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CALX - Q2 2015 Calix Inc Earnings Call

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PRESENTATION

Operator

Greetings and welcome to the Calix second-quarter 2015 earnings conference call. (Operator Instructions). As a reminder, this conference is being recorded. It is now my pleasure to introduce your host, Tom Dinges, Director of Investor Relations for Calix. Please go ahead sir.

Tom Dinges - *Calix, Inc. - IR Director*

Thank you, Kevin, and good afternoon everyone.

Before we begin the call, I want to remind you that this conference call contains forward-looking statements regarding future events, including but not limited to the size of our follow-up set of opportunities, the long-term growth prospects for Calix, expectations for the next quarter, development of new products that will continue to help our customers transform their networks, the future business and financial performance of the Company, and expectations of revenue, gross margin, operating expenses, litigation expenses, earnings per share, stock-based compensation, and amortization of intangibles. These forward-looking statements are based on estimates, judgments, current trends and market conditions that involve risks and uncertainties that may cause actual results to differ materially from those contained in the forward-looking statement. I would encourage you to review the Company's various SEC reports, including our most recent annual report on Form 10-K and our quarterly report on Form 10-Q to be filed shortly after this conference call and available on www.SEC.gov in which we discuss these risk factors. All forward-looking statements are made as of the date of this conference call. 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 a non-GAAP estimate to enable interested parties to evaluate our performance in the same manner in which we evaluate our own operation. 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 expense, acquisition related expenses, if any, and amortization of acquisition related intangible assets. To help you better understand these results, we have included a reconciliation of our GAAP and non-GAAP results in our earnings press release. All numbers that are discussed 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 Calix's President and CEO, Carl Russo. Carl?

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

Thank you Tom and good afternoon everyone. Joining me on today's call is William Atkins, our Executive Vice President and Chief Financial Officer. I am going to say a few words about how the second quarter progressed before handing the call over to William who will take you through the numbers in greater detail. I will then spend some time giving you our views on how we see the access market developing in the near and longer-term as well as how we are positioning Calix to take advantage of these trends.

We saw business momentum increase throughout Q2 driven by strength across our tier 2 and tier 3 customers, resulting in revenues of \$99.1 million. On the product side, we saw strength across all of our offerings while our GigaCenter solution had another strong quarter of growth with the platform now in the hands of more than 300 service providers in just its third quarter of availability. Gross margins of 51% were a new record for Calix as our customers continue to value our unified access solutions. I will revisit this and other developments after William takes you through the quarter more detail. William?

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

Thank you Carl. We last provided you with guidance regarding Q2 on April 28 and in that guidance, we estimated revenues of between \$94 million and \$98 million, a gross margin of between 48% and 49%, and operating expenses in a range of \$48 million to \$49 million, thus resulting in an EPS of between negative \$0.06 and negative \$0.02 per share. Actual revenue for the quarter was \$99.1 million and EPS was \$0.06 per share with revenues above the top end of our guidance and earnings per share also above guidance. We incurred a relatively low level of expenses in relation to our Occam litigation and EPS would therefore have been at the same \$0.06 per share level after taking into account litigation expenses. While there will be quarterly fluctuations in this trend, we continue to expect gross margin to grow over time and we were pleased with Q2's 51% level above our 48% to 49% guidance range and the first time in Calix's history that we have recorded a gross margin in excess of 50%. Product and customer mix contributed to this outperformance. And Q2's gross margin was also up significantly from Q2 2014's 47.7% level.

Operating expenses came in at \$47.3 million, below the bottom end of our \$48 million or \$49 million guidance range and up \$5.7 million from the same quarter a year ago with this year-over-year increase primarily due to additions in headcount, particularly in research and development. We only recorded \$0.1 million of Occam litigation related expenses in the quarter with operating expenses therefore being \$47.2 million without taking into account these costs.

Q2 was cash generative with a \$1.7 million increase in the aggregate balance of cash and marketable securities. We ended Q2 with a total of \$99.5 million, up from Q1's \$97.8 million figure. On a year-over-year comparison, the \$99.5 million level for Q2 2015 was up \$20.2 million from Q2 2014's \$79.3 million equivalent.

We used our share repurchase program to return a total of \$3.4 million to shareholders in the roughly two months since we announced the program. We expect to continue to repurchase Calix shares. We also expect to be operating cash flow positive in Q3 and for the rest of the year.

