

THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

CALX - Calix Inc at Jefferies Global Technology, Media and Telecom (TMT) Conference

EVENT DATE/TIME: MAY 13, 2015 / 2:00PM GMT



CORPORATE PARTICIPANTS

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

CONFERENCE CALL PARTICIPANTS

George Notter *Jefferies LLC - Analyst*

PRESENTATION

George Notter - *Jefferies LLC - Analyst*

All right, we're going to go ahead and get started here. My name is George Notter. I work here at Jefferies covering the communications infrastructure space. We are very happy today to have William Atkins from Calix to join us to talk about Calix and their opportunities. So welcome.

We are just going to do a Q&A session. I've got some questions. I can lead it off and if any folks in the audience have questions as well, we can chime in.

I wanted to kind of start off by just talking about -- William joined the Company, obviously, a little over a year ago. Looking back at the stock in I think roughly the same place, although the Company is little bit bigger, I think, than it was, by and large, in terms of -- certainly in terms of revenue and profitability.

But can you talk more about what's changed in a year in terms of the finance organization and how you guys run the business. How you look at the pipeline. Sort of the nuts and bolts CFO stuff. What have you done?

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

Okay, well a lot of that is CFO inside baseball, which would bore everybody here to death and would only be noticeable if I were to screw it up, essentially.

But I would say that when I came in, I found that the financial planning and analysis function, which is a pretty critical function in any finance organization, had a lot of blended accounting-type responsibilities. And so I didn't have what I would regard as sort of a pure mission for those folks. And that was one of the first things I did was basically reorganize the group to give people a relatively clearer path, if you will, and a clearer set of responsibilities.

And that reflects sort of my own bias for a lot of analytics and a lot more detailed forecasting than perhaps had been in place at the Company previously. And then that has, I think, externally manifested itself in terms of increasing focus on building backlog going into each quarter and building more linearity and more of an understanding of the underlying revenue base. So that is really, I would say, what I've been focusing on internally.

George Notter - *Jefferies LLC - Analyst*

Got it, okay. I think to some degree, it is a pertinent question, right? I mean, the Company has got admittedly checkered history in terms of the -- to some degree, you had a lumpy business, right.

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

Yes.



George Notter - Jefferies LLC - Analyst

And things could pop up at the end of the quarters and create changes relative to expectations. And so I guess what's interesting about this to me is that now if you are running a more linear business, a more backlog-driven business, theoretically, the Company would have less risk, fewer surprises, and so on.

So to what degree do you think things have changed on that front? I mean, how much backlog do you have, how linear are the quarters? Any way to kind of qualify or quantify kind of where you are on that front?

William Atkins - Calix, Inc. - EVP and CFO

I would say that in the sense, we are a good house in a bad neighborhood in that we and other equipment suppliers are necessarily subject to the whims of the telecom service providers. And they don't really lift the covers off too much in terms of what their own plans are, which is why we and our peers really only a guide out on a 90-day basis.

So it's hard to therefore say that definitively that we've gotten better skill at forecasting, say, nine months out, right? Particularly given the fact that some 65% of our revenues are Tier 3 and Tier 2 carriers.

George Notter - Jefferies LLC - Analyst

Right.

William Atkins - Calix, Inc. - EVP and CFO

And each of these guys are relatively granular in terms of the kind of the size of the orders that they make and the like. But what I would say -- and we don't quantify it or break it out -- is that there has been increasing, to use your term, linearity, sort of if you will, a flatter distribution of revenues in each quarter. And that becomes sort of a self-reinforcing cycle.

If you, as CFO, are not managing yourself in a sense to sort of hit the ball out of the park in the last two weeks of the quarter, then you start to get better pricing behavior relative to customers. You start to get better gross margin performance.

You also start to get better management of your working capital. You see your days of receivables starting to perform better. And so that is how it manifests itself.

What I would say, I've now been CFO for five quarters essentially. And so this is been my second Q1, if you will. I came in in February of last year. So I came in midway through Q1 of last year.

It is a seasonal business, but if you look year over year -- and again, we don't call it out -- I would say that this is the beginning quarter backlog performance, for want of a better term.

[I don't know whether it's the stuff] you've got in the bank as you start each quarter is getting better -- not necessarily sequentially. You shouldn't look at it that way, but if you look at it year over year, we are just simply getting better at having a little bit more money in the bank going into a quarter, which again, reinforces that behavior going into it.

I may perhaps be an overly conservative guy, but I believe in essentially delivering what I promise and not trying to sort of, again, stretch at the end of the quarter. That just doesn't make any sense.



