conference call. With me today are Chief Financial Officer, Ita Brennan; and Chief Strategy Officer, Dave Welch.

Our fourth quarter accomplishments reflect outstanding execution of our growth strategy and a solid finish to a very busy and productive year. We shipped our first DTN-X in June, as promised, and again recognizing revenue for the product in the third quarter. Its traction has been phenomenal and we have entered the 100-gig market with force. In just over two full quarters of production we have secured 22 DTN-X customer commitments, including seven customers new to Infinera, and we have shipped over 2,000 100-gig ports.

With the DTN-X, we've penetrated a broad set of customer segments and also cracked into the tier 1 market, which effectively doubles our addressable market globally. Our tier 1 readiness is demonstrated by our backbone win with CenturyLink and our successful completion of OSMINE certification, milestones that mark substantial progress in a short period of time. We think it's important for you to know that our trial activity for the year was significant, helping to build a solid pipeline as we enter 2013. While the sales cycle can be long, we are greatly encouraged by the continued customer interest and strong market acceptance of the DTN-X.

Current market trends are contributing to our optimism. We believe that the economics for long-haul networks for 100-gig are now better than those of 40 gig, prompting many carriers to choose 100 gig. The 100-gig ramp is exceeding even the most optimistic forecast, and most analysts are increasing their near-term expectations for 100-gig purchases.

Furthermore, analysts such as [ph] Odom (04:34) showed a 40-gig long-haul market, tailing off faster than expected. These factors reaffirm our view that there is no economic or technical justification for deployment of new 40-gig networks, and support our strategy of focusing on 100-gig with the DTN-X. In addition to a migration to 100-gig, we're also seeing a move toward convert solutions as carriers strive to optimize their networks and reduce costs by integrating switching with DWDM transmission, OTN today and packet tomorrow.

With our PIC-based super channels, the DTN-X is a capacity leader in point-to-point DWDM. And as the market embraces the benefits of mesh networks, we are uniquely positioned with our integrated approach. Unlike our

competitors who, we believe, are retrofitting older 10-gig and 40-gig platforms with 100-gig and compromised switching capability, the DTN-X was built from the ground up with terabit scale per slot in converged switching, all without compromise of their intelligent next-generation control plane. When customers select a DTN-X, they are building state-of-the-art networks for the next decade.

Our double-digit fourth-quarter revenue growth, both year-over-year and sequentially, is a positive sign we are moving in the right direction. We continue to achieve good traction with the DTN-X, adding customers across a broad range of segments, including tier 1s both domestic and international, cable, submarine, bandwidth wholesalers, content providers, and research and education customers.

We announced our first deployment for a tier 1 domestic fiber-optic backbone. CenturyLink chose Infinera DTN-X featuring 500 gigabit per second long-haul super channels to enhance its nationwide next-generation backbone transport network. This network will support critical video, mobile and cloud IP services and extend their ability to deliver up to 100-gigabit Ethernet services to data centers and customer facilities around the country.

Another significant milestone achieved was the successful completion of the online certification process, which enhances our ability to gain additional backbone business from U.S. tier 1 providers. Through this process, we have shown the interoperability of the DTN-X platform with existing systems, enabling providers to accelerate their network deployment upon selection of Infinera. We shipped over 1,000 100-gig ports of the DTN-X deployments in the fourth quarter.

Equally important, our deployments are going well. We have over 180 terabits of capacity on live networks in 23 countries around the globe. Because of our digital optical network approach, our customers are able to move more rapidly from purchase order to production network when compared to alternative approaches. In turn, they can start generating new service revenue quickly, demonstrating that Infinera continues to deliver on our time-is-a-weapon promise.

And while we've done very well with the DTN-X, our DTN platform also continues to create success. We added four new invoiced DTN customers in the fourth quarter, for a total invoiced customer count of 111. We also had three customers announce the availability of 100 gig e-services on the DTN in the fourth quarter, showing the extensibility of the DTN's digital optical architecture. We believe that the capabilities of the DTN in conjunction with the DTN-X show the breadth of our portfolio and our ability to address varying customer market requirements.

Moving on to a technology update, we continue to lead the industry in technological advancements. In November, we announced Instant Bandwidth with our first Instant Bandwidth customer, TeliaSonera international carrier. We followed up this week with another significant Instant Bandwidth customer, KDDI Corporation in Japan.

Instant Bandwidth enables customers to activate 100 gig of line-side bandwidth to a software command the same day the service is turned on. This option offers fast feed-to-service and supports a success-based revenue model for our customers, so they can deploy bandwidth in 100 gig increments as it is required. We do not believe any competitor can match this capability.

We also announced the first successful demonstration, in conjunction with our customer ESnet, of a prototype SDN open transport switch to control the DTN and DTN-X using the open flow protocol. The fundamental digital optical network architecture of our platform already virtualizes optical wavelengths into pools of capacity. We often refer to this as bandwidth virtualization. And we believe this is optimal for SDN approach.

In January, we completed a successful demonstration of Soft Decision Forward Error Correction, often referred to as SD-FEC, with Telstra Global on a very challenging 4,200-kilometer submarine link between Hawaii and California. This technology has the potential to significantly improve existing fiber capacity, helping providers extend the life of their valuable installed fiber plant. These technology demonstrations showed that Infinera is continuing to drive innovation as we help the industry transform to a more scalable, converged, and intelligent transport network architecture.

