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CALX - Q1 2014 Calix, Inc. Earnings Conference Call

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CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

Victor Chiu *Raymond James - Analyst*

Mark McKechnie *Evercore Partners - Analyst*

Christian Schwab *Craig-Hallum Capital Group - Analyst*

Tim Quillin *Stephens Inc. - Analyst*

Simona Jankowski *Goldman Sachs - Analyst*

Amitabh Passi *UBS - Analyst*

Mike Lin *Stifel Nicolaus - Analyst*

George Notter *Jefferies & Company - Analyst*

PRESENTATION

Operator

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

I would now like to turn the conference over to your host, Mr. David H. Allen, Director of Investor Relations. Thank you, 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'd like to remind you that on this call, we'll be making forward-looking statements regarding future events, including but not limited to the size of the funnel of our 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 for the Company, and our expectations for 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 multi-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 our various SEC reports, including our annual report on Form 10-K for the period ending December 31 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 in which we evaluate our own operations. These non-GAAP measures exclude certain charges and benefits, which we do not consider to be a part of our ongoing activities, but 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 the numbers that are discussed in today's conference call are non-GAAP unless otherwise noted.

This conference call will be available for audio replay in the Investor Relations Section of the Calix website at www.Calix.com.

In addition, our earnings press release, along with supplemental financial data, has been posted in the Investor Relations section of the Calix website, which you may want to review in conjunction with our press release and conference call remarks today. I would now like to turn the call over to Calix President and CEO, Carl Russo. Carl?

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

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

The Calix team performed well in the first quarter. Revenue exceeded our expectations on a backdrop of increasing activity in our customer base. We made good progress with our E-series family, especially in our international markets.

Furthermore, William has come up to speed rapidly. And without further ado, I will turn the call over to him to review Q1 in detail and share our guidance for Q2. William?

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

Thank you, Carl. As a reminder, the guidance that we provided on February 11 for the fourth quarter called for revenues of between \$78 million and \$84 million; gross margins of between 45% and 45.5%; and operating expenses in a range of \$41 million to \$41.7 million; with the resulting EPS being a loss of between \$0.07 and \$0.12 per share.

Actual revenue for the quarter was \$85.8 million and EPS was a negative \$0.03 per share, both better than our guidance. Gross margin was 45.9% and operating expenses came in at \$40.7 million, both metrics slightly ahead of our guidance.

As we anticipated, we saw declining cash this quarter and Calix ended the quarter with total cash of \$75.5 million, down from \$83 million.

Revenue for the quarter was down \$4.7 million or \$90.5 million in the same period last year and down seasonally from the prior quarter of \$94 million.

International revenue was \$10.6 million in Q1, down from \$12.7 million in Q1 a year ago and from \$13.6 million in Q4. We had one 10% customer again this quarter.

At 45.9%, gross margin was a little higher than had been expected and reflected customer and product mix, deferred and recognized or shipped revenues, and movements in inventory reserves. The gross margin in Q1 was down from the 48.1% level of 2013's Q1, but up from Q4's 45.2% level.

Q1 operating expenses at \$40.7 million were slightly lower than anticipated and down from the prior quarter by \$300,000. This favorable outcome reflected good control over operating expenses and timing differences related to consulting activities that will impact Q2. OpEx was up \$1 million from the same quarter a year ago, primarily due to expenses associated with our international expansion activities.

Turning now to the balance sheet, we ended the quarter with total cash of \$75.5 million, a decrease of \$7.5 million in the quarter. Receivables DSOs were 43 days compared to 41 days in the previous quarter. Inventory levels decreased as expected to \$45.1 million from \$51.1 million in Q4, while inventory turns decreased to 3.4 from 4.1 turns, reflecting that higher starting balance in Q1.

Deferred revenues were \$47.5 million, down from \$53.3 million in the prior quarter and reflecting the completion of a number of BBS projects that were recognized as revenues during the first quarter.

Let me now discuss our guidance for the second quarter of 2014. Historically, Q2 has tended to be a higher performing quarter than Q1 and we expect this trend to continue. Very importantly, we expect to return to profitability and to be cash flow positive in Q2 and for the rest of 2014.

Our guidance for Q2 is as follows. The revenue range for the second quarter is expected to increase and to be in a range of between \$94 million and \$97 million. Gross margins are expected to be down slightly this quarter, primarily due to two factors. One, product and customer mix considerations, and two, the recognition of additional BBS revenues, which have lower margin outsourced professional services related to contract closeouts. Consequently, we anticipate gross margin to come in between 45% and 45.5% in Q2.

