Finisar Corporation

Moderator: Jerry Rawls
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Operator: This is conference # 59806101

Operator: Good afternoon ladies and gentlemen. Welcome to the Finisar Corporation announces third quarter results conference call. Just a quick reminder, today's call is being recorded. And now at this time, I'll turn things over to Jerry Rawls, Chairman and CEO.

Jerry Rawls: Thank you, Karen and good afternoon, everyone. We appreciate your taking time to listen to our conference call today. A replay of this call should appear on our website within eight hours. An audio replay will be available for two weeks by dialing 1-855-859-2056 for domestic, or 1-404-537-3406 for international. Enter the conference ID number 598-06-101.

I need to remind all of you that any forward-looking statements in today's discussion are subject to risks and uncertainties which are discussed at length in our annually and quarterly SEC filings. Actual events and results could differ materially from any forward-looking statements. In addition, the Company undertakes no obligations to update any forward-looking information presented.

Unless otherwise indicated, all results discussed are on a non-GAAP basis. A complete reconciliation of our GAAP to non-GAAP results may be found in our earnings press release and in the Investor Relations section of our website.

We have prepared some slides for today's earnings call. You can view them by connecting to the Investor Relations page of our website at Finisar.com.

Click on Investors, then scroll down to Webcast Archives and click. You will see a listing for today's third quarter 2017 earnings call.

I am pleased to announce that Finisar achieved another all-time quarterly record for revenues and profits in our third quarter. Revenues were $380.6 million, an increase of $10.7 million, or 2.9 percent over the second quarter, and 23.1 percent over the third quarter a year ago. This growth was primarily from strong demand for 100 Gigabit per second transceivers. In addition, customer demand for wavelength selective switches and ROADM line cards continued to be strong. I'm going to let Kurt take over and review the rest of the numbers for you. Kurt?

Kurt Adzema: Thanks Jerry.

Sales of Datacom products increased by $7.3 million, or 2.8 percent compared to the second quarter. This increase is primarily due to higher sales of 100 Gigabit transceivers. Sales of 100 Gigabit transceivers for Datacom applications increased approximately 9 percent compared to the second quarter and more than 110 percent over the third quarter of the prior fiscal year.

Sales of telecom products increased by $3.5 million, or 3.2 percent compared to the second quarter. This increase is due to higher sales of wavelength selective switches and ROADM line cards, primarily to our Chinese OEM customers.

In the second quarter, we had two 10 percent or greater customers. Our top 10 customers represented 57.4 percent of total revenues compared to 57.9 percent in the second quarter.

Non-GAAP gross margin was 37 percent compared to 37.2 percent in the second quarter.

Non-GAAP operating expenses were $70.5 million compared to $69.4 million in the prior quarter. Non-GAAP operating expenses as a percent of revenue decreased to approximately 18.5 percent of revenue compared to 18.8 percent in the second quarter.

Non-GAAP operating income was $70.4 million, or 18.5 percent of revenues compared to $68.3 million, or 18.5 percent of revenue in the second quarter.

Non-GAAP operating income was $67.2 million, or 59 cents per diluted share compared to $65.2 million or 58 cents in the preceding quarter.

Average diluted shares for non-GAAP purposes totaled 114.9 million.

Interest and other income was approximately $900,000 in the third quarter and is expected to be up approximately $1.3 million in the fourth fiscal quarter.

Non-GAAP taxes for the third quarter were approximately $4.1 million. Non-GAAP taxes for the fourth fiscal quarter are estimated to be approximately five percent. Non-GAAP taxes for FY18 are estimated at approximately six percent.

Cash, cash equivalents and short-term investments increased by $588 million to approximately $1.2 billion at the end of the third quarter compared to $626.3 million at the end of the second quarter. This increase is primarily due to the issuance of $575 million of 0.5 percent convertible notes due in December 2036, which yielded net proceeds of $569.3 million. Excluding those net proceeds, cash would have increased $18.7 million during the quarter.

Capital expenditures were approximately $42 million in the third quarter and are expected to be approximately $50 million in the fourth fiscal quarter. The increase in capital expenditures in the fourth quarter will be driven by the expansion of capacity in our VCSEL laser FAB in Allen, Texas to enable us to pursue new 3D sensing opportunities for consumer applications.

In addition, at the beginning of the fourth quarter, we acquired the rights to a parcel of land adjacent to our current manufacturing facility in Wuxi, China. In the fourth quarter, we expect to start construction of a building on the site, whose primary use will be manufacturing. We expect the construction of this building will be completed in the second half of calendar 2018.

Capital expenditures for FY18 are estimated to be approximately $35 million to $40 million per quarter.

Weighted average fully diluted shares for the fourth fiscal quarter are expected to be approximately 115.5 million for non-GAAP purposes.