Revenues for the quarter were \$99.1 million, an increase of \$1.1 million or just over 1% higher than last year's second-quarter level of \$98 million. We saw some timing shifts as well as weakness in a few geographies, which contributed to international revenues being \$7.5 million in Q2, down from \$12.6 million in Q2 2014. International revenues were 8% of Q2 total revenues and 9% of first half total revenues. We had one 10% customer in the quarter.

Turning now to our balance sheet, receivables DSOs remained at the same healthy 37 day level as in the first quarter and were broadly in line with our 38 days per quarter for Q2 2014. Inventory levels increased very slightly to \$40.7 million in Q2 2015 from Q1's \$40.6 million level. And we are down from \$45.9 million in Q2 2014. Inventory trends increased to 4 times in Q2 from 3.6 times in Q1 and also increased slightly from Q2 2014's 3.9 times.

The Q2 deferred revenue balance was \$28.5 million, the same level as for Q1, with this zero to minimal change reflecting our closeout of broadband stimulus projects in the quarter. As per federal government guidelines, all broadband stimulus projects have to be completed by the end of July.

At this stage of the year, it's worth pausing to review how Calix performed over the first half of 2015 relative to the same period last year. First-half 2015 revenues increased by \$6.3 million to \$190.2 million, or up 3.5% from last year's \$183.8 million level. And gross margins came in at 50.1% for the first half versus 2014's first-half number of 46.9%.

Operating expenses increased by \$13.1 million to \$95.5 million for the half versus 2014's first-half level of \$82.4 million. After deducting Occam litigation expenses of \$1.9 million, the first-half operating expense figure would have increased by \$11.2 million to a \$93.6 million figure with last year's operating expenses remaining at that \$82.4 million level.

First-half 2015 earnings per share were breakeven and \$0.00 per share versus last year's first-half EPS of \$0.07.

Turning now to our Q3 guidance, revenues for the third quarter are expected to be in a range of between \$107 million in \$111 million with the resulting midpoint of \$109 million being up 3% from the \$105.8 million level achieved in Q3 of 2014. Gross margins are expected to be broadly in the same range as they were in Q2. We are guiding to a 49% to 50% range for Q3, up from last year's Q3 level of 44.8%. Operating expenses are expected to be in the range of \$50 million to \$51 million, up from last year's Q3 level of \$42.7 million. Occam litigation related expenses that will not be reimbursed by its insurers are expected to be approximately \$0.3 million.

The expectations I've just finished taking you through result in a guidance range for Q3 earnings per share of \$0.05 to and \$0.09 or \$0.06 to \$0.10 after taking possible Occam litigation expenses into account.

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

Carl Russo - Calix, Inc. - President, CEO

Thank you, William. Our sole focus at Calix is to address the coming transformation in the access infrastructure market. The current network transformation driven by the device enabled subscriber connecting to content and applications in the cloud will continue to accelerate. This transformation is inevitable and there is no going back. The GigaCenter product family is just one example of this and over these last three quarters, we have given you an approximate customer take-up rate as a proxy for its growth. At well over 300 customers, it is now part of our ongoing business. And as such, I will no longer call it out separately.

This quarter, we also took the covers off of our G.fast and NG-PON2 initiatives. While material revenue contributions from these are farther out in the future, we are encouraged by the early signs we are seeing. As our resources are increasingly aligned with our unified access architecture offering, our research and development efficiencies will continue to improve and we believe we have the critical mass necessary to execute on our growth initiatives.

To be clear, we will continue to make the strategic investments necessary to drive our unified access architecture vision, which will enhance both our gross margins and our operating margins. Our confidence in our future remains high and we believe our stock offers significant value at current levels, and we will continue to repurchase our stock.

Before I turn the call over for questions, I would like to take a moment to shed some light on why Calix is so well-positioned for the future. Today, the industry is abuzz with the concepts of software defined networks and network function virtualization. SDN and NFV are concepts that are currently driving significant change in the data center. Make no mistake, these concepts will ultimately affect every networking market sector from

the data center all the way to the subscriber's device with each market affected differently. This will drive a shift in the value ratio between software and hardware and this is precisely what our SXA and EXA software has been architected to do.

