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CALX - Q2 2012 Calix, Inc. Earnings Conference Call

EVENT DATE/TIME: JULY 31, 2012 / 8:30PM GMT

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PRESENTATION

Operator

Greetings and welcome to the Calix Q2 2012 financial results conference call. At this time all participants are in a listen-only mode. A brief question and answer session will follow the formal presentation. (Operator Instructions). As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, David H. Allen, Director of Investor Relations and Treasurer for Calix. Thank you, Mr. Allen, you may begin.

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

Thank you, operator, and good afternoon, everyone. Before we begin the call, I want to remind you that this call contains forward-looking statements regarding future events, including the future business and financial performance of the Company and our expectations of revenue, gross margins, earnings per share, stock-based compensation and amortization of intangibles. These forward-looking statements are based on management's expectations, estimates and judgment, and current and market conditions, and involve risks and uncertainties that may cause actual results to differ materially from those contained in the forward-looking statements.

I would encourage you to review the Company's various SEC reports, including our annual report on Form 10-K for the fiscal year he ended December 31, 2011, and our quarterly report on Form 10-Q for are the quarter ended March 31, 2012, available at www.sec.govin 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 such information.

Also on this conference call we will be discussing GAAP and non-GAAP results. We are providing the non-GAAP estimates to enable interested parties to evaluate our performance in the same manner which we evaluate our own operations. These non-GAAP measures exclude certain charges and benefits which we do not consider to be part of our ongoing activities or meaningful in determining financial performance, including stock-based compensation expense and amortization of acquisition-related intangible assets. To help you better understand those results, we have included a reconciliation of GAAP and non-GAAP results in the earnings press release. All numbers that are discussed in today's conference call are non-GAAP unless otherwise noted.

This conference call will be available for audio replay in the Investor Relations section of the Calix website at www.calix.com. In addition, our earnings press release has been posted on our website along with supplemental data, which you may want to review in conjunction with our press release and conference call remarks.

I now would like to turn it over to Calix's President and CEO, Carl Russo. Carl?

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

Thank you, Dave. Good afternoon, everyone. Joining me on the call today is Michael Ashby, our Executive Vice President and Chief Financial Officer. Before I turn the call over to Michael, I would like to give a brief review.

As we indicated in our preannouncement on July 11, we saw weakness across nearly all parts of our customer base in Q2. As you are aware from reports by other companies in our industry, macroeconomic concerns have had the effect of slowing down capital projects in the tier one service providers, and we have experienced that same effect at some of the tier two service providers as well. In the case of our tier three customers, however, there were increasing concerns over the USF/ICC reform and the implementation of the Connect America Fund, and those concerns led to an unexpected slowdown in ordering during the second quarter.

I will provide additional commentary after Michael discusses our Q2 results in more detail. With that, I would like to turn it over to Michael Ashby.

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

Thank you, Carl, and good afternoon, everyone. It you have not already done so, I would encourage you to go to the investor portion of our website and download the financial slides that we posted concurrent with our press release earlier today. My prepared remarks will provide a financial overview and the related business trends, and I will provide guidance for the third quarter of 2012. As a reminder, the guidance we provided in May for the second quarter included a revenue of $93 million to $97 million, gross margin to be at around 45%,operating expenses to be just over $38 million, and EPS between $0.07 to $0.11 a share. We also expected to be cash flow positive.

On July 11 we provided preliminary estimates for Q2 for revenue of $79 million and EPS of $0.04 per share. Our Q2 actual results consistent with the July 11 estimates. Actual revenue for the quarter was $78.9 million. Gross margin was 45.2%. Operating expenses came in at $33.5 million, and EPS $0.04 per fully diluted share. We were cash flow positive for the quarter and ended the quarter with $53.1 million of cash on hand.

I will now provide some color on the shortfall in revenue experienced in Q2. While our major accounts, national accounts and regional accounts were all under our internal targets for the quarter, the biggest shortfall was in the smaller tier three or regional accounts, who historically account for more than half of our business. The quarter actually started off as expected, but the middle of the quarter was weak. We anticipated being able to make up the middle of the quarter weakness in the last month, but while June was a strong month for us, it was not sufficiently strong to make up for the shortfall in revenue in the entire quarter.