We excluded from our non-GAAP results a number of charges or benefits that were either non-cash, or we consider outside of our core ongoing operating results. These totaled $20.8 million last quarter.

If you included all these items as required under GAAP, we generated net income of $46.4 million, or 40 cents per diluted share appeared to net income of $48.8 million, or 43 cents per diluted share in the second quarter. That concludes my comments and I'll turn it back to Jerry.

Jerry Rawls: Thanks Kurt. We expect our revenues for the fourth fiscal quarter of 2017 will be between $360 million and $380 million.

Datacom revenues should grow by approximately $5 million mostly from continued growth of 100 Gigabit QSFP28 transceivers. This will be partially offset by lower sales of 10 gigabit and below short wavelength transceivers.

We expect telecom revenues to decline by approximately $15 million, mostly from three factors annual telecom price reductions; seasonality associated with Chinese New Year; and lower revenue from our 100-gig CFP transceivers in China.

We expect fourth quarter non-GAAP gross margins will be approximately 36 percent, primarily due to the impact of the telecom price reductions and our expectation of lower levels of revenue.

Fourth-quarter operating expenses will be approximately $70 million.

Non-GAAP operating margins will be approximately 17 percent. Non-GAAP earnings per diluted share should be from 50 to 56 cents.

We are optimistic about FY18. We believe our revenues will grow again, starting from the first quarter. We expect continued growth from the sales of the 100-gigabit QSFP28 transceivers, mostly for hyperscale data centers. We are currently sold out on this product and despite our continuing to add capacity, we expect that sold-out situation to last at least through the end of calendar year 2017.

In addition, we expect to finally achieve qualification in the first quarter of FY18 for both our 100-gigabit coherent CFP2-ACO transceiver and our ROADM line card for use in the Verizon metro upgrade. Our qualification will be with a key OEM customer. We have already completed qualification of our CFP2-ACO and multiple customers and are in the qualification process with several others.

We also believe the Chinese service providers will begin domestic deployments of ROADMs in the second half of calendar 2017.

Finally, during the third quarter, we shipped many thousands of our high-powered VCSEL arrays for 3D sensing. We are continuing to add manufacturing capacity in anticipation of strong demand from this application in the second half of calendar year 2017. And now with that, I'm going to turn it back over to Karen and open it up for questions. Karen?

Operator: As a reminder if any participant has a question, please press star one on your telephone keypad. We'll pause for just a moment to compile the Q&A roster. And one moment please. Again, one moment please. And your first question comes from the line of Patrick Newton of Stifel.

Patrick Newton: Given the stock action post-market, the question I'm getting from investors is how is this different than 2011? You walked us through some of the puts-and-takes on the lower guidance, I think focusing on 100G CFP and also walked through some potential growth items through the remainder of this calendar year but if you could maybe help us allay some peers here, that would be great.

Jerry Rawls: Well, 2011 happened in a much larger magnitude and much more suddenly a-- there was way overcapacity -- or not overcapacity -- over-inflation in inventories. The inventory levels were very high levels and so as a result, when there was this inventory correction, it was a really big deal. We don't believe that, that is happening.

There maybe a little bit of inventory in the system but several products around the industry that are still in the sold-out condition but is not as pervasive as it was in 2011 and particularly in the two big product lines that were driving this way.

Kurt Adzema: I think the second thing, as Jerry mentioned in his comments, is we expect revenue to grow again starting in the first quarter and I think that's different. I think obviously we sold less than we expected this quarter and the guidance is lower than we had expected but we do expect FY18 to be a strong year for all the reasons Jerry talked about.

Patrick Newton: Great and then I guess on the QSFP28 side, Jerry, you said you were sold-out; you are adding capacity and you should be sold out at least through calendar 2017. If we look back at Arista just a couple weeks ago, they talked about optical supply constraints easing as early as this first calendar quarter; is there any way you can help us maybe square their comments versus what you are seeing?

Jerry Rawls: This is the same source that said only a couple weeks before that, that the demand for 100 Gig optics would be at least 10 times when anybody had ever forecasted. So I think there are sort of mixed signals there. From our standpoint, demand is really strong from a lot of directions. It's not just OEMs like the one you mentioned but it's predominantly driven by the hyperscale data centers. I don't see it being the tight situation being released for a very long time.

Patrick Newton: And just, if I can sneak one more in. Thank you for the details on 3D sensing and generating revenue in the quarter, but I think investors, in general, see

Finisar as having less of an market opportunity perhaps than competitors given the perception of less capacity stemming from four inch VCSEL wafers that maybe put you at a disadvantage per -- versus peers.

