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CALX - Q2 2013 Calix, Inc. Earnings Conference Call

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George Notter *Jefferies & Company - Analyst*

Simona Jankowski *Goldman Sachs - Analyst*

PRESENTATION

Operator

Greetings and welcome to the Calix, second quarter, fiscal year 2013 financial results conference call. At this time, all participants in a listen-only mode. A brief question and answer session will follow the presentation. (Operator Instructions). It is now my pleasure to introduce your host, David H. Allen, Director of IR and Treasurer for Calix. Thank you, Mr. Allen. You may now begin.

David H. Allen - *Calix, Inc. - Director of IR, 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, our expectations of a similar set-up and performance next quarter as in this 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 our expectations, estimates and judgments and current trends and market conditions and 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 quarterly report on form 10-Q for the period ending March 30, 2013, available at www.SEC.gov in which we discuss these risk factors. All forward-looking statements are made as of the date of this conference call and except as required by law, we do not intend to update this information.

Also on this conference call we will be discussing GAAP and non-GAAP results. We are providing the non-GAAP estimates to enable interested parties to evaluate our performance in the same manner 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 on-going 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 earnings press release. All numbers that are discussed are non-GAAP unless otherwise noted. This conference call will be available for audio replay in the Investor Investor Relations section of the Calix web site 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 our conference call remarks. I now would like the turn the call over to Calix President and CEO, Carl Russo.

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

Thank you, Dave. Good afternoon, everyone. Joining me on our call today is Michael Ashby, our EVP and CFO.

The second quarter of 2013 brought continued strong execution of our strategy. We remain focused on delivering the value of our unified access portfolio to our customers. This value continues to resonate with our customers as we saw strength across all of our product offerings, geographies and customer tiers.

Looking ahead, customer buying behaviors are continuing to normalize and as such, I expect us to demonstrate a similar step up in performance next quarter as we did in this quarter. With that, I would like to turn the call over to Michael.

Michael Ashby - *Calix, Inc. - EVP, CFO*

Thank you, Carl. Good afternoon, everyone. If you've not already done so, I would encourage you to go to the Investor Relations portion of our web site and download the financial slides that we posted concurrent with our press release earlier today. My prepared remarks will provide an overview of our financials and the related business trends. I will close by providing guidance for the third quarter of 2013.

As a reminder, the guidance we provided in April for the second quarter called for revenue between $94 million and $98 million. Gross margin between 45% and 46%. Operating expenses at approximately $40.7 million and the resulting EPS between $0.02 and $0.06 per share.

Actual revenue for the quarter was $94.4 million within, and at the lower end, of our guidance.

Cross margin was 47.6%, significantly ahead of our guidance.

Operating expenses came in at $39.9 million, lower than our guidance and as a result, EPS was well ahead of our guidance at $0.10 per fully diluted share.

We had strong cash flow and ended the quarter with $69.4 million of cash on hand. Putting it all together, it was another very solid quarter for us.

We continue to see strength across all areas of the business. As you may recall, revenue in the first quarter of the year was up 15% from the same period in 2012, revenue for the second quarter was up 20% compared to the same period last year. Each tier that we operate in domestically did well and International business performed well for us as we continue to add new customers.

The first half of the year is clearly positioned as well to achieve our objective for the year as a whole.

Our International revenue is 13% of total revenues and we did have one 10% customer this quarter. Cross margin at 47.6% was better than we had expected.

Gross margin strength was across the board and primarily reflects the value we bring to our customers and the differentiation that our unified access portfolio brings to the market.

Operating expense is $39.9 million increased by less than $200,000 from the prior quarter.

We have told you at investment conferences and meetings over the last couple of quarters that our objective for 2013 and 2014 were to return to revenue growth while continuing to improve gross margin percent, control our operating expenses, and increase our operating profit. The first two quarters of the year show we're making good progress and we expect that to continue. Operating expense control has been important and while we don't expect to be able to hold up expenses flat each quarter, we do believe that we can continue to improve our efficiencies and our leverage.