As Carl mentioned earlier, business with our larger customers was impacted by the macroeconomic conditions, and in the case of the tier three accounts widespread uncertainty by USF reform and the implementation of the Connect America Fund, or CAF, the rate of return carriers. As Carl will discuss later in the call, we believe we are well positioned to continue to serve our customers with leadership in fiber access [to media sell copper] access products.

We have not seen any change in our competitive situation and do not believe that we are losing market share. Rather, we see an overall slowing down and frankly cannot predict how long that slowdown will last. We continue to make progress in the TAM expansion growth areas that we had previously highlighted, namely the former Qwest properties with CenturyLink, the properties that Frontier acquired from Verizon, and the international marketplace.

A $78.9 million, revenue was flat with the prior quarter. We did see an increase in deferred revenue of $4.8 million, consistent with our guidance. Shipments against broadband stimulus orders were the primary factor leading to this increase. While broadband stimulus revenue was up slightly this quarter over the first quarter, BBS revenue remains under 10%.

Once again, we had one 10% customer in the quarter, and while international revenue was up slightly in dollar terms it remains at 7% of total revenue, the same percentage as last quarter. We added 10 new international customers during the quarter, and while the initial revenue from the customers were small, we are encouraged by our increasing pipeline of international opportunities.

Gross margin was 45.2%, about the same as in the first quarter. Operating expenses came in at $33.5 million,lower than our guidance, primarily due to reversing the bonus accrual for the year. If you exclude the effect of accrual reversals, operating expenses are running at rate of approximately $35 million per quarter. We had earnings per share of $0.04 for the quarter, up from $0.01 in the first quarter.

Turning to the balance sheet. Solid working capital management, including our ongoing activities to reduce inventory levels, enabled us to generate positive cash flow from operations, ending the quarter with total cash at $53.1 million, up $3.5 million from the prior quarter.

DSO was 52 days, up slightly from the previous quarter due to the back end loaded quarter, but still within our target range of 50 to 55 days. Inventory levels continue to decline, and we ended the quarter with $33.2 million of inventory on hand. Inventory turns improved to 4.4, up from 3.6 at the end of the first quarter. Deferred revenue $39.1 million, up $4.8 million from first quarter.

One final note on the balance sheet. We have completed our annual goodwill impairment analysis, and it is currently being reviewed by our auditors, Ernst & Young. Our conclusion is that the goodwill on our balance sheet has not been impaired, but that conclusion is subject to final sign-off from Ernst & Young.

Let me now move to guidance for the third quarter. Both Carl and I have mentioned that in the second quarter we experienced weakness across most parts of our customer base, and in particular among our regional tier three customers. The regulatory uncertainty associated with the USF/ICC reform and the CAF implementation impacted our tier three customers' spending decisions, and these concerns are likely to continue at least through the end of this year. As a result, we do not expect to see any return to normal patterns among those customers in the near future. While we do not expect to see further declines in our tier two -- tier one and tier two customers, we are not planning on seeing any particular growth in the near future from this portion of our customer base either.

As a result we expect revenue for the third quarter to be flat with the second quarter. Gross margin is likely to decline about one percentage point because of an increase in service revenues during the third quarter relating to broadband stimulus deployment. Operating expenses, as I already mentioned, will be in the $35 million range. As a result, we anticipate EPS to be between $0.01 and $0.02 per share, slightly less than the second quarter, because the second quarter benefited from the bonus accrual reversal. We expect DSOs to remain within our range, inventories to continue to slowly decline, and we plan on being slightly cash flow positive once again in the third quarter.

Although it is our practice to provide guidance for only one quarter at a time, we have previously told you that your goal for 2012 was to grow revenues at 20% based on market expansion opportunities in the former Qwest lines acquired by CenturyLink, former Verizon states acquired by Frontier, and new international markets and growth from broadband stimulus projects. Given the current environment, we believe it that this target is now out of reach, and I would like to take a moment to expand on this. CenturyLink/Qwest remains an important market expansion opportunity for us, and we expect to sell successfully into the former Qwest properties once we have received the necessary certifications.

As we have mentioned in the past, the internal CenturyLink/Qwest testing and certification process has take and lot longer than we had originally planned. Our first products will not complete their process until mid-November, more than a year after completing initial online certification work. As a result this opportunity has effectively move into 2013.

At Frontier we are making very good progress and have now received purchase orders, albeit small ones, from 11 of the 14 states that Frontier acquired from Verizon. We expect to be able to prove ourselves in the former Verizon states over the next few months, and while we believe we will receive more business from the former Verizon states over the remainder of this year, it will build slowly, with significantly revenue more likely to ramp in 2013.