Operating expenses will increase at a rate slower than revenues in Q2. OpEx is expected to be in the range of \$42.3 million to \$42.9 million with a sequential increase primarily due to compensation expenses derived from increases in headcount and from annual salary adjustments. Given our revenue and margin expectations, we expect to return to non-GAAP profitability in Q2 and to generate a range of zero to \$0.02 per share.

Inventories are expected to decline slightly from Q1. Finally, we expect to be cash flow positive in each of the remaining quarters of 2014. At this point, I'd like to turn the call back over to Carl. Carl?

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

Thank you, William. In this quarter alone, there have been numerous examples of an acceleration in the demand for broadband services. While gigabit is a buzzword, it is really about providing high-performance broadband services to a variety of subscribers. In residential offerings, it is driven by entertainment, video, and gaming, along with an increasingly mobile workforce. In enterprise offering, it is driven by an acceleration of content and applications moving to the cloud. Along with an explosion of connected devices, these changes point to a future access infrastructure different from that which exist today. And with our focus set of software, system, and service offerings, we believe Calix is well positioned to succeed in this market. With that, I would like to turn the call over for questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Simon Leopold, Raymond James.

Victor Chiu - *Raymond James - Analyst*

Hi, this is Victor Chiu in for Simon Leopold. I wanted to ask about the status of your Tier 2 and Tier 3 customer base and how that's trending since that's been upgraded and impact on your results previously. And -- yes, I just kind of wanted to see if you could give us an update a little bit on that first.

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

Victor, thanks, and please say hello to Simon. Let me break that up for you -- this is Carl. And I'd like to actually separate it because I think Tier 2 and Tier 3 is often discussed as if they were one tier or one behavior. And we see very different behaviors between what are traditionally Tier 2 carriers in the smaller carriers that make up Tier 3.

In the Tier 2s, we are seeing mostly a sideways movement in their business and have seen over the last few quarters. While we think we are doing well inside of those customers, there's no noticeable uptick or downtick in that segment of the market.



We have, however, historically commented on the uncertainties affecting the smaller carriers in the space, and that causing them to at times delay or stand still on otherwise CapEx investments that they would have made. What we have seen in the last quarter is an acceleration of opportunities in the smaller carriers' space. So what we refer to as Tier 3 has actually been accelerating in a very meaningful way not only in breadth, but also in the number of deals that we see showing up in the funnel. So we've actually seen an uptick in that business in Q1 and it continues to accelerate into Q2.

Victor Chiu - *Raymond James - Analyst*

Is this divergent from what happened in Q4 because it seems like Tier 2 and Tier 3 are both a bit soft, and yes, that seemed like what that kind of (multiple speakers) was.

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

Well, to be clear in Q4, you may remember our comments of saying a chilly wind blew through the space, and most affecting larger customers down to smaller customers. So to speak directly to the Tier 3, the smaller service providers of all types, we've seen that actually continue to build. Since late in the fourth quarter it started to get active and it's really started to step up in the first quarter.

Victor Chiu - *Raymond James - Analyst*

Okay. I think that seems contradictory to your largest competitor, Adtran, who mentioned specifically that Tier 2 and Tier 3 had started to become weak for them, a bit delayed from you guys. So are they just trailing you? Is that kind of how we should think about that, or is there kind of a diverging pattern between your customer base? And is there a [shortening], I guess? Is that a component of it as well?

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

So I can't speak to what someone else said. The only thing I can tell you is, look, we have direct relationships with all of our customers. And obviously, you see this trend of discussions around gigabit communities, but frankly, more enhanced broadband services that we think architecturally we're well-positioned for. So I really can't address what somebody else would say. I can only help you understand what we are seeing. So I mean I'm sorry for that, but that's what we're seeing.

Victor Chiu - *Raymond James - Analyst*

So you're not seeing share gain as a component of the accelerating Tier 3 revenue?

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

So we don't make comments really on market share gains or specific customers' (technical difficulty). I can just tell you what we're seeing from an interest level, and it is quite marked in what we are seeing in the smaller carrier space.

Victor Chiu - *Raymond James - Analyst*

Great. That's fair. And just one last thing, on the gross margin, can you give us a little bit of color on what exactly a product mix was that led to the (inaudible) this quarter and what the contribution would be next quarter?