In summary, 2012 was a strong year for Infinera. To date we have secured 22 DTN-X customers, achieved number one market share in 100 gig ports in our first quarter of recognizing revenue, shipped well over 2,000 100-gig ports total, active over 180 terabits of capacity in 23 countries around the world, and added 13 new customers.

Our fourth quarter financial performance also demonstrated significant progress and an increased cash balance, strong bookings and solid sequential revenue growth of 14% which was on top of a 20% sequential increase in the third quarter. We are encouraged by signs that indicate healthy market demand. Over the past four quarters, bandwidth consumption has increased and customers across market segments are looking at increasing their network investments.

In looking to 2013, consistent with the themes we [ph] had (10:39) at our recent analyst day, our priorities are straightforward. We will focus our efforts on winning footprint and gaining market share. This will be balanced with a commitment to prudent financial management. We strongly believe our unique vertically integrated manufacturing model combined with continued bandwidth fill will drive us to sustained profitability and as a result increase shareholder value.

Before turning the call over to Ita, I would like to thank the Infinera team and our partners for their hard work and dedication during the year, and congratulate them on a job well done. I would also like to thank our customers for their continued support.

Ita will now provide a detailed financial review.

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

Thanks, Tom, and good afternoon. Here's the analysis of our Q4 results and our guidance in Q1 2013 based on non-GAAP. [indiscernible] (11:27) non-cash stock-based compensation expenses. Total GAAP revenues in Q4 were \$128 million, in line with our guidance of \$122 million to \$132 million. Our strong revenue performance for the fourth quarter was led to robust sales of our DTN-X platform combined with continued deployments of DTN. We recognized DTN-X revenue from seven additional customers this quarter, one of which was a new invoice customer to Infinera.

In addition to this one new DTN-X customer, we also added four new DTN customers, taking our total invoiced customer roster to 111. We had one greater than 10% customer in the quarter, which was a competitive carrier. The top five customers also included three bandwidth wholesalers and a tier 1. International revenues totaled \$47 million or 37% of total revenues for the quarter. EMEA accounted for \$40 million or 31%, with APAC and the other Americas each representing 3%.

Service revenues for the quarter were \$18.6 million, up from \$12.9 million in Q3, reflecting a higher level of deployment activity in the December quarter. This higher mix of deployment services also resulted in lower services gross margins at 60%, down from 69% in Q3. We expect services gross margin for Q1 to be consistent with the fourth quarter levels, reflecting ongoing deployments.

Overall gross margin in Q4 was 36%, at the higher end of our guidance of 35% to 36%, and as anticipated in our October call, down from 39% in Q3. Product mix for the quarter was healthy with bandwidth field sales consistent with prior periods. However, our new footprint common equipment sales increased as we ramped DTN-X. In fact, fourth quarter optical amplifier shipments were amongst the highest in the company's history. This was indicative of the large number of new deployments completed in the period, and is reflective of a significant amount of 100-gig footprint that we are winning with DTN-X. We are also pleased with our continued progress on yield improvements and cost reductions on the DTN-X platform and continue to make progress towards the entitlement yields.

All things being equal, we'd expect to see the benefits of these improvements in financials later in the year once existing inventories have been consumed. In the meantime the DTN-X units we are selling have a higher cost structure, and this, combined with a higher common equipment mix referenced earlier, contributed to the lower gross margin levels experienced in Q4.

Operating expenses for the quarter came in at \$51 million, slightly better than our guidance which called for spending of approximately \$52 million and flat with spending levels in Q3.

Looking forward to the March quarter, we expect operating expenses to be approximately \$51 million, reflecting continued focus on cost control and cash management balanced with spending to support trials and other critical customer-facing activities. Overall head count for the quarter was 1,242 versus 1,235 in Q3. Headcount additions were primarily related to a small number of R&D hires and increased direct labor for manufacturing.

Our operating loss for the quarter was \$5.4 million. Other income and expense for the quarter was favorable at \$0.1 million. Net loss for the quarter was \$6 million, resulting in a loss per diluted share of \$0.05, at the better end of our guidance which called for a loss of \$0.04 to \$0.08 per diluted share, and a continuation of the improvement seen in Q3 with a loss per share of \$0.07.

Now turning to the balance sheet. Cash, cash equivalents, restricted cash, and investments ended the quarter at \$188 million, up from \$183 million in Q3. We generated \$8.3 million of cash from operations in the December quarter, a significant improvement over usage of \$29.3 million in Q3. DSOs came in at 76 days, up from 74 days in Q3. This increase was contrary to our outlook on the October call, as we had expected DSOs to improve significantly. We executed well in collections, but linearity remained a challenge, with a larger portion of our revenues coming from new deployments with acceptance terms. As we look forward to the March quarter, we anticipate some improvement in DSOs.

Inventory turns were 2.6 times versus 2.3 times in Q3. Overall inventory levels increased to \$128 million, mainly due to increased levels of inventory awaiting customer acceptance at the end of the quarter. Accounts payable days were 56 days, up from 48 days in Q3.

