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CALX - Q2 2014 Calix, Inc. Earnings Conference Call

EVENT DATE/TIME: JULY 29, 2014 / 8:30PM GMT



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PRESENTATION

Operator

Greetings, and welcome to the Calix second quarter 2014 financial results conference call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. (Operator Instructions) At the 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, Mr. Allen. You may begin.

David Allen - *Calix, Inc. - 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 growth 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 margin, earnings-per-share, stock-based compensation, and amortization of intangibles.

These forward-looking statements are based on estimates, judgments, and 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 statements. I would encourage you to review the Company's various SEC reports, including our Annual Report on Form 10-K for the period ending December 31, 2013, and our Form 10-Q for the period ending March 29, 2014, available at www.SEC.gov, in which we discuss these risk factors.

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

Also on this conference call, we will be discussing GAAP and non-GAAP results. We will be providing the non-GAAP estimates to enable interested parties to evaluate our performance in the same manner in which we evaluate our own operations. These non-GAAP measures exclude certain charges and benefits which we do not consider to be part of our ongoing activities, or meaningful in evaluating our financial performance, including stock-based compensation expense, acquisition-related expenses if any, and the 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 press release. All numbers 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 President and CEO Carl Russo. Carl?

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

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

The Calix team performed well this quarter. Revenue exceeded our expectations and the quality of our earnings was excellent. This crisp execution all occurred on a backdrop of increasing activity in our customer base and with positive signs coming across all areas of our business.

I will come back with some thoughts on what is ahead. However, I would like to turn the call over to William to review Q2 in detail and share our guidance for Q3. William?

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

Thank you, Carl. We last provided you with non-GAAP guidance regarding Q2 on April 29. And in that guidance, we called for revenues of between \$94 million and \$97 million, a gross margin of between 45% and 45.5%, and operating expenses in the range of \$42.3 million to \$42.9 million, thus resulting in an EPS of between \$0.00 and [\$0.02] (corrected by company after the call) per share.

Actual revenue for the quarter was \$98 million and EPS was \$0.10 per share, both better than our guidance. Gross margin was 47.7% and operating expenses came in at \$41.6 million, both metrics also ahead of our guidance. As we indicated on April 29, we expected Q2 to be a cash-generating quarter and it was, with Calix ending the quarter with total cash and marketable securities of \$79.3 million, up from Q1's \$75.5 million.

Revenue for the quarter was \$98 million, an increase of \$3.6 million from last year's second quarter level of \$94.4 million. It was also up sequentially from this year's Q1 \$85.8 million figure.

International revenue was \$12.6 million in Q2, up from \$12.1 million in Q2 2013 and also up from \$10.6 million in Q1. We had one 10% customer again this quarter.

At 47.7%, gross margin was higher than had been expected, and reflected customer and product mix, a contribution of deferred and recognized revenues, and some timing differences in anticipated revenues.

The gross margin in Q2 was up from Q2 2013's 47.6% level and also up from Q1's 45.9% level.

Q2 operating expenses of \$41.6 million were slightly lower than anticipated, but were up from the prior quarter by \$0.9 million. Timing shifts and engaging outside consultants, and implementing real estate and other plant, property, and equipment improvements, and in hiring, contributed to this favorable performance relative to guidance.

OpEx was up \$1.7 million from the same quarter a year ago, primarily due to increases in personnel expenses, largely consisting of annual compensation adjustments, and also due in part to additions in year-over-year headcount, which increased slightly from Q1.



Turning now to the balance sheet, we ended the quarter with total cash and marketable securities of \$79.3 million, an increase of \$3.8 million in the quarter. We expect the remainder of the year to be cash flow positive.

Receivables DSOs were 38 days compared to 43 days in the previous quarter. In anticipation of another strong quarter, inventory levels increased slightly to \$45.9 million from \$45.1 million in Q1. Inventory turns increased to 3.9 times in Q2 from 3.4 turns in Q1, while decreasing from Q2 2013's 4.4 times.

