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CALX - Q4 2013 Calix, Inc. Earnings Conference Call

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PRESENTATION

Operator

Greetings, ladies and gentlemen. And welcome to the Calix fourth-quarter and fiscal year 2013 financial results conference call.

(Operator Instructions)

As a reminder, this conference is being recorded. It is now my pleasure to introduce your host David Allen, Director of Investor Relations and Treasurer for Calix. Thank you, sir, you may begin.

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

Thank you, operator. 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 funnel of sales opportunities; the 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; the 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 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 quarter report on 10-Q for the period ending September 28, 2013, available at www.sec.gov, in which we discuss these risk factors. All forward-looking statements 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 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 those results, we have included a reconciliation of our GAAP and non-GAAP results in our 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 Calix's website at www.Calix.com. In addition, our press release, along with supplemental financial data has been posted to the investor relations section of the Calix website, which you may want to review in conjunction with our press release and our 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 and CEO*

Thank you, Dave. And good afternoon, everyone. We have a lot to talk about today.

In the last two weeks we issued two key press releases. The first was announcing an entirely new solution offering from Calix. The second and most recent was the announcement of Michael Ashby's retirement and William Atkins joining as our new EVP and CFO. I am happy to say that both Michael and William are here with me today.

Michael has been committed to Calix for over 11 years, as an early private investor, as a member of the Board of Directors and as EVP and CFO. As many of you may know, I asked Michael to come out of retirement three years ago to help us after our IPO. I want to personally thank Michael for his many contributions to Calix over the years. He will be missed.

However, as you can see in the press release, Michael is serious about his retirement this time, as he will be stepping out of both his operating and board roles. But before we have a retirement party for Michael, he has agreed to work with William and me for the next six months, first as Principal Financial Officer and Principal Accounting Officer, until the end of this month. And then Michael will convert to an executive advisor until the beginning of August.

Michael, we simply could not have gotten this far without you. Thanks.

I am extremely pleased we were able to identify and recruit the right CFO for the next stage of Calix's development and growth. William's experience as CFO and background with both large and small public telecommunications companies will serve Calix well as we continue to build a stronger company, and continue to bring unified access solutions to our expanding customer base.

Rather than me tell you about William, please allow me to let William tell you about himself. William?

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

Thank you, Carl. As today is my second day on the job, I am going to be brief. I am excited to be joining Carl and his colleagues at Calix, and to participate in what are some pretty fundamental changes that are sweeping through the telecommunications sector.

I have been looking to join a company that is positioned to take advantage of and to lead the transformation of telecommunications networks in a bandwidth-hungry world. This trend is not going to slow down any time soon. And what Calix is doing in access networks positions the Company perfectly to be the key player in this space.



I spent over two decades as an operator, investor and advisor in the telecom space, and I couldn't be happier to be joining Calix. I am grateful for all the work that Michael Ashby and his finance and legal team have done in helping to establish the platform for the Company's growth. And I look forward to continuing to build on that platform.

With that I'll hand it back to Carl. Carl?

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

Thank you, William.

On our conference call on October 29, we indicated that Q4 results were going to be lower than we had thought earlier in the year due to a lack of year-end budget flush spending. In fact, the magnitude of the shortfall turned out to be larger than we thought when we gave that guidance, as a number of customers realigned their Q4 spending with their budgets.

As we evaluate the market and the results of companies in our space, it is clear that a chilly wind blew through the larger customers in the North American market in Q4. As you will hear later, those effects will continue into Q1 and then mitigate. Having said that, our funnel of opportunities is the largest it has ever been. And we are launching an entirely new product solution into that upswing in activity.

Actual Q4 revenue of \$94.0 million and \$0.03 of EPS were consistent with the revenue and EPS range we provided when we announced preliminary Q4 financial results on January 8. More importantly, we do not believe that the actual Q4 spending levels are indicative of a change in our customers' project plan, our competitive position, or our growth opportunities going forward.

For the full year Calix achieved record sales in 2013, up 15.9% over 2012. Our non-GAAP gross margin improved for the sixth year in a row to 47.3%, up from 34% back in 2008. And we generated positive cash flow from operations for the fifth year in a row, \$40.8 million in 2013.

After Michael has gone through the details for Q4, I will come back and provide our Q1 guidance and share with you some thoughts on the coming year. After that we will open up the call to your questions. Michael?

Michael Ashby - *Calix, Inc. - Principal Financial Officer & Principal Accounting Officer*

Thank you, Carl. I also want to welcome William to the Calix team. And thank William for allowing me to resume my retirement which Carl interrupted three years ago.