Before I turn my attention to the balance sheet, I would like to remind you on a non-GAAP basis, we exclude certain charges that we do not consider to be part of our on-going activities or are not meaningful in evaluating our financial performance as a company. These charges, the amortization of intangibles, and the amortization of stock-based compensation are both non-cash items.

Turning to the balance sheet, we continue to manage our weight in capital and ended the quarter with total cash of $69.4 million, an increase of $21.3 million. DSO was 56 days, the same as in the previous quarter.

Inventory level decreased to $37.4 million from $39.2 million at the end of the first quarter and inventory returns improved to 4.4 up from 3.7 in the previous quarter.

Deferred revenue amounted to $71.1 million, up $5.6 million from the prior quarter.

Let me now move to our guidance for the third quarter of 2013. We are pleased with the strength we've seen in the business over the last few quarters and expect to continue to build on that momentum. For the third quarter, we are guiding to a revenue range of between $102 and $106 million.

We expect gross margin to come in between 46% and 47%. As we have repeatedly stated, our gross margin can fluctuate from one quarter to the next and we believe over any four quarter period, we'll see a gradual increase toward a long-term target of gross margin in the low 50% range.

Q3 operating expenses will fall between $41 million to $42 million. The increase in operating expenses is primarily the result of selectively adding head count as we continue to grow the business. The result in EPS will be in the range of $0.11 to $0.15 per share.

DSO should remain around the same level. Inventories will be flat to slightly up and once again, we plan on being cash flow positive for the quarter. At this point, I would like to turn the call back over to Carl.

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

Thank you, Michael. To reinforce our strong guidance for Q3, I would like to take a few minutes to update you on the latest from Calix.

Yesterday, we began delivery of our next release of new products designed to make our customers more competitive and more profitable. All are EXA-based offerings that expand our unified access portfolio and I would like to take a moment to highlight just a few.

For service providers looking to extend the life of their copper assets by bringing fiber closer to the subscriber and shortening their loop lanes, the E3-48C shield Ethernet services access node enables internet speeds of 100 megabits per second and greater. This vectoring ready, bonding capable, topology independent platform allows voice, video and internet services to be offered from a single converged node. Capabilities that are unique in the industry. For customers deploying fiber all the way to the premises, the E7-2 is now able to support more than 1,000 gigabit per second enabled subscribers from a single 1RU chassis. The unique modular chassis architecture of the E7-2 allows customers unparalleled flexibility at the lowest entry cost, and unprecedented scalability as they add new subscribers and new services.

Furthermore, the node-splitting feature of the E7-2 enables the in addition of network capacity in the simplest and most cost effective manner ensuring our customers remain competitive for many years to come. In short, the access innovation contained in the E series product family is why it continues to be the fastest-growing product in Calix history.

Further enhancing our customer's fiber to the premises service offerings is our just released Home Gateway software upgrade which, remarkably, allows hundreds of thousands of our 700 GE ONTs already in the field to instantaneously become fully featured, residential services gateways. And this software is available to all of our Calix advantage program members as a simple and free download.

When combined with our conference consumer connect offering, our customers can offer to their subscribers an extensive menu of high value, in home managed services, thereby, raising ARPU and dramatically lowering churn. More revenue, lower operating expenses, and CAPEX efficiency is what unified access brings to our customers and why it continues to resonate with competitive service providers around the globe. At this point, I would like to turn the call over for questions. Operator?

QUESTIONS AND ANSWERS

Operator

Thank you. We'll now be conducting a question-and-answer session. (Operator Instructions). Our first question comes from Amitabh Passi from UBS.

Amitabh Passi - *UBS - Analyst*

I was wondering if you can help us understand the dynamics in the quarter. The revenues came in at the low end. Just trying to understand if you can give us some color geographically, maybe by customer base, what trends you saw. Then the sequential guidance, quite healthy. Any color you can give us in terms of again, where the strength is coming from. Across your customer base. That would be helpful.

Michael Ashby - *Calix, Inc. - EVP, CFO*

Yes, Carl, do you want to take that first response?

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

Well, sure, I can take the first response from a general statement. Very clearly as we stated in the call, we're seeing good strength across all of the segments so I would not attribute either the guidance or the results to any one segment on the top. Frankly, we're seeing it everywhere. I'm not sure how to answer your question with any differentiation.

