# FINAL TRANSCRIPT

Thomson StreetEvents℠

# CALX - Q2 2010 CALIX INC Earnings Conference Call

Event Date/Time: Jul. 22. 2010 / 8:30PM GMT





THOMSON REUTERS

## CORPORATE PARTICIPANTS

**Denis Quinlan**
*Calix Networks, Inc. - General Counsel*

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

**Kelyn Brannon**
*Calix Networks, Inc. - EVP & CFO*

## CONFERENCE CALL PARTICIPANTS

**George Notter**
*Jefferies & Co. - Analyst*

**Ehud Gelblum**
*Morgan Stanley - Analyst*

**Simona Jankowski**
*Goldman Sachs - Analyst*

**Nikos Theodosopoulos**
*UBS - Analyst*

**Vivek Arya**
*Bank of America/Merrill Lynch - Analyst*

**Mark Sue**
*RBC Capital Markets - Analyst*

## PRESENTATION

**Operator**

Good day, ladies and gentlemen, and thank you for joining the Calix Second Quarter 2010 Earnings Conference Call. At this time all participants are in listen-only mode. We will conduct a question-and-answer session towards the end of the conference.

(Operator Instructions)

---

**Operator**

I would now like to turn the call over to Mr. Denis Quinlan, General Counsel for Calix. Please proceed, sir.

---

**Denis Quinlan** - *Calix Networks, Inc. - General Counsel*

Thank you, operator, and good afternoon, everyone. This conference call contains forward-looking statements which are statements regarding future events including, but not limited to the future financial performance of the Company and our expectations of revenue, gross margins and earnings per share. These forward-looking statements are made pursuant to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995.

You are cautioned not to place undue reliance on these forward-looking statements which are based on Management's expectations, estimates and judgment 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. More information about potential factors that could affect the Company's business, results of operations and financial condition is contained in the

Company's periodic reports including the Company's quarterly report on Form 10-Q for the fiscal quarter ended March 27, 2010, available at www.sec.gov.

All forward-looking statements are made as of the date of this conference call and except as required by law we do not intend and undertake no duty to update this information to reflect new information, future events or circumstances or otherwise. Although this call may be replayed as of a later date, its continued availability does not indicate that we are reaffirming or confirming any of the information contained in the live conference call today.

In addition, on this conference call we will be discussing GAAP and non-GAAP results. These non-GAAP results exclude certain noncash charges and benefits, including stock-based compensation expense, amortization of acquisition-related intangible assets and changes in the fair value of preferred stock warrants and preferred stock dividends, as we do not consider these items to be part of the Company's ongoing operating activities or meaningful in evaluating the Company's financial performance.

To help you better understand our results, we have included a detailed reconciliation between our GAAP and non-GAAP results in our earnings press release. This conference call will be available for audio replay in the Investor Relations section of the Calix website at investor-relations.calix.com. In addition, our earnings press release has been posted to our website.

I would now like to turn the call over to Calix President and CEO, Carl Russo. Carl?

---

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

Thank you, Denis. Good afternoon, everyone, and welcome to our earnings conference call for the second quarter 2010. Joining me on the call today is Kelyn Brannon, our Executive Vice President and Chief Financial Officer.

I will provide a brief overview of the business and marketplace and then turn the call over to Kelyn to walk through the financials in detail. After that, I will come back to summarize and take questions.

Our second quarter results were ahead of our expectations and demonstrated continued strong growth in our business. Revenues for Q2 2010 were up 50% year-over-year to $71.7 million. This resulted in a non-GAAP net profit for the quarter of $5.5 million.

Our financial results reflected both a market and macroeconomic environment that was significantly improved over the second quarter of 2009. Broadband demand among our customers, subscribers remained strong and communication service providers continued to bring fiber forward in their networks.

Communication services providers continue to face a changing market environment where consumers are consistently creating more broadband services while competition intensifies and the regulatory environment remains unpredictable. In the face of this challenge service provider behavior has become increasingly polarized.

Many are looking at this emerging market environment, seeing opportunity and ramping up investment in their networks, realizing that the competitive, regulatory and financing environments are as favorable as they will ever be. This constituency is rapidly moving fiber forward and looking to Calix for the solutions that allow to become more operationally efficient, flexible and responsive to consumer demand.

In contrast to this mentality there is a portion of the market that sees the environment as too unpredictable and seeing risk have slowed their spending, waiting for additional clarity. We believe this polarized environment will exist at least until there is clarity on the regulatory front.

There is little debate that regulatory reform will be enacted and that programs like the Universal Services Fund will be transformed. However, we believe that this reform once put forth and enacted will ultimately recognize that IOCs serve a high and growing percentage of rural America today and that investing in these rural service providers, and by association the digital and economic future of rural America, provides the highest return on investment both politically and economically.