Before commenting on the quarter, I would like to say that while I am retiring from Calix, I remain a large shareholder in the Company, and continue to believe in the long-term growth prospects for Calix. While the ups and downs of telco capital expenditures make life somewhat unpredictable for companies such as Calix, I am a firm believer in the network transformation that Carl talks about. And I believe that Calix is the best-positioned company to take advantage of this transformation over the long term.

Now let's review our fourth-quarter results. As a reminder, the guidance we provided on October 29 for the fourth quarter called for revenue between \$97 million and \$103 million, gross margin between 46% and 47%, operating expenses in the range of \$43 million to \$44 million, and the resulting EPS between \$0.03 and \$0.08 per share.

On January 8 we announced that revenue for the fourth quarter would be between \$93.5 million and \$94.5 million, and EPS between \$0.02 and \$0.04 per share. Actual revenue for the quarter was \$94.0 million, and EPS of \$0.03 per share, both in line with our revised guidance. Gross margin was 45.2% and operating expenses came in at \$41.0 million.

We had another positive cash flow quarter. And Calix ended quarter with total cash of \$83 million. Revenue for the quarter was up 2.8% compared to the same period last year. International revenue was \$13.6 million in Q4, up 74.7% from Q4 a year ago. We had one 10% customer again this quarter.

Gross margin at 45.2% was a little lower than had been expected. This was primarily a result of the lower revenue and a different customer and product mix than we had originally anticipated. Operating expenses of \$41 million was lower than anticipated. This reflected both good control over operating expenses and a reversal of bonus accrual due to the Company missing its revenue plan.

Looking at the balance sheet, we ended the quarter with total cash of \$83 million, an increase of \$2.9 million in the quarter. DSO was 41 days, down from 46 days in the previous quarter. Inventory levels increased to \$51.1 million, while inventory turns decreased to 4.1 from 5.0 turns. The increase in inventory reflects the fact that we shipped less than planned during the quarter. The Company expects to reduce inventories in Q1, 2014. Deferred revenue was \$53.3 million, down from \$63.4 million from the prior quarter, reflecting the completion of a number of BBS projects that were recognized as revenue during the quarter.

Before I turn the call back to Carl for our guidance for the first quarter and his observations about our business outlook, I would like to point out that for the full year of 2013 revenue was a record \$382.6 million, up 15.9% over the prior year. Gross margin improved to 47.3%, up 290 basis points from 2012. And EPS increased to \$0.39 per share from \$0.15 per share in 2012. And we generated \$40.8 million from operations, up from the \$27.7 million we generated from operations in 2012.

So, while we are disappointed with the 2.8% year-over-year revenue growth in the fourth quarter, the year as a whole showed considerable improvement.

At this point I would like to turn the call back over to Carl.

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

Thank you, Michael. Let me now discuss our guidance for the first quarter of 2014. While the sequential seasonal decline from Q4 to Q1 has moderated in recent years, over the last six years we have averaged about a 20% sequential decline in revenue from Q4 to Q1.

While we are very encouraged by our prospects, which I will discuss in a bit, given the larger than expected weakness we experienced in the fourth quarter and the fact that a number of our customers are still setting their budgets, we want to be extra prudent in setting expectations for Q1. Therefore our guidance for Q1 is as follows.

Revenue range for the first quarter is expected to be between \$78 million and \$84 million. Gross margin is expected to come in between 45.0% and 45.5%. Operating expenses will be in the range of \$41.0 million to \$41.7 million. And the resulting EPS loss will be in the range of \$0.12 per share to \$0.07 per share.

Additionally, we expect DSOs to range between 45 and 50 days.

Inventories are expected to decline to the mid \$40 million range. Given the fourth quarter's reduced level of accounts receivable, we do not expect to be cash flow positive in the first quarter.

As for 2014 and beyond, allow me to reiterate that our current sales activity is at its highest level ever. And while we do not expect it to close in time to materially affect Q1, we do see a brightening throughout 2014. Our confidence is further strengthened by the recent announcement of our solution for the next generation of Ethernet-based access networks. Designed to meet the demanding service needs of cloud-based enterprises, future wireless infrastructure backhaul, and gigabit powered communities, this new offering has three key components.

First, Service Verify, a new Compass software application that allows communication service providers of any type to stay ahead of their most demanding subscribers through comprehensive proactive monitoring, management and marketing of performance-based services. Furthermore,



Service Verify uses intelligent, predictive techniques to allow the communication service provider to stay ahead of their subscribers by addressing issues before the service level agreement has been breached.