Capital expenditures were \$3.2 million compared to \$2.5 million in Q3. This resulted in capital expenditures for the year of \$25.4 million, down significantly from the \$39.4 million spent in 2011. We intend to continue to manage capital expenditures to an approximate run rate of \$20 million per annum. We were pleased with the improvement in our cash balance in the December quarter. However, we still have work to do around working capital management and the optimization of inventory levels. This will remain a focus area for the company as we continue to grow the business.

Now turning to our outlook for the first quarter and beyond. We continue to see strong interest in the DTN-X platform with a healthy pipeline of RFPs and lab trials. We are 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 network builds are DTN-X based, we continue to win new customers and new deployments with the DTN platform.

The seasonality associated with tier 1 can have an impact on the timing of bookings and revenue, and while not changing the underlying momentum, does limit our visibility to the quarter. Based in our current view, we believe that revenues for the first quarter will range from \$115 million to \$125 million. And while reduced from Q4 levels, this represents 12% growth on a year-over-year basis.

Looking beyond the March quarter, we would reiterate our 2013 outlook discussed at analyst day, which calls for growth on a year-over-year basis of 10% to 20%. We continue to expect pressure on gross margins for the next couple quarters as we ramp deployments and production of the DTN-X.

Our guidance for Q1 2013 calls for gross margin levels in line with those experienced in the December quarter of 35% to 36%. This assumes continued footprint and DTN-X wins in the quarter, with high levels of common equipment driving lower initial gross margins. This footprint is the foundation required to achieve an ongoing profitable business model and longer-term sustainable growth. We remain committed to our 2013 gross margin outlook of 38% to 40%, with the expected benefit of cost reductions and product mix improvements later in the year.

As outlined at our analyst day, we believe that with solid revenue growth, our vertically integrated model 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 revised mid-term target of 45%. As we look at operating expenses, we intend to tailor spending to levels that support a consistent cash flow breakeven point by the second half of 2013. This must be done in a manner that supports a competitive roadmap and continued growth in new footprint wins.

So in summary, our guidance for Q1, which is based on non-GAAP results and excludes any non-cash stock-based compensation expenses, is as follows. Revenues of approximately \$115 million to \$125 million; gross margins of approximately 35% to 36%; operating expenses of approximately \$51 million; operating and net loss of approximately \$6 million to \$11 million; and based on estimated average weighted diluted shares outstanding of \$116 million, this would lead to a loss per share of approximately \$0.05 to \$0.09. Please note the basic share count is expected to be 114 million for the quarter.

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

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] Our first question comes from Rod Hall of JPMorgan. Your line is now open.

Joe Park

Analyst, JPMorgan Securities LLC

Q

Hi. This is Joe Park calling on behalf of Rod Hall. I just wanted to talk a little bit about your outlook and really dig into DTN-X specifically. Seems like there's a lot of good customer traction, but it seems like the revenue ramp is going to be delayed. Understanding the sales cycles are longer, what type of visibility do you have versus what you saw at your analyst day regarding your 2013 revenue outlook?

And I'd also like to ask you about the gross margin progression, because even though you're at the high end of your guidance range this quarter, it seems like you're sticking with that range. So why exactly do you think you'll be trending with that current guidance range?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

This is Tom. Yes, a number of questions there. I'm going to poke at the first one first, which was your comment that it appears that the DTN-X revenue ramp is delayed. And I'm just going to disagree with you pretty vehemently. I don't think that the revenue ramp is delayed at all in six months. We've won 22 customers. We've raised our top line. We've achieved number one market share on 100 gig. And I think the ramp has been phenomenal, and quite frankly, it's pretty much right on track with what we said we would do at the analyst day in Q4.

In regard to visibility, the first quarter of any year in our industry has a little bit of lightness in visibility as new budgets are awarded and as people make their plans. We still feel comfortable that

there will be a reasonable amount of investment in network builds this year. We feel very comfortable that the majority of them are going to be migrating to a 100 gig. We believe very vehemently that more and more people are going to be looking at making an investment in platforms that not only are 100-gig ready, but are ready for expansion into both converged networks and in terabit capabilities, which is the sweet spot of what the DTN-X was designed for.

So I believe that the short-term visibility in this period of time is a little challenged. The more macro visibility we are very comfortable with. We believe, roughly, that industry analysts are correct in that this market should grow roughly 10% this year. And we are staying committed to growing between 10% and 20% if that's the case.

In regard to gross margin, I will let Ita comment after I do. Our gross margins are as we kind of laid out, as we ramped this product, there are a number of gross margin opportunities to improve as we try to – we put out at analyst day. First and foremost is just ramping volumes and achieving the yield profile that we think this technology can earn. We are well on that path. But as Ita can explain more thoroughly, we have the cost structure of the PICs that we made two quarters ago that are hitting our bottom line this quarter, and we need to flush those out. In addition, we need to continue to drive further cost reduction of the PIC technology.

Second of all, this is the phase of our product deployment, and because the product deployment are going very well, we are putting in a lot of footprint. That footprint, not only for us but anybody in the industry, is going to have a low margin. And that creates the opportunity to fulfill – or fill that capacity over time with higher-margin product.