Calix continued to innovate in the second quarter across our Unified Access portfolio, which in turn fueled deployment momentum and market share gains. During our Q1 earnings call we announced that we had achieved RUS acceptance of our EXA Powered E7 Ethernet Service Access Platform, allowing for widespread adoption in the market.

In Q2 we saw the benefit as the E7 achieved a milestone by reaching deployment at its 100th customer in only a second quarter of availability. This makes the E7 the fastest adopted Calix platform in the Company's history.

Also during our Q1 call we introduced the availability of Release 7.0 for the EXA Powered C7 Multiservice Access Platform. Q2 saw expanding deployment of Release 7.0 by our customers, enabling them to fully transform their networks from TDM, ATM and SONET to natively switch to Ethernet services delivery, and in so doing gain significant operational efficiencies in their networks.

These milestones are emblematic of our Unified Access approach and reinforce our belief that taking a long-term architectural view of the Access Infrastructure is the best way for our customers and for Calix to build strategic value.

With that, I will turn the call over to Kelyn Brannon, who will provide details on our Q2 2010 financial performance. Kelyn?

---

**Kelyn Brannon** - *Calix Networks, Inc. - EVP & CFO*

Thank you, Carl, and good afternoon, everyone. I will walk through our unaudited statement of operations and compare the second quarter ended June 26, 2010 to the second quarter of 2009. After that, I will briefly discuss the balance sheet.

Unless otherwise indicated, I will be discussing non-GAAP financial measures. A reconciliation of GAAP results to non-GAAP is provided in our earnings release. To arrive at non-GAAP results we adjust for noncash expenses which include stock-based compensation, amortization of acquisition-related intangible assets, changes in the fair market value of preferred stock warrants and preferred stock dividends.

Revenue for the second quarter came in at $71.7 million, a increase of 50% from the $ 47.8 million reported in the second quarter of 2009. As you recall, Q2 of 2009 was impacted negatively by the uncertainty surround the Broadband Stimulus Initiative and the overall macroeconomic environment.

Non-GAAP gross margin for the second quarter was 42.3%, which represents an improvement of 686 basis points from the 35.4% in the year ago quarter. This improvement was primarily due to cost reductions in raw materials, product and customer mix and leveraging our fixed costs over our higher revenue base.

While our long-term goal is to improve overall gross margin, on a quarter-to-quarter basis we would expect our gross margin to fluctuate. Please be mindful that any one quarter can run ahead or behind that long-term trend.

Turning to operating expenses, I will be discussing non-GAAP operating expenses which exclude stock-based compensation which is detailed in our press release within the condensed statement of operations. Non-GAAP R&D spending was $11.4 million for the second quarter of 2010, an increase from the $10.1 million in the corresponding period of 2009.

The increase compared to the prior year quarter is primarily due to increases in increases in payroll and related costs and consulting expenses. Looking into the second half of 2010, we plan to make additional investments in our R&D organization as we accelerate product deliverables to new markets.

Non-GAAP sales and marketing spending was $8.9 million for the second quarter of 2010, an increase from $7.6 million in the corresponding period of 2009. The increase in 2010 is primarily the result of an increase in payroll and related costs including higher commissions on increased booking, as well as an increase in travel-related expenses.

Non-GAAP G&A spending was $3.7 million for the second quarter of 2010, an increase from $3.3 million in the corresponding period of 2009. The increase over 2009 was driven by an increase in payroll and related costs, consulting and professional services expenses and insurance for our directors and officers, partially offset by a decrease in bad debt expense.

Non-GAAP operating income for the second quarter of 2010 was $6.3 million, as compared to a loss of $4 million in the corresponding period of 2009. Given our net operating loss carry forwards in excess of $350 million, we do not anticipate incurring meaningful income tax expenses for the foreseeable future, and therefore we estimate a non-GAAP effective tax rate of between 5% to 10%.

Adjusting for these items and assuming the conversion of preferred stock to common stock, as of the beginning of the period, non-GAAP net income for the second quarter was $5.5 million fully diluted earnings of $0.14 per share, compared with a non-GAAP net loss of $5.2 million or a loss of $0.19 per share in Q2 of 2009.

Turning to the balance sheet, at June 26, 2010 cash and marketable securities was $101.9 million, down from $117.8 million at March 27, 2010. As a reminder, during the second quarter of 2010 our underwriters exercised their overallotment option related to our IPO providing net proceeds of $11.5 million. And we also elected to pay off our term loan of $20 million. The net effect of these two transactions was to reduce our cash by $8.5 million. With the repayment of the term loan we expect interest expense to be approximately $50,000 per quarter.