Second, the E5-520 and the E5-308 Ethernet Service Access Nodes are the latest extensions to our E series family. A natural complement to Service Verify, the E5-520 and E5-308 ESANS offers state-of-the art metro Ethernet form CE 2.0 compliance, an advanced timing support across multiple form factors and powering options. EXA powered for rapid turn-up and provisioning, the new E5s create a network infrastructure that is agile, nimble and responsive, enabling faster time to revenue for Calix customers.

The E5 nodes can also function individually or in complementary fashion as integrated service demarcation and aggregation switches in the network, creating powerful opportunities for CapEx and OpEx efficiency by eliminating the need for box-on-box deployments. And, last, Calix consulting service is helping our customers quickly deploy these new revenue-generating services in their subscriber offerings.

With global cloud IP traffic projected to increase nearly five-fold over the next five years, much of it driven by business-critical cloud-based applications, and mobile IP traffic projected to increase 13-fold over the same period, we believe we are expanding our addressable markets at just the right time. These clearly differentiated solutions target two of the largest market opportunities facing service providers around the world. As extensions to our unified access portfolio, these new solutions allow the winning service providers of the future to build the most powerful and efficient networks available in the market today.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

George Notter with Jefferies.

George Notter - Jefferies & Company - Analyst

Thanks very much, guys. I had a question about the guidance. I am wondering if there is any revenue that you are anticipating that would be held over from Q4 given the lack of budget flush that would maybe fall into Q1. And in that context it seems like the guidance is a little bit low, in my mind. But can you talk about just what you are assuming in terms of push-outs from Q4 to Q1? And then what you are assuming in terms of the timing of CapEx budget approvals. How is that really different this year versus prior years? And then also any thought regarding the weather patterns we have seen here in Q1. Is that impacting your outlook for Q1, as well? Thanks.

Carl Russo - Calix, Inc. - President and CEO

George, when you say push-out, I assume what you mean is -- Q4 was down so did they basically marshal their cash and revenue will show up in Q1. Am I getting your question right?

George Notter - Jefferies & Company - Analyst

Correct. I think you guys suggested you wouldn't see normal Q1 seasonality given the Q4 experience.



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

Yes, we initially thought that but the roll off continued. And so, no, we do not anticipate push-outs. The size of the funnel that we are seeing is actually sales activity for 2014 going forward. None of it represents activities from Q4 per se.

So, if you can imagine a funnel, even though the top of the funnel is the largest it's ever been, it simply takes time for that to make its way through to orders and revenue. And it is just too risky to think that it will materially affect Q1. So no push-outs from Q4. Did I clearly answer your first question?

George Notter - *Jefferies & Company - Analyst*

Sure, yes. And then also just curious about the timing of budgets. What's in your expectation there?

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

The budgets have clearly taken some time to get laid in in different customers. And we have seen a number of customers going through, frankly, strategic decisions as to how much of their budgets they're going to deploy where, and specifically to what technologies. So, we have seen a surprising number of mid-sized customers start to shift their budgets towards fiber-to-the-prem.

And we think that that's the strategic grappling that we have seen in all the larger customers. Some of them have made it through that decision process and some not.

As to the weather, look, I am not going to blame anything on the weather, but it's clearly been an interesting weather season. I'll leave it at that.

George Notter - *Jefferies & Company - Analyst*

Got it. And then the other question I had, I wanted to ask about the Ericsson relationship. I was a bit surprised you guys didn't really talk about it in your opening remarks. Can you give us an update there? Where are you in terms of the OS or element management system integration with the heritage Ericsson product? And then also give us a sense for where you are in terms of the sales and marketing effort. Thanks.

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

Sure. Sorry for the surprise. We are obviously just going to talk about international and the growth. And obviously, as you have seen, we grew more than 100% year over year.

To the specific thing I think you are asking about, which was the next release of the system going into the Ericsson sales organization, that is actually coming to CA here at the end of this month. And all signals are go. So, we are actually looking for robust growth in our international sales organization to continue in 2014.

George Notter - *Jefferies & Company - Analyst*

Got it, great. Thank you.

Operator

Simon Leopold with Raymond James.



Simon Leopold - *Raymond James & Associates - Analyst*

Great. Thanks. I just wanted to step back and think about the year as you see it shaping up. I think a couple weeks back, with your prior announcement, you talked about expectations to be able to grow by double digits in 2014. Now with the Q1 guidance in front of us do you still see the view that 2014 can be a 10% growth year, or are you rethinking that at this point? And then I've got a follow up.