So as customers deploy, as customers start generating revenue and then need to expand their capabilities, which will happen starting anywhere from a couple of quarters after initial deployments to longer than that, we'll have the ability to generate substantial margins on that revenue for a long period of time. Ita?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yes, I'm not sure there's a whole lot to add to that other than your question – referencing where we are now versus where we were at analyst day. I mean, I don't think anything has changed in terms of our outlook.

We had cautioned around Q1, just given the typical industry dynamics that we see. And I think that's what we're seeing here. It just takes longer to get ramped up from a bookings perspective in Q1. From a gross margin perspective, I think it's been clear that there was always going to be a ramp improvement in margins and expansion in margins as we went through the year. So I don't think anything has necessarily changed in our view since analyst day in December.

Joe Park

Analyst, JPMorgan Securities LLC

Q

Thank you very much.

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

Ehud A. Gelblum

Analyst, Morgan Stanley & Co. LLC

Q

Hey, guys. Thanks. I appreciate it. Questions, question one, the CenturyLink Qwest deployment, can you give us a sense as to where we are in that, and the pace of that as we look into Q1 and as we look into the rest of the year?

And then another question about 100-gig shipments, can we get to the point where we can start counting them and kind of just seeing how much they were up or where they were flat in Q4 and kind of what they do again in your estimation of Q1?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

So on CenturyLink Qwest, as we've announced we have been selected. We have achieved OSMINE certification which was required to expand that capability, be it on the original FOA, or first office application. We have rails that are up and running and carrying live traffic. And we have a rollout through the next rest of the year of extending that backbone across more and more of their service to markets.

So I'm very excited about that opportunity and I think that – we've worked with these guys for a very long time. They are a very great customer. And they decide to go in a direction and you execute, you have a lot of opportunity.

We also continue to do very well with them in their Metro, both in their regulated and unregulated with the DTN. And so we anticipate our relationship with CenturyLink to continue to blossom and grow over the foreseeable future.

In regard to 100 gig, we do break out the ports. We do that for market analysts and we will be doing that anytime now where the market analysts will report, I think the middle of February, what the overall port count was. The port count was up over Q3, but I don't think we are specifically stating what ports or how many we shipped this quarter versus Q3.

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yes, and we're not going to break out the revenue between kind of 10-gig and 100-gig because that's really not how the business works, right. Things that you should look at is, we did say we invoiced seven new DTN-X customers in the quarter, and I think it's fair to say that the DTN-X revenue continues to grow and is becoming more significant from a total revenue perspective.

Ehud A. Gelblum

Analyst, Morgan Stanley & Co. LLC

Q

Yes. Back to the question at CenturyLink, did you recognize revenue in Q4 or is that still unrecognizable?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yes, we have recognized revenue on the CenturyLink DTN-X deployment.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

First builds.

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yes.

Ehud A. Gelblum

Analyst, Morgan Stanley & Co. LLC

Q

Okay. And you expect that to ramp pretty much all throughout the year, or do you think it will be lumpy?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

I think in this industry everything is lumpy. You know if people buy a whole bunch one quarter, then they tend to deploy it the next quarter. But I think that...

Ehud A. Gelblum

Analyst, Morgan Stanley & Co. LLC

Q

Not necessarily, sometimes initial builds will actually grow over a course of two, three or four quarters in a row before they hit the lumpy stage. So I'm just wondering where we are in that process.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Well, we're in the growth phase right now. They continue to award us extensions to the network that we have already built.

Ehud A. Gelblum

Analyst, Morgan Stanley & Co. LLC

Q

So it's not – we're not in the lumpy stage yet. We're still in the growth phase?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

You know, fine, is backward looking...

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Ehud, to be honest.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Backward looking, it's really easy to tell you. Right now, we anticipate they're going to continue purchasing.

Ehud A. Gelblum

Analyst, Morgan Stanley & Co. LLC

Q

All right. So let me try something else, pricing, competitive environment, how are you seeing pricing in 100-gig? I know, you mentioned it's below 40-gig. It's been that way for some time on a per bit basis. When you look at your competitors you're up against Siennas, the Alcatel Luents, the Huaweis. How have you seen the pricing environment? Have people kind of taken their foot off the gas pedal in terms of declining pricing or are they still aggressive? I mean, obviously...

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Yeah, I think, I guess...

Ehud A. Gelblum

Analyst, Morgan Stanley & Co. LLC

Q

You see them take another step down?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Yes, I'll I guess answer it in a couple of ways. One, the first way, which is if you're looking at a transponder based comparison, prices came down radically year-over-year as people were interested in making sure that market share was preserved. Particularly I think is we came to market, they were interested in not letting us have a foothold.

I think that the pricing on a transponder basis has gone to more normal levels now. So I don't think that we're going to continue to see the dramatic reductions that the last year had. And I also think customers are more and

more interested in the cost of converged networks versus alternative architectures. And when you bake that into it, it becomes more of a network costs versus a transponder cost discussion. And I think that discussion is going to take more and more meaning every year moving forward.

Ehud A. Gelblum

Analyst, Morgan Stanley & Co. LLC

Q

Okay. One last thing, EMEA was pretty strong this quarter. Anything in particular we should read into that? Any – was it one customer issue? Was that a...