Net accounts receivable increased by $10.4 million, sequentially, from Q1 of 2010 as a result of increased shipment activity we experienced in Q2 of 2010. Average DSOs on accounts receivable were 39 at the end of Q2, versus 50 in the year ago quarter.

Inventories were $24.9 million, yielding inventory turns of 5.4, as compared to 4.7 in Q2 of 2009. Deferred revenue was $37.8 million, an increase of $5.9 million over the prior quarter, due to increased shipment volumes.

For Q2 depreciation and amortization was $1.2 million and the amortization of our acquisition-related intangible assets was $1.5 million. As a reminder, the amortization of acquired intangibles related to our acquisition of OSI will expire in early February, 2011.

Now turning to guidance, as you know, Q3 historically exhibits seasonality and is typically flat to down from Q2. As such, we expect third quarter revenue to range between $70 million to $74 million. We expect a non-GAAP EPS range of between $0.04 per share to $0.08 per share, calculated on fully diluted weighted average shares for the quarter of approximately $40.1 million.

We expect the basic weighted share count to be approximately 37.4 million shares. This guidance also assumes an effective tax rate of approximately 5% to 10%. For Q3 we expect stock-based compensation to be approximately $7.5 million to $7.9 million.

With that, I will turn the call back over to Carl.

---

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

Thank you, Kelyn. As you have just heard we executed well in Q2 and we believe we are well positioned to execute in the quarters ahead. We believe that consumer and business demand for bandwidth hungry services continues to expand at an accelerating rate, much faster than the networks ability to meet this demand.

Thus, we have a special urgency to execute on our vision of a Unified Access Infrastructure so that our customers may be best positioned to meet this demand and win in the marketplace. As you have seen through our financial results, as well as our press releases throughout the quarter, Calix continues to see increased momentum in every segment of our business, whether product, customer, geography or new market, as well as deeper penetration of our existing customers.

Before I discuss the business further I would like to mention an item regarding corporate governance. Effective Tuesday of this week, Paul Ferris, our first venture board member and an active member of our board for 10 years, has resigned. Paul was instrumental in guiding Calix through significant growth during a variety of market conditions and we deeply appreciate the decade of service that Paul provided to the Company. We wish him well as he ushers other companies to new stages of growth.

Now, regarding the business, I would like to specifically discuss three areas that we suspect may be front of mind. First I would like to address the Calix opportunity at Frontier now that the Verizon transaction is closed.

As you are aware, Frontier has been a Calix customer for over seven years. On July 1, Frontier completed the acquisition of approximately 4.2 million Verizon access lines, more than doubling its size in terms of access lines. As you are also aware, Calix does not presently sell to Verizon, and as such these lines represent a significant expansion of our addressable market. However, Calix Access Platforms are not deployed in the Verizon network, and as such, we have never been integrated into Verizon back office systems.

We began our efforts to integrate into these newly acquired network and back office systems immediately after the July 1 close of the acquisition and we are working diligently to complete integration as soon as possible. We are pleased with the support that we have received from the Frontier and Verizon integration resources to date and we look forward to offering our solutions to millions of new addressable lines in these areas as soon as the acceptance is complete.

Second, I would like to give a brief update on the potential CenturyLink/Qwest combination. We continue to be encouraged by the progress that we are making at both companies. We believe that our long-term view of industry evolution and the transformation of the Access network aligns closely with the vision of this combined entity. We are excited by the CenturyLink/Qwest combination and we will continue to work diligently with the teams from both companies as we intend to earn their business one day at a time.

Third, I would like to give you a brief update on Broadband Stimulus. As you have seen, Q2 marked continued momentum for Calix in securing vendor selections for stimulus awards. To date, Calix has announced that it has been awarded the Access business for nine different round one broadband stimulus award recipients whose aggregate project funding value exceeds $100 million with broadband access being just a portion of that total

All round one broadband stimulus awards have now been announced by the RUS and NTIA and vendor selection by award winners continues to move forward. The first wave of awards for round two of the Broadband Stimulus program were disclosed on July 1 and we expect award announcements to continue throughout the summer.

Calix customers have shown broad interest in the stimulus awards program and our Unified Access portfolio is well suited to what we refer to as first mile projects and to some middle mile projects as well. We are encouraged that the vast majority of the projects awarded to date have been for fiber access, and we believe that as our already announced stimulus vendor selections demonstrate, our Unified Access portfolio is an excellent fit for helping these service providers move fiber forward.

Q2 marked a quarter of strong execution and strong results for Calix. As we look to Q3 we see a clear path to achieving our goals, but remain mindful of the macroeconomic climate, and therefore we will keep our hands close to the levers as we manage our business.

At this point, I would like to turn the call over for questions. Operator?

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions). Your first question comes from the line of George Notter of Jefferies & Company. Please proceed.