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

Yes, I think that's precisely the right question to ask, Simon. Let me go back and tie out a couple of items. Largest funnel we've ever seen, launching new products that are going to expand product markets and customer segments, lots of activity. And I think we're set up for a good year. As a matter of fact, I think we are set up for a very good year except for Q1. And I think it would be imprudent for me to set your expectations that we're going to climb out of Q1 by virtue of the strength in Q2, Q3, Q4 and still grow at double digits in this year. We may, but I think it will be challenging.

Simon Leopold - *Raymond James & Associates - Analyst*

Okay. I am really looking for something beyond a year, but if we think about what we have heard over the last, let's call it, number of weeks to month or so about network neutrality and the cable operators raising their CapEx budgets, when you talk to your customers, how are they putting these issues into their plans, their strategies and ultimately spending with you? And when does it actually turn into your business? Does that question make sense?

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

It does. But our customers -- we are expanding our customer segments. So the way I would like to address this is to say the following.

How about if I tie it back to, for example, gigabit communities, of which I am sure you are aware there have been approaching some 20 announcements now of gigabit communities. And as you might imagine, we have a rather disproportionate share of those communities. That is, I think, the number one exciting thing that's got everybody's interest.

Now, there are different folks looking at it saying -- well, I don't have a gigabit community that I have to compete with so maybe I can wait. But everybody is starting to resonate around where the Internet is actually going. If you watch, for example you said net neutrality.

Let's take the FCC as a broader example. If you watch what Chief Wheeler has said, he is clearly looking at the Internet differently than his predecessor. The predecessor was on a 4 megabit, 1 megabit plan. They have come out and said 4 megabits isn't accurate. They're rejiggering the whole approach to cap, and opening it up to a much broader set of competitors.

I wish I could put it in a timing bucket for you. But very clearly you are starting to see people grapple with where do we place our bets and on what technologies? I want to stop there and ask you --.

Simon Leopold - *Raymond James & Associates - Analyst*

That's a fair answer. I think part of the point of my question is that we can't put a timing range on it. But it's clearly going to take multiple quarters for your customers to, I think, respond. Is that fair?

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

En masse, yes. But as you have seen, many of them are already starting to respond early but not broadly.

Simon Leopold - *Raymond James & Associates - Analyst*

Right, but I mean to the point where it matters.

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

Yes, and I think actually it may have mattered in a negative sense in Q4 and Q1 as people are grappling with these big strategic decisions, if you follow what I'm saying. Many of these folks are confronted with -- wait a minute, what does this gigabit mean to us? By the way, across all different types of service providers, regardless of their species lineage, if you will.

Simon Leopold - *Raymond James & Associates - Analyst*

Okay. And then just one last one. You said in your prepared remarks no change in competitive landscape. Now that contradicts what some of your competitors are claiming. How do we frame the two different views?

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

I don't know if I can help you there. I think if you go analyze the different results from different vendors across the state it will become clear that North America was a challenging environment. But we are focused solely on broadband access and we grew 16% year over year. So I think you would have to put it that way.

Simon Leopold - *Raymond James & Associates - Analyst*

Okay. Thank you very much.

Operator

Amitabh Passi with UBS.

Amitabh Passi - *UBS - Analyst*

Thank you. Carl, the first one for you is just can you help us maybe rank order your growth initiatives for the year? Because, to your point, I think digging out of the 1Q guidance, my expectation is maybe we are looking at another flat year on a top-line perspective. But I would just like to understand how you think about the gross margin this year. You talked about the international funnel developing, but maybe you can just give us a few more specifics around the drivers.

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

Let's take that one first, and I will certainly allow you a follow-up, if you would like, on the top. I think it's the question that frames up the challenge for Calix historically and then where we are going and why we are so excited.

We have historically been in the province of the North American wire line service providers. And, as you know, we have grown considerable share in that space. We are now on the cusp and have actually been pushing out into both customer segment expansion -- so, for example, international -- as well as you are now starting to see us launch into new product market places. As we do so, we are playing in a much bigger sandbox, if you will.

So, we feel way better about our growth prospects going forward because those are the two big drivers. The customer segment expansion in all different directions, international being a hallmark of them. And, by the way, international still not a majority of our business, but having more than doubled we are very encouraged.

And now with Service Verify, the 520 and the 308 coming to market, and as extensions to the E-series product set and what's coming beyond that, we are very excited about those prospects, as well. If you then look at the gigabit initiatives that are going on, what's going on with the FSAN. I think you are familiar with the FSAN Group. By the way, the next FSAN meeting, Calix is hosting. We are very excited about the future.