George Notter - Jefferies LLC - Analyst

Okay, very good. So let's talk about current business trends. You guys came out of Q1. You talked about greater-than-normal seasonality among some of your larger customers.

Can you provide any more insights in terms of what's going on right now with those customers? And you've talked about an improvement in the second half and do you have visibility there? Are you seeing it in terms of orders forecast? Kind of walk through sort of the tenor of the business and how it's going to change?

William Atkins - Calix, Inc. - EVP and CFO

Got it, okay. Certainly, the year started more slowly than past years have. And I think more slowly across the board in our space than I think industries or like you had had anticipated.

And your peers, who were looking at the service provider space as well, I think were surprised that the fact that CapEx wasn't coming in line with prior years or even expectations. Our customers don't tell us exactly why they are starting late, but basically budgets were put in place late.

If you look at, for example, a CenturyLink, who I think guided to, what, \$3 billion in CapEx earlier this year. I think their Q1 actual CapEx was like 8% down year over year. And I haven't heard any noises from them, for example, of any adjustments to that guidance. So that therefore implies little bit more compression into the second half of the year than you would otherwise expect.

In terms of what we see with our business sort of pulling away from those broad industry trends that we see in our business is, again, we are still on those 90-day cycles, so I don't have people telling me that they're going to place an order in December for XYZ equipment.

George Notter - Jefferies LLC - Analyst

Right.

William Atkins - Calix, Inc. - EVP and CFO

But, for example, we have a new product, a GigaCenter. We announced that we had over 100 customers sign up for this product as at year end 2014. And as that quarter ends, we were at 200 -- more than 200 customers, in fact.

So the underlying trends for that product are good. If you look at a typical product rollout, particularly for us, where we have so many Tier 3 customers, the pattern tends to be a lot of customers ordering small quantities each of a product.

And obviously, the more customers you get, then you start to follow through with more sort of sales to those customers. And so we feel good about GigaCenter sales to those customers, which is obviously a nice thing to have.

But there are so many other trends going on under the surface that I really can't call the second half of the year. But if I look at sort of broader industry dynamics in terms of what I'm seeing and then if I look at product that we are monitoring very carefully, which is a new product, we feel good about it, I guess is what I would say.



George Notter - Jefferies LLC - Analyst

Let's talk about GigaCenter, then. Can you walk through folks -- for folks how the product is positioned, what you're trying to achieve with the product. I'm particularly interested in what it does to your TAM, right? Because the ASPs I think for the product are considerably larger than traditional ONTs, for example.

Kind of walk us through how you see the product, the TAM, and what it does for you?

William Atkins - Calix, Inc. - EVP and CFO

Okay. Well the GigaCenter is basically the most advanced subscriber edge device that currently in the telecom market today. And so that sounds great. What does it actually do for us? What does it do for the service provider?

Well, obviously, what it does in a greenfield deployment, it gives the service provider some future proofing, which is important. It also, when sold in connection with or combined with our Consumer CONNECT software, it gives a service provider a better understanding of underlying subscriber usage patterns. And also gives them the opportunity to help the subscriber to manage their home network, which creates a more intimate relationship between the service provider and the end user.

I would say in telecoms, generally, you've seen service providers try to have a lot of stickiness with their end users based around walled gardens of content and the like. And I think we would agree: video is probably the last walled garden to fall.

And when you therefore assume, perhaps, thinking a few years ahead, that that walled garden is no longer going to be a source of differentiation, then I do think having a greater intimacy with the subscriber in terms of network management and in terms of also understanding the subscriber's flows that you can basically tailor your service offerings is going to become increasingly important for operators.

And then turning to your question about expanding the addressable market. With these devices, first, we're naturally going to our existing customers and we're going to sort of a, quote, a classically traditional profile for the device, where it simply plugs into the fiber that comes into the home.

But ultimately, you could see these devices, for example, being sold to be attached to existing devices. So that an operator could, for example, ship one of these units, which, say, had an Ethernet feed into it, rather than a fiber-optic feed into it, and have that device plug into an existing older optical networking terminal that's in the home.

And that's a great way, for example, to expand. Even within existing customers, obviously your addressable market, but it also allows you to potentially sell your product into markets where, say, your competitors' products are being deployed.

George Notter - Jefferies LLC - Analyst

Got it, okay. Interesting. And then the TAM -- so what is the ASP on GigaCenter relative to an ONT that you'd previously sold?

William Atkins - Calix, Inc. - EVP and CFO

We don't break that out, but the price point is higher.