Deferred revenue was \$45 million, down from \$47.5 million in the prior quarter, reflecting the completion of a number of broadband stimulus or BBS projects that were recognized as revenue during the second quarter. As I noted earlier in my discussion about gross margins, the level of closeout of deferred revenue in Q2 was lower than we anticipated going into the second quarter, but was more than offset by demand from other customers. We expect the completion of these projects by the end of the calendar year and for the substantial balance of our BBS-related deferred revenues to be recognized in our P&L by year-end.

In terms of guidance for the third quarter of 2014, we expect revenues to increase over Q2. We also expect to continue to be profitable and cash flow positive for the remainder of 2014.

Our guidance for Q3 is as follows. Revenue for the third quarter is expected to be in a range of between \$102 million and \$106 million. Gross margin is expected to be down this quarter, primarily due to two factors: one, product and customer mix considerations, and two, the recognition of additional BBS revenues, some of which will have carried over from timing delays in the second quarter.

As we discussed in the April earnings call, these BBS revenues have lower margins because of their higher level of contracted professional services. In part, due to the possibility of some bunching of deferred revenue recognition in the third quarter, we are widening our guidance for our anticipated gross margin. And we are therefore guiding to a 44.5% to 46.0% range for Q3.

As was the case this past quarter, we expect operating expenses to increase at a rate slower than revenues in Q3. OpEx is expected to be in the range of \$42.5 million to \$43.5 million with a sequential increase primarily due to consulting and personnel expenses, and expenses related to the facilities improvements that I mentioned earlier. The expectations that I have finished taking you through result in a guidance range for Q3 earnings per share of \$0.05 to \$0.10.

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

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

Thank you, William. The second quarter brought more examples of the acceleration in demand for broadband services, particularly fiber-based services. And looking forward, that demand continues unabated.

The secular opportunity is making high-performance broadband services available to all subscribers regardless of their location. And Calix is focused solely on enabling this evolution in access infrastructure. We are seeing this play out in our expanding dialogue with different types of service providers including traditional telcos, cable operators, municipalities, electrical operatives, wireless companies, and new market entrants across the globe. The Calix unified access architecture speaks directly to these converging business models and our focused software, system, and service offerings are gaining interest and footprint on all fronts.

In closing, I am encouraged that we are matching this increasing opportunity with the continuously improving execution of the Calix team. And, with that, I would like to turn the call over for questions. Operator?



QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Tim Quillan, Stephens.

Tim Quillan - Stephens Inc. - Analyst

I understand kind of the limited visibility in your business, but 4Q was obviously a swing factor last year to the downside. In previous years it has gone up. Do you have any feedback at all from your service provider customers of what 4Q might like in terms of a budget flush or a lack thereof?

Carl Russo - Calix, Inc. - President and CEO

Stated simply, we are seeing business as usual right now, which I would say is more reminiscent of the times past, so, certainly no negative indicators. William, you may want to comment on what you are seeing as you look out.

William Atkins - Calix, Inc. - EVP and CFO

Yes. I think we have indicated that we are looking at single-digit topline growth for calendar year end and that is something we are very confident about, Tim.

Tim Quillan - Stephens Inc. - Analyst

Okay. And then, how is the pipeline building for 2015? So I tracked your website. There is 32 deployments of gigabit services. We hear a lot about gigabit right now. It sounds like within your customer base there is a little bit of REIT mania right now that might free up additional capital that could be spent on broadband equipment. But how do you think about building up a growth story as you get past this year?

Carl Russo - Calix, Inc. - President and CEO

It is not a funnel per se; I think you have hit on all the trends. Pretty clearly, we are seeing increasing conversations across every segment, as I indicated in my earlier comments, around the world. So it is a generalized trend of trying to meet that demand for providing subscribers broadband services regardless of their location and the implication that has across not only the networks, but the business model.

And so, to your point, you are seeing REITs, you are seeing -- we've commented earlier how our customer is self-funding and making investments as opposed to relying on the federal government. We have been seeing positive signs and those trends continue, as I mentioned, unabated. So for us, it looks the same throughout, no doubt.

No downward slowing, but also I wouldn't say that there is going to be some geometric acceleration. It is just slowly but surely building this momentum, so very encouraging.