Now, to your point about it being a flat revenue year, I wouldn't use those terms. The question that I got was -- is it double digit. I think double digit will be challenging given Q1. But I do not believe Q2, Q3, and Q4 will look anything like flat. But I don't think they're going to be big enough, at least at this point, to make up for what we have seen in Q1. Does that answer your question?

Amitabh Passi - UBS - Analyst

Yes. And then maybe just as a follow-up -- and, again, this has to do with the business model. I look at your Company over the last five or six years, you have grown sales quite dramatically, you have improved gross margin. And yet I think we are stuck in the \$0.40 to \$0.45 of earnings power. When do we start to see incremental leverage? Is it purely a top-line-driven story or are there additional levels on the out-mix front?

Carl Russo - Calix, Inc. - President and CEO

From my perspective, I think right now I don't want to knock the legs out from underneath William's chair, as he just joined today. But let me give you my perception. And I think I did in my earlier comments.

We have worked very hard to build a franchise in the North American wire line access base. And I think if you talked to our customers I believe they would tell you we are one heck of a vendor to them. But for us to reach our growth aspirations, especially that which is driven by the convergent story of unified access, we must expand customer segments, and we must expand product markets

And, so, for this next period of time I am going to be focused very much on helping drive that growth. Maybe when you get a chance to meet William he will tell you what he is going to be focused on. But for me this is very much about focus on now, let's go expand our growth prospects, and bring unified access to a much broader set.

Amitabh Passi - UBS - Analyst

Okay. Thank you. I'll step back in cue.

Operator

Simona Jankowski with Goldman Sachs.

Simona Jankowski - Goldman Sachs - Analyst

Hi, thanks very much. I did just want to follow up one more time on the revenue guidance, Carl. And that is just to ask on whether there might have been some impact from a product cycle transition, just to the extent that some of your customers might have been anticipating some of the new products you just announced.



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

No. You know the metaphor Osborning? No such Osborning in that because, in fact, it's not a transition, it's an extension. So, it actually has no negative impacts, only positive ones.

Simona Jankowski - *Goldman Sachs - Analyst*

Okay. And then the other comment I wanted to follow up on is targeting some cloud-based enterprises. Can you expand on that? Are you starting to target a different customer base? What kind of customers are we talking about? Enterprises? Web 2.0? Would love a little more color there.

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

I think I may have confused you on that one. So, first of all, let me ask your forgiveness. Here is what we were saying -- that the trend of more and more cloud-based enterprises changes the very nature of the service providers' networks.

So, please, let me be clear. We are focused on communication service providers but that trend dramatically changes, as you know, the traffic across the networks and the services that service providers offer. It places a very different demand for the quality of those networks when what was formally a desktop computer in an enterprise connected over a LAN to the data center in the basement now becomes "a bring your own device" connected over a WAN to a cloud-based set of services that are who knows where.

So that wide area network now has to perform as if it was 100 feet away but it surely is not. That's what we were talking about, especially with this new extension to the E-series family. Sorry for confusing.

Simona Jankowski - *Goldman Sachs - Analyst*

Okay. Fair enough. I also wanted to ask about the funnel of opportunity you mentioned a couple times as far as it being, I think you said, an all-time high or very strong. Is that a quantitative or a qualitative statement? In other words, is that something that you see in salesforce or whatever CRM you use? And if so, can you just give us a little bit more around that? What kind of increase are we talking about, what kind of deal sizes, et cetera?

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

I appreciate your desire to quantify it. By the way, it is a quantified statement. But forgive me, from a competitive standpoint I wouldn't share those pieces. But to your point, yes, in our customer relation management system in our processes, which I think are now quite robust, we have seen a growing of the sales funnel of opportunities. And, in fact, it is the largest it has ever been and we are just now launching these new products into that.

So, it would appear to us that we are clearly on an upswing from a sales activity standpoint. But, again, I cautioned earlier that it takes time for those deals, obviously, to come through to get to closes and then to get to revenue.

Simona Jankowski - *Goldman Sachs - Analyst*

Got you. And then just last one on your broadband stimulus-related revenues. As I recall, that's winding down this year or toward year end. Just from a modeling perspective, as we think into next year for 2015, how much of a step down do you think is reasonable to assume for that?

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

You mean from broadband stimulus?

Simona Jankowski - *Goldman Sachs - Analyst*

Yes. So, whatever you have in your deferred and you still think you'll recognize through the course of this year. Presumably that amount steps down quite a bit next year. Just want to make sure we are cognizant of that delta.

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

Yes, it will wind down slowly but surely. Simona, I will come back to you and get you those numbers.