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yes, I mean, I think it's just more that as customers start to deploy DTN-X, we start to see – we'll see some lumpiness around the geographical split. But we are seeing a lot of interest in the DTN-X and 100-gig in Europe.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Europe has a number of customers who have deployed and are in the process of making a DTN-X decision. So we're seeing a fairly robust activity on new builds. I guess the backdrop, as you know, of a European financial challenge and I would say more metered fill coming out of Europe. But a reasonable amount of new build activity in both Eastern and Western Europe.

Ehud A. Gelblum

Analyst, Morgan Stanley & Co. LLC

Q

I appreciate it. Thanks, guys.

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Thank you.

Operator: And our next question comes from Subu Subrahmanyam with TheJudaGroup. Your line is now open.

Subu Subrahmanyam

Analyst, TheJudaGroup

Q

Great. Thank you. Could you talk maybe about profitability kind of what the model looks like as you get to breakeven and if you anticipate that happening in any given quarter in 2013?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yes, so I think if we go back to what we talked about on analyst day just in terms of 2013, first, we talked about getting to a cash flow breakeven point in the second half of 2013, right. And obviously, we put a revenue range out there that's in this 10% to 20% growth range. So you can envisage a ramping revenue line and some margin expansion as we go through the year to stay in that 38% to 40% gross margin rate for the year, right. Beyond that we've talked about margin expansion to 45% at the gross margins level, right, and I think that becomes a combination of leveraging the PIC and the modules plans and factories that we have, but also starting to see the benefits of mix from the network footprint that we are putting in now. I mean, we are making heavy new footprint deployments right now and we ship more amplifiers in Q4 than we have since way back at the beginning of 2009,

right. We're definitely investing right now in footprint and you will start to see margin expand out of that as we go through the year and then onwards beyond that.

Subu Subrahmanyam

Analyst, TheJudaGroup

Q

Understood, and cash flow breakeven will be – it will be operating breakeven as well in the second half of 2013?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yes, I mean right now for sure we would say you start to hit the cash flow breakeven point. And when it kind of turns to P&L breakeven, whether that's kind of in the second half or little bit later, it's hard to tell you. Our kind of guidance right now has been around say we would hit a consistent cash flow breakeven by the second half.

Subu Subrahmanyam

Analyst, TheJudaGroup

Q

Understood, and then on pricing – sorry. On pricing, Tom, the question was around 10-gig, I mean, how does 100-gig compare to 10-gig in terms of pricing right now for the top carriers? I know it is less expensive than 40-gig, but on a perfect basis versus 10-gig?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

I'm going to ask Dave. Dave, you want to answer that?

David F. Welch

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

A

Yes, I think the – I understand that 10-gig and 100-gig are slowly migrating to where they're applying to different applications. And it's not really a head-to-head number of 10-gig to 100-gig. You've got more 10 gig in the metro area and lower capacity issues in the long haul. With long-haul route 100 gig is probably on par, it's a little bit below that of 10-gig on an application. In lots of applications where you don't need the capacity of the 100-gig or you don't need better granularity on a wavelength basis, 10-gig is more competitive. So I'd say it's not quite a – it's not quite a fair comparison to have between the two.

Subu Subrahmanyam

Analyst, TheJudaGroup

Q

Fair enough. But for a carrier that has 10 gig at the backbone today, though, it sounded like if they replace – are replacing with 100-gig, it's less expensive on a per bit basis than 10-gig. Did I understand that right, Dave?

David F. Welch

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

A

For incremental business, if I have a 10 gig previously deployed network, it will be less expensive to incrementally put more 10-gigs on that network than it will be to upgrade the system and all the comments that are required of that to 100-gig.

Subu Subrahmanyam

Analyst, TheJudaGroup

Q

Understood.

David F. Welch

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

A

If I am planning a network that I have an incremental build on multiple 100-gigs of bandwidth that I need to put on a network, then it will likely pay that common expense to install 100-gig, so I can get on a better dollar per gigabit train. But there's an entry price to that.

Subu Subrahmanyam

Analyst, TheJudaGroup

Q

Right, I meant transponder to transponder really comparison.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

And certainly from an operating cost, 100-gig for a core backbone is substantially less power, space, ease-of-use, provisioning. The CapEx as is probably, as Dave said, roughly on par. From an operating expense, it's substantially less. There's nobody that's going to, in my mind, build a 10-gig core network at this point that has any substantial volume. It's just not practical.

Subu Subrahmanyam

Analyst, TheJudaGroup

Q

But they will add 10-gigs to their...

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

They will add 10-gig.

Subu Subrahmanyam

Analyst, TheJudaGroup

Q

Understood, thank you.

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

Michael Genovese

Analyst, MKM Partners LLC

Q

Great, thanks very much. It's, I believe you said during the prepared remarks that you shipped 1,000 10-gig ports during the fourth quarter. So I just want to verify that you said that. And based on that number, all of you do you think that you are number one on that metric in the fourth quarter? It looks like you might be. And could you just speak kind of qualitatively about the competitors -- Sienna, Alcatel, Huawei? Anybody you're seeing more than anybody else, anyone whose technology looks better, anyone acting differently than others on pricing? And then, I have a second question later.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

I'll let you handle the first part.