International expansion continues to be a major goal at Calix, and we are encouraged by our progress. Our pipeline of potential business continues to grow each quarter. At 7% of Q2 revenue, the revenue from the increasing pipeline remains small, and it will be some time before it becomes meaningful. We have done a good job in securing orders from broadband stimulus awards. Revenue from these orders remains largely in front of us. As we have been turning for some time now, and we have certainly seen in this quarter, broadband stimulus is not additive, because most of broadband stimulus orders are with small tier three service providers, who generally speaking do not have the resources available to support multiple projects simultaneously.

When a customer of ours wins a broadband stimulus award, they will build out that part of the network and put off other builds until that project has been completed. We had talked about broadband stimulus being a meaningful part of our growth in 2012. We still expect that to be the case. However, some customers have declined to take broadband stimulus funds, while others have delayed starting projects, so we expect broadband stimulus will have less of an impact in 2012 than we had expected earlier the year.

In summary, the opportunities that we talked about are largely still ahead of us, while we had hoped to be able to capitalize on many of the opportunities during the second half of 2012, it now looks as if meaningful progress will spread into 2013. As a result of this change in environment, we have decided to push back the analyst day we had planned in 2012 to sometime in 2013 so we can concentrate on managing our business.

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

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

Thank you, Michael. While I am concerned about any slowdown in our market and how long it might last, I remain optimistic about our growth prospects and opportunities. Our product portfolio is well positioned to meet the needs of our customers. The pressure for service providers to upgrade their networks to meet the ever-increasing demand for broadband services remains real.

Up to now we have addressed only around 10% to 15% of the access global access market, and I believe we are on course to significantly expand our total addressable market over the next few quarters. Most importantly our ability to maintain our margins and positive cash flow, even during a soft revenue period, speaks both to the viability of our operational model as well as our ability to continue to be strategic in our execution and investments.

As Michael said, our market expansion opportunities are still all ahead of us. I am confident that we will take advantage of these opportunities. However, the current demand uncertainties in the marketplace will keep us mindful in the near term.

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

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions). Our first question comes from the line of Blair King with Avondale Partners. Please proceed with your question.

Blair King - *Avondale Partners - Analyst*

(Inaudible -- no mic) -- questions. Just a couple. Maybe, Carl, this one can revert back to you on the -- on just an update relative to the rate of return carriers and what the process there might be once they enter the mix on the Connect America Fund distribution. What is that process like? How

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are they looking at it? And I guess your -- any view you have on whether or not they are reevaluating their fiber builds, given the seemingly lower subsidies that they may be receiving off of those funds at some point in time?

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

And is there a second question, Blair, or is that the one?

Blair King - *Avondale Partners - Analyst*

I guess that is -- I will leave it at that. That is probably adequate.

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

So look, I know you follow this pretty closely, and so you know that if I answered your question to the depth that we might want to answer it, we will be here for an hour and a half. So let me go at that time at a surface level, and make sure that I invite you to set up a separate call with Geoff Burke, who handles the detail for us, so that you can get into the details off this call.

Blair King - *Avondale Partners - Analyst*

Sure.

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

But suffice to say let me answer by answering the following. We are clearly seeing customers reevaluate how they are looking at business models based upon the whole USF/ICC and CAF reform, and clearly the rate of return folks you might say most of all. We are seeing folks that were formerly looking at projects that might have been fiber to prem, for example, slowing that down and thinking about it, only to return and then in fact go forward with the project, but perhaps more on a VDSL2 approach.

So we are clearly seeing changes in thinking, but as you know from looking at the math, it varies greatly from customer to customer. In a general sense, it is clearly injected an uncertainty into the marketplace that Michael alluded to in his comments and I did in mine, but to break it down further than that really requires almost an analysis of each segment and each customer by where they fit in the quantile analysis.

So if you are okay with that, I would ask that you set up a separate call with Geoff.

Blair King - *Avondale Partners - Analyst*

Okay, I will do that. Thank you very much, Carl.

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

You bet, Blair. Other questions for you?

Blair King - *Avondale Partners - Analyst*

No, that'll do it. Thank you very much.

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

Okay. You're welcome.

Operator

Thank you. Our next question comes from the line of Simon Leopold with Raymond James. Please proceed with your question.