The GigaCenter is just the latest example of a platform designed to take advantage of this value shift. Our ability to capitalize on this value shift from hardware to software over the long term has been the fundamental reason why our gross margins have gone from 35% over just six years ago to over 50% today. In short, we believe the coming SDN/NVF driven changes in the networking space are ideally aligned with our founding vision of one unified access infrastructure that seamlessly connects the device enabled subscriber to the content and applications they require in the cloud.

With that, I would like to open the call for questions. Kevin?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Paul Silverstein, Cowen and Company.

Paul Silverstein - Cowen and Company - Analyst

If I could ask two questions if I may. One, Carl, clearly the gross margin was very strong and I think I heard in the guidance that on the one hand I thought you said consistent with Q2 but then in the next breath, no shame here, but I think you said you are guiding for 49-ish%, something in that range. The 51.5% was extraordinary. Can you discuss the strength of that gross margin and what we should expect going forward? I heard you say you expect further uplift, but are we now looking at potentially even better than that over the long term?

And then other question is with regard to revenue. What are you most optimistic about and what are the biggest risks on the downside from a longer-term perspective, for not just the coming quarter but as we look out over the next 12 months or so?

Carl Russo - Calix, Inc. - President, CEO

Okay, did you say two questions or three Paul, just to make sure?

Paul Silverstein - Cowen and Company - Analyst

However you like to consider those statements.

Carl Russo - Calix, Inc. - President, CEO

Okay, you didn't have a third? --

Paul Silverstein - Cowen and Company - Analyst

I apologize. I did not have -- I have plenty of other things, but I want to be respectful of other people on the call.



Carl Russo - Calix, Inc. - President, CEO

Okay. So I'll answer your first question first and then before I answer the second one, I want William to make a comment. In my prepared remarks, the gross margin, as you know, in our company has been a trend over many years and what's continuing to drive it is the software content and the value that that software delivers in our architectures to our customers. So I expect this trend to continue but it will do so in a noisy fashion, but you can draw a trend line through it pretty straight. And again, it's driven by our EXA and SXA architecture. William, do you have comments on maybe some of the details?

William Atkins - Calix, Inc. - EVP, CFO

Yes, in terms of the details, we obviously came out with 51% and we're talking about 49% to 50% for Q3. But remember that guidance is creeping up 1 percentage point from the last time we issued guidance. So we continue to be confident that we're going to get to over 50% gross margins and we are very much on that trend although there will be quarterly fluctuations.

Specific to that, Paul, in this last quarter, we just had some timing shifts in some customer revenues which gave us a slightly richer share of that gross margin in Q2 relative to what we anticipate for Q3, but we see the overall trend is going up and so that essentially is what's going on there under the hood.

Carl Russo - Calix, Inc. - President, CEO

And then on the revenue piece, Paul, let me start by saying what I'm most optimistic about on the revenue side is the fact that our value proposition reflected in our gross margins continues to go up and that allows us to stay really focused on our growth initiatives. So let me break them down.

Obviously, first, I said I will stop talking about it as a separate item, but the GigaCenter as a proxy for what we view as the converged unlicensed wireless subscriber edge. It's obviously very exciting for us going forward.

Right behind that, one of the investments that we outlined last quarter which is still out in front of us but closer in is G.fast and the level of positive feedback we're getting from prospects and customers on that technology. And I wouldn't go beyond that on the product side.

And then on the customer side, it's a matter of, as we continue our channel expansion and new customer efforts, we continue to put a lot of pins on the map and so our brand continues to broaden. So those would be the three dimensions that I would say I'm most optimistic about.

As far as my biggest fear, the secular trends that are driving what we're doing, there's nothing that's going to stop them other than something that in my mind is a macroeconomic malady, and we've certainly seen that in the past. Other than that, there's nothing I see that would be anything that we would worry about.

Paul Silverstein - Cowen and Company - Analyst

Carl, given the size of CenturyLink in this VSL vectoring project they are discussing -- and I know it doesn't appear that VDSL vectoring has been a big focus of yours historically -- does that present particular -- on the downside of the equation, does that present particular risk to Calix?

Carl Russo - Calix, Inc. - President, CEO

By the way, good question, and it seems to be a bit of a misconception, and maybe I am the chief progenitor of it, I don't know. Vectoring has been a focus of ours since vectoring showed up. We have been delivering vectoring technology into the market for actually over two years. We don't talk about it much, but we have been doing it for over two years and have continued to expand and enhance it.

