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CALX - Q3 2014 Calix Inc Earnings Call

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Amitabh Passi *UBS - Analyst*

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Tim Quillin *Stephens Inc. - Analyst*

PRESENTATION

Operator

Greetings and welcome to the Calix Q3 2014 earnings conference call. (Operator Instructions). As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Mr. David Allen. Thank you and you may begin.

David Allen - *Calix, Inc. - Director of IR and Treasurer*

Thank you, Operator, and good afternoon, everyone.

Before we begin this call, I would like to remind you that this conference call contains forward-looking statements regarding future events, including, but not limited to, the size of our funnel of sales opportunities; long-term prospects for Calix; our expectations for the next quarter; our development of new products that will continue to help our customers transform their networks; future business and financial performance of the Company; and our expectations of revenue, gross margins, earnings per share, stock-based compensation, and amortization of intangibles.

These forward-looking statements are based on estimates, judgments, current trends, and market conditions and they involve risks and uncertainties that may cause the actual results to differ materially from those contained in the forward-looking statements. I would encourage you to review the Company's various SEC reports, including our annual report on Form 10-K for the period ending December 31, 2013, and our Form 10-Q for the period ending June 28, 2014, available at www.sec.gov, in which we discuss these risk factors.

All forward-looking statements are made as of the date of this conference call and, except as required by law, we do not intend to update this information.

Also on this conference call, we will be discussing GAAP and non-GAAP results. We are providing the non-GAAP estimates to enable interested parties to evaluate our performance in the same manner in which we evaluate our own operations. These non-GAAP measures exclude certain charges and benefits, which we do not consider to be part of our ongoing activities or meaningful in evaluating our financial performance, including stock-based compensation; acquisition-related expenses, if any; and amortization of acquisition-related intangible assets.

To help you better understand those results, we have included a reconciliation of our GAAP and non-GAAP results in our earnings press release. All numbers that are expressed in today's conference call are non-GAAP, unless otherwise noted.



This conference call will be available for audio replay in the investor relations section of the Calix website at www.calix.com. In addition, our earnings press release, along with supplemental financial data, has been posted in the investor relations section of the Calix website, which you may want to review in conjunction with our press release and conference call remarks.

I would now like to turn the call over to the Calix President and CEO, Carl Russo. Carl?

Carl Russo - *Calix, Inc. - President, CEO*

Thank you, Dave, and good afternoon, everyone. Joining me on today's call is William Atkins, our Executive Vice President and Chief Financial Officer.

I am happy to again report that the Calix team performed well, achieving record revenue for the quarter. As you will hear in William's remarks, our crisp execution was reflected in the excellent quality of our earnings. In addition, the excitement in the market around fiber-based high-capacity service offerings continued to accelerate this quarter.

I will come back with some more observations on the market and thoughts on what is ahead. However, I would now like to turn the call over to William to review Q3 in detail, then share our guidance for Q4. William?

William Atkins - *Calix, Inc. - EVP, CFO*

Thank you, Carl.

We last provided you with non-GAAP guidance regarding Q3 on July 29, and in that guidance, we called for revenues of between \$102 million and \$106 million, a gross margin of between 44.5% and 46%, and operating expenses in a range of \$42.5 million to \$43.5 million, thus resulting in an EPS of between \$0.05 and \$0.10 per share.

Actual revenue for the quarter was \$105.8 million and EPS was \$0.09 per share, both at the top end of our guidance. Gross margin was 44.8% and operating expenses came in at \$42.7 million, both metrics also in line with our guidance.

As noted in our last quarterly results call, the business continues to be cash generative. Calix ended Q3 with total cash and marketable securities of \$87.8 million, up \$8.8 million from Q2's \$79 million.

Revenue for the quarter was a record \$105.8 million, an increase of \$2.1 million from last year's third-quarter level of \$103.6 million and up 8% sequentially from this year's Q2 \$98 million figure. International revenue was \$13.8 million in Q3 (corrected by the company after the call), up from \$10.7 million in Q3 2013 and up from \$12.6 million in Q2 of this year.

We had one 10% or greater customer again this quarter.

At 44.8%, Q3 gross margin was at the lower end of guidance and reflected the impact of changes in customer and product mix and inventory write-downs, with deferred and recognized revenues coming in line with expectations. The gross margin in Q3 was down from Q3 2013's 48.1% level and from Q2 2014's 47.7% level. The inventory write-downs related primarily to lower-than-anticipated growth in sales of the BLM product line, acquired from Ericsson in 2012.