Tim Quillan - Stephens Inc. - Analyst

And do you have -- and I think -- and this is my last question. But I think at one point you had a target -- targeted business model in terms of the margins. Is there -- do you still have a target operating margin, which I think was kind of high teens, low 20s, at one point? And at what revenue level might you hope or expect to get to something that looks like that? Thank you.

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

So let me give you a generalized statement and then I am going to ask William to give you some color. We have long stated that we believe that we could slowly but surely build through a greater than 50 point gross margin. I think you remember that, Tim. And we don't see anything that gets in the way of that.

Obviously, as we go into markets where we don't have share, you're going to typically see margins that are lower than our corporate average. We have talked about those drivers; new products coming in. But the net of it is, we believe we have the opportunity to get over 50 points of gross margin and I don't think there is any change there.

From a growth standpoint, on the operating margin -- and I will ask William to make a comment -- I want to make sure that I am being clear that we are going to make disciplined investments in both the sales, marketing front of the business, as well as in product development areas where we see the opportunity to get returns. I am not trying to signal anything that is wildly disproportionate and our OpEx is, in fact, under-growing our revenue growth. But I just want to make sure that you understand that if we see an opportunity, we are going to go for it.

Now, with that, I will let William do the other side of this.

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

Thanks, Carl. Basically, Tim, to Carl's point, we are seeing our operating expenses growing more slowly than our revenues, and that is a trend that we like to see to continue. We are still focused on achieving those better than 50% gross margin levels and a 30% operating [expense] (corrected by company after the call) level. So that is something that we are still targeting, but we are not putting a specific figure on it. So with that, I think that we are confident about that kind of margin growth going forward.

Operator

Christian Schwab, Craig-Hallum Capital.

Christian Schwab - *Craig-Hallum Capital - Analyst*

Great. Fabulous quarter, guys. International revenue -- did I miss that? Did you give that?

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

International revenue is going to be around 13% of Q2 for this quarter and we did disclose it. Let me just get the specific member while Carl can talk a little bit more about the international opportunity.

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

I am given the opportunity to vamp for time here, Christian, but I am glad William is turning it over a second.

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

It was \$12.6 million.



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

Now, let me just fill in the mapping. I am very encouraged by what we are seeing in international because what we are now seeing is the organic new accounts, pins on the map growth that we have been focused on for quite some time. And we are opening new accounts a very good rate and it is building a nice, robust foundation to bookings growth in the future. And that is exactly what we are seeing going forward.

So, while the revenues are obviously a trailing indicator from bookings than they are growing, we expect that growth to start to accelerate.

Christian Schwab - *Craig-Hallum Capital - Analyst*

Great. And then, just roughly, as you see accelerated demand for the fiber-based services, can you give us roughly an idea of the mix of cable today and where that could possibly be, exiting 2015 or 2016?

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

I won't give you a breakdown by segment. Obviously, we don't do that. We have announced a few items in the quarter that we thought would be interesting and material for both our customers and our investors. With the announcement of Open Link Cable, which allows our customers to deploy fundamentally a GPON fiber to the prem infrastructure inside of a cable operating model, we are clearly seeing increasing dialogue across all the different types of service providers. But, beyond that, I wouldn't go.

Christian Schwab - *Craig-Hallum Capital - Analyst*

Great quarter.

Operator

George Notter, Jefferies.

George Notter - *Jefferies and Company - Analyst*

I wanted to ask more on the international business, \$12.6 million. That number I guess is flat year on year and up a chunk sequentially, but can you tell us more about what is going on with the Ericsson reseller arrangement? Do you have proof points now where you are selling E-series into heritage Ericsson EDA 1500 customers inside that network management umbrella? And when do you expect to see more of a ramp on that arrangement?

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

George, thanks, and, again, I think you are on a cell phone. We are having a hard time hearing you, but I think you are asking for proof points on Ericsson. And so, specifically to the E-series and selling that product, we are definitely seeing proof points across the board.

And, again, as I mentioned earlier, it is about pins on the map; also existing infrastructure and just the general numbers of customers that we are interacting is growing at a good clip. Inside of that, yes, the E-series is, in fact, being deployed in those environments. As far as something material and something that you might see press releases on, we will see if there is something interesting in the future. But the direct answer to your question is yes, we are.