I'm curious; is this perception wrong and can you comment on whether you have the potential to generate several levels of revenue that have been alluded to by your competitors?

Jerry Rawls: Well, revenue levels and the potential for revenue levels in the second half of our next fiscal year -- or going to be our next calendar year, actually, are going to be tens of millions of dollars. I don't know exactly what our competitors have said but it's a huge potential for a lot of people in the industry. We are adding capacity; we are hiring people. We are adding equipment. We are increasing our capacity very dramatically.

It is true that we manufacture on 4-inch wafers; we think our yields are higher on 4-inch wafers than they would be if we were processing 6-inch wafers and so we made a very conscious decision to stick with 4-inch. VCSEL wafers are very thin and very fragile.

Patrick Newton: Thank you for taking my questions. Good luck.

Operator: And your next question comes from the line of James Kisner of Jefferies LLC.

James Kisner: I guess first one related to verify something. There's been some chatter about you guys having some product quality or qualification issues on a couple different LR4 products. I want to clarify whether you are seeing any of that? Is that at all creating a lack of offset as CFP rolls off? Can you clear the air on that issue?

Jerry Rawls: Our issue on CFP is pretty system specific and they are pretty customer specific. We sell these things to a lot of people but in these particular cases, they are going to have to be some component changes and in one case, component and for more changes just to be able to be compatible with all of these systems from an OEM. Each OEM build lots of boxes. Each one of those boxes, you have to qualify.

Each one of them has a motherboard that has different characteristics. The chip that you interface with and your optical device interfaces with has a different trace link, primarily the chip. The impedance matching is often quite different. We've had, in some cases, the power supply and the characteristics of the power supply is really quite different. So anyway, we have run into a couple of those where we are having to make some changes to be compatible with our customers' motherboard.

James Kisner: Okay, so how are you -- just in general, as you step back, how are you thinking about the CFPs, CFP2, CFP4 business in aggregate this year? Do you think that CFP is going to give you higher ASP because of the gearbox and there's been some talk about positioning QSFP28 as well for LR4 but as you look at that bucket of CFP Datacom modules, is that going to be a significant headwind in this calendar year?

Jerry Rawls: We think that CFP2, well, first of all, for the year, we're going to have very strong sales if we added up for all the quarters but as we go into the next fiscal year, I would expect that CFP sales themselves are probably going to be flat, maybe. I don't know that they are likely to grow because the problem is CFP is migrating to CFP2 and we have CFP4 and all of those eventually are going to go to QSFP28 so anyway, CFP has been a good product for a long time for us but we're not expecting a lot of growth out of it in the future.

James Kisner: I guess depending on the qualification issues you were talking about, are those temporary and are you expecting those to be resolved in the next quarter or two or finite period of time?

Jerry Rawls: I would expect in the next quarter or two is probably a good estimate.

James Kisner: Okay, I will pass it on.

Jerry Rawls: It could happen in a matter of -- in one case, it could happen in a couple of weeks but these are difficult things to predict sometimes. Because it depends upon what you are testing and a bunch of what the -- attention that the end customer has to pay on these issues.

James Kisner: Okay, thank you very much.

Operator: And your next question comes from the line of Doug Clark of Goldman Sachs.

Doug Clark: Maybe just a follow-up on the qualification issues. Can you help us size or quantify either the impact to the fiscal third quarter or the fiscal fourth quarter guidance that you are anticipating from the specific issues?

Kurt Adzema: So Doug, can you clarify? You keep referring to them as qualification issues. I think Jerry alluded to we've got some technical issues on the CFP with a couple customers now we are working through. Could you be more specific on your question?

Doug Clark: Well, I guess maybe to address that specifically what is the revenue impact of those technical issues that you are facing now with customers? Is it $5 million, $10 million in the quarter and the guidance?

Kurt Adzema: Again, I don't think we're going to get into that level of detail. It's a little hard to break it out in terms of the impact of the technical challenges with those customers versus we have seen, just in general, some slower demand in CFP. I think that others have also talked about around Chinese New Year and expecting the first half of the year. So it's a little hard to quantify just the impact of that.

But obviously, it's something we hope to resolve shortly and get shipping on those again. But in the meantime, 100 Gig QSFP28 has continued to grow at an incredible rate for us and as Jerry said, we expect to continue that capacity and be sold out this year, and that's really going to be the growth driver for the Company.

Doug Clark: Okay and maybe another question on 3D sensing. Can you give us a sense, right, you've been adding capacity now pretty aggressively for two quarters? How much capacity do you anticipate being online by the second half of the year to service these customers -- or customer, or customers? Can you give us a sense on how far down the road you will be?