Michael Ashby - *Calix, Inc. - Principal Financial Officer & Principal Accounting Officer*

Simona, we expect it to go down over the next couple of quarters as we recognize more of the BBS. And about middle of this year we'll reach a more stable level of deferred revenue, which is going to be something between \$30 million and \$40 million. And probably stay at around that level.

Simona Jankowski - *Goldman Sachs - Analyst*

I see. Okay. Thanks very much.

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

The majority of it is pretty much worked through at this point in time.

Simona Jankowski - *Goldman Sachs - Analyst*

Okay. Terrific. Thank you.

Operator

Paul Silverstein at Cowen and Company.

Paul Silverstein - *Cowen and Company - Analyst*

Carl, a couple of questions, if I might. First off, you guys have established a five-year track record of driving improvement and meaningful improvement in gross margin into the high 40%. I recognize that quarter two doesn't a trend make. But this quarter and the guidance for Q1 represents, I think, the first backslide of any meaningful nature in a while. How much of that is simply a function of the lower volume? How much of that is other factors? And, as importantly, as we look out into the more distant future, does it get back to improvement into the low 50% trajectory, which I think is the trajectory you previously were on? And then, if I may, I've got a couple questions on revenue.

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

Let me go back. First of all, Michael, maybe you want to address just the current and the previous quarter, and then I will come back and maybe give you a feel for where we are going forward. Okay, Paul, good question. Michael?

Michael Ashby - Calix, Inc. - Principal Financial Officer & Principal Accounting Officer

Sure Paul. Q4 and Q1 is just primarily the impact of the lower revenue and lower absorption rate during the quarter, and some mix of customer and product. But those don't make a trend. I think what we have always said, and keep repeating, is over any four-quarter period we expect to see gross margin increase. And that is primarily based on mix of product. But any one quarter or one or two quarters we might see it go down. And in any four-quarter period we expect it to continue to increase. And we do expect it to continue to head towards the 50% range that we've talked about for some time.

Carl Russo - Calix, Inc. - President and CEO

Now, as we look forward, Paul, let me give you a sense for the puts and takes on margin. To the extent that margin grows more slowly given our product mix and our aggressiveness in the market, it likely means that our revenues are growing faster. So, I believe the model still remains intact.

As I look at product mix, value, the value proposition to our customers, there is everything that points us toward the greater than 50 points. But I could also augur up scenarios where we have deals that we go take share with in the international market or new customer segments that actually average the margin growth a little slower but will yield greater revenue growth. Does that make sense?

Paul Silverstein - Cowen and Company - Analyst

Yes. But, Carl, just to be clear, to make sure I understand, correct me if I am wrong, the general proposition, as Ethernet-based platforms have been an increasing portion of your revenue over time, those are somewhat higher margin. But the tension you're highlighting is you may choose to use price within your platforms with new deals in order to win footprint. Are those the two primary tensions in translating it to gross margins go-forward?

Carl Russo - Calix, Inc. - President and CEO

Yes. And I would tell you, I would almost say Ethernet and the IP content in them continues to raise the delivered service and value to our customers. So, that is the upward trend.

And, to your point, when you are moving into new markets and new segments, you are at low market share. And you are the aggressor so you are naturally going to be likely at lower margins. And then you blend those two together.

But I want to make sure that I am not confusing you on the steady state model. I am actually more robustly satisfied that we are on the right direction to greater than 50 points of margin given the product sets and the value.

Paul Silverstein - Cowen and Company - Analyst

All right. If I may, if I could ask you a question on the revenue. And if I could return to your sales funnel. And I appreciate there is only so much you want to say in terms of quantification, et cetera. But as a general proposition, if we look at your revenue simplistically measured by existing customers coming back to you and penetration to new accounts in terms of driving revenue growth, how much of your optimism, how much of this improvement, your record sales funnel, is a function of new customers, new applications, new products? But in particular new customers. And how much of it is the existing customer base that you expect to return in a more robust manner once you get beyond the soft patch?

Carl Russo - Calix, Inc. - President and CEO

You can imagine that the customer segment expansion would represent a minority, and existing customers would represent a majority. We are clearly seeing our existing customers as we go into this year moving into the mode of --- "we've got to go forward and invest in our businesses." Which at times, as you have heard me say in the past, has not been clear.

There have been times when our customer set have wondered about whether or not they should be investing, or how they should be investing, or they might have been confused by certain government programs. We are seeing very positive signs from, frankly, all of our customers. So, the minority is customer segments new; the majority is customer segment existing.

Now, to your question about new products, I would love to tell you that there is a significant portion of it from new products, but we just launched them so they're not even in the funnel yet. But that will then also add another minority to it.