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

Yes, I'll excuse William from answering that question because as you know, we don't answer the mix questions, again, because we view access as a space. But William, you may want to make a comment on next quarter's guidance.

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

Yes, on next quarter, we've explicitly I think noted that we're going to see some type of a little bit on (inaudible) gross margins and downward pressure on that, and that's because we're seeing our BBS programs running through. As I noted in the call, we're basically moving to close out those contracts, and that involved an externally contracted services element, which is lower margin than our average corporate margins, so that affects our margins over the next few quarters.

Victor Chiu - *Raymond James - Analyst*

Good. Okay, great, thank you.

Operator

Mark McKechnie, Evercore.

Mark McKechnie - *Evercore Partners - Analyst*

Let me ask you three questions really or subjects. First is the standard update on your project with Ericsson. Carl, could you give an update on the program? Did we see any revenues this quarter? What type of engagements are happening here with carriers? Are we still looking at a ramp in the second half of the year? Any thoughts on the margin profile -- when that ramps up? And I've got a couple after that.

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

So I'll take that one, Mark. Good afternoon.

On the Ericsson piece, as you know, there's always revenues in the quarter from Ericsson as we've continued with the program from day one. I think your question is what are we seeing from a growth perspective and are we on plan.

The bad news there is if you look at our international revenues year over year, you'll notice that they look to be relatively flat.

The good news is there's a reason for that. And the reason for that is we've started to operationalize the E7 and the E-series product family into the BLM footprint with the [EntriView] (corrected by company after the call) management system integration that we've been speaking about. And the good news is we're now in labs and in situations that caused the customer to want to test it, which inexorably has a sloping effect on their willingness to order. We expect that effect to basically work its way through over this quarter and next -- so pardon me, first quarter and second quarter. But I'm very encouraged with the progress that we're making across the footprint now.

Mark McKechnie - *Evercore Partners - Analyst*

Carl that -- for this Ericsson, it sounds like that's to some of your existing customers, right, if they're pausing. I'm more curious as to how the new customer activities are going there.

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

Well. Did I stun you with that answer, Mark? The new customer activities are going well. There are many situations that we work together on and are working together on right now, so the short answer is well.

Mark McKechnie - *Evercore Partners - Analyst*

Got you. Okay, no, I appreciate that.

And then maybe for William, on the OpEx guidance this quarter for June it looks like a little higher than that dot, not crazy out of the range or anything. But I wanted to ask do you -- one, was there -- it sounded like you alluded to some sort of a one-time pause in Q1 that might have gotten pushed into Q2, so do you think looking out to a year, are we going to be seeing OpEx go up every quarter in line with revenue? Or do you think you can hold it a little flatter there relative to your revenue growth?

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

Well we don't provide guidance out beyond a single quarter, so the short answer is that there were some timing aspects that pushed some of those operating expenses out to Q2, but I can't really comment further than that.

Mark McKechnie - *Evercore Partners - Analyst*

Okay, got you. And then probably the last one here for me is on the new products, and maybe Carl, you can chime in on this. I guess about a quarter ago you announced the business services products for the cable operators, and I wanted to get a sense for how that launch is going.

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

And by the way, thanks for asking and I hope I didn't confuse you back then. Those products are available for all service providers. And to update you, we have now just begun our first lab trials, and so, so far so good. We'll knock on wood, but stay tuned. But it's progressing down the path that we want it to go down.

Mark McKechnie - *Evercore Partners - Analyst*

Okay, great. Very good. Thanks. I'll turn it over. Bye, guys.

Operator

Christian Schwab, Craig-Hallum.

Christian Schwab - *Craig-Hallum Capital Group - Analyst*

Great, thank you, solid quarter. As we look to gross margins, would you expect gross margins to continue the trend to be up on a year-over-year basis when we exit 2014 versus 2013?

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

In terms of over the year -- and a key element of that is going to be the movement of those last BBS contracts as they move through our P&L. As we've indicated in the past, we expect those substantially to be off our balance sheet by year end, and therefore, the margin pressures associated with those closeouts will ease by the end of the year. But let me turn it over to Carl for some of the bigger picture outlook.

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

Yes, I mean just real quickly as we've discussed for a while now -- and Christian, thanks for coming on board. We do appreciate it. We've been experiencing a trend of expanding gross margins since we went public. And we attribute that to the shifts in the access infrastructure and how the networks are architected, the systems that we build.