Jerry Rawls: I don't know exactly how to quantify that one. We are going to produce in calendar year 2017 many, many more VCSEL than we have ever produced in our history and we celebrated a few years ago, our 100 million VCSEL chips so the capacity is pretty astounding for us. So I'm not -- but it's not something that I can -- or I'm willing to exactly lay out how many wafers and how many die we're going to produce.

Doug Clark: Okay, understood. And then maybe one final question just looking out to next gen, I know you just got for fiscal fourth quarter but looking into FY18, any sense on if growth rate should accelerate or decelerate after coming out of 2017, which is mid-teens growth?

Kurt Adzema: Well, I think there's certainly a lot of factors that go into that. I think Jerry just finished talking about the 3D sensing opportunity and that could have a major impact and really add to our revenue. So I think it all depends on how aggressive you want to be on your assumptions on that. But we're not at the point where we are wanting to quantify that.

But certainly, I think there are a lot of reasons why we are optimistic about FY18 that Jerry talked about. It starts with the QSFP28 transceivers, some of the metro products, you're going to look at Verizon and then still WSS domestically and China. So lots of reasons to be positive and expect significant growth in FY18.

Doug Clark: Thanks for taking my questions.

Operator: And your next question comes from the line of Alex Henderson, Needham.

Alex Henderson: I was hoping you could slice and dice a couple things a little bit more for us. Talk a little bit about what you're thinking on 10 Gig, 40 Gig and whether that business is now going to not just flatten out, but actually start to roll over in a sequential basis going forward beyond the impact of the pricing?

Obviously to date, we haven't really seen most of the upgrades kick in and the scaled-out data centers because there's been other constraints but that looks like it's going to resolve itself so is that going to start to roll over more aggressively?

Jerry Rawls: Alex, I am not sure. We had predicted internally a few quarters ago, that we thought that 40 Gig and 10 Gig sales would decline at a modest rate for a long time. But we haven't seen that. We're still sold out on 40 Gig. QSFP 40 Gig product, we are at capacity; we can't ship all the stuff we've got orders for. Our 10 Gig is one of those where we have been surprised. We are not sold out.

We have had quarters in the last few quarters where we had sales that were up substantially in the quarter and others where they were down modestly. But I don't -- I guess I think that 10 Gig is likely to be flat to down a little bit in the future but I don't think it's going to be a very dramatic reduction because I think a lot of what we sell in 10 Gig goes into enterprise data centers and enterprise data centers are making a big transition to 100 Gig. A lot of them are still upgrading from 1 Gig to 10 Gig and some of them are still going from -- no, actually it's from Cat 5 cable 1 Gig to optics in 10 Gig, so…

Alex Henderson: Can you give us some sense of what's going on in the fiber channel segment of the market?

Jerry Rawls: I think fiber channel has been a really stable business for us. It hasn't been a rapidly growing business for us but it has been really stable. We have some great customers there. It is the big threat that everybody talks about is will cloud services take over all of these SAP and Oracle databases? If they do, well, then it's not clear whether the big cloud services providers are going to run fiber channel in their cloud data centers.

Now, I will tell you, there are a lot of fiber channel SAN's in these big cloud operators today and I don't know how that's going to expand. But anyway, overall, our expectations for fiber channel revenues are modest. We don't expect a lot of growth there.

Alex Henderson: So seasonal decline on pricing and then just flattish on volume?

Jerry Rawls: I think that's probably right. We don't see a lot of variation in the pricing in that market and we make a lot of them. We are really competitive in that market because our volumes are so big.

Alex Henderson: One more product area, so the shortwave, you mentioned it in your prepared remarks, the sub-10 Gig stuff. I'm assuming that, that's down to very low single-digit kind of revenue levels and that it's not anticipated that, that is going to change in a meaningful way. I was a little surprised to hear it. I thought it was already small enough to have fallen out of the mix.

Can you talk about what your plans are there? Whether you're going to use any capacity in that space or whether you're going to continue to keep it at very low levels?

Kurt Adzema: Again, I think we talked about 10 Gig and lower shortwave being down and that's a combination of several things. I think it's a little bit of the wireless, as you talked about, Alex, but also we do see 1 Gig ethernet and 10 Gig ethernet being down this quarter. So you are right.

There's still wireless is a couple of percent, as you said, low single-digit percent. Certainly as a percent of the business, we expect it to decline just because it's not really growing but there will be opportunities down the road, maybe not in the near term to come out with next generation products and be more aggressive in that market. But I just think certainly in the near term, flat to declining market certainly a smaller and smaller percent of our revenue as most of our growth was driven by QSFP28.

Alex Henderson: One last question and I'll cede the floor, if I could. Just on the telco side, excluding the ROADM wave selective switch stuff, what was the trajectory of the non-ROADM non-wave selective switch telco business?

Kurt Adzema: I'd say