George Notter - *Jefferies and Company - Analyst*

Got it, okay. And I also wanted to ask about linearity in the quarter, and the DSO calculation came down some. I presume that there was less in the business shift in the last month. Is that fair to say?

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

Less of a what -- sorry -- in the last month?

George Notter - *Jefferies and Company - Analyst*

Just backend loading.

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

There is a bit of backend loading that happens, but that is a trend that happens in pretty much every quarter. We are just basically seeing a greater customer take-up. And so, no; it is also a little bit of deferred revenue that affects that calculation. But even if you took the deferred revenue movements out of the quarter, it would still be a very solid DSO number.

Operator

Simona Jankowski, Goldman Sachs.

Simona Jankowski - *Goldman Sachs - Analyst*

I wanted to ask you a follow-up question on the gross margin guidance. I think -- I understand the BBS impact, but outside of that, can you just expand a little bit on the product and customer mix factors that you are referencing? And, if we were just to look at it on a like-for-like basis, so excluding the impact of BBS, what would margins be doing in that scenario?

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

We don't discuss specific margins relating to specific customers or specific products, Simona. But what we have said in the past is that, when you have follow-on business once you have established footprint, that does tend to be at a higher margin level. And so that tends to be what happens when we talk about customer and product mix.

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

And let me just add, Simona, just a little bit of color, because I think this may help you with what you are trying to get at. The underlying trends of the business are supportive of us expanding our margins to over 50 points over time.

Simona Jankowski - *Goldman Sachs - Analyst*

Got you. So, Carl, so you are not seeing any more intense pricing. It is just the ebbs and flows of in which quarters you happen to have more new customer acquisitions versus in which quarter you may have more of a fill kind of business. Is that right?



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

There are little pieces of that, but I want to go back to your first question which was from a competitive standpoint. We are seeing no significant changes in the competitive stance around the globe. You will see little things over here and little things over there, but statistically speaking, it is consistent with what we have seen.

And, to your point, certainly parts of it are mix. Parts of it are new customers, specific things you may be doing. But, again, I want to echo what I said earlier, which is the underlying trends of the business are, in fact, supportive of us trending over 50 points of gross margin over time.

Simona Jankowski - *Goldman Sachs - Analyst*

And, during the quarter, Cisco announced that they are entering the access market as well with a GPON product. Can you just comment if you have seen them yet or if you have any view of that product, and what you think of them getting into the business, perhaps more in the intermediate to longer-term?

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

Always excited to see more people acknowledge what we are seeing in the access space, number one. Number two, it really goes under the heading of what I said earlier, in that we are not seeing any significant changes in the competition from an access perspective. But, obviously, over time, anybody stepping into the space we are going to see eventually.

And if you look back over 10 years, we have seen competitors come and go. We take none lightly or frivolously. They are all viable competitors in the space. But, strategically, we remain focused on unified access infrastructure globally.

Operator

Simon Leopold, Raymond James.

Simon Leopold - *Raymond James - Analyst*

I wanted to get two quick clarifications and then a trending question. On the clarification, I think you said the gross margin forecast for 3Q was 44.5% to 46.0%. Did I get that correct?

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

That is correct, Simon. We are widening our guidance by half a percentage point in each direction, effectively.

Simon Leopold - *Raymond James - Analyst*

Okay. And then, in terms of the revenue guidance, on prior calls you have talked about expectations of delivering year-over-year growth in each of the quarters. And the low end of this guidance, the \$102 million, would actually be down a little bit year-over-year. So it sounds like you are backing off on that prior comment. Am I reading this correctly?

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

Well, I will give you my perspective, because I'm the one that said I think we can deliver quarter over quarter -- year-over-year growth in each of the remaining three quarters. The midpoint of William's guidance is \$104 million, which, in fact, represent incredibly modest growth over I think \$103.7 million, which is what we did last year this quarter.

So, backing off I think is probably a misread. I think there has to be a range that William is comfortable with and that is what he has done. William, I don't mean to speak for you, but apparently I just did.