But we've also been clear to try and counsel folks on when we have opportunities to be footprint aggressors or expand market share, that will sometimes have a downward effect on gross margins. Obviously, we have stepped off in the last year into a pretty big push into international markets, and those are markets where we don't have any share. And as you move into new markets, those deals are typically going to be lower than the deals that you would have in your existing markets.

So the long-term trend, we believe, is going to continue to be up and to the right. But having said that, in any given quarter, you may see some attenuation either way, and I think William has articulated what's going to go on in second quarter, we believe.

Christian Schwab - *Craig-Hallum Capital Group - Analyst*

Great. As far as some of these government initiatives for increased spending, targeting real broadband, is there any of the four that you guys have highlighted previously that you believe will have a more material impact in a timely manner than others? Or are we kind of in a wait and see in all of them?

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

They all have impacts. I don't know that I would jump forward and say that any one of them has a bigger impact than the other.

To be blunt, last week's news -- I think it was last week's news -- on Commissioner Wheeler's announcement on net neutrality may ultimately have the biggest effect in driving the infrastructure investments forward. And that's not in the set of things that you mentioned.

Christian Schwab - *Craig-Hallum Capital Group - Analyst*

Right, right. Okay, great.

And then my last question -- we would anticipate then or should we anticipate, I should say, that we will see year-over-year revenue growth this year in the international business?

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

So I'll answer the broad question. I don't think there's any question that we're going to see that growth. And something that you'll see in our kit on the website is we added some 20 new customers this quarter, as you might imagine, the vast majority of which were in the international markets.



And the goal -- the program that we follow and the goal that's very clear for the teams is first and foremost, gaining customer references, so if you will, pins on the map in our regions that could start to gain the Calix experience and speak positively about it in region. And we are making very good progress in our international markets on putting pins on the map.

Christian Schwab - *Craig-Hallum Capital Group - Analyst*

Excellent. No other questions. Thank you.

Operator

Tim Quillin, Stephens.

Tim Quillin - *Stephens Inc. - Analyst*

In terms of the international outlook, does the completion of the interface with the Ericsson management system mainly impact, in the near term, your install base? So in other words, as you said, there is this pause to evaluate those products, but are your opportunity sets, then, greatest within that install base that have been buying the BLM 1500 platform but now are evaluating the E-Series for maybe broader initiatives?

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

The short answer is time will tell. Having said that, we're actually very encouraged by the number of new prospects that have shown up in the funnel that were basically unleashed by having the E-Series products available for our international markets. Because they really weren't until this most recent release -- release 2.3 for the E-Series products. So what's happening now is it is starting to go out into the channel with a viable product series that allows our customers internationally deploy the E-Series with our T-Series Premises family and address in a meaningful way those opportunities that we haven't been able to address before.

In the existing customers, it clearly has a slowing effect. But I guess my -- if I were to put a finger in the air and say which way does the wind blow, I suspect our larger opportunity very quickly is going to be not in the install base but actually in new prospects that are jumping into the funnel with Ericsson as a partner.

Tim Quillin - *Stephens Inc. - Analyst*

Right. And then -- this is kind of going back a ways, but Ericsson was a GPON domain supplier to AT&T. Does the completion of the interface with the management system give you a toehold into AT&T? Or what would be the steps that you might need to take to be a GPON supplier if AT&T starts building these GigaPower networks like they've suggested they would?

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

So Tim, I think yours is a very logical question to ask. And as you know from a competitor perspective, we do not talk about individual customer situations, and that would certainly be one that in recent times, would be, I think, on everybody's minds.

Suffice it to say that as we look at the marketplace and individual customers moving towards higher capacity and deeper service offerings across the access infrastructure, we believe that that expands our opportunities in the marketplace. But other than that, I would really prefer not to speak about any given customer.



Tim Quillin - *Stephens Inc. - Analyst*

Okay. And I'll ask you another specific question about a customer, but with CenturyLink, I wouldn't ask you to try and preview any additional projects they might announce, but they've already announced a couple projects that you're supporting, one of which is in Las Vegas. And I was wondering if you just, within Las Vegas, if you could tell us how far along you are in that process in terms of maybe the number of neighborhoods versus the number of planned neighborhoods or however you want to try and capture that opportunity.

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

Is there a sixth amendment I can appeal to? So unfortunately, Tim, I would go back, as you might imagine, to the answer on the previous question. But by the way, these are all the right questions. I understand that, but we are really very cautious about sharing information with any customers or prospects. If they want to share it, they can. That would not be something that would be appropriate for us to share. I hope you can understand that.