George Notter - Jefferies LLC - Analyst

Okay, got it. And then where is the turning point there? I mean, you've got 200 customers, I guess, who purchase products. But it sounds like more of these purchases are evals or becoming larger evals effectively.



William Atkins - Calix, Inc. - EVP and CFO

Yes, exactly.

George Notter - Jefferies LLC - Analyst

When do you start to see kind of conversion to more broader rollouts from those customers? Are you starting to see that now?

William Atkins - Calix, Inc. - EVP and CFO

I would watch this space later this year. We're starting to see some customers ordering in quantity, but I'd rather call it in the rearview mirror than sort of put myself out there. Because I don't have enough of a trend to basically help you with that.

But we do see a small number of customers now starting to order meaningful quantities of devices, which is pretty much what you'd expect at this stage in the product rollout. But it's too early for me to call a number, so to speak.

George Notter - Jefferies LLC - Analyst

Great, okay. And then how do the margins on that product compare to the rest of your business? Just out of curiosity.

William Atkins - Calix, Inc. - EVP and CFO

They are better. We've been in the subscriber edge market since our acquisition of OSI in 2006 for 9 years, right? And we have said and continue to say that we see our corporate gross margins increasing. We see ourselves going above 50%.

And we've also been on record as saying that the customer premises or subscriber edge device component of our revenues is an increasingly important part of our revenues. So therefore, inherently, we feel comfortable about the kind of margins that we are getting on these devices.

George Notter - Jefferies LLC - Analyst

Great, okay. One of the things that's changing in the marketplace right now, we recently wrote a piece on gigabit fiber-to-the-prem launches. We've seen quite a few of those in the marketplace this past year.

So can you -- in fact, Calix has won a lot of those markets, of course. Can you talk about what's driving the market right now? Is it Google fiber or is it the improved economics of fiber-to-the-prem? What do you kind of see out there?

William Atkins - Calix, Inc. - EVP and CFO

I think it's literally all of the above. I think a third element I would add to it is literally do you abandon your fixed network if you are a fixed operator.

If you are a telecoms company, and you are up against cable, in almost all the situations where you're not offering fiber, you are essentially on the back foot in terms of the kind of broadband speeds you can offer.

So as a telco, therefore, you're basically asking what are you going to do with this asset? Are you going to invest to essentially future proof it, lower your operating expenses, and give yourself the ability to have that more intimate relationship with the end user that I've described?



Or do you run it essentially for cash? And that very broad-brush, black and white, is the kind of decision that I think any telco CFOs having to make.

And where they've got options, for example, to invest in wireless, then they've got a broader portfolio of decisions to make. Whereas people who have got a narrower set of decisions will probably favor wireline investments, say, over wireless.

So I think that that is a lot of what is driving what is going on. There's a sense that if the telcos are going to in a sense strike back at the cable space, particularly in anticipation of DOCSIS 3.1, then the time to invest is now.

And to your point -- and I read your piece, which is a great piece, by the way -- I think the economics are getting better on these deployments. And then you do see the inevitable reaction of both nationwide and into-the-city markets to the likes of Google fiber rolling out in cities. And so that does tend to incent people to make announcements and to follow through those announcements.

George Notter - Jefferies LLC - Analyst

Got it. Great, okay. One of the things here I think you're sort of driving towards here in the discussion is the transition from fiber-to-the-node to more fiber-to-the-prem in terms of the investment.

I understand AT&T recently made an announcement that they were going to just -- all the broadband going forward would be fiber-to-the-prem. But talk about how that impacts your business in terms of margins, profitability, your positioning competitively. Like how do you see that? Is it a good thing or a bad thing for Calix?

William Atkins - Calix, Inc. - EVP and CFO

Well, again, we've been talking about the subscriber edge as being an important part of our business. So to the extent that you've already got, for example, a Calix piece of equipment in an operator's data center that's already in a sense feeding that node, then you will obviously sell upgrades to that equipment, additional line cards, etc. But really the opportunity is in the subscriber end points. And so we see that as being quite a positive trend.

The other thing I would suggest is -- and we did call this out in our last earnings call -- is that it's not always going to be fiber all the way to the end user, right? I mean, G.fast we think is very interesting technology and we think that G.fast could be a great solution for operators.

My sense is we have got these sort of broadband deserts in their markets, where they are simply unable to convince landlords of five-story walkups or multiple tenant office buildings to go in and upgrade the wiring. And with G.fast, you have the ability to give that end user a true gigabit-like broadband experience. So I think that that is also a trend that's worth monitoring.