---

**George Notter** - *Jefferies & Co. - Analyst*

Hi guys. Thanks very much and congratulations on a very strong Q2. I had a question on the Q3 guide. You mentioned flat to slightly down. If I look at traditional seasonality in your business we don't have that many data points in terms of the quarterly seasonal trends, but certainly the business is up quite a bit sequentially in 2009, roughly flat in '08, up quite a bit in '07.

And then I go look at advanced fiber, for example. Obviously the data points there go way back in terms of time, but historically there Q3 was seasonally stronger than their Q2. And so my question here is why is flat to slightly down the right guidance for you guys in Q3? Thanks.

---

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

George, it's a great question and we too are looking at this and want to make sure that we are keeping a sharp on what feels like a return to what has been normal seasonality for us. So, as you know, 2009 was very much an anomaly as a year, so let me go back and share with you some data points to hopefully shape our thinking on this.

Interestingly enough, when we go back in history if you look at Q2 and Q3 together they have almost every year represented 50% of our business, and therefore Q1 and Q4 coupled together are 50% of our business. Q2 and Q3 have traditionally run very close together in numbers for us historically. And so while we are encouraged by what we are seeing in the marketplace we are also sensing that this is starting to return to normal seasonality, so that is what is driving our guidance.

As you remember, last quarter's range was 66 to 71. This quarter's range is 70 to 74. So we feel as we look at the quarter that it is up, but we are trying to compare that to what we have seen seasonally and not get ahead of ourselves. Am I answering your question?

---

**George Notter** - *Jefferies & Co. - Analyst*

Got it. Yes, that works. Okay, thanks very much. And then just shifting gears a touch, if I look at the gross margin this quarter, obviously way ahead of expectations for Q2 and you guys referenced product mix, customer mix. I think you also said something about raw material costs going down, but can you give us more flavor for what is driving that? Is it -- if I look at product mixes it is more about Release 7.0, or the new P-Series or the E-Series products? Was there a lower mix of CenturyTel revenue? Any more flavor you could give us behind those comments would be helpful. Thanks.

---

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

George, great point again. I would make sure I repeat what Kelyn said. We tend to think of extrapolating this business sort on a least-squares fit, and we look at the dots and try and fit it accordingly. Clearly Q2 represented a dot that would be above the trend line that we set everyone's expectations on. And let me see if I can break it down into a number of different pieces and maybe give you a sense for the levers that can pull the margin one way or another.





THOMSON REUTERS

So, obviously entering new markets, being aggressive on footprint, expanding new customers, all of those things can pull to the left, i.e. down on margin. And we certainly anticipate remaining that, in that aggressive stance going forward.

Product mix, as we look at our products, and clearly we believe that we are doing a better and better job of getting tighter product market fit, and when you do that with a product for example like the E7, which is an Ethernet services Access platform, we think we get a product market fit, and therefore likely have above corporate average margins.

So those are the levers that pull on it. Now there is also another piece that is improving in the business quite rapidly and that is Tony Banta and his team, and Kevin Pope and his team from a product development standpoint continue to focus on the cost reduction supply chain side of the business, and they are making great progress.

So there is one to the right, one to the left and one that runs across the business. So, am I giving you a sense for the levers?

---

**George Notter** - *Jefferies & Co. - Analyst*

Yes. That helps a tone. I am trying to -- if I -- if you asked a different way I guess I am trying to back into what the right baseline would be in terms of setting gross margin expectations going forward. And certainly you guys have been -- you are pretty consistent in saying you expect the margin to grow, go up.

Certainly I think the long-term margin structure you said is 42% here. Do you still think that is the right ultimate target on gross margins? Do you now maybe see, given product mix or some of the operational things you are doing, could that 42% be higher? What is the thought process on the baseline and where it can go?

---

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

So, let me give you the levers on that in a longer term perspective. As you remember when we went public on the road show, we said this sort of our near-term operating model. I don't think any of us expected, I am sure you didn't either, that the near-term would be our second quarter public so, thus, the conundrum.

I don't think we have enough data points yet to reset that near-term data point, but also let me counter that with by saying I don't know that there is a long-term margin point if our assumption that the Access Infrastructure is moving from a box-oriented last mile to a systems-oriented first mile is true, then I don't know where the margins go. I just know that they go up.

So we don't have enough data points to reset that model yet. We would probably wait a few more quarters of performance to do that. But, again, let me add a few other levers to what you are talking about.

We entered 100 new accounts with the E7 in under two quarters. If you compare that to any vendor in any industry, certainly in the service provider industry, you will get a feel for that is a true testimony to the fit of that product. It is also a true testimony to our direct engagement model that when we have a tight market fit we ought to be able to gain tremendous traction.