Tim Quillin - *Stephens Inc. - Analyst*

Yes. And maybe I can ask a little bit more generic question in terms of the Google Fiber impact or the impact of AT&T, but you can't pick up a newspaper or read the web without hearing about planned fiber rollouts. And I have to think that's impacting your customers' decisions right now.

You kind of suggested that within Tier 2, that they are kind of moving sideways, they have, and I think you expect them to continue to move sideways, but are the level of discussions changing at all with that customer set because of what Google and AT&T are doing?

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

Well, I don't think there's any question that -- it's not just the Google and AT&T effect or -- the gigabit networks I mentioned in my comments -- that the buzzword is gigabit. But you have so many other things.

I just mentioned for example the FCC commissioner's plan on net neutrality; the fact that frankly you can't open a newspaper on any given day without seeing an article in it that directly relates to the access infrastructure. So there are a bunch of things that are influencing all our customers of all sizes.

The Tier 2's in particular -- I believe (inaudible) has an opportunity to expand their footprint. And has potentially a source of funding to build some of their networks. So if I were to put the thing that I see first and foremost from the Tier 2's, it would be that.

But they too are looking at the effects and impacts of these higher speed offerings, and we are seeing some movement there in the Tier 2's as well with either offerings or contemplated offerings.

Tim Quillin - *Stephens Inc. - Analyst*

Okay. And then lastly -- and maybe this question is for William, but what is the level of visibility that you have on the second-quarter guidance? And it would be great if you quantify that level of visibility, but maybe if not just qualitatively. The implication is kind of low double-digit quarter-over-quarter increase, which is good, but kind of given the momentum you saw at the end of the quarter, is it something where it's a relatively conservative number or is it a number that is a full solid number that you would have to stretch to get?

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

Got it. Well, if you could imagine, one of my top priorities in the past quarter as I've been getting my feet firmly under the desk has been zeroing in on guidance and on forecasting. So these are numbers that I am highly confident of, so I'm not going to couch those being too conservative or too much of a stretch. It's basically how I see it being played out in Q2. It's just that simple. These are the guardrails that we plan on having the Company moved on in Q2.

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

And I would echo that sentiment, Tim. Our goal is to try and set up these ranges for where we believe the business will land. We were fortunate in Q1 to have some things occur earlier than we actually thought they would, and they came in at the end of the quarter. And so, thus, we overachieved. But our goal is always going to be to set these guardrails as reasonably as we can to give you our best view of where we believe we will end up.

Tim Quillin - *Stephens Inc. - Analyst*

Okay, thank you.

Operator

Simona Jankowski, Goldman Sachs.

Simona Jankowski - *Goldman Sachs - Analyst*

I wanted to follow up a little bit on the gross margin expectations. I think you mentioned as one of the drivers some of the professional services related to BBS buildouts here. Can you just remind us what that revenue run rate is right now quarterly? Is it in the high single digits? And also how much of that is left? Is that really most of what's in deferred on the balance sheet?

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

Sure. In terms of deferreds, as you go back and look at our Ks and Qs, obviously we break those out and we show you the extended warranty component of deferreds. And so you can pretty easily back the extended warranty component out, and what is left at least historically is a very good proxy for how those BBS revenues run through our balance sheet and through our P&L. So if you look out to the end of the year, we will substantially run down the BBS contract revenues that are currently sitting on our balance sheet.

Simona Jankowski - *Goldman Sachs - Analyst*

Okay. Terrific. And then, how should we think about that transition then into next year? Is that -- should we think about that as kind of chunk of revenue the goes away that you need to replace with something else, like perhaps your international efforts? Or do you just think that those Tier 3's who are benefiting from that funding will just increase their own CapEx?

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

It's William here. As Carl has indicated, we're very confident of the strength and the funnel. And so again, if you can imagine, another area that I was really drilling down on over the past quarter and in fact, even before joining the Company was this whole question of the deferred revenue runoff and its interplay with projected revenues going forward. And I'm glad to say that that strong funnel basically underpins my confidence, so we're going to continue to have revenue growth going forward.



Simona Jankowski - *Goldman Sachs - Analyst*

Okay.

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

And Simona, let me add one other color piece if I may because you've been with us since the IPO and you rode this. So initially, we all looked at BBS as an incremental source of funding, remember that?