George Notter - Jefferies LLC - Analyst

Got it. So you see G.fast mostly in the MDU [multi-dwelling unit] environments?

William Atkins - Calix, Inc. - EVP and CFO

Yes. It can and will be used in other environments, but it's fastest and best over these short runs and twisted pair. And so that inevitably means you're going MDU multiple tenant office buildings.



George Notter - Jefferies LLC - Analyst

Got it, okay. Got it. Connect America Fund. So I think a week, week and a half ago, we got a bunch of new news there in terms of the Phase 2. And you had 10 different operators get offered pretty significant subsidies, I think.

Can you walk us through what was announced on CAF II and how that compares to the prior subsidy model that was in place? And again, I presume you're going to say this is good for Calix. But walk us through what's going on.

William Atkins - Calix, Inc. - EVP and CFO

Okay. Before I get to Calix, just broadly -- basically, you're seeing anywhere between \$1.7 billion, \$1.8 billion made available annually over a 6-year period. We've seen -- and I'm going to use round numbers.

Calix customers, CenturyLink, I think potentially get as much as \$0.5 billion I think in a year. I think we're looking at Frontier getting close to \$300 million and Windstream close to \$200 million, something like that. So basically, those three companies are already over half of that amount.

And then in terms of the timing, I think they had four months, roughly, from the end of April?

George Notter - Jefferies LLC - Analyst

August 27, I understand.

William Atkins - Calix, Inc. - EVP and CFO

Yes. So end of August is basically when these guys can decide to pony up and take the money or not. In terms of how that -- now they are sort of talking about us and what it does for us, it is not easy to get a read on whether people are essentially going to decide already today that they're going to accept that funding and they're going to start to preorder equipment.

George Notter - Jefferies LLC - Analyst

Right.

William Atkins - Calix, Inc. - EVP and CFO

Or whether they're going to wait until literally the end of August to make those buying decisions. So from a revenue impact, first of all, I would say from revenue impact for us, because we and our peers were way too optimistic about broadband stimulus and what it was going to do to the space, we are not calling CAF as being incremental dollars.

If they are, we'll call them in the rearview mirror. We're not going to put ourselves out there and call them ahead of time, because we were wrong last time. It could simply be a substitutional form of funding for people, rather than incremental, if you know what I mean.

George Notter - Jefferies LLC - Analyst

Right.

William Atkins - Calix, Inc. - EVP and CFO

And certainly, you look at our Tier 3 customer base. That's likely to be the case, because they have limited human resources. So they simply can't deploy two or three extra teams to roll stuff out.

George Notter - Jefferies LLC - Analyst

Right. It's a pig in a python problem.

William Atkins - Calix, Inc. - EVP and CFO

Exactly. Does that answer your question?

George Notter - Jefferies LLC - Analyst

It does. And then -- but as I understand it, the subsidy program previously was USF. And it was substantially less money on an annual basis being floated out there to fund operators.

Now I think, frankly, more of those USF funds were going to more of your traditional kind of Tier 3 guys also, whereas this CAF program is more oriented around sort of the top 10 operators in the US. So it is more money on an annual basis, theoretically, that's flowing through here.

So I think the other distinction also is that we are now funding applications that previously were fully uneconomical like to address. So whereas operators -- you mentioned Frontier, Windstream, CenturyLink -- are going to focus more of their fiber-to-the-prem efforts on more attractive looking markets; suburban, higher density, more aerial kind of places.

Now we've got a lot of dollars out there floating around that they're going to fund, again, real kind of rural opportunities. So does the addressable market access lines get bigger for you guys to ultimately address? And maybe it's not this year or next year, but ultimately, there's a bigger body of access lines that you guys can fund.

William Atkins - Calix, Inc. - EVP and CFO

Yes, I think you framed very well. I would say in the Tier 3 space, because of the pig in the python problem, I would put that to the side, if you will.

George Notter - Jefferies LLC - Analyst

Yes.

William Atkins - Calix, Inc. - EVP and CFO

Obviously, some dollars will flow there. So I think in the Tier 2 space, it becomes quite an interesting dynamic, where these guys are able to basically expand their footprints and lock more people in.

Once you've spent that CapEx, you tend to have a very sticky kind of subscriber relationship. And so that could be quite interesting, is the way I would put it, particularly in a Tier 2 space.

George Notter - Jefferies LLC - Analyst

Got it. Okay. How about -- you obviously have an existing run rate of business in these places. CenturyLink, Frontier, and Windstream. Is there any potential to overhang demand, right? The current run rates that you're experiencing with those customers in front of this CAF II fund and that decision point?