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

Yes. You just did. I think the complicating factor here is the deferred revenue that we have touched on in our answers to some of the questions and in our prepared remarks. And what we are seeing there, just to expand on that a little bit, is these are revenues which in a sense are the lowest priority for a customer to close out.

They have already received the underlying equipment. They have already made the best of to vast majority of their payments. And it is essentially just a question of closing out paperwork together with working with some outside third-party consultants. And so their priority is lowest for basically closing out this revenue base.

But, what we are seeing here is we are seeing some pressure coming from the relevant funding government agencies in the other side to have this paperwork closed out, which is why we remain confident that the deferred revenue component that is comprised of the BBS deferred revenues is going to come down by the end of the calendar year to a small level. But, nevertheless, there could be some timing shifts between Q3 and Q4, which is why we are being very, very explicit about what is going on with those revenues.

Simon Leopold - *Raymond James - Analyst*

Okay. That's very helpful. And I wanted to see if we could put gigabit in a little bit more context, in that you have talked about numbers of projects. And they are a nice number -- several dozen gigabit projects. I would like to get a sense of the context of how many customers you have overall, so that we can sort of place the 32 in context of that. And then a sense of how much revenue -- what percentage of revenue is coming from these projects now and what you expect it will be, let's say, in 2015.

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

So let me answer the first question, first. We are on record as saying we have over 1000 customers, by the way, and we said it is larger than that. We have actually been on record saying we have over 1000 customers that are doing fiber to the prem. So that puts that into perspective.

The reason we are citing these is they are early indicators of what is clearly the conversation in the marketplace, Simon. And so with that, you can anticipate that, from a revenue standpoint, it is a very small percentage.

Having said that, it is arguably and strategically the most important conversation that is going on out there when you couple it with the rich broadband services that are being put over top of these gigabit offerings. So we believe today it represents the best future prognosticator that exists in the marketplace.

Simon Leopold - *Raymond James - Analyst*

And that is pretty much what I suspected. So, where my question was sort of going was trying to get a good sense of -- and I was assuming it was small this year is -- when does it get to be material? When do you maybe hit a 10% of revenue threshold from gigabit projects?



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

Right. So what you are asking me to call is the elbow of the market, right?

Simon Leopold - *Raymond James - Analyst*

Yes.

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

And here is the way I'm going to answer your question. I don't know. Here is what I can tell you. The pre-elbow ramp is slowly but surely tilting up. So we are going to get to an elbow, or it is just going to continue to tilt up and we won't even know we are at an elbow until we are past it. Does that make sense?

Simon Leopold - *Raymond James - Analyst*

It does. It does. I appreciate the frankness.

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

I mean, I wish I could give -- listen; trust me. William would love me to be able to give an accurate forecast of that number. I cannot. But I will tell you, there isn't a customer visit that I make where this conversation isn't front and center. Not a single one.

Operator

Paul Silverstein, Cowen and Company.

Paul Silverstein - *Cowen and Company - Analyst*

Just a couple including clarification, if I may. One, going back to the question about Cisco that Simona asked, I trust, Carl, from your comments that they are not having on pricing. Put aside market share issues that you clearly are responding to, but they are not impacting pricing at this point either.

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

Who is they?

Paul Silverstein - *Cowen and Company - Analyst*

Cisco.

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

Oh, no. No. We are not seeing anything that -- I mean, we are seeing no change in the competitive situation out there.



Paul Silverstein - *Cowen and Company - Analyst*

If I heard you correctly earlier, you said there was no meaningful change in pricing, either, or am I making that up?

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

Well, no. No. There is no meaningful change in the competitive landscape. So what does that mean? It means that pretty much each quarter on seasonally adjusted, we see ASP erosions of certain amount of things of that nature. The trend is the same as it has really been for quite a while. So there is always going to be some level of pricing erosion. We don't see anything discontinuous with what we have seen in the past. So does that -- is that clear?

Paul Silverstein - *Cowen and Company - Analyst*

Yes. I recognize that your industry and every product market in which price is coming down, the simple question is if the rate of change changing and I heard you say no.

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

No. That's correct.