As far as any customer that wants to do it, we stand ready to do it. And obviously, in our largest customer, we would certainly be ready to deliver it if that's the way they want to go. And they're obviously evaluating their access investments as they look out into the future with their new Chief Technology Officer, Aamir Hussain.

Paul Silverstein - *Cowen and Company - Analyst*

I will pass it on. Thanks guys.

Operator

Amitabh Passi, UBS.

Amitabh Passi - *UBS - Analyst*

I had a couple of questions just on the model and then one bigger picture question for you, Carl. William, I wanted to start with gross margin again. Apologies to beat up on that point, but just on the last three quarters, I think from 4Q 2014 to 2Q 2015, you've now seen about a 300 basis point expansion. I know you have called out customer and product mix, but it seems like there's something more structural that has changed in the business just in the last two to three, four quarters. Maybe you can just help elaborate -- I mean give us a little more insight I think just in terms of the expansion and the sources of the expansion there.

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

Sure. And I'm going to steal a little bit of Carl's thunder here both from his prepared remarks as well as to the answer he gave. Essentially, as a result of the R&D investment that we've been making, particularly in what can be broadly described as the operating system side of the business, that has showed through to sustained gross margin improvement within our products. And we see those products that reflect that investment becoming an increasingly large portion of our revenue. So that's what's going on when we talk about improving product mix.

And then in terms of customer mix, it's simply a question of some lower margin customers simply not generating the revenues that we had expected in the quarter. But note that I'd say that's a timing shift and we still believe those revenues are going to come in and we're confident they're going to come in, but they are just simply shifting from Q2 to Q3. And that's why we are careful to emphasize that there can be some choppiness in this onward progression to greater than 50% gross margins.

Amitabh Passi - *UBS - Analyst*

Okay, got it. And then Carl, maybe just a couple of big questions -- bigger picture questions for you. I think, one, media was recently reporting about Huawei being incrementally focused on the smaller carriers in the US, particularly with their fiber offering, so I wanted to ask you about that.

And then just secondly, AT&T, I think it was John Donovan at the Open Networking Summit that spoke about disaggregating GPON OLTs and building them on commodity hardware. I would love to get your thoughts on that as well.

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

Obviously, from a competitive standpoint, I think we remain a forceful competitor anywhere we compete and certainly in our incumbent footprint, we certainly hear lots of drum banging. I'm not sure I would say that we see necessarily lots of penetration behind that, so hopefully that helps you understand that one.

As far as AT&T's comments on disaggregating GPON and things of that nature, I wouldn't speak specifically to what Mr. Donovan had to say or their intent, but I would frame it in what I was discussing in my prepared remarks. SDN and NFV as concepts are setting up for a roiling in the data center. And that change is going to roll straight through the network all the way out to the device. How it affects each space, however, will be different.

As an example, let's look at the data center and look at a completely abstracted hardware environment where you have pools of resources that you can draw from. As soon as you go into the access network, well, you don't have pools of resources because you have single lines that go out to the subscribers.

So it doesn't mean those concepts can't be applied, but it will be slightly different than the way people may think. However, the concepts that I think Mr. Donovan was speaking to are concepts that we would agree with in general.

Amitabh Passi - UBS - Analyst

Excellent. And then may I just ask one quick follow up again, maybe for you, William. Just on OpEx, you guided \$50 million to \$51 million. Should we expect a gradual creep or trending up as we progress through the year or would you again expect things to maybe trend back down as we move towards 4Q and beyond?

William Atkins - Calix, Inc. - EVP, CFO

Yes, we don't, as you know, Amitabh, guide out more than one quarter. So what I would say is more a broad declaration of corporate intent, which is that, over time, you're going to see operating leverage emerge in the business. You are already seeing it happen at the gross margin level and you will over time see that happening at the operating level as well.

Amitabh Passi - UBS - Analyst

Okay, excellent. Thank you.

Operator

Simon Leopold, Raymond James.

Simon Leopold - Raymond James & Associates, Inc. - Analyst

First, a modeling question that kind of follows up on Amitabh's last question, because when I look at the guidance for operating expenses in September, roughly a \$3 million rise for September -- the June quarter was lower than what we expected. So, I guess one of the things I would like to try to understand from you is how much of the spending trend between the two quarters are reflective of timing issues as opposed to more general trending spend?