William Atkins - Calix, Inc. - EVP and CFO

Maybe. I mean, those are the kinds of questions I'm asking internally. And that in a sense goes back to maybe that's one of the reasons why the operators were slow out of the gate with their budgets this year. Maybe it was CAF; maybe they were sorting out what they were going to do with CAF.

You know, we do have a weekly discussion with senior management about how are we doing in terms of bookings and customer orders and the like. And this is a question that comes up quite a bit, particularly right now. So it is right in the middle of that four-month period, essentially, or beginning of that four-month period.

I'm not getting any noise back indicating that that's happening, but that doesn't mean it's not. There is simply the information flows is imperfect.

George Notter - Jefferies LLC - Analyst

Got it. Okay, great. Can you talk about -- one of the other things that's going on in the industry right now is Verizon is selling a bunch of access lines to Frontier. Frontier is obviously a customer for you guys.

I understand that less than half the access lines are coming across are FiOS markets. Can you kind of talk about is there an opportunity for Calix there?

William Atkins - Calix, Inc. - EVP and CFO

Yes, there is this is the short answer. We think that if you look at the earlier transitions to Frontier of those sorts of assets, they tended to take longer to integrate those assets into their underlying operating systems.

I think that inevitably, they're going to -- they are better at it now and they're less cautious now, because they're seasoned pros at doing this. And so therefore that means that near term, there's going to be potentially more of an opportunity for a conversion, if you will. So we see this being a good thing, when a non-Calix customer transfers local lines to a Calix customer inherently.

George Notter - Jefferies LLC - Analyst

Got it. Okay. And you are also integrated into the OSS systems that come across, I think, to Frontier?

William Atkins - Calix, Inc. - EVP and CFO

Yes.

George Notter - Jefferies LLC - Analyst

At one point, there was an issue, because those OSS systems were Verizon systems. And then now I think they're Frontier systems. So that goes smoothly.



Okay. Last couple of minutes here. I wanted to ask about the gross margin performance in the Company.

William Atkins - Calix, Inc. - EVP and CFO

Sure.

George Notter - Jefferies LLC - Analyst

49% in the most recent quarter. You're talking about the Company ultimately being run above 50%. But can you just talk tangibly about what's driving improvement in margins.

And I actually asked a question of Carl on a conference call. And Carl basically said price-performance and it was sort of silly answer, I thought. But now is your opportunity --

William Atkins - Calix, Inc. - EVP and CFO

I'll tell him.

George Notter - Jefferies LLC - Analyst

-- to open the kimono and really tell us a lot more about what's going on and --

William Atkins - Calix, Inc. - EVP and CFO

You're really putting me up on a pedestal now. (laughter) And I'm going to disappoint everybody.

Well, what I would say is that -- what we have said is that customer premise is, as defined in the sector again, we prefer to use the term subscriber edge, because that really gets to the true heart of what the device does.

Subscriber edge devices are an increasing portion of our business and they are good margin products. And our corporate gross margins are going to increase, we believe.

George Notter - Jefferies LLC - Analyst

Okay.

William Atkins - Calix, Inc. - EVP and CFO

Secondly, we've also said that the E-series, which is our latest and greatest product family, is an increasing portion of our sales -- as it should be. That's sort of a truism, right? Any new product family should be an increasing portion of your product sales. It is also inherently a higher-margin product family than our older product families.

I think the other thing that is going on is we're very focused on trying to get much more -- and I'm going to use a non-engineer's term -- sort of commonality, if you will, in terms of the underlying components of products and product design. And also you try to get a little bit more commonality in terms of the underlying software that runs these devices.

And it's very surprising to see how much in a sense of the software and of the underlying hardware components are tailor-made for each -- I'm going to use a horrible term -- box that gets sold.

And the more commonality you can get across different systems within a product family and the more you can reuse the underlying operating system between those different systems, the more efficient you are and the better your margins are. And that's also an overall corporate philosophy.

George Notter - Jefferies LLC - Analyst

Got it. Okay. Is that a trend that you are just pushing through right now or is that something that's been going on and working out --. Got it. Okay.

William Atkins - Calix, Inc. - EVP and CFO

That's been going on. That's what Calix has been doing for years and if you look at our trends, it's been a successful one.

George Notter - Jefferies LLC - Analyst

Got it, great. Okay. We are out of time, so we'll cut it off right there. But William, thank you very much for your time today.

William Atkins - Calix, Inc. - EVP and CFO

Not at all, George, thank you.

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2015, Thomson Reuters. All Rights Reserved.