Simon Leopold - *Raymond James & Associates - Analyst*

Thank you. I wanted to see if we could delve a little more into trying to get a sense of how the year ends up. In term its of rescinding the full year guidance, I don't know that really tells us much new. I guess what I would like to understand is you typically had some pretty strong seasonality in the fourth quarter, and it doesn't sound like you are painting a picture that says you expect even your normal seasonal pattern in December. But I'd like to try to get some sense of how you are thinking about the year wrapping up.

And maybe just related to that question, you did talk about expectations. You finished the integration testing at the Qwest footprint in November. Does that mean that you expect to see that ramp begin in December, and you would be able to provide some update by year end on that?

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

Simon, this is Michael. Thanks for the question. As far as the year is concerned, the comment -- we haven't really commented on Q3, and we are only going to comment on one quarter at a time.

What we are saying is that we expect Q3 to be flat. That does not necessarily mean there isn't going to be seasonality in Q4. We are just not prepared to comment on Q4 until we get closer to that point in time. As you are aware traditionally it is a seasonally strong quarter. That may be the case, but atthis moment in time we will see how Q3 works out, and if the particular regional customers then how their buying pattern is during this quarter before we comment on the remainder of the year.

As far as the Qwest question is concerned, we -- the product's complete mid-November, so it is fair to say that we would expect to receive some business in December, but it is obviously going to be fairly small and the majority of that is going to come in 2013.

Simon Leopold - *Raymond James & Associates - Analyst*

Okay. And then just one follow-up. In terms of what is going on with the stimulus programs and the series of delays and as well as the CAF program, is there an increasing possibility that carriers essentially who were considering it get to the point where they simply say, no, we don't want to be anywhere involved with this program, it is just not worth the trouble?

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

Let's talk broadband stimulus separately from CAF, because I'm not sure that is the case with CAF. But in the case of BBS we certainly have seen customers turn down the funds. AndI think there is the risk that the longer this goes on some, it is possible that some other customers may decide not to go through with it. We have -- and I think we talked about this number before -- we had about $50 million of awards to our customers that they have turned down. That is $50 million of access business, so it is fairly considerable. That number could grow depending upon -- over time. So broadband stimulus has certainly continued to slip and been affected by people deciding whether or not to take those funds or not.

In CAF I don't think there is the same issue there, because that is really a question of funds -- money that has been redirected from voice to broadband, so it is more a business transformational project that moves -- incents service providers to roll out broadband as opposed to simply voice. And so I don't expect that people are going to turn that down. I think that is going to be a means of funding they will use the next few years. And as you know, that-- for the rate of return carriers, $1.8 billion a year for the next number of years, so -- five years. So it is pretty is significant --

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Simon Leopold - *Raymond James & Associates - Analyst*

Just one clarification, please. On the broadband stimulus you talked about some being turned down. So what is your total view -- multiyear view on how much money is available to you from the broadband stimulus funds?

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

Over the whole period of broadband stimulus?

Simon Leopold - *Raymond James & Associates - Analyst*

Yes.

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

I think the total amount that we expect to get in terms of access equipment is about $180 million.

Simon Leopold - *Raymond James & Associates - Analyst*

Thank you.

Operator

Thank you. Our next question comes from the line of Sanjiv Wadhwani. Please proceed -- with Stifel Nicolaus. Please proceed with your question.

Sanjiv Wadhwani - *Stifel Nicolaus - Analyst*

Thanks. One clarification and a question. Michael, on the 10% customer, safe to say it is somebody that contributed 10% in the past, or is it a new customer that we should be thinking about?

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

No, I think it is pretty safe to say that is someone that we know here.

Sanjiv Wadhwani - *Stifel Nicolaus - Analyst*

Got it. Okay. Just, Carl, I want to just get clarity on the USF reform. I think a couple of weeks ago we had major telcos collecting accepting I think $115 million of the $300 million in USF allotted to them. I'm curious what is going on there. Clearly there are carriers accepting these funds, but at the same time you are seeing a lot of pause from your tier three carriers. And just trying to parse through all of this information and maybe get

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some clarity on what exactly our tier three carriers are telling you, and what we should be expecting in 2013, because looks like over the next couple of quarters they are not going to be spending much I guess.