Paul Silverstein - *Cowen and Company - Analyst*

Secondly, at the risk of beating the dead horse since the question has come up many times, but I will ask it again just to make sure I understand. I am a little slow on the uptake.

With respect to visibility, which has been a constant issue over your many years in business, and in this marketplace, how would you contrast or compare your visibility today to 90 or 180 days ago? And what, given the pickup in activity -- or if I remember correctly two quarters ago, three quarters ago, you cited a meaningful improvement or meaningful increase in the nature of the conversations you were having. And now, today, we hear about a continuance of those conversations, a furtherance.

What could go wrong that would -- what could change for the worse in terms of the rug being pulled out? How likely is that? Help us understand how quickly things could change or not change.

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

There is a couple of ways I want to come at this question, because you are right, and obviously the concerns you address are the same concerns we have ourselves. So we are constantly testing and retesting our assumptions. And William joining us helped actually refine those processes even further.

That being said, let me give you a few indicators. We are seeing our customers expand the horizons on which they are making investment decisions. And that would be a positive sign. We are seeing our customers evaluating fiber much deeper or fiber to the premise. And in order to do so, you have to think about your return on investment from a very different economic model with different returns. But you have to have a more strategic scope when you make that investment decision. We are seeing more of that.

And so, unlike last year where we were sort of seeing the conversations, but everybody was trying to sort of figure out in that last quarter what is going on with this effect, the Google effect, if you remember those conversations, I don't even see a hint of that today. If I then align that what I

feel are better and better processes internally to take what was already a robust sales funnel, but now really work on the details, I don't see any of the big -- I don't see any big rocks of going wrong.

There could be smaller rocks. I am encouraged by our internal execution. So I don't mean to be looking through rose-colored glasses. I am not seeing any negative language.

And the last piece is you are also seeing increased investment from our customers in their own businesses. Tim earlier mentioned REITs, I think. There is all sorts of investment constructs that are being used to marshal dollars to make those investments. And let me ask William to add color to this.

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

Yes, I think, Paul, I have said this to you as well as to some of the other people that are on the call. I mean, in addition to getting really granular on the sales funnel, as Carl has highlighted, one of my major goals is obviously to improve the predictability of our numbers going forward. And so, coming out of that process is a strong desire to start the beginning of each quarter with a much more solid understanding and much more reliable book of revenues, if you will, than might have previously been the case.

So I am still working my way towards that, but that is basically our end goal and that is what we are working towards. I hope that helps you.

Paul Silverstein - *Cowen and Company - Analyst*

It does. And I am going to apologize to you all and the others on the call, but if I could just ask one more along these lines. And, Carl, I think you identified in your remarks a meaningful increase in your customers. I don't know if that was a general comment or in connection with international.

But either way, I don't think you have done it historically, but can you share with us quantification from how much revenue came from new customers and how many new customers we are talking about in terms of speaking to this visibility from another perspective?

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

Yes. So we have never shared it from a percentage standpoint, Paul, as I think you would understand and respect. But, you also have a long history in this industry. And you understand in complex networking businesses, that new customers and new network wins lead to add-on business because when you go in and build a network, you are constantly adding to it.

And so what we are continually seeing over 20 new customers every quarter and, obviously, a significant percentage of them are coming out of the international market, and that is a really healthy rate. And when we look further out in the final and look at new opportunities, gee, guess what? Those customers that are new customers that we closed a quarter or two quarters ago are popping back up in the funnel with new business.

So it is just that healthy, organic growth that you really want to see that has taken us a while, frankly, and longer than I thought a number of years ago to get going international. But it is going.

Operator

Amitabh Passi.



Amitabh Passi - UBS - Analyst

William, my first question was for you. You exited the quarter with a deferred revenue balance of \$45 million. I think historically warranties and stuff have been around \$21 million. Do you expect the deferred revenue balance to come down by the difference -- \$25 million, \$26 million the next couple of quarters? Is that how we should be thinking about it?

William Atkins - Calix, Inc. - EVP and CFO

Broadly, that would be the correct trend. But, just to get into the numbers a little bit more, we finished Q1 with deferred revenues of \$47.5 million and we dropped, as I think I referred to, in my remarks, we dropped total deferred revenues down by \$2.5 million.