Q3 operating expenses at \$42.7 million were at the bottom end of our guidance range, but up from the prior quarter by \$1.1 million. This sequential increase was primarily due to increased compensation expenses. OpEx was up \$2.4 million in the same quarter a year ago, primarily due to increases in personnel expenses, largely consisting of annual compensation adjustments and also due in part to additions in year-over-year headcount, which also increased slightly from Q2 of this year.



Turning now to the balance sheet, we ended the quarter with total cash and marketable securities of \$87.8 million, an increase of \$8.8 million in the quarter. We continue to expect the remainder of the year to be cash flow positive.

Receivable DSOs were 39 days, compared to 38 days in the previous quarter. Inventory levels fell to \$43.8 million in Q3 from Q2's \$45.9 million level, due in part to the increase in inventory reserve that I noted earlier.

Inventory turns increased to 4.6 times in Q3 from 3.9 times in Q2, while decreasing from Q3 2013's 5 times.

Deferred revenue was \$38.9 million, down from \$45 million in the prior quarter and from \$63.4 million in Q3 of 2013. We closed out deferred revenue in line with our expectations and we continue to expect the completion of the bulk of our remaining broadband stimulus projects by the end of this calendar year. We see the substantial balance of those BBS-related deferred revenues being recognized in our P&L by year-end and for BBS projects to no longer be a discernible component of our revenues in 2015.

In terms of guidance for the fourth quarter of 2014, we expect revenues to increase over Q3. We also expect to be profitable and cash flow positive in Q4.

Our guidance for Q4 is as follows. Revenue for the fourth quarter is expected to be in a range of between \$107 million and \$111 million. Gross margin is expected to be up this quarter, and we do not currently expect increases in inventory reserves similar to those that we took in Q3.

Our expectations for deferred revenue recognition were met in Q3 and we are therefore tightening guidance for our gross margin range in Q4. We are guiding to 46.5% to 47.5% range for Q4.

Operating expenses are expected to be in the range of \$44 million to \$45 million, with the sequential increase over Q3 primarily due to sales and marketing expenses related in part to our Calix User Group Conference, which we hosted in Las Vegas earlier this week, and due to increased depreciation expense related to facilities improvements.

The expectations that I have just finished taking you through result in a guidance range for Q4 earnings per share of \$0.10 to \$0.14.

Given that we are now close to year-end, it is appropriate for me to tally our actual year-to-date results and our Q4 guidance to give you the resulting implied guidance for the 2014 year. Revenues would be in the \$396.6 million to \$400.6 million range, up from 2013's \$382.6 million level. Annual gross margins should be in the 46.2% to 46.5% range. Annual operating expenses are expected to be in the \$169 million to \$170 million range.

At this point, let me hand the call back over to Carl. Carl?

Carl Russo - Calix, Inc. - President, CEO

Thank you, William.

Last quarter, I spoke of the enormous secular opportunity in front of us. Stated simply, enabling our customers to provide high-performance broadband services to their device-enabled subscribers, whether they are at home, work, or play, represents a significant shift in the access infrastructure opportunity.

The most recent example of our pursuit is the brand-new Calix GigaCenter solution. In concert with our Compass software offering, the new GigaCenters change the paradigm in wireless premises solutions. Announced at the very end of Q3, the GigaCenters have gotten off to a very fast start, with shipments beginning on time last week.

I just left the 2014 Calix Users Group, and while there is lots of enthusiasm for our entire portfolio of products, if the excitement for the GigaCenter translate into orders, the GigaCenter will likely set a new record for the fastest-growing product in our history.

It is clear that just as our execution has been improving, the addressable market for Calix is growing. To prepare for this opportunity, we have continued to add strength to our leadership team and to our Board of Directors. And if we match our market expansion with continuously improving execution, then the future will be bright, indeed.

With that, I would like to turn the call over for questions. John?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Amitabh Passi, UBS.

Amitabh Passi - UBS - Analyst

Can you clarify the deferred revenue comment you made? I think you ended around \$38.9 million. Should we expect that number to trend down towards the \$26 million, \$27 million range by 4Q? And does that -- is that partially helping your fourth-quarter outlook?

William Atkins - Calix, Inc. - EVP, CFO

All we are saying is that we're expecting them to no longer -- deferred revenues to no longer be a major component of our P&L after your year-end.