William Atkins - Calix, Inc. - EVP, CFO

That's a great way to phrase the question because you are wrapping it entirely correctly, which is it's both a mix of how we performed a little bit better than guidance and also how we are seeing the quarter shape up for Q3. And inherently implied in there is exactly what you've highlighted, namely a timing difference.

As we've noted, headcount and personnel expenses are an important part of our OpEx with R&D being an important part of those. And inherently, if you simply don't hire as quickly, for example, that can feed into some of these timing differences. There are also some elements that you can

only predict on an average basis. Travel and entertainment can fluctuate from quarter to quarter, things along those lines. But I would characterize it essentially as a timing shift, exactly the way you framed your question.

Simon Leopold - *Raymond James & Associates, Inc. - Analyst*

Great, thank you. And then in the past, you've talked about the CAF II program as while certainly a potentially nice tailwind for your business, you would look at it as largely substitute CapEx and not necessarily a material driver for revenue growth. More recently, some of your competitors have found it very bullish, talking about it as really incremental CapEx. And I would like to revisit your views on the government's CAF II program.

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

So Simon, William and I are both looking at each other like do you want to go first, do you want me to go first? So I will go first. My words on this will be as follows.

Look, we are excited by CAF II. We've been -- as you know, you're a long-term follower of the Company. We have talked about the rejiggering of the USF fund and getting it to broadband, and so we're here. It's an exciting program. We view it as a funding source that is not necessarily going to be incremental. And we are resolute in that belief today, having lived through broadband stimulus where, as you well remember, there was much hype, lots of discussion, and it openly turned out to be, frankly, substitutive of funding source, maybe a little bit of a pull-forward, but not sustainable. It may turn out that it's incremental. But in our view, and certainly my view, it is best to treat it as in fact a funding source and not incremental. There's a whole bunch of reasons for that, not the least of which is just simple bandwidth of people and how much can you get done in the macro sense.

So that's my view. We are excited about it. Our customers are excited about it, lots of work going on, but it is right now viewed as a funding source. William, any color you want to add?

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

No, I think you hit the nail on the head, Carl. That's exactly what our stance is on this.

Simon Leopold - *Raymond James & Associates, Inc. - Analyst*

Okay, Carl, one last question which I imagine you won't like but I will try it anyway. We pay a lot of attention to your top customer and the patterns there. Just trying to get a sense of your feeling as to how you are trending share-wise, your market share at your top customer versus your primary competitor. We tend to get a lot of noise around this, and I would like your perspective on how you see market share moving with your top customer.

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

We don't speak about it going forward, so I appreciate the caveat of not liking it. If not liking it is metaphor for not answering it, then answer is that's correct. I won't answer it going forward, but I will point you backwards and say that there's been noise over that customer ever since the dawn of time with Calix. And over the last five years, pardon my euphemism, but we've been losing market share for the last five years, starting at 29% and ending at 51%.

So we're going to keep executing with our head down and continue to make sure that we do our best for our customers and help them win. And at the end of the year, when the Ks are filed, we will go sort it all out. But directly, we believe we are doing the right things for our customer and helping them succeed. Hats off to Aamar Hussain who is their new Chief Technology Officer. He's got a lot of things to go corral in a company that has built itself very rapidly through acquisition. He's got a lot of mouths to feed and a lot of strategic alignment to do, but in no uncertain terms we believe we are well-positioned to help that customer succeed.

Simon Leopold - *Raymond James & Associates, Inc. - Analyst*

Great. And one last big picture, you talked a bit in your closing comments about the gross margin improvement and you talked about NFV and SDN coming to affect your business. Presumably, this is not affecting your business. It was not part of the 51% gross margin. This is much more of the prospect of a higher margin contribution in maybe 2017 and beyond. Is that the right way to think about your comments?

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

So the answer is yes, but I want to add one piece of color to it because we have always viewed the access infrastructure as it moves towards a unified access infrastructure as slowly devaluing hardware. That doesn't mean not valuing hardware, just devaluing it. And actually a greater percentage of the value add is driven by specifically your software architecture. So actually historically the way we have thought about things has driven that margin expansion. My comments were intended to help everyone understand that, actually, as we look at SDN and NFV, it's a continuation of those trends. But to your point, that's in front of us, not behind us.