Paul Silverstein - *Cowen and Company - Analyst*

Fair enough. Two more quick questions, if I might. One, without asking you about any specific customer, cable customers in your general proposition, is there any visibility as to that group of customers becoming meaningful, defined as 5% to 10% or more of your revenue? Or is that still downstream? And then I've got one more.

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

Here is the way I would answer your question. As you know, in the future we believe that there will be communication service providers, and they will provide services irrespective of where they came from. But some may come from wire line, some may come from wireless, some may come from cable. With that in mind, the cable MSOs today are an expanding customer segment for us, and have been for quite some time. And we expect that to continue. Just as we expect the wireless customers to become an expanding customer segment for us, as well.

Paul Silverstein - *Cowen and Company - Analyst*

Okay. Quick question on visibility. These things are never one-quarter events, as we just saw yet again in terms of Q4 and the Q1 outlook. When you talk about a return to growth in the balance of the year, albeit given what's going on in the first quarter being a stretch to get to double-digit growth for the year, how much visibility, solid visibility, do you have? What's the risk that 90 days from now the outlook for Q2 isn't much different than the outlook for Q1 and then it was for Q4? How much visibility do you really have?

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

We have visibility over the course of a year, for sure. But I think I would be doing you a disservice if I said it was a year because clearly we have good short-term visibility in the next 91 days, and pretty reasonable visibility beyond that 91 days into the next 91 days. But each quarter you go out it lessens. So, the risk in the next 91 days having that happen, I believe, is relatively low. When you go past that it could certainly happen.

Paul Silverstein - *Cowen and Company - Analyst*

Thank you. I'll pass it on.

Operator

(Operator Instructions)

Mark McKechnie with Evercore.

Mark McKechnie - *Evercore Partners - Analyst*

Great, thanks. Michael, job well done, and enjoy the retirement. And welcome, William. A few questions here. On the Q4 miss, can you give a little more detail what rolled off? You talked about architectural decisions at your customers. Was this a fall off of copper versus fiber, or terminals versus infrastructure? Can you characterize that? And is that same pattern playing out for March, as well?

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

To go back, the chilly wind that we saw was very much across the larger customers in North America. We then, if you go and look at the space and look at various companies in the space -- systems providers, for example -- I think you will see that those numbers correlate. So very much a North American phenomena, and very much a larger than smaller customer phenomena.

And from my perspective, I think the key driver is the grappling with the strategic decisions around the step-up in investment in the access infrastructure, in the Internet speeds, gigabit communities, et cetera. So, I think that's the number one driver. And I think it's rolled into Q1 and budgets are now coming into place. And that's where we stand.

Mark McKechnie - *Evercore Partners - Analyst*

Okay. Got you. And, so, I guess the idea is, once those architectural decisions are made, that's when this funnel you are talking about that's building, they start pressing the button. And it sounds like --.

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

Well -- sorry, Mark, go ahead, you finish your question.

Mark McKechnie - *Evercore Partners - Analyst*

It's kind of laying out similar to what Paul was asking earlier. You feel pretty confident in an uptick in June. I was going to get at, do you think June could approach that December level? Go ahead, Carl.

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

I think the second, third, and fourth quarter represent quarters where we will have the opportunity to have comparable year growth. So Q2 will be larger than Q2 of 2013. That type of growth.

However, what I was trying to be clear was, if you do all of that, and you look at Q2, Q3, and Q4, and they're good strong growth quarters year over year, Q1 being what it is will make it difficult for us to achieve double-digit growth for the year. Okay?

Mark McKechnie - *Evercore Partners - Analyst*

Got you, yes.

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

But I want to go back and tie out a couple comments I made to make sure that I am answering your question clearly. So, if I may, earlier I mentioned some of our mid-sized customers have been grappling with and making decisions around how they were going to go and invest and where in their network. And some of them have started to lock down on their focus on the access infrastructure, and specifically rotating the majority of



their CapEx into more fiber-to-the-premise deployments as opposed to shortening copper loops and doing fiber-to-the-node. We have been seeing that trend in a number of different places. But that's a statement of mid-sized customers, not the larger customers. Okay?

Mark McKechnie - *Evercore Partners - Analyst*

Okay. That's helpful. Maybe a question for Michael. Given that backdrop, where is your breakeven? We can figure out breakeven from an earnings perspective. But if you start hitting those types of top lines we are talking about, any desire or any plans to cut your OpEx or to reduce your spending here as you go through the year, as we are talking about a lower level of business?