We don't guide to specific numbers Q-on-Q, but what I will say is that, I think as we flagged for you back in Q2, the deferred revenues came in a bit below our expectations, and so we were widening our gross-margin guidance just in case we had a bunching of deferred revenues. What we are saying is that in fact deferred revenues came in line with our expectations, so we see them moving through the remainder of the year pretty much in line with what we have seen previously and we don't expect them to spill over substantially into 2015.

Amitabh Passi - UBS - Analyst

Okay, so then is there a possibility that 1Q 2015, all things being equal, just optically on numbers, may look a little subseasonal just because of this deferred revenue movement that is going on in the fourth calendar quarter?

William Atkins - Calix, Inc. - EVP, CFO

So you are saying optically our numbers may look -- I couldn't hear that last part?

Amitabh Passi - UBS - Analyst

A little subseasonal in 1Q, just because 4Q, you get the deferred rev balance, but then that all goes away, so 1Q 2015, we should be modeling off -- x'ing out the deferred rev benefit in 4Q and then thinking about seasonality into one -- I just want to make sure we trend and model 1Q 2015 appropriately, given the deferred rev?

William Atkins - Calix, Inc. - EVP, CFO

Yes, the short answer is yes, basically.



Amitabh Passi - UBS - Analyst

Okay. Okay (multiple speakers)

Carl Russo - Calix, Inc. - President, CEO

William is not giving guidance for Q1 currently.

William Atkins - Calix, Inc. - EVP, CFO

Exactly.

Amitabh Passi - UBS - Analyst

Understood, understood, Carl. Carl, just from your perspective, the tone sounds a little more constructive. Last year, we didn't get a budget flush. I think we have seen a gradual improvement or progression through the year.

Just curious, conversations you are having. At least from a headline perspective, we are seeing a lot of movement around gigabit. Are you more optimistic as you look out at 2015? Do you feel like you have enough in your funnel and pipeline to make 2015 a pretty decent year in terms of growth?

Carl Russo - Calix, Inc. - President, CEO

I think I have been accused of being optimistic in the past. I don't know, frankly, how you do this job without being an optimist.

But as I said in my comments, I'm excited about what I'm seeing from our customers, from our prospects in the market. The shifts, I think we are well placed to go take advantage of this, and we will see as we go through the year. I think job one for us is to continue to build an understanding of what's going on out there and share it with our investors in a credible fashion.

William, do you have any color you would care to add?

William Atkins - Calix, Inc. - EVP, CFO

No, the only color I would add there is that what we see is obviously that the classic quarter-to-quarter seasonality that occurs during the year. What we are aiming to do here is to avoid the trend you see amongst vendors to sometimes back-end load their orders in the quarter.

What we therefore see is an elimination of bad behavior -- for example, giving customers favorable terms to meet any notional revenue target that people may or may not have in a quarter. And so, we are seeing just basically a more level amount of demand, if you will, during the course of the quarter.

Carl Russo - Calix, Inc. - President, CEO

That's a good point because that natural demand, if we don't get in the way of it, yields the quality of earnings that you have been seeing improve here at Calix over the last three quarters.

To your question about next year, that's really a statement of how do we feel about our products and the demand in the marketplace. So the coupling of those two things together, I am certainly looking forward to next year, but right in front of us right now is Q4.

William Atkins - *Calix, Inc. - EVP, CFO*

Yes, we are not going to go any further out than that.

Amitabh Passi - *UBS - Analyst*

Perfect. You know what, guys? I will step back in the queue and come back later if there is time. Thank you.

Operator

Doug Clark, Goldman Sachs.

Doug Clark - *Goldman Sachs - Analyst*

It's a question regarding your fourth-quarter guidance, certainly up sequentially. Wondering how much of that or what your expectations are for year-end budget flushes amongst your customers? What is implicitly within your guidance in terms of potential budget flush?

William Atkins - *Calix, Inc. - EVP, CFO*

We are not forecasting any budget flush in those numbers. We are not assuming any budget flush in those numbers, so the short answer is, no, we are not seeing it.

Doug Clark - *Goldman Sachs - Analyst*

Okay, and changing gears a little bit, on international, obviously up nicely sequentially and year over year. Can you talk a little bit about what drove that, and then, similarly, what your expectations are for the fourth quarter in terms of international growth?

William Atkins - *Calix, Inc. - EVP, CFO*

In terms of international, we don't guide specifically to a number for Q4, but in terms of sequential growth, we see international being pretty much across the board. We didn't see any specific region or any specific customer type lead us one way or the other. It's just good across-the-board growth in international. That's how I would explain it.

Carl, do you want to add some color?