Simon Leopold - *Raymond James & Associates, Inc. - Analyst*

Great. Thank you for taking my questions.

Operator

George Notter, Jefferies.

George Notter - *Jefferies LLC - Analyst*

I wanted to ask about GigaCenter. If I remember correctly, last quarter, you said you had 200 customers, that GigaCenter was immaterial to total revenues. Is that product line still immaterial to revenues?

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

No.

George Notter - *Jefferies LLC - Analyst*

Okay.

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

So if your question is -- and so my answer -- you phrased it in a negative. It's not immaterial. So let me state it differently. Once we got past 300 and some other things that were going on, it is now obviously a part of the business. We're not going to call it out separately anymore.

George Notter - *Jefferies LLC - Analyst*

Okay. And then I guess this begs the next obvious question. What's the threshold for materiality inside your Company? Is it 5% of revs, 10% of revs? How do you think about it?

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

I don't, and as near as I can determine, with terms like significant, material, and other words that go around, they seem to have somewhat of a whimsical definition. The best I can give you, George, is it's a functioning part of the business now and growing.

George Notter - *Jefferies LLC - Analyst*

Okay. And then I guess maybe a more interesting piece of it, if you go back to the 200 customers you had exiting Q1, I guess I'd be curious what their reorder rates have looked like, how many of those guys are coming back to buy more product and are now pulling in commercial volumes as opposed to trial testimonies?

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

Yes, so I tried to paint a picture last time of our earliest customers startup. Every customer goes through a maturity curve. The earlier ones are now in deployment phases. The later ones are still working through those phases and it just continues to build. So you can draw that curve yourself I think.

George Notter - *Jefferies LLC - Analyst*

Okay. And then any more commentary about the international business? Obviously, it was quite a bit smaller than it's been in recent quarters. What's the factor there?

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

So my commentary strategically is as, we've noted in the past, it's going to be noisy as you push into a new market. As we refocus and have settled down in essence the way we're going at international, we remain committed to that market. However, I think William would allude to some timing pieces set around some orders. And it doesn't take much to sort of move it around noisily. I just want to make sure strategically I make it clear we are committed to the markets that we are expanding into. William, do you have anything to add?

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

Yes, the only follow-on comment I would make about international is we've already addressed the timing shifts, quarter end, etc., but as I think I've said to people in the past, this is going to be a game of inches internationally. I think that it's going to be a question of simply improving our dots on the map so to speak. Last year was investing in a global network and now, going forward, it's all about extracting value out of that global network of direct sales as well as sales to our resellers. So we are committed to it and we recognize it's going to take time.

George Notter - *Jefferies LLC - Analyst*

Thank you.

Operator

(Operator Instructions). James Faucette, Morgan Stanley.



James Faucette - Morgan Stanley - Analyst

I wanted to circle back on the CAF and subsidization programs. Some of the other vendors in the space have said that they saw a surprising amount of CAF I activity here in the June quarter. Did you see anything like that that helped contribute to your outperformance firstly?

And then as we look forward, I fully appreciate and I think it's right, the prudent view you are taking of CAF II as just a different funding source, but as those funds become available, is that impacting at all design or evaluation activity, etc., such that you can start to get a view into how your customers are going to behave around the roll-off and roll-on of those funding sources?

Carl Russo - Calix, Inc. - President, CEO

So James, let me go to your CAF I question first. As you may remember, CAF I was actually small compared with CAF II. And so we've certainly seen activity that was related to CAF I but nothing that I would cite as causing any outsized issues inside of this quarter's performance or our current forecast for next quarter.

As for CAF II, I guess the way I would phrase this, and William, I ask you to add some color, is it is certainly helping us with visibility and obviously -- well, frankly, what you all have modeled and picked up on, which is this backend loaded year more weighted towards the second half than the first half. We are clearly seeing more visibility and thus our forecast for Q3. William, do you want to add any more do that?

William Atkins - Calix, Inc. - EVP, CFO

No, I think you're pretty much hitting the nail on the head, Carl. That's about it.