Having said that, as you know, early traction in a systems environment typically means two systems, four systems, 10 systems, 20 systems, but those same customers will come back and order much more than their initial order. So we are actually very early in E7 penetration.

On the C7 side, Release 7.0 is very early in its penetration, so there is a number of things that as I look forward make us feel very good about margins. But, and let me just counter that with by saying we intend to remain aggressive on a footprint environment, so it is really how those things fall in any one quarter that will determine the quarterly performance. But I think you are right to question what the long-term model, but we do not have enough data at this point in time to reset that.

**George Notter** - *Jefferies & Co. - Analyst*

Got it, fair enough. Thanks very much.

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

Thanks, George.

**Operator**

Our next question comes from the line of Ehud Gelblum of Morgan Stanley. Please proceed.

**Ehud Gelblum** - *Morgan Stanley - Analyst*

Yes, can you hear me?

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

We can hear you fine, Ehud.

**Ehud Gelblum** - *Morgan Stanley - Analyst*

Hello?

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

We can hear you.

**Ehud Gelblum** - *Morgan Stanley - Analyst*

Hello?

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

Yes. Ehud --

**Ehud Gelblum** - *Morgan Stanley - Analyst*

Hello? Okay, first of all, quick housekeeping is were there are 10% customers and can you give us a sense of what the mix on both the revenue line and the gross profit line was between the C7 and the E7 Series?

**Kelyn Brannon** - *Calix Networks, Inc. - EVP & CFO*

So as to the number of 10% customers, we had one in the quarter. And as to the mix of products on the revenue line or gross margin line, we don't provide that type of -- we don't provide segment reporting on that.

**Ehud Gelblum** - *Morgan Stanley - Analyst*

Do you have a sense as to large the 10% customer was? I am just trying to get a sense as to how, again, some of the pieces behind the gross margin and how much of the gross margin may have come from the E Series penetration versus how much may have come from less discounting to that one large 10% customer.

**Kelyn Brannon** - *Calix Networks, Inc. - EVP & CFO*

So, as we said, we have one 10% customer and as we have said in the past we will disclose this on an annual basis because 10% customers kind of come in and out of the quarter. And I am going to like -- I am going to turn it over to Carl in just a second to give a little bit more color, but as Carl was just mentioning, we are pleased with the penetration that we are making with the E7 today where we are sitting at over 100 customers and I will let him answer if he wants to give some more color.

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

Yes, and just the color I would give is simply that the E Series is continuing to grow, but again we won't break it out, but it is definitely continuing to grow. And I would simply say that I am happy with the balance of our customers as at the Company.

**Ehud Gelblum** - *Morgan Stanley - Analyst*

So if the E Series continues on the trend that you are looking at and your 10% customer does not get larger as a percent of revenue, considering that most discounts that you give are most likely to be to that 10% customer, then we should see gross margin on the flat to up kind of trajectory.

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

I understand what you are doing there, Ehud, and I don't know that that is a bad assumption, but keep in mind that we are adding new customers and by the way in this quarter, interestingly enough, our address market expanded to some 40 million lines at various customer wins and some of them actually quite large.

So the caveat to what you are asking me is keep in mind that as we are expanding our address market we are winning customers that they themselves are large, and that will probably have an entry pricing effect that will be pulling down on those gross margins. So if it wasn't for those things and we sort of said let's stop growing our address market then, yes, I would agree with you. But we are going to remain aggressive from a footprint standpoint.

**Ehud Gelblum** - *Morgan Stanley - Analyst*

Okay. That actually makes a lot of sense. Back to your comments, Carl, on the Frontier access line acquisition, as you integrate into the Verizon back office, what is the next procedure from there? Does that take three to six months and at that point you start competing with other competitors in the space, other vendors in the space and you have to wire center by wire center to win business?

Or does Frontier make a global decision at that point that they would either go with Calix or with somebody else for the entire four million access line slot? How does the process roll out from here?

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

So, great question, and so we would love to be able to say here is when we are done. I don't think we have enough data to be able to predict that, although we are very pleased, as we stated, with the progress that is being made and the support that is being shown. So as we get the ability to predict the ending of that integration we will come back and share that information with you.

On how does it work post that, different customers take different approaches, but I will tell you our assumption always is that it is quite literally done on a wire center by wire center, project by project, planner by planner basis. And that is how we structure our sales teams and that is how we approach the customer from the standpoint of we appreciate the opportunity to earn the business and we will go earn it every day.

And so to put the last part of that sentence together, really when you achieve an acceptance or you come out of a lab, it is more of a hunting license than it is a contract, per se. Did that make sense?

---

**Ehud Gelblum** - *Morgan Stanley - Analyst*

Yes, it is. Has anyone else achieved the back office innovation? Has anyone else gotten business already within that footprint that you know of?