And as I recall indicating to everybody on the call, if you remove the extended warranty component from the deferred revenues that we disclosed in our 10-Q, you will see that basically all of that movement was in a non-extended warranty component, which is a very good proxy for BBS revenues. So you can see that the rate of erosion of those revenues slows from Q1 to Q2, and that is what led to our remarks about deferred revenue timing differences.

Looking forward, we see that rate picking up. And, by the end of the year, we are going to have some deferred revenues that relate to broadband stimulus on the balance sheet at the end of the calendar year, but nothing like the levels we have had in the past. It will be a relatively small amount and we will see the erosion of most of those revenues taking place over the next couple of quarters.

Amitabh Passi - UBS - Analyst

I guess the motivation for the question was if I normalized of the deferred revenue movements -- and, again, I am making a assumption here -- if you presume \$7 million, \$8 million comes through in Q3, it seems like ex-deferred revenue, the base business is roughly flat sequentially despite the positive commentary, the growing pipeline. So I was just trying to understand if there is some other dynamic that may have helped 2Q that you are not seeing repeated in 3Q in the base business.

Carl Russo - Calix, Inc. - President and CEO

The short answer is, no, we are not. As Q2 demonstrated, with the timing shift of deferred revenues in Q3, we still delivered a good quarter. And we see going forward strong underlying revenue growth, absent the BBS revenues, are still strong.

Amitabh Passi - UBS - Analyst

And then one final question. So, as we think about the early part of 2015 as the BBS headwinds are behind, and I understand and appreciate that gross margins can be volatile. Should we still expect directionally margins to maybe trend back to 46%, 47% in the first half of 2015?

William Atkins - Calix, Inc. - EVP and CFO

We are not guiding people to specific margin levels for specific quarters or halves in 2015, but overall we are seeing gross margin ultimately trending to over 50%. And so, as you say, there are going to be some chops and lumps and bumps along the way, but that is what we see happening. But, no, we are not going to guide to specific margin for quarters or halves in 2015.

Amitabh Passi - UBS - Analyst

Okay that's fair enough. Thank you.



Operator

(Operator Instructions) Sanjiv Wadhvani.

Sanjiv Wadhvani - *Stifel Nicolaus - Analyst*

Two questions. Carl, I was wondering if you could talk about CAF, and any thoughts on spending outlook from tier 2s and tier 3s. I don't think we went through that during the call.

And then, second question related to that is one of the competitors is sort of talking about how CAF is resulting in more services-oriented revenues as they do things like insulation for some of those customers. I am wondering if you are getting those same types of requests from some of your tier 2, tier 3 customers. Thanks.

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

So I may have to ask you to clarify, but let me go back on the first piece. As we have discussed many times, CAF is in essence a funding source. It is going to be driven towards more underserved environments. Typically that is going to be more rural than urban, which basically comes straight over top of what has been a traditional strong point for Calix in those service providers. So we view it as a positive.

Having said that, I don't want to say it is like BBS, but oftentimes what you will see service providers do is they will look to bundle both the product and the installation in the form of a project when they go in and deploy it. So there are certainly times when we see bundled services and systems together in the form of a project. And, in which case, you will see from a gross margin standpoint, those particular situations are likely to have lower gross margins than the typical mix.

And we will make decisions on a deal by deal basis as to what strategic to us and what we want to compete on. If you are asking me about doing services separate from that, that.

Sanjiv Wadhvani - *Stifel Nicolaus - Analyst*

No. That was it actually. That was kind of a bundled a situation where it is sort of broadens a project, but as a system and services piece bundled together. So no, you answered my question on that. I appreciate it.

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

Yes. And we will go compete for those as we see strategic alignment with where we are heading.

Operator

(Operator Instructions) There are no further questions at this time. I would like to turn the floor back over to Mr. Allen for closing comments.

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

Thank you, operator. Calix will be participating in the Jefferies Semiconductor and Hardware and Communications Infrastructure Summit in Chicago on August 27. Information about future investor events will be posted on the events page in the investor relations section of Calix.com.



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

Operator

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

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