Michael Ashby - *Calix, Inc. - EVP, CFO*

I would agree with that. I think we saw strength in tier one, tier two, tier three and International business and as we look forward, we've already seen that changing. It doesn't seem to be any one area that's doing them better than another. They're all performing fairly strongly.

Amitabh Passi - *UBS - Analyst*

Just a quick follow-up on gross margins. Just trying to understand the sustainability of these levels. I want to confirm whether the E3-48C, whether you recognized revenues in the quarter.

Michael Ashby - *Calix, Inc. - EVP, CFO*

No, I don't believe we recognized revenue for the E3-48C in Q2. That's a Q3 shipment product.

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

Sorry, Michael. Real briefly, in my comments, Amitabh, I said they began shipping yesterday.

Amitabh Passi - *UBS - Analyst*

I missed that. Sorry. My bad.

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

It is a Q3 product, Sorry, Michael. Go ahead.

Michael Ashby - *Calix, Inc. - EVP, CFO*

General answer to the question of margin, I think we have been pleasantly surprised with the strength of margins and we do see that continuing. I think we have seen strength in the mix of products. Custom mix hasn't changed very much. Primarily mix of products. We've seen it has been well accepted by the customer base. As you know, those have pretty good margins. We are slowly seeing the margins stabilize at that higher rate and we expect that to continue.

Amitabh Passi - *UBS - Analyst*

Okay. Perfect. I'll step back in queue.

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

Thanks, Amitabh.

Operator

Our next question comes from Simon Leopold, from Raymond James.

Simon Leopold - *Raymond James - Analyst*

Great. Thanks a lot. Just a couple of things I wanted to follow up on. One was the International business. Wondering if we can get an update on the strategy and the position in that market of where you stand, what you think the trajectory is both considering the Ericsson partnership as well as without it.

The other topic I wanted to touch on was vectoring. You mentioned one of the products now, the new platform being vectoring ready. Which I guess suggests it's not quite there yet but could be upgraded to vectoring. My impression is you guys have been a little bit quieter on vectoring and some of your competitors have been crowing about the importance of vectoring. Carl, if you could maybe give us some perspective on how you think the technology plays into the marketplace. Thanks.

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

Let me go to your first question first. Which is International. The way I look at it, and I think we've been consistent about this, is two-fold. One, we want to make sure we're putting, if you will, pins on the map. So what we're tracking is new customers, new customers, new prospects showing up in the funnel. How are we doing? As Michael alluded to in his prepared comments, we continue to see very good traction as far as the number of new customer that we're gaining each quarter, and the number of new prospects showing up in the funnel.

The second dimension is obviously the expansion of our partnership and as I think we've discussed previously, with the addition of some key folks into the business, we continue to see that partnership getting stronger and stronger so we're very encouraged there, as well. On the vectoring side, we've spoken to this before but let me make sure I re-amplify it and clarify, if you will. We think vectoring is a great technology to extend the life of copper assets. But like all technologies that has applications in some places and not in others.

We've been very early to market with vectoring-capable platforms. To your point, the capability means there's no hardware changes. There are merely software downloads to go and bring more and more features to them once they're in the field. We view vectoring as a transient technology to get to even higher speeds as our view of this network is that it's going to continue to explode from a demand standpoint. You don't have to look much further than yesterday's news on, for example, the chrome cast HDMI dongle that Google announced and think about the implications of that and the demands it will place on the network. So we're very much supporters of vectoring and believes in it. We're very much, as you know, a standards-based company. And we will deploy vectoring as we see where it makes sense for our customers to bring competitive broadband into their networks. Does that answer your question, Simon?

Simon Leopold - *Raymond James - Analyst*

It does somewhat. Let me just see if we can zero in. Do you expect vectoring to be a material revenue generator or is it really just kind of incremental to the current base of business?

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

I look at vectoring not the same way technologically but the same way you would view product life cycles like ADSL and ADSL2 and then ADSL2 plus and VDSL. I don't know that any of them are significant market expanders as much as they are the next technology that gets deployed in that market.