James Faucette - Morgan Stanley - Analyst

Great, thanks. And then looking at GigaCenter and some of the newer initiatives there, you've been pretty consistent in the transitions that you've talked about and how you expect those to improve your margin. Is GigaCenter and some of the newer projects at the stage of being margin accretive already or should we expect that there is some sort of ramp and maturation phase at the peaks of those cycles, etc., and that's when you get the most margin impact? I'm just trying to understand how much the margins can move as you continue to expand the product portfolio and if adding new products tends to be margin accretive out of the gate.

Carl Russo - Calix, Inc. - President, CEO

So, as you get smarter, your product market gets tighter and your margins on those products go up. I'm not going to speak to any one product and its gross margin, so let me generalize it first and then I want to come back with a slightly different cut at this, if you will bear with me.

On GigaCenter, GigaCenter is built on the EXA platform, which I mentioned earlier is the architecture that has been helping us drive greater value to our customers in the form of service velocity for them to their customers and a lower cost of running the networks. This is a continuation of that theme. So you can sort of -- I will let you reason through that.

And the second piece is I would ask you to sort of correlate two things. One is obviously an increasing mix of GigaCenter in our numbers, but also our margins, if you will, not going down. So I guess that's sort of the double negative, because it's likely not either below or significantly below where our corporate average gross margins are. So I'd hate to be a double negative in answering your question, but I wouldn't point any further than that, if you will forgive me James. Anything you want to add, William?



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

Yes. What I would say is, look, we've been saying GigaCenter sales have been increasing. We've also stated that the subscriber edge sales are customer premises, and those sales, have been increasing as a portion of our revenues over time, and our gross margins have been increasing over time. So inherently, therefore there must be a meaningful aggregate margin contribution delivered by this product that's better than what we have before.

James Faucette - *Morgan Stanley - Analyst*

I appreciate that. That's really helpful (technical difficulty) how intelligent I am and improve my margins over time too, thanks.

Operator

Sanjiv Wadhvani, Stifel.

Sanjiv Wadhvani - *Stifel Nicolaus - Analyst*

Carl, I just wanted to clarify on CAF II, I just wanted to clarify that that starts in 2016 and I think it's through August when those providers have to accept those funds. So I just wanted to clarify that.

And then broadly on CAF II and including CAF I actually, I think one of your competitors talks about a services component over there. Just curious whether that is part and parcel of some of these deals or whether you are involved in any of those services requests from service providers. Thanks.

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

Good question, Sanjiv. So first and foremost, on CAF II, you're correct. We view it as a 2016 and beyond effect. You may see some early things, very early things, happening late, late, late December 31st sort of thing this year. The acceptance date is August 27, so roughly a month hence from now, so you have that right as well.

As for the services component, as I know you are aware, we have a professional services and a consulting services organization. The professional services organization basically helps our customers with an end-to-end deployment of our products should they require that. That's very different than just sort of our run-of-the-mill turf sort of contracts, go out feet on the street contracting environment. That is not business that we would do.

So to bring that together to your question, where our customers want to, in essence, outsource the building of something in their network, whether it's CAF II or not, and they want us to do it end-to-end with our systems, that is something that we do already today. If they were looking for us to go out and do general installations on someone else's products, we do not do that. Does that help?

Sanjiv Wadhvani - *Stifel Nicolaus - Analyst*

That's helpful. And just the overall margins on professional and consulting services are pretty much in line with the corporate average, or where do they kind of stack up?

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

So I'm, again, going to be careful about breaking this out. At the end of the day, here is a way of thinking about it. Very clearly, consulting services probably have a higher margin than professional services and professional services have a higher margin than anything that would look like a bid

master or feet on the street sort of turf contract. So all-in, we're going to do what we believe delivers high value for our customers, but I would be very careful about answering your question directly about what the margins are per se.

Sanjiv Wadhvani - *Stifel Nicolaus - Analyst*

Okay, that's helpful. Thank you.

Operator

(Operator Instructions). Aaron Fogle, Stephens.

Aaron Fogle - *Stephens, Inc. - Analyst*

This is Aaron filling in for Tim. I just had a few quick questions. First, international revenue was down and I know you all touched on that earlier, and it sounded like perhaps there are some push-outs. I was wondering if you could provide any color on the outlook for the rest of the year, if that changes anything.