Carl Russo - *Calix, Inc. - President, CEO*

I guess the color I would add is the 2014 User Group over the 2013 User Group, we see more folks from around the world, and so I had a chance to meet with a number of our international customers one on one at the User Group, and to me what's exciting is what we have been alluding to now for a couple quarters. It's putting pins on the map.



We see more and more new customers coming in, more and more excitement about the product offerings that we have, and so I want to make sure the team stays focused on adding new customers, and I believe that, ultimately, that will flow through into the growth statistics accordingly.

Doug Clark - *Goldman Sachs - Analyst*

Great, and then if I could sneak in one more quick question. Can you quantify the impact of the inventory write-down on gross margins?

William Atkins - *Calix, Inc. - EVP, CFO*

I won't quantify the impact on gross margins, per se, but I will say that inventory write-down was probably the primary factor in that gross margin shift quarter to quarter.

We will be coming out with our 10-Q, which will explain this in more detail, but if you look at the amount of a write-down that we took in Q3 of this year, we wrote down some \$2.1 million of inventory, and if you look at year to date, the number is \$4.7 million. If you compare that to, say, last year's equivalent periods, last year for the quarter it was \$0.2 million and for year to date, it was \$0.5 million, so that gives you an understanding of the extent of it. You will have a fuller explanation in our 10-Q, but we have basically given you the underlying drivers for that.

Doug Clark - *Goldman Sachs - Analyst*

Great, thank you very much.

Operator

George Notter, Jefferies.

George Notter - *Jefferies & Company - Analyst*

I guess I wanted to go back to the question about just visibility of business and the outlook into Q4. I know that one of the goals of the Company is to try to run a more backlog-driven business, and maybe extend lead times a little bit and have more visibility as you roll from quarter to quarter.

I guess I am wondering if in the context of the guidance for Q4, you do expect to continue to be able to improve visibility in backlog levels relative to the quarters that you are printing. And that same question, I think, for just the Q3 printed. Were you able to improve the backlog-driven nature of the business or not? Thanks.

Carl Russo - *Calix, Inc. - President, CEO*

George, I would like to come back and add some color to this, but let me let William address the question directly.

William Atkins - *Calix, Inc. - EVP, CFO*

I think, George, it's almost the inverse in the sense of talking about beginning quarter backlog. It's more about eliminating that end-of-quarter spike, and so, inevitably, that means you're going to have a leveling of bookings and of revenues during the course of the quarter. That starts to mean as you get toward the quarter-end, you are obviously going to have some bookings flow over into the next quarter.



But I don't want to guide on a specific detail on backlog or book-to-bill ratios or anything like that. We are just simply trying to create a more normalized level of business, and we are seeing customer behavior actually adjust as well, in line with that. I don't know, Carl, if you want to add some color to that.

Carl Russo - *Calix, Inc. - President, CEO*

George, a lot of this comes, frankly, out of vendor behavior, not customer behavior, and let me approach it from a different perspective.

If I think about what we have been trying to do since the beginning of the year, and specifically with William's help, customers deploy products every day of the year. They build new networks, they add line cards, they deploy new services.

Our behaviors can sometimes get in the way of that natural demand flow. When I think about it operationally, we have been very focused on trying to get everything out of the way of that natural demand flow, and when you do that, good things ensue.

But I know that this is an imprecise measurement and I suspect William will scowl at me when I say it. He already is. Look, from my layperson's balance-sheet analysis, I look at DSOs when I'm trying to understand how a company is doing from a quality of earnings standpoint.

I think if you look at DSOs, these are very low DSOs. It's hard to get there without having pretty good linearity, and I think that linearity speaks more to the naturalness of us meeting the customer's demand.

So that's a long-winded way of saying I think you're going to see a continued improvement of quality of earnings, albeit they are pretty high quality right now.

George Notter - *Jefferies & Company - Analyst*

Got it, and then just to extend upon that, is it fair to say that you were able to further improve that linearity in Q3 or was most of the improvement, looking back, really in Q2 or Q1?

Carl Russo - *Calix, Inc. - President, CEO*

It's been continuous from my perspective. Eventually, it asymptotes to some performance level. William.

William Atkins - *Calix, Inc. - EVP, CFO*

Yes, we are continuing to see improvement in that, George, and I'm just cautious because we are coming over to year-end and we will see how things go over year-end. But quarter to quarter, we're still seeing a better result for flattening that demand curve, I guess is the way I would put it.

Carl Russo - *Calix, Inc. - President, CEO*

Yes.

George Notter - *Jefferies & Company - Analyst*

Great, okay. Thank you very much.