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yes, so I think it was over 1,000 100-gig ports, right, and that's – obviously we think that's a very compelling shipment number. Whether it puts us in number one market share or not, we'll have to wait and see when the market share data comes out. But we do think that's a pretty compelling metric. In terms of the competitive landscape, I'd ask Tom maybe to chime in on that a little bit.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

So it's a competitive environment. The people that we primarily see continued to be Sienna, very spread across almost all areas. And certainly in certain areas, we see a lot of Alcatel. Alcatel continues to be aggressive on pricing, which it continues to perplex me. We see less and less Huawei, and that's a – I would say a statement that applies in both North America and in Europe.

Michael Genovese

Analyst, MKM Partners LLC

Q

Great. That's a very helpful answer. Thanks. And then on -second question, here in the fourth quarter and with the first quarter guidance, I mean, you have very solid performance. But this is actually a time when your comps, suppliers' different people on the value chain have – they're seeing some weakness I think particularly in December and the March quarter, everybody's hoping CapEx or comp in CapEx will ramp in the second quarter in the back half. But you've done well in this period of CapEx weakness. What are your expectations – what are your expectations for CapEx in the second quarter, in the second half and is that a part of the story here? Do you think that is this just a 100-gig product cycle or is this 100-gig product cycle plus better CapEx?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

I think that my view is that when people have CapEx discussions, what they're vastly talking about is, what is Verizon and AT&T going to buy? And I think that looks at the world too narrowly. And if you look over the history of time, more and more flows of traffic on the internet are moving to alternatives besides that. Those alternatives, be they wholesalers, be they Internet content people, be they cable people, have been the core of Infinera's business. And we see both with our core, but also new opportunities of Tier 1s domestically and international, we see an environment where it is – there are more plans to build more networks at this time of the year than we have seen in the last couple of years.

So I think part of it certainly is a 100-gig migration to the optical reboot of 100-gig. Part of it is people trying to make a more intelligent transport layer by putting some of the intelligence of historically routing and switching layers into the optical layer, because it can be done more cost-effectively. And part of it is, there is a lot of just fundamental demand for increased high-capacity capability. I think we are seeing a reasonable amount of that. But that's different than the discussion of AT&T and Verizon are having bigger CapEx plans. And it's very easy to, I think, use those synonymously with the industry and I don't believe they're synonymous anymore.

Michael Genovese

Analyst, MKM Partners LLC

Q

Yeah. That's another great answer. But – so do you not necessarily then have a view on the second half of the year and whether CapEx would be 20% higher in the second half of the year, this year or not and that's really, it sounds like it's almost irrelevant to your trajectory, but just for the heck of it, do you have a view there?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Yeah. I don't really have a view that would be unique or have any insight into that other than what I hear from the same people you hear from, analysts and suppliers.

Michael Genovese

Analyst, MKM Partners LLC

Q

Okay. All right. Well, great keep up the good work. Thanks.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Thank you.

Operator: Our next question comes from the Sanjiv Wadhvani with Stifel Nicolaus. Your line is now open.

Sanjiv R. Wadhvani

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Thanks. Tom, I just wanted to get a gauge when you look at the RFPs and RFIs that are out there, would you be able to characterize as to sort of what percentage of them are on the 100-gig side?

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

I'll have Dave answer that question.

David F. Welch

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

A

Yeah, whether we see a bunch RFIs, RFPs in the long-haul space and understand that these are questions, not necessarily decision points, but I'd say probably about 70% of the RFIs and RFPs that we have out there ask the question of 100-gig capability. They also – we're seeing actually a substantive take up of – 75% of the RFPs are asking for integrated OTN switching with that and that plays right into our strengths for the...

Sanjiv R. Wadhvani

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Got it. That's helpful. So I guess within that context and you know it's a broad level question, when you look at the product revenue increase in December versus September, there's about \$10 million. I'm guessing the DTN-X sort of probably did north of that \$10 million. I'm just trying to get a gauge. I know you don't want to break out specifically on the DTN-X. But in 2013, should we be looking at DTN-X accounting for half of your shipments or revenues or any metrics that you can broadly talk about?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah. I mean, Sanjiv, I don't think we're going to break that out. And to be honest, it's not really a relevant metric. Once we're steady state with the DTN-X and we can provide the network infrastructure, either 10 DTN or DTN-X, it doesn't really matter. So we are selling networks and we're selling both products into the same customers, right. So I'm not sure that we're not – we're probably not going to break that out just from an accounting perspective and I'm not sure it's really a helpful metric. I mean, we have tried to provide some metrics around the numbers of

customers that are invoicing and so on, so you did see us invoice another 7 DTN-X customers this quarter. So clearly, it's ramping and it is becoming a significant part of the overall revenue number.

Sanjiv R. Wadhvani

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay. But just from a clarification point of view, is it fair to assume that the \$10 million increase that you saw in product revenues from Q3 to Q4, the DTN-X did higher than that?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah, I mean, the – clearly, we've said a lot of the new higher capacity – new network deployment are going with DTN-X, so that should say that it's higher than that, right.

Sanjiv R. Wadhvani

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Got it. All right. Thank you.

Operator: And 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. I just wanted to ask some questions about your Instant Bandwidth program. I think you now have a couple of customers on that, including TeliaSonera and KDDI. How does that impact revenues and margins relative to your traditional sales model? And also, what kind of customer do you think would be more attracted to using this kind of a sales model versus the traditional one?