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

Since Michael is retiring, let me address that, if you would, Mark. If we thought that what we were seeing was more than the Q1 phenomena, I think we would be looking at things very differently. The challenge we have is that when we look at the funnel, and we look at just all the anecdotes in addition to the quantitative funnel metrics, we see growth. So yours truly is inclined to make disciplined investments in that growth going forward. And as long as the funnel continues to build as it is, then we will continue to do so.

Mark McKechnie - *Evercore Partners - Analyst*

Okay. Got you. And then one last line of questioning here. On Ericsson, it sounds like you talked about some milestones being hit at the end of the month here on the product integration side. For Ericsson specific, are all the products you are shipping through Ericsson -- first off, is that still the old Ericsson products? So, have you started shipping any of Calix C-series through the Ericsson yet?

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

The answer is no to the C series, yes to the E-series.

Mark McKechnie - *Evercore Partners - Analyst*

On the E-series, okay.

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

And the further release that was referred to earlier simply expands that pretty meaningfully. And that's coming available at the end of this month, Mark.

Mark McKechnie - *Evercore Partners - Analyst*

Okay. I got you. And then in terms of development of that Ericsson channel throughout the year, it sounds like we had some contribution here in March. Are you expecting that to be a meaningful contribution -- meaningful meaning 10% of sales or so -- in the back half of the year? Or how are you feeling about the ramp on Ericsson here?

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

Just like we have some channel partners in the United States domestically, and we don't break them out, we wouldn't break out the international piece. We view it as the international growth. And as I commented earlier, international growth more than doubled the business. And we are

looking for robust growth again in 2014. And you can opine for yourself how much of that might be with a channel partner or not. But we are certainly excited by the partnership.

Mark McKechnie - *Evercore Partners - Analyst*

Great. Okay. Thank you.

Operator

Sanjiv Wadhvani with Stifel Nicolaus.

Sanjiv Wadhvani - *Stifel Nicolaus - Analyst*

Thanks. Carl, I just wanted to confirm what you just said on June and September. You are looking at year-over-year growth. So, June sort of \$95 million, north of \$95 million, and September being north of \$100 million. I just wanted to confirm that first before my question.

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

I think we certainly have that opportunity to grow year over year Q2, Q3, and Q4, for sure.

Sanjiv Wadhvani - *Stifel Nicolaus - Analyst*

Got it. Okay. The question I had was related to the Connect America Fund. Obviously you've seen a lot of uptick from tier 2 carriers, and I think that might be helping some of your funnel and what you are seeing with your existing customers. I am just curious as to see what do you think might happen with the tier 3s, and what gets them to accept the Connect America Fund? And do you think there's some changes that need to be made there to help them out? Thanks.

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

Great question. And, as a matter of fact, if you follow it there are changes being proposed in CAF, as we speak. First and foremost is the notion of what is broadband. And saying 4 and 1 isn't adequate, as a matter of fact 4 isn't even adequate. And starting to rethink where we are going from a broadband standpoint.

Obviously, you have heard things about connecting schools and libraries and all sorts of other discussions going on from the government's perspective. But for us, the notion of starting to think about the template being gigabit networks, which we are hearing time and time again, also we are hearing it from a pilot perspective at the FCC, that directionally is very helpful, we believe, for the country in general but specifically for all service providers.

But there is another key change, which is they've now opened -- they're planning on opening up CAF to any service provider being able to compete for it. So, no longer any reverse options in certain segments or other restrictions. But simply allowing, for example, as you can think about a census district, allowing if you were a service provider and I was a service provider and William was a service provider, we could all go compete for it.

And I might be a cable MSO, you might be a wire line provider, William might be a wireless provider. Whoever can describe the best solution, and provide it at the most competitive price, is going to have the best chance of winning. And so that dramatically changes the playing field. Does that make sense? That does. That's helpful actually. So, these changes are happening and that helps with your tier 3 base as we roll into 2014 and beyond essentially. Yes. Very clearly the new chairman of the FCC is a new chairman of the FCC. He thinks very differently than the previous one, I believe.



Sanjiv Wadhvani - *Stifel Nicolaus - Analyst*

Got it. That's helpful. Thanks so much.

Operator

(Operator Instructions)

It appears there are no further questions at this time. I would now like to turn it back to Mr. David Allen for closing comment.

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

Thank you, operator. Calix will be participating in a number of investor conferences this quarter. We hope you can join us at one of these events, including two later this week in San Francisco which will be webcast from 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. Information about these events will be posted on the events page in the investor relations section of Calix.com.

Once again, thank you for joining us today. And good-bye for now.

Operator

Thank you. Ladies and gentlemen, this concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.

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