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

Well, to Michael's point , these are things that -- these funds are going to get distributed. And as you know, there is a whole gaming approach to whether or not I choose to take them as an individual carrier. Perhaps back to Blair's question earlier, thematematics are a little complicated, and so to the extent that a primer is required and you want to dig into the details, I would ask again that I'll get you together with Geoff and he can take you through the details.

What's going on simply is everybody is looking at these things. They have their consultants working with them, their cost consultants, and trying to figure out do they bid, don't they bid? Should they go after the funds? If they do go after the funds, what does it mean? What is the rate of return? And so you've got a lot of people working through their models to figure out whether or not they want to take the funds. If they do, what is the business going forward. And it literally varies from customer to customer.

Sanjiv Wadhwani - *Stifel Nicolaus - Analyst*

Got it. okay. And I guess the question is, as a follow-up over there, I think Frontier and -- Frontier actually did accept some funds, $72 million or something. Is that going to flow through the -- on top of what they already are doing with the Verizon properties? Is it additive to that? Is it not additive? Can you help with that situation?

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

Let me act on Michael's comments, and, Michael, if you want to add some color, please do.

What we are finding as we look at these programs is for service providers that have a certain amount of capacity to do things, if they go take these funds, they are basically going to be able to do what they had capacity for and won't do additional. So itis a source of funding, not necessarily a source of incremental funding. For customers with more capacity, they have a shot of taking on in addition to, but it is not clear to us that they will. Michael?

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

I agree with you, Carl. The majority of our customers have their business plans and their capital expenditures plans, and they look on things like BBS or Connect America Fund or other means of raising money as just ways of funding their plans. So I think in general these tend not to be additive, they justtend to be a way for them to fund the plans that they have in place.

Sanjiv Wadhwani - *Stifel Nicolaus - Analyst*

Got it. That's helpful. Thanks.

Operator

Thank you. Our next question comes from the line of George Notter with Jefferies & Company. Please proceed with your question.

George Notter - *Jefferies & Company - Analyst*

Hi, thanks. If memory serves, you guys were talking about the Connect America Fund and all the changes going on in the regulatory environment as being an incremental positive for your business, that some of the uncertainty would start to clear up. Certainly I understand there was uncertainty in the marketplace prior to all of this going down. I guess I'm trying to better understand what changed your perspective from a few months ago.

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

Maybe I will start with that George, and then Carl with comment. I don't think anything has changed. I think what we said is positive, but positive for the industry, not specifically just for Calix. I think what we believe this is very positive, because it does move moneys from an operating subsidy for voice to an incentive for broadband buildout. So we think that is positive for the industry as a whole going forward, andI don't think your position has changed on that. Carl, do you want to go into more detail?

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

Well, just briefly to add, George, to your point, it is a positive. We have certainly looked at this over time as being more are or less of a positive for us. If I were to add any concern to it related to us, it is how you people use it inside of their budget versus as incremental to budget. Clearly any funds that go in to building up broadband are beneficial and put a base underneath the marketplace.

But, again, I want to echo, we continue to try to understand the timing of it, the implications of it, how much our customers can take on. To Michael's point, in a macro sense, we think it is a great positive to be shifting from a subsidy on voice OpEx to an incentive on broadband CapEx. But how it boils down into each different customer turns out to be a lot more complicated than I think one would have imagined at the start.

George Notter - *Jefferies & Company - Analyst*

The other question I had, are you seeing anything new in the competitive environment? I heard what you said earlier about not losing market share, but it just seems to me that the competitive environment could intensify if some of your competitors are struggling and looking for other markets, adjacent markets to back into and get more aggressive on. Is that something that you are seeing? Is that something that is a possibility in looking forward? I'm speaking specifically about ADTRAN

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

Well, I mean, any competitor. Always possible. Always wary of it. Not seeing any change in the competitive dynamic in the markets that we serve.

George Notter - *Jefferies & Company - Analyst*

Got it, thanks.

Operator

Thank you. Our next question comes from the line of Ehud Gelblum with Morgan Stanley. Please proceed with your question.

Ehud Gelblum - *Morgan Stanley - Analyst*

Hi, guys. Thanks. It's Ehud. Couple questions. First, Carl, if I got this right from what you said before, you got OSMINE approval last November and are getting qual and being able to ship into Frontier this November. Is that -- you said it was a year later? A, did I get that right, or B, is that the normal timing, or did something happen to delay after the OSMINE approval?

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

By the way, Michael said it.