Simona Jankowski - *Goldman Sachs - Analyst*

Yes.

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

And then we thought it was going to be any day now and it became any year now. And in retrospect, we finally realized that in fact what it is -- and by the way, we've projected this forward as we think about CAF, it's not an incremental funding source but in fact a substitutable funding source. So I think part of what -- if you read between the lines of what William just said, is we expect the inverse to happen; that as that funding source goes away -- and we are seeing this by the way in spades in our small service provider customers, which is they are bringing on their own out of operating income funding sources to go and build additional network. It's a very healthy process in our opinion.

Simona Jankowski - *Goldman Sachs - Analyst*

Yes -- no, that makes a lot of sense. I'd also wanted to come back to the margins again. I think you made the comment that since you have these BBS remaining projects for a few quarters and it sounds to me like you have the international pricing issue with you for a few quarters as well as you go out and expand, that this impact might be with us for a few quarters. Was that the right interpretation, in other words, that we might see gross margins here in the mid-40%'s perhaps for the remaining quarters of the year?

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

By the way, it may be. I suspect it will gently drift back up. I just wanted to make sure that in the earlier question, I made it clear that as you chart -- and you specifically have charted our gross margin expansion over time, while it's pretty prone to least squares fit, it's not exactly linear. And some of the things that can push it out to the right and slow it down a bit is when we are going after footprint expansion and moving into new markets.

As that is a percentage of revenue, so let's just say international revenues grew faster than we thought. Likely that would come with more pressure on gross margin. Gross profit would go up, but if revenues expand dramatically in markets that we are new to, then you're going to see that push out to the right. I think in general, we're going to see it drift up over the course of the year, but drift is the word I would use.

Simona Jankowski - *Goldman Sachs - Analyst*

Yes, one of the things that we historically look to for providing margin expansion was this mix shift from the C-Series to the E-Series. Now, if I think about an E-Series deployment internationally, is that now a lower margin than the C-Series was domestically? Or is it just lower than the E-Series domestically but still higher than where the C-Series was?



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

Yes, it really depends -- I appreciate you're trying to parse it that way, but it's even more granular than that. It's on an individual customer by customer, situation by situation, second quarter, first order -- it's very complicated, Simona.

In general, the easiest way I would ask you to think about it is when we're putting pins on the map and they are in new regions, so the first pin that goes into that region is likely going to be at a lower margin than it will be later on.

Simona Jankowski - *Goldman Sachs - Analyst*

Okay, terrific. Well thank you very much, appreciate it.

Operator

Amitabh Passi, UBS.

Amitabh Passi - *UBS - Analyst*

Thank you. I just had a couple on my end. Carl, of the 20 new customers you added in the quarter, were there any Tier 1's?

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

I hope you'll respect me for saying I'm not going to answer that question.

Amitabh Passi - *UBS - Analyst*

Okay. (multiple speakers)

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

Amitabh, just to finish, if there were, they would have been international.

Amitabh Passi - *UBS - Analyst*

Okay. Maybe -- and I don't know, Carl, if you can help us here, you've talked multiple times about a developing expanding funnel of opportunities in international markets. Are there any metrics you can give us in terms of just getting a feel for how that funnel is developing, particularly over the last couple of quarters?

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

There's no metric, simply that it's getting larger and it's getting larger as funnels do. When funnels start to expand, they obviously expand at the top first, and you see a lot more deal flow coming in, and then eventually it starts to work its way through the funnel. We're just seeing -- we're seeing expansion at the top of the funnel, and it's pretty consistent. And then it just works its way through the funnel. So there's no metrics that I would give you to try and help you vector in on that. I'm just trying to give you a sense for the directionality of the business.



Amitabh Passi - UBS - Analyst

Okay. And then maybe just one final one for William. Accounts payable, can you help us understand what happened this quarter and how do we think about that going forward?

William Atkins - Calix, Inc. - EVP & CFO

Yes, we just basically took on some inventory at the end of Q4 and so, therefore, we just paid that down this quarter. That's substantially what happened.

Amitabh Passi - UBS - Analyst

So you're back at a more normal level now?

William Atkins - Calix, Inc. - EVP & CFO

Yes, I would agree.

Amitabh Passi - UBS - Analyst

Okay, all right. Thanks.

Operator

Sanjiv Wadhvani, Stifel Nicolaus.