Simon Leopold - *Raymond James - Analyst*

That's clear. Thank you very much.

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

You bet.

Operator

Thank you. Our next question comes from George Notter, from Jefferies.

George Notter - *Jefferies & Company - Analyst*

Hi, guys, thanks very much. I guess I wanted to ask about you know, again, the gross margin performance has been super impressive, obviously. Not just this quarter but over the last couple of years. Certainly, it sounds like the E series is a big piece of the story there. You guys are conveying lots of value-added features to customers and getting better pricing. But can you help us understand, is there an aspect of this coming from the ONT strategy? Historically, you guys have had much better margins than the ONT side than others have in the past. I'm wondering if there has been change in the mix and the portfolio. Is there change in your strategy in terms of providing those from Calix perspective or outsourcing them to third parties? Can you give us a sense of any impact from ONTs? Thanks.

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

So the direct answer to your question, George, is no. That is not a significant driver. And in actuality, product mix per se is less a driver than it is the acceptance of the unified access approach to building networks. And as customers see the value in that, it frankly helps our margins improve across all aspects of the business. So we obviously continue to drive as a leader in fiber to the premises, our entire premises strategy ONTs and other devices, et cetera. But there's no one thing I would call out, I think in the way you're asking the question, like is there something going on underneath that that's helping the margins in a disproportionate sense, so my answer would be no.

George Notter - *Jefferies & Company - Analyst*

Got it. Also, I think I misheard the monologue here. You talked about gross margins improving going forward at a trend toward I think the 50% long-term range. Can you restate that comment? Was that over a four quarter period or longer timeframe that you're looking at?

Michael Ashby - *Calix, Inc. - EVP, CFO*

No. Our long-term target, George, is gross margins in the low 50%. We've always set that as a three to five-year timeframe of which we are starting through that. It is at least another couple of years before we start to get to that level. We have seen margins increasing each quarter and over any four-quarter period, we expect it to continue going up and we will eventually be able to get to the low 50% range.

George Notter - *Jefferies & Company - Analyst*

Got it. Any four-quarter period, you would expect increases. Great. Last question I had was just to come back to the Ericsson discussion. If I look at your International revenue, it looked like it was about flat in dollar terms sequentially. Can you just talk about when we might expect to see some kind of inflection point with that relationship and that channel for you guys? Is that something you would expect to see this year or is that more a 2014 opportunity?

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

Well, I'll give you my impressions and Michael, feel free to add color. I don't know that we're going to see an inflection point like an elbow in that sense, George. I think we're going to just see a continued increase in the deals that are showing up in the funnel, the mix of products, the different regions and I view it as being sort of much more organic in that fashion than having an elbow. If it does get an elbow in the way that you're saying it, well then I think we'll be doing better than we think at some point in the future. Right now, we're just planning on continued growth of International with part of it being through Ericsson. Michael?

Michael Ashby - *Calix, Inc. - EVP, CFO*

Yeah. I think the good news for us, is that International, last year and the year before was in the 7% to 9% range. We're stabilizing up in the 13% to 14% range. It is good and I think it shows the progress we have made. That progress, Ericsson is one small part of that. The progress is then going after the International Tier 2 and Tier 3 accounts, some strength in both the Caribbean and Canada, and that seems to be stabilizing at a good level. I think that I agree with Carl, Ericsson is not going to just suddenly take off. Having said that, I don't think we'll see the full impact of that partnership until 2014.

George Notter - *Jefferies & Company - Analyst*

Got it. Is there a sense of urgency on your part? It feels like there's a fair amount of access opportunities out there in the world right now. I listened to the Alcatel-Lucent call this morning and I think those guys were talking about 46 deals they've signed in the last three quarters and I would imagine some of those are certainly existing customers where they've re-upped for new details. Do you feel like you need to move more quickly through the Ericsson channel getting that sales and marketing effort ramped because you're missing opportunities or do you think this is a natural progression of the marketplace?