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

Yeah. I think the Instant Bandwidth for us is an added tool to the toolbox in terms how we sell and how we approach customers. It allows us to, for a particular customer type, where they really want to match their spending revenue, it allows us to kind of more closely align ourselves with their business model, right. It's not – what we see is that lots of customers want to come in and buy the 500-gig capacity upfront. But we'll also see some customers where this model is a better fit to their needs and what they want. So we see it as a competitive tool in certain circumstances. But we still see a lot of customers wanting to actually go and purchase the capacity upfront.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

I think Ita provided the right context. We're providing a choice to customers. We have no bias one way or the other. And the opportunity for us is to be on the same side of the table as our customers. So as they're trying to win business, we can put them in the best spot to do that today and tomorrow.

And I think that we give them a choice. The people who want to use 500-gig today, and there's several of those, we have that choice. People who want to pay for a 100-gig today because they're uncertain about tomorrow, they know they're going to grow, they're not sure when, we give them that choice. We're on the same side of the table as our customer and none of our competitors can offer this.

Simona K. Jankowski
Analyst, Goldman Sachs & Co.

Q

Just to be clear, so \$1 of revenue that is booked as Instant Bandwidth, does that have the same margin profile as if it had been sold as a 500-gig increment?

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

A

I think the network margin, what Instant Bandwidth allows us to do is, one, win more deals and take greater market share, because it's not a tool. Two, it impacts or positively impacts our overall margin portfolio profile.

Simona K. Jankowski
Analyst, Goldman Sachs & Co.

Q

And that positive impact is over the life of the sale, or is it in that initial 100-gig increment?

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

A

It's over the medium range, relatively short amount of time for [indiscernible] 45:00). It's a value to the customer. The customer that can turn on circuits instantaneously in a day as opposed to a 40-day process that might exist in an alternative mechanism.

Simona K. Jankowski
Analyst, Goldman Sachs & Co.

Q

Okay.

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

A

That value we get credit for.

Simona K. Jankowski
Analyst, Goldman Sachs & Co.

Q

And then just separate question, you commented on 100-gig price pressure normalizing now, or subsiding. What about 10-gig, how are pricing trends evolving in that part of the market?

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

A

They're pretty stable, stable in the realm of standard yearly reductions that go on within the industry. Again, you have to look at it as 10-gig is being utilized on a brownfield fill. In the long haul, there's not a lot of greenfield long haul, there is some for 10-gig, and then, there is a lot of lower capacity different application metrics where 10-gig plays a role.

Simona K. Jankowski
Analyst, Goldman Sachs & Co.

Q

Okay. Thank you very much.

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

Thank you.

A

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

Alex Henderson

Analyst, Needham & Co. LLC

Hey, guys. First up, congratulations on the really nice customer win rate. I was hoping you could give us a little bit more clarity on the 22-customer piece. What portion of those 22 were existing customers? And what portion were new customers? Is it all – is that 7 DTN-X new customers that you were invoiced all new? And customers are those – the only new customers that are in the 22, I assume they're not?

Q

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

Yeah. So out of the 22 purchase commitments, we've said there are seven that are new, right. If you look at kind of what's been invoiced versus that, we've probably invoiced a little over half of those 7 new customers at this point.

A

Alex Henderson

Analyst, Needham & Co. LLC

Okay. And can you help me out a little bit on the guidance for 1Q on the mix between product and service? Obviously, your service jumped up quite a bit in the December quarter. You probably made comments about this earlier, I missed the first 10 or 15 minutes of the call. So will that come down back to a similar level to the mix that you had in the first half of 2012? Or will it – is that driven by the installation rates, which therefore will keep it higher and therefore higher as a percentage of the overall revenues?

Q

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

Yeah, I think we would expect it to come down off of Q4, but probably not back to the levels that we saw kind of earlier in 2012 or even at the end of last year, right. So we have – the volatility has been driven by the amount of deployment from the level of deployment activity that we're doing. So Q1 will still have a very healthy deployment – amount of deployments going on. So it won't be as high as Q4, but it'll probably be higher than what you had seen historically for a while.

A

Alex Henderson

Analyst, Needham & Co. LLC

Okay, one last question and to keep it try – keep it a little short here, the mix of customers that you're seeing as we're going into the first half of 2013, between customers that were existing customers driving revenue and customers that you're seeing with extended period of acceptance criteria associated with new builds, can you talk a little bit about what the mix is between those in terms of dollar value of revenues ordered? Is there a fair amount of pent-up revenue that is waiting for accrual of that acceptance criteria?

Q

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

I think you'll see this in the 10-K when we file it, but our backlog, and that includes kind of our financial backlog, is pretty much flat to where it was at the end of last year, right. So it's not that there is a tremendous backlog of

A

stuff kind of on the books coming into Q1. That's why the visibility in Q1 is important, right. What we do see though is that – I think the comment about the linearity is because of the acceptance of the stuff, it's pushing some of our revenue to the backend of that quarter, and it's taken longer to kind of process that revenue in a quarter, right, but it's not that we're coming in with a huge backlog kind of into Q1.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

Even customers who we have had a relationship for a long time, when they buy a new platform like the DTN-X, some of them want to do acceptance on the first network build, not all of them, but some of them. So it's important that we don't parse too fine around new customer versus old customer because sometimes a new DTN-X customer and old customer will have the same acceptance criteria. I think one of the things that you should look at, as Ita pointed out, our backlog is roughly where it was on growing bookings, that's a very significant sign. I mentioned it in my commentary, the DTN-X networks that we're deploying, not only have we ramped and are shipping aggressively, but the turn-ups are going very well.