Ehud Gelblum - *Morgan Stanley - Analyst*

You guys kind of sound alike sometimes. The accent is very similar.

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

It's Qwest, not Frontier, by the way.

Ehud Gelblum - *Morgan Stanley - Analyst*

I'm sorry, you're right.

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

It's CenturyLink/Qwest, so let me go through it. That is exactly right. I don't know that is the normal process. I think what we have to look at CenturyLink and Qwest are going through their own integration process, and I think if there was anything that we learned, it was going through the OSMINE process took X amount of time. That amount of time wasn't too different from what we thought. But the backend IT integration from that point into the combined CenturyLink/Qwest IT organization, as they're going through their own integration, took longer than we thought. I think now we are getting better sense for how long it takes, and it will probably be a little more predictable. But that was what in fact Michael said, and that is correct.

Ehud Gelblum - *Morgan Stanley - Analyst*

And do you think that has been true of everything that Qwest has been doing as part of CenturyLink? Or is it just (inaudible -- multiple speakers) --

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

I can't comment, because I can only look at the project tracks that we're looking at. Look, this is a huge integration that they are going through, so I don't -- I think it with be unfair, unwise and frankly I would be throwing a dart into a very dark area to say that is true for everything. They have all sorts of integration things that they are doing that have nothing to do with us or access or anything else.

Ehud Gelblum - *Morgan Stanley - Analyst*

Okay. If we slide over to the other side of that tier one, and you may have said it before, I understand the regulatory issues, and we will talk about that as well, but on the tier three side. With the tier one you are involved with, how did that business fare are quarter to quarter and how are you seeing that in the next quarter? With the primary part of CenturyLink.

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

Business in the legacy CenturyLink continues much the same as it has in the past, without any major changes. It can vary somewhat from quarter to quarter, but generally speaking it is pretty consistent, and I think we have a good relationship on that side of CenturyLink. So no change in outlook as far as that is concerned.

Ehud Gelblum - *Morgan Stanley - Analyst*

So in three quarters in a row that are going to be roughly, Q1, Q2 and guidance for Q3, would you say CenturyLink is essentially flat as well, the core legacy part of it? [Enlarging]?

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

Yes, I think CenturyLink is flat because I think they have continued to put the emphasis and more money onto the Qwest side of the network, which -- because they needed to quick to try and bring that strength in that side of the network, as opposed to the CenturyLink one, which was already fairly robust.

Ehud Gelblum - *Morgan Stanley - Analyst*

That is helpful. With everything going on the tier three side, what gives you confidence -- or are is there anything that you can hang your hat on, that when you get into 2013 some of the regulation around USF and CAF frees up?

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

I think part of that is the FCC is supposed to come out with more clarity between now and the end of the year, and as that happens that will obviously calm things down some what. Plus, I think we have seen the trade associations of the regional service providers lobbying to try and change things. We have seen some of them actually filing lawsuits to try and get changes made. And those haven't succeeded. I think the lobbying has not been terribly successful. There were some changes, but the FCC is now basically holding the line.

So I think slowly the regional service providers are going to realize that it is what it is, and it is not going to change very much, and they are going to have to get on with their business. SoI think over the next few months that becomes clearer to them, and the FCC issues more clearer regulations, and then it will slowly just sort itself out.

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

Yes, it's not -- it's incremental clarity to Michael's point, Ehud. It is not some milestone driven like, a-ha, the veil will be lifted.

Ehud Gelblum - *Morgan Stanley - Analyst*

Right. But one of the issues that I've understood -- because it has been about $100 million of CAF funding that has been turned down. And the issue that I understood it was that the FCC is allowing$775 of expense per household, and several carriers are saying that is not economic if that is all you are going pay me to build out to those households. Do you see any leverage or any changes in the numbers? Or with that number staying solid, I don't know if there will be a change in carrier behavior.

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

No, you are actually talking about the tier two service providers. They're not the regional service providers. They are the ones who have this initial cap. And there is some posturing going on amongst them that the $775 per line is the fixed amount that they are entitled to get if they choose to go after it, and clearly for $775 a line they have to try and make a business case that works. So that depends on which part of the network it is as to whether or not that can make sense for them. How much they would normally invest, and how much they will get in subsidy to decide on whether they have the right business case. And I think, as I said, there is some posturing that they are trying to look to get additional funding.