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

So I hear what you're saying, George. By the way, I think the question is exactly right. You know, you get up every morning looking at that. Frankly, I want to make sure we're growing our revenues and, over time, growing our margins and that means selling to the value that we built into the architecture. So it is very easy to start chasing revenue opportunities that, in the end, may not be yours anyway. And I'm very sensitive to the fact that we could go chase revenue opportunities that actually put significant downward pressure on gross margins. Because they're not speaking to the value of what we're doing. So for us, we would rather stay focused on continuously growing the business and growing obviously across all of our customer bases. And not chasing deals, per se. But do I have a sense of urgency to want to grow the business? You bet.

George Notter - *Jefferies & Company - Analyst*

Got it. Thank you.

Operator

Thank you. Our next question comes from Simona Jankowski, from Goldman Sachs.

Simona Jankowski - *Goldman Sachs - Analyst*

Hi, thanks very much. Just one more follow-up on the growth margin side. You talked to the mix aspect of it. Can you also touch on the pricing environment, how would you compare the pricing environment competitively versus this time last year?

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

I don't see any significant change in ASP erosion either to the positive or the negative over that period of time. I believe I've got that right, Michael?

Michael Ashby - *Calix, Inc. - EVP, CFO*

Absolutely. I don't think there's any change in environment. We've always said it is price competitive, not price crazy but it is the same now as it was a year ago.

Simona Jankowski - *Goldman Sachs - Analyst*

It is fair to say that none of the margin expansion has been attributable to an easier type environment even as we've seen some consolidation in the industry?

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

Certainly not from my perspective, Simona. Not at all. Nor is it because we're seeing ASP erosion at a more rapid rate and we're doing a super job on cost reductions.

Simona Jankowski - *Goldman Sachs - Analyst*

Okay, gotcha.

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

It feels very much the same year over year to Michael's point.

Michael Ashby - *Calix, Inc. - EVP, CFO*

Sorry, Simona. I was just going to add we've concentrated and talked about this before. A lot on improving the gross margin. There are a whole series of things that we do and focus on to make sure that we can increase our gross margins and those involve controlling our costs, reducing costs, improving our negotiating strategy as well as mix of product and mix of customers. It is a whole combination of things. It is not any one thing.

Simona Jankowski - *Goldman Sachs - Analyst*

Sure.

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

In addition to that, let's understand that gross margin is sort of a short hand for how your customers value what you're providing them. And so you know, George asked the question earlier, we're focused on thinking it is architecture we're bringing to our customers and making sure that we grow the business as we're doing that.

Simona Jankowski - *Goldman Sachs - Analyst*

Sure. My other question which is going to be more on the demand environment, can you just characterize what you're seeing in the tier two segment? Some of the major customers there have guided Cap Ex down for the year but they are facing more pressure now from cable competitors, even Google fiber coming in with much, much faster speeds. How do you see that tier responding to that competitive pressure and do you think that might influence them to change their posture on Cap Ex either this year or into next year?

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

So my opening comment would be that the Cap Ex in cross segments has been relatively flattish. But I don't know that I would separate any one tier. The general competitive environment from the service provider standpoint to your point, for example, Google, I think it sets up pressure across all segments. I don't think it is just reserved to the tier two's, and I know you're not saying that. I think that set up pressure there. How each service provider chooses to respond to it, I think still remains to be seen. Michael?

Michael Ashby - *Calix, Inc. - EVP, CFO*

Yes, I agree with that. It varies. Customer by customer as to how they're responding. There's no question that the advent of gigabit networks and those becoming more talked about and more prevalent is changing the environment.

Simona Jankowski - *Goldman Sachs - Analyst*

Great. Thanks very much.

Operator

Thank you. (Operator Instructions). We appear to have no further questions. I would like to turn the call back over to our speakers for closing comments.

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

Thank you, operator.

Once again, everyone, we would like to thank you for joining us today.

This quarter Calix will be participating in two investment conferences. We hope you can join us at the Jefferies Midwest corporate access day in Chicago on August 28th and the Deutsche Bank D day access technology conference in Las Vegas on September 12th. Information about the conferences will be made available on the Investor Relations section of Calix.com.

Thank you for joining us today.

We remain focused on executing against the opportunities ahead of us and we look forward to speaking to you at one of these forums.

Good-bye for now.

Operator

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