Mike Lin - Stifel Nicolaus - Analyst

Hi, this is Mike, speaking in for Sanjiv. First question I had was about the revenue forecast for the rest of the year. I think in the last quarter's call you mentioned that Q2 and Q3 look strong, but it looks like you've pushed in those orders and got them earlier into Q1, so for the rest of the year, what was sort of the outlook looking like? And did you still expect the annual forecast to be below 10% for the year in terms of growth?

Carl Russo - Calix, Inc. - President & CEO

So right now I would say that there's nothing that would cause us to change how we're viewing the year. And obviously, as William has mentioned, we focus on guidance one quarter at a time. So our guidance for the quarter is \$94 million to \$97 million, and that's what we're focused on. Beyond that, even though we were ahead of plan in Q1, there's nothing I'm going to tell you that should say raise models for the year.

Mike Lin - Stifel Nicolaus - Analyst

Understood. And going back to your comment earlier, you were saying that the net neutrality legislation that has been coming up could probably have more of an impact than the CAF2 funding legislation. Could you maybe expand on that a little bit? Was that a comment that affected your space in particular or more so in some of the network monitor equipment company space?



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

Oh, no, no, no. No, no. Very specifically in the access space. So let me see if I can give you an example. And there's going to be a lot of gnashing of teeth as there's information heard on the whole ruling coming up, but here's a simple view.

If I'm a Web 2.0 company and I have a remarkable market cap to revenue multiple, part of the reason I have that market cap to revenue multiple is an assumption that the access infrastructure is going to continue to be opened up, made more robust, enhanced. Because if it isn't, then my business model is pinched. Does that make sense, Mike?

Mike Lin - *Stifel Nicolaus - Analyst*

Yes.

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

Okay, so now, if I'm one of those companies, and the rate of infrastructure investment is too slow, I might go out and say, you know what, I need to start rattling sabers and build some infrastructure to get people moving.

Mike Lin - *Stifel Nicolaus - Analyst*

Got it.

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

And if I was the CFO of one of those companies, I might actually say mission accomplished because it's got everybody moving.

Now you come along with net neutrality, and here's one man's view, this being my view, if I'm one of those companies, I have a choice between either building my own infrastructure or renting someone else's, which is what Commissioner Wheeler's net neutrality proposal allows me to do. I'm all for renting so I can focus on my business.

As that renting happens, those are dollars that are going to go directly into the infrastructure. So that ruling has the potential to significantly expand the rate at which infrastructure is invested in and also the technologies that are potentially chosen to do it. It's a net positive.

Unidentified Participant

Okay, that's very interesting. Well thank you. I appreciate it.

Operator

(Operator Instructions). George Notter, Jefferies.

George Notter - *Jefferies & Company - Analyst*

Thank you. I wanted to ask about -- get more color on the experience with Ericsson. I guess I was a little bit confused, Carl, about your comments on release 2.3 and at the same time, you said that new customer opportunities perhaps are bigger than even selling through the existing Ericsson customer set. You guys have owned this Ericsson access business for a year and a half now. I guess I'm trying to understand why you haven't seen



some of these new opportunities I guess percolate up earlier than just now? And why is release 2.3 kind of a catalyst for you to again go address those new opportunities? Thanks.

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

Great question. Basically, we didn't have an internationalized family of Premises products to go along with the E7 systems to sell the complete network. Sorry if I did not make that clearer in an earlier conference call. So release 2.3 is of seminal importance to us expanding our international business in two dimensions. One is being able to sell the E-Series with the appropriate other end of the network on it, and so that opens us up to new opportunities. And the reason you haven't seen the new opportunities before is because until you have the product set, it's hard to do business.

George Notter - *Jefferies & Company - Analyst*

(multiple speakers). Sorry, when did release 2.3 precisely start to ship?

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

Let's just say within the first quarter.

George Notter - *Jefferies & Company - Analyst*

Okay. Got it. I'm sorry I interrupted you. You had another piece of the response.

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

No, George, you're welcome to interrupt me anytime.

The other piece of that is, now, go into the installed base, where we're looking to bring the E7 into that install base via the software integration, etc., and that has to be tested. So you sort of have this lull effect going on until two things happen, you add the new opportunities into the funnel because now they can go sell them, and you get through the hand off, if you will, of having -- formerly have these units; now I can go sell this new thing and potentially deploy it as well.

George Notter - *Jefferies & Company - Analyst*

Got it. Okay, very good, that makes sense. And then the other question I had was just on -- was there any potential or any weather impact on the business in Q1 that you guys noticed?