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

Well, Aaron, it's William here. First of all, as I've noted, there are some timing elements to that, so international did get pushed out. But for the half, obviously we're showing it 9% or so of total revenues, which is below where the equivalent would have been, say, a year ago. Going forward, we don't specifically breakout revenue components out in our guidance, but we remain comfortable with where the international business is trending. That's pretty much all I can say there.

Aaron Fogle - *Stephens, Inc. - Analyst*

Okay. And then I guess my second question is around the seasonality. So typical seasonality kind of suggests a sequential revenue increase in 4Q. Is there anything this year that we should expect differently? Do we still expect that same type of seasonality this year?

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

Well, what I would say is that as recently as in 2013, we actually had a downshift from Q3 to Q4, so what I would say is that we are certainly seeing the second half being stronger than the first half, very much in line with what you and your colleagues have observed from us and our competitors.

But the second point I would make is that, if you take the aggregate of the Street's projections for example, if you look at our own historical performance, this is shaping up to be a relatively backend loaded year and it's just in that sense a bit of an unusual environment. But I don't think I want to call Q3, Q4 as being upward sequential. The fact of the matter is you can have a stronger second half than a first half without having that take effect. So I'm not going to call that. I don't know, Carl, if you want to talk at length about any of these --

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

Well, your guidance forecasts Q3 up, I know that.



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

Yes, exactly, that's all I'm doing.

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

So Aaron, no more color than that, if you would, please.

Aaron Fogle - *Stephens, Inc. - Analyst*

Got you. All right. Thank you. And then the last one I have is on -- I know you expect operational leverage over time, but should we expect OpEx to grow more slowly than revenue in 2016? And that's it for me. Thank you.

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

The short answer is that, over time, we're going to have OpEx diminish as a percentage of revenues. I'm not going to call specific quarters, but that very much is our goal.

On the gross margin side, Carl was talking about how we are already setting ourselves up for SDN and NFV and how that's feeding through already into our gross margin outperformance if you will, given the change in our product mix. And that is therefore going to follow through into operating expenses. I don't know, Carl, if you want to talk more broadly about this.

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

Well, actually, that's a good segue. It brings me back to the point I made earlier about EXA and SXA and what it does for our customers from a service velocity standpoint and a lower cost of running the network.

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

Yes.

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

Actually, it also has those same effects internally. It actually gives us great leverage from an R&D standpoint and lowers our costs as well. But you have to see the benefit of that over time. So I think William's words are correct and over time, I think we will achieve the effect that you're looking for.

Aaron Fogle - *Stephens, Inc. - Analyst*

All right. Thank you.

Operator

Amitabh Passi, UBS.



Amitabh Passi - UBS - Analyst

Hey, William, just a quick question on the buyback. I guess I would've expected you to be a little more aggressive this quarter. I was just curious. You bought back \$3.4 million of stock. I think you have \$40 million authorized. I just wanted to get your thoughts in terms of how we should be thinking about the buyback cadence.

William Atkins - Calix, Inc. - EVP, CFO

Yes, I've got it. I would say that, on the buyback, remember, we only -- we announced the buyback roughly a month into the quarter because that's when our results call takes place. So you've got to divide that number and basically increase it until you get to three divided by two to get to almost \$6 million, not quite \$6 million obviously in terms of the number of the trading days in the quarter. So that's a pretty good representation of the kind of buyback volumes that we've been doing, and that's a pretty good representation of our intent for the future. I don't want to call it quarter-by-quarter, but as Carl noted I think a couple of times in his remarks, we do intend to continue to repurchase shares.

Amitabh Passi - UBS - Analyst

Okay. Thank you. That's all I wanted to clarify.

Operator

Thank you. We've reached the end of our question-and-answer session. I'd like to turn the floor back over to management for any further or closing comments.

Tom Dinges - Calix, Inc. - IR Director

Thank you Kevin. Calix will be participating in the Jefferies Semiconductor Hardware and Communications Infrastructure Summit on the 25 and 26 of August in Chicago as well as participating in a number of investor meetings during the third quarter. Information on future investor events will be posted on the events page in the Investor Relations section of calix.com. We remain focused on executing against opportunities ahead of us, and we look for to meeting with you at one of these upcoming events. Once again, thank you for joining us today. Goodbye for now.

Operator

Thank you. That does conclude today's teleconference. You may disconnect your lines at this time and have a wonderful day. We thank you for your participation today.

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