---

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

I can't speak for anyone else achieving integration. I am not aware of anyone else achieving integration. There are vendors, however, that are vendors to Verizon that by default will be in essence integrated into those back office systems, and therefore should be off and selling today.

---

**Ehud Gelblum** - *Morgan Stanley - Analyst*

Thanks a lot and one last thing. At what point during the quarter or prior did you start feeling that it made sense to start looking at regular seasonality for Q3, as opposed to some of the same patterns that you saw last year which was an up for Q3?

---

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

So June is really where it started to feel like, you know what, this is starting to feel to me like we are getting back to a normal environment. From the middle week of November in 2008 until really this time it has been much more unusual. So we are -- everything about it is starting to track toward that seasonality and that is why we are messaging to it, but not by the way, to your point. It is a good question. We didn't feel it in April, much more later in the quarter.

---

**Ehud Gelblum** - *Morgan Stanley - Analyst*

Okay, excellent. I appreciate it.

---

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

Thank you. Great questions, Ehud. Thank you.

---

**Operator**

Our next question comes from the line of Simona Jankowski of Goldman Sachs. Please proceed.

---

**Simona Jankowski** - *Goldman Sachs - Analyst*

Hi, thank you so much. I just wanted to ask you a question on the EPS guidance. It seems like you are looking for EPS to go down meaningfully despite revenues being relatively flat. And just doing the back of the envelope math on that, it would seem to imply gross margins declining sequentially by something like four or five percentage points, which would in turn imply the cost of goods sold would have to go up by 5% to 10% sequentially, so just curious. What would the right cost of goods sold up by that kind of amount of flat revenues?

---

**Kelyn Brannon** - *Calix Networks, Inc. - EVP & CFO*

Hi, Simona, it's Kelyn. I just quickly on your model kind of thinking through that, one of the things in the script that I indicated is that we are looking at increasing our investment in our R&D organization. And so we will see a somewhat meaningful increase in R&D expenses in Q3. And I would anticipate that to be about $2 million in Q3.

---

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

And let me just add some color to that, Simona, because as we have discussed before, if we thought we were doing something on the OpEx side that would be nonlinear from history, we would message that. And what Kelyn just messaged is a significant statement.

What is driving that is -- well, there is a number of factors, but what is driving it really is OSMINE and things of that type which we had forecast frankly not in this year. We had forecast it in our original plans for next year and it is being brought forward into Q3. And so that is actually what is driving your back of the napkin difference.

---

**Simona Jankowski** - *Goldman Sachs - Analyst*

Okay, that is helpful. And maybe, Kelyn, are you able to give us a OpEx guidance a little bit more broadly behind just the R&D line?

---

**Kelyn Brannon** - *Calix Networks, Inc. - EVP & CFO*

I would tell you that the meaningful change in our OpEx is in the R&D line.

---

**Simona Jankowski** - *Goldman Sachs - Analyst*

Okay. And then for Carl, just to follow-up on the comment you made about a portion of service providers slowing their spending in response to the regulatory environment and sort of seeing a bifurcation there, does that net/net cause you to be incrementally more cautious on the spending environment? Or is that being offset by the other camp of service providers that are ramping up investment?

---

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

A great question and, Simona, we really thought about sharing this or not because what we are seeing is this sort of polarization. And we felt it was meaningful enough since, look, we have a direct organization that directly addresses this space. I think we know it as well or better than anyone else. It is clearly something that as think about our business we wanted to share with our shareholders.

Now, to your point, it is not affecting the numbers that we are putting up on the board as I think what you have seen would be the case. But there is clearly a regulatory haze out there that you watch people look at the regulations and look at the environment, and they are literally coming to two diametrically opposite conclusions. It is fascinating to watch.

I would tell you that the majority are moving forward and it is the minority that are looking at it and going this is way too uncertain. And over time I believe the folks that are in the uncertain column, frankly, will either move to the we are going invest, or they will end up putting themselves so far behind that they won't be able to escape it and they will get acquired.

So I am not sure I would boil it down to the numbers so much. It is a behavior that we thought was worth noting.

---

**Simona Jankowski** - *Goldman Sachs - Analyst*

Okay, and then just -- thank you for that, Carl. And then just lastly, as you look at the dynamics behind your guidance, and in particular thinking about the gross margin, are leaving room in there for any particular larger deals that you have in mind that might fall into this quarter that might require more aggressive pricing from a footprint acquisition perspective? Or is this kind of just more business as usual in terms of the size of deals you are going after and so you are just modeling it is just from a trend line perspective, as opposed to having a couple of larger things in mind?

---

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

Now --

---

**Kelyn Brannon** - *Calix Networks, Inc. - EVP & CFO*

So I would, so oh, sorry.