I think that you'll find, and if you go talk to customers when they're deploying our networks, it's not taking them a long time to turn them from a PO into a revenue-collecting network for them, and that means the acceptance is happening as planned. And I think on a new technology, sometimes that's a risk or a challenge. The DTN-X is leveraging the lessons learned of the DTN and it is continued to be easy to buy, easy to deploy, easy to turn up and easy to start collecting revenue on.

Alex Henderson

Analyst, Needham & Co. LLC

Q

I'm going to – at the risk of being a liar, I'm going to ask one more question because you spurred a question. Can you give us some sense of what the percent fill is on the boxes that are being shipped out? I mean, are you shipping 25% loaded, 30% loaded, 35%, what kind of ratio?

David F. Welch

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

A

Now people typically deploy things relatively lightly loaded. These are 5-terabit boxes. They're not going out with 5 terabits of bandwidth then. They're going with something less than that.

Alex Henderson

Analyst, Needham & Co. LLC

Q

25% a reasonable guess?

David F. Welch

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

A

I don't think...

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

A

We're going to go there.

Alex Henderson

Analyst, Needham & Co. LLC

Q

Okay. Thank you very much.

Ita M. Brennan

Chief Financial Officer, Infinera Corp.

Okay. Thanks, Alex.

A

Operator: And we do have time for one final question and that question comes from George Notter with Jefferies. Your line is now open.

George C. Notter

Analyst, Jefferies & Co., Inc.

Hey, thanks a lot for squeezing me in guys. I guess I wanted to ask about – Tom, I'd love your perspective on the disclosure from Alcatel-Lucent are on the time of their financing, they said their terrestrial optical gross margins were around 17%. And I guess, I bring the question up because you guys are trying to drive a margin expansion story here. Here's a competitor that's – it feels like based on that gross margin, really being aggressive on pricing. I mean, do you think that's a real inhibitor to your ability to expand margins over time? Or do you kind of look through that, I mean, what's your perspective? Thanks.

Q

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

I think my perspective is a couple of fold. One, we do see them being aggressive in the market. And we were never sure what allowed them to do that. When they had to publicly disclose their margins, it became clear that they were doing it not because a cost structure advantage, but because – I assume, because they desperately need to hold and grow their market position to allow time for them as a company to light their ship.

A

I think that 17 points they articulated has probably – is probably lower than reality, a true cost of goods. I assume that as a company like Alcatel, there is a fairly significant corporate overhead that they have to pay to the mother ship. I don't know what that percentage would be, but I assume it's non-trivial. But even if you add 5 to 10 points, you're still talking mid 20s from a gross margin perspective.

And that tells me a couple of things, one, they had a cost structure disadvantage, not a cost structure advantage. Second of all, when we compete head to head with them, we are winning a reasonable amount of business and we – candidly, customers who have use both, they say our experience is significantly better.

So sometimes, you can lower price when you're trying to buy market share. Sometimes you lower price if you have a product that is in certain characteristics inferior. Sometimes you have to lower price to get rid of the risk premium as Alcatel goes away. I don't know what is their thinking process. But I feel pretty comfortable that they cannot continue to be price leaders and cost laggards over the intermediate term.

And we are going to continue to develop cutting-edge technology. We are going to continue to deploy networks that carry live traffic quickly. We are going to continue to work very hard to delight our customers and I think that combination is going to be pretty hard to beat.

George C. Notter

Analyst, Jefferies & Co., Inc.

Got it. One last one, NSN recently sold their optical business to a private equity firm. Are you guys seeing any impact from that in a market place? Is that dislocating customers or creating RFP or RFI activity? Any impacts there would be interesting to hear about. Thanks.

Q

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

A

In my observation, George, it would be – it's probably too soon to see an impact from that event. We are seeing an impact from the events with NSN over the last year where people became – companies became suspicious of their commitment to staying in the optical space. We've recently won a couple of deals that's displacing old NSN optical gear but that's not triggered by the recent sale. That was triggered a while back by the concerns of NSN not being committed to optical.

I do think that that shoe was going to drop still. I think that the acquisition I think reaffirms that the industry is going to change and consolidate because the structure of the industry today probably isn't viable. I think that – I don't know Marlin but I certainly respect their courage of attacking this industry with a company like NSN who has good footprint, but to the best of my knowledge has no differentiating technology. And I think they're going to have – they got a mouthful to swallow. That's all I know.

George C. Notter

Analyst, Jefferies & Co., Inc.

Q

Great. Thank you.

David F. Welch

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

A

Thanks, George.

Thomas J. Fallon

President, Chief Executive Officer & Director, Infinera Corp.

Thank you all 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 that concludes today's conference. Thank you very much for your participation. You may disconnect at this time.

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