They're trying to get that amount changed, and they're trying to see if they can build out in areas where there is some wireless competition today, which so far the FCC have said no, and so that is all again going to sort itself out over the next few months. And so that the funds that have not been accepted to date doesn't necessarily mean that they are not going to come back and be accepted later on. And then there is this reverse auction that will happen eventually when these lines are not taken. So it is all going to change over the next couple of quarters.

Ehud Gelblum - *Morgan Stanley - Analyst*

Appreciate it. Thanks so much for your answers.

Operator

Thank you. (Operator Instructions). Our next question comes from the line of Amitabh Passi with UBS. Please proceed with your question.

Amitabh Passi - *UBS - Analyst*

Hi, thank you. Michael, first question for you. How do we think about the variable component in our OpEx. I'm just wondering if revenues were to recover in 2013, any guidance you could give us in terms of how we should think about the leverage in the model and how OpEx scales as we look out into 2013?

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

Yes, the in general our operating expenses are -- the majority of them are some what fixed. The variable portion of our operating expenses is relatively small and relates primarily on the sales side of the business. So we have pretty good control over our operating expenses and basically -- and obviously because we are seeing some weakness in revenue, we are holding operating expenses essentially flat and will not allow them to increase unless and until we start it see the revenue increase going forward.

From a longer term point of view, and I think you are aware of this, our model is to get operating expenses down to the low 30% of revenue. And I think I have said this before at different meetings that in order to get to that point we need revenues to be at least in excess of $100 million a quarter, probably about $120 million a quarter, and then we start to see OpEx getting down to the low 30%.

Amitabh Passi - *UBS - Analyst*

Great, I appreciate it. As a quick follow-up, would you expect international sales to be up sequentially in the third quarter? And then maybe where you are seeing the most interesting opportunities overseas?

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

Sure. As far as the international revenues in the third quarter, we do expect them to be up sequentially from the second quarter. Again, starting obviously from a relatively small base, but yes, we do expect to grow each quarter actually and as we look out. As far as where the opportunities are, I would ask Carl to come in for that one.

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

We are actually seeing them around the world. As Michael commented earlier, we had 10 new accounts open up, and that is the leading indicator that we focus most on as we penetrated the territory. We are actually seeing a very clear set of opportunities amongst the smaller service providers that we use to build the business in the first place here in North America. And we see those opportunities literally spread out in Europe, in Asia, in the Middle East, in South America. So we are seeing them where we expected to see them.

Amitabh Passi - *UBS - Analyst*

Okay. Thanks.

Operator

Thank you. (Operator Instructions). We do have a follow-up from the line of Simon Leopold with Raymond James. Please proceed with your question.

Simon Leopold - *Raymond James & Associates - Analyst*

Thanks. When you think about the trends towards 2013, do you see other customers within essentially opportunities of breaking into the 10% customer rank other than the traditional customer you have had in that area?

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

So, are you saying in the year of 2013 do we think there maybe other large customers available to us?

Simon Leopold - *Raymond James & Associates - Analyst*

And not necessarily for the full year, but there are quarters where you think you could have enough diversity that you would have a second 10% customer or an alternate 10% customer?

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

We do.

Simon Leopold - *Raymond James & Associates - Analyst*

Any color on how to think about that?

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

So the answer is yes, we do, and I don't know that I would give you any more color, Simon.

Simon Leopold - *Raymond James & Associates - Analyst*

Maybe just domestic as opposed to international?

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

No, I won't. Suffice it to say that we believe we will have the opportunity to have a greater than 10% customer in addition. I wouldn't specify where at this point.

Simon Leopold - *Raymond James & Associates - Analyst*

Okay. Thank you.

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

You're welcome.

Operator

Thank you. Ladies and gentlemen, at this time there are no further questions. I would like to turn the floor over to David Allen for closing remarks.

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

Thank you, operator , and thank you for joining us today. We hope you can join us at one of our upcoming investment conferences which we are participating in this quarter, including the Jefferies Semiconductor and Hardware Midwest Corporate Access Day in Chicago on August 28, the Deutsche Bank DB Access 2012 Technology Conference in Las Vegas on September 11, and the ThinkEquity 9th Annual Growth Conference in New York on September 13. Information about these events is posted on the Investor Relations section of our website.

Thank you for joining us today. Despite the challenges associated with the current environment, we remain focused on executing against the opportunities ahead of us, and we look forward to speaking with you at one of these forums. Good-bye for now.

Operator

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