---

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

I'll let Kelyn go ahead and do that, but I think you have teased out from George's question, and Ehud's question and my comments about footprint aggression that we are clearly leaving room in the model to be aggressive. And so you heard Kelyn's comments earlier saying that data point on margin from this quarter would be above the trend line. That would clearly be the case. Kelyn, do you want to add some color to that also?

---

**Kelyn Brannon** - *Calix Networks, Inc. - EVP & CFO*

And what I would add, as I mentioned in the script, that when we look at one quarter and we often say this that perfectly run we are lumpy. That goes to our cash flows and certainly our gross margin.

As we think about returning to a more normal seasonality and we think about what is going on in the second half of the year, whether it is fiber bills or whatever it happens to be, you are going to see swings in our margin, both ahead and behind of what you have seen perhaps in Q2. That is the nature of our business.

**Simona Jankowski** - *Goldman Sachs - Analyst*

Thank you very much.

**Operator**

Our next question comes from the line of Nikos Theodosopoulos of UBS. Please proceed.

**Nikos Theodosopoulos** - *UBS - Analyst*

Yes, hi. Let me just kind of go through one by one. So the first question is on the accelerated R&D with the word OSMINE mentioned, that kind of rings a bell, tier one telcos. So is this acceleration of that kind of development due to the Qwest/CenturyLink merger? Is it motivated by something else? And is OSMINE important to a CenturyLink after it buys Qwest and it wasn't before? Can you put some color on that?

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

I certainly can, Nikos. I mentioned OSMINE and other things, so as we think about for example Frontier back office integration there is an expense related with that, but also to your point. That is correct. That would be being driven by our stance as we pursue Qwest as a customer.

**Nikos Theodosopoulos** - *UBS - Analyst*

Okay, but it sounds like, okay, okay, right, fair enough, okay. And then the other thing is, back to Frontier, what is going to be the catalyst for them to stop buying line cards or extensions to their installed platform when vendors are already installed, and integrated, and using and then move on to Calix?

Are there certain vendors, or maybe you can quantify what percentage of those installed lines perhaps have legacy platforms that they would have to basically rip out anyway and that would provide the catalyst? Can you give your thoughts on that?

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

I certainly can, and I won't speak for Frontier because, to your point, as you might imagine those installed lines that came from the Verizon acquisition have many, many different platforms. Lots of them are either underserved or un-served, as far as broadband. And many of those platforms really can't be easily upgraded to deal with where they are going forward.

Frontier has vendors that they have grown accustomed to. I believe Calix would be one. And so as they look at going forward, listen, if the platform can be upgraded and easily upgraded, I would certainly look for them to do that. But for the most part they have significant swaths of their environment where they simply have to go to new platforms to get the services that they need to get out to their customers.

**Nikos Theodosopoulos** - *UBS - Analyst*

Okay, okay. I will follow up later and I will follow up on that. And just the last question, if I look at the $100 million number that, the nine awards and the $100 million that was driven by stimulus, the number seems kind of low relative to broader set of awards and so forth. Do you -- if I look at this $100 million, how would I compare it to public decisions? What percentage of the public decisions do you think this $100 million represents because it seems like a low number when I think about the totality of the first round of awards?

---

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

Right. Well, the first round of awards were roughly $2 billion, right?

---

**Nikos Theodosopoulos** - *UBS - Analyst*

Right.

---

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

And so, as you have heard us say before, half of them will likely fall into the last mile access category, which is what we compete for. And even though the awards have been made, vendor selection is still actually in front of us on most of the round one, believe it or not.

---

**Nikos Theodosopoulos** - *UBS - Analyst*

Okay.

---

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

So those are kind of -- in other words, the service provider that has gotten the award is now off doing vendor selection. We have announced separate awards. I believe there has been 12 total last mile awards announced as in equipment vendors. Nine of them we have awarded -- we have announced. And there are still lots of awards that are out there being competed for. So that is how I think you should think about it, Nikos.

---

**Nikos Theodosopoulos** - *UBS - Analyst*

Okay, all right, great. Thank you.

---

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

Thank you.

---

**Operator**

Our next question comes from the line of Vivek Arya of Bank of America/Merrill Lynch. Please proceed.

---

**Vivek Arya** - *Bank of America/Merrill Lynch - Analyst*

Thank you and thanks for taking my question. If you were set aside any new potential tier one footprint that you may not get in Q3, would you expect gross margins to flat, up or down sequentially?

---





THOMSON REUTERS

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

Hard to say, again, because of mix and other items, but clearly if you -- your question is a good one, Vivek, but it is pretty clear that if you took away footprint aggressive deals in the quarter it is going to have an upward affect on margin. I haven't calculated whether it would be flat, up or down, but clearly you are taking away something that functions on the left side of the margin lever. I would have to think about it quite a bit to answer your question with precision.