Operator

Tim Quillin, Stephens Inc.

Tim Quillin - *Stephens Inc. - Analyst*

Nice results. With regards to the write-down on the BLM series, not particularly surprising you are not selling a lot of that product, but what kind of success are you having or do you feel like you can have in converting that customer base over to your E-Series platform?

Carl Russo - *Calix, Inc. - President, CEO*

I am going to ask William just to color it, if you would like, at the end. It's a great question because I think in William's comments, you heard a notion of the growth is less than we thought. So I want to frame it under those terms. The growth is less, not shrinking, but it is growing less fast and it speaks directly to your question, Tim.

Again, I just got back from sitting across the table, which is always interesting, with customers. It's very clear, two things. Number one, our customers that have BLM are comfortable that we are continuing forward with it and they will continue to deploy it. So that's number one.

But what is driving, in my opinion, the slackening of the growth rate is actually their excitement for the E-Series product set. They are increasingly comfortable with the E-Series and what it means to them going forward, and we are seeing more and more pins on the map on the E-Series, as well as BLM customers adopting the E-Series.

Actually, it's a good news story, but it has a depressing effect on that growth rate. So I think William's actions in the quarter were appropriate. William, I don't know if you want to add.

William Atkins - *Calix, Inc. - EVP, CFO*

No, I think you have said it all, Carl.

Tim Quillin - *Stephens Inc. - Analyst*

Yes, that makes sense.

William, in the 10-Q, you will break out deferred revenue by product and services. Would you be able to give us what that number was at the end of 3Q? I think it was \$23.5 million at the end of 2Q.

William Atkins - *Calix, Inc. - EVP, CFO*

You are talking about the deferred revs, excluding the extended warranty component, and looking at the other as a proxy for movements in broadband stimulus?

Tim Quillin - *Stephens Inc. - Analyst*

Precisely.

William Atkins - *Calix, Inc. - EVP, CFO*

Okay, yes, we were at \$23.5 million in Q2 and it looks like we're going to end up around \$17.4 million for Q3.

Tim Quillin - *Stephens Inc. - Analyst*

Perfect, okay, great. Thank you.

Then, Carl, this is a big picture and probably a long question, but I was wondering if you could comment on some of the big opportunities ahead of you and I guess maybe in order of timing that you might see those. I think you have talked about maybe a relatively large international win, a relatively large cable win, or a relatively large Tier 1 US service provider win. What kind of progress you are making towards the eventual achievements of those big events for you?

Carl Russo - *Calix, Inc. - President, CEO*

Tim, you're right. That was a long question. I guess I can't just say no comment, right? But I am going to hijack your question a little bit.

As you know, we make it a policy not to talk about any particular customer situations. I think you have been kind enough to phrase it in the terms of large opportunities. There are clearly specific large customer opportunities that exist that we are pursuing, some of which we are avoiding and some of which we are pursuing. We think we are better and better placed over time to pursue them.

Beyond that, I would not comment. However, I would like to take large opportunity and change the dimension of it for a moment away from a specific customer situation and into a market situation, because we do perceive there being a sea change in how networks are going to be structured in the access infrastructure. And back to that GigaCenter comment I made earlier, as a sweeping market statement, we think there is a large opportunity which will be made up of many sizes of customer opportunities in this next shift in the network.

So while we are as excited about the opportunities in front of us at any one customer, and we believe we are making good progress, I am frankly even more excited by just the sweep of the market and how our customers and prospects are perceiving it, and I had a chance to get a visceral sense for that at the User Group in watching the body language of how customers were responding to this. We are definitely on the right track.

Tim Quillin - *Stephens Inc. - Analyst*

Perfect, thank you very much.

Operator

(Operator Instructions). Mr. David Allen, there are no further questions at this time. Would you like to make any closing remarks?

David Allen - *Calix, Inc. - Director of IR and Treasurer*

Thank you, Operator. Calix will be participating in three investor conferences in the fourth quarter, the Stifel Midwest One-on-One Conference on November 13 in Chicago; the UBS Global Technology Conference on November 18 in Sausalito, California; and the Goldman Sachs US Emerging/SMID Cap Growth Conference on November 20 in New York City.

We look forward -- information about these events will be posted on the events page in the investor relations section of calix.com.



We remain focused on executing against the opportunities ahead of us and we look forward to meeting with you at one of these upcoming events. Once again, thank you for joining us today and goodbye for now.

Operator

This concludes today's conference. Thank you for your participation. You may disconnect your lines at this time.

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