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

No. And if I ever blame something on the weather, shoot me.

George Notter - *Jefferies & Company - Analyst*

Got it, fair enough. Thanks very much, guys.



Operator

Mark McKechnie, Evercore.

Mark McKechnie - *Evercore Partners - Analyst*

Hi, guys, yes, a follow-up question. So Carl, first I had to make this comment. No offense in response to an earlier question, you talked about if you were a CFO, but I really don't envision you as a CFO of a carrier customer. But the second question is on your second-half outlook -- I want to get a -- or at least as I'm looking out to the second half, trying to get a better feel from you from where we are on this architectural pause that we talked about, with the Tier 2's and Tier [3's] (corrected by company after the call) shifting from copper to fiber in response to the Google spend and the video traffic and what have you.

But Carl, do you get a sense -- is this the entire industry, across your entire customer footprint? Is this a third of it? Is this the big guys, the small guys? Any kind of metrics you can give as to where they might be in that cut over, as we think about what to forecast for September and December?

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

So I want to go back to your comment about our comments on a pause because I most definitely did say that in the past and that was a Q4 statement -- that we had seen a pause and from our perspective, it was clear that what caused that pause was everybody trying to orient around what's all this stuff about gigabit, what's going on here, the competitive circumstances, Docsis 3.0, 3.1. Lots of information to assimilate.

To be clear, we are not seeing that pause today. As a matter fact, we're seeing the exact opposite, that it has lifted and people are now taking action. That action is not flowing smoothly across each segment or each customer grouping. In some areas it's happening faster and in other areas, it's still a little bit sideways. That's what I was commenting on when I was talking about Tier 2s looking a little more sideways and actually the smaller service providers of all types starting to accelerate. So does that help clarify that, Mark?

Mark McKechnie - *Evercore Partners - Analyst*

Yes, it does, so I can kind of envision across your customer base all shapes and sizes. Some are testing it out, probably, but from where you stand, do you think most all are evaluating it and are just at different phases of deployment?

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

Certainly a majority are evaluating these items. I can't say everyone, but surely a majority. And I want to make sure I close out one other item, because I think you were looking for sort of a view into later in the year; is that correct?

Mark McKechnie - *Evercore Partners - Analyst*

That's exactly right, yes.

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

So let me tie that out with the question that was asked earlier. We definitely feel better about the business. We like what we're seeing in the funnel, but I don't feel good enough yet to have anybody thinking any differently about the second half of the year. We're giving guidance for Q2, and I would strongly disregard any changes in the second half. We'll get there when we get there, and on our next quarter conference call, we'll be able to give you a better view into what's going on there.



Mark McKechnie - *Evercore Partners - Analyst*

Got you. No, that's helpful. One other metric that could help -- again, I'm not sure how much you will share with me -- your relative mix of fiber versus copper if that's -- I know a lot of your systems can do both. But are you at the point where you're seeing an acceleration in the shift from copper to fiber in the deployments? And is it half of your deployments or where are we at there?

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

So there's probably one milestone I might share with you but let me make sure I set your expectations correctly. You've heard this before, but I want to reiterate it in a different way. We think about the access infrastructure as converging into a unified access infrastructure. We build systems that are very networking oriented, and as such, segmenting things by the subscriber-facing physical connection doesn't make sense to us. So we don't think of the business in that way. And as you know, we shift lots of different physical interfaces across our product sets.

What I can share is I believe we have eclipsed the 1,000 customer mark on fiber deployments. So it is happening.

Mark McKechnie - *Evercore Partners - Analyst*

Got you. Okay, no, that's great. Thanks, guys.

Operator

(Operator Instructions). It appears there are no further questions at this time. I would like to turn the call back over to management for any closing remarks.

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

Thank you, operator. Calix will be participating in three investor conferences this quarter. We hope you can join us at one of these events, including the Jefferies 2014 Global Technology, Media and Telecom Conference in Miami on May 7; the Cowen and Company 42nd Annual Technology Media & Telecom conference in New York City on May 28; and the Stephens 2014 Spring Investment Conference in New York City on June 4.

Live and archived audio webcast of these presentations will be available from the Investors 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 Calix.com Investor Relations section. Once again, thank you for joining us today and good bye for now.

Operator

Ladies and gentlemen, this does conclude today's teleconference. You may disconnect your lines at this time. Thank you very much for your participation and have a wonderful afternoon.



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