---

**Vivek Arya** - *Bank of America/Merrill Lynch - Analyst*

Got it. And, secondly, I haven't done the complete model, but it looked like cash from operations was an outflow this quarter. I was wondering if there is any specific reason or maybe I just need to redo my model.

---

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

And let me let -- Kelyn, why don't address that?

---

**Kelyn Brannon** - *Calix Networks, Inc. - EVP & CFO*

So there is no, as I mentioned earlier that our business is lumpy and that goes to our cash flows, as well as our P&L. But I will tell you is that Q1 benefited from the strong activity within Q4, so the collections were incredibly strong coming in from Q4 into Q1.

As you know, our DSO was 39 days. We have very strong collections there. Our receivables are up sequentially on the increased volume, so nothing unusual there. It is just growth.

---

**Vivek Arya** - *Bank of America/Merrill Lynch - Analyst*

Got it. And just lastly, there is some expectation of 20%, 25% or so sales growth in 2010 and I am wondering if you were to win an opportunity at Qwest or Frontier, then would that be incremental to that 20%, 25%? And really what would be the timeframe for winning any of those opportunities given the time it requires to get equipment certified and so on? Thank you.

---

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

They all take time for sure, Vivek, and obviously you know that as you are asking that question, quarters for sure, depending upon the size of the deal and who the customer is. Obviously, Qwest today is not a customer. We are certainly working diligently to do that.

Frontier, on the other hand, is a good customer and a continually getting better customer. So the timelines there might be shorter than you might assume from a Qwest standpoint, but I don't know that I have enough information to give you any precise guidance on when or how.

---

**Vivek Arya** - *Bank of America/Merrill Lynch - Analyst*

Got it. Just one last one, if you look at the makeup of sales this quarter, would you say there were more upgrades? Or was it more new footprint in Q2?

---

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

Q2 was a pretty natural quarter for us in what we are used to so a broad mix of new accounts, as we mentioned earlier, new address markets and subscriber line growth, significant amounts of penetration with new platforms, but early in their life cycle. And there are things that are in front of us that represent significant upgrades that we haven't even started yet with, for example, the 7.0 upgrade of C7, so really a pretty normal quarter in terms of left and right mixes.

---

**Vivek Arya** - *Bank of America/Merrill Lynch - Analyst*

Great. Thanks and good luck.

---

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

Thanks very much, Vivek.

---

**Operator**

(Operator Instructions). Our next question comes from the line of Mark Sue of RBC Capital Markets. Please proceed.

---

**Mark Sue** - *RBC Capital Markets - Analyst*

Thank you. I was just wondering does it feel like the dollar value for equipment for these Access projects are getting bigger as we get closer to the event, perhaps any thoughts there in terms of just any indications from the service providers as we move through the process. That would be helpful, thank you.

---

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

Hey, Mark. I want to ask a clarifying question there. I want to make sure I understand what you are saying. So as we get closer to stimulus deals, are the dollar values of the orders getting bigger, is that what you are asking me?

---

**Mark Sue** - *RBC Capital Markets - Analyst*

No. As we get closer to the stimulus do you -- are the dollar values being talked about for the equipment? Are they actually getting bigger or they kind of staying the same as we get we get some more clarity as we get closer to the event?

---

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

Clearly as you go down some of these RPs the dollar values of the initial network orders are larger because obviously there is dollars being funded into this space. I would give you one caveat, and this is for everyone on the call. There is nothing like $7.2 billion being waved in front of a set of service providers and their vendors to cause things to get very competitive. But clearly the size of the orders are larger in those that relate to broadband stimulus.

---

**Mark Sue** - *RBC Capital Markets - Analyst*

Okay. And since we know what the denominator is, do you think the numerator for equipment, just for equipment as it relates to the opportunities for someone like Calix, is that getting larger or smaller?

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

In the broadband stimulus, as a rule of thumb that we use, for example, we say roughly 15% is roughly what we see in access equipment, or is there a different fraction you are looking for?

**Mark Sue** - *RBC Capital Markets - Analyst*

Just within Access, if that has moved or moved quarter-to-quarter?

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

No. I would not. I -- there is nothing I have seen that will cause me to move it up or down.

**Mark Sue** - *RBC Capital Markets - Analyst*

Okay. That is helpful. Thank you, Carl.

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

Thanks, Mark, appreciate it.

**Operator**

There are no further questions at this time. I would now like to hand the call back over to Carl Russo.

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

All right. As there are no further questions we very much appreciate your interest and attention to Calix. We appreciate your joining us today and we will look forward to seeing you in 91 days to report on our Q3.

**Operator**

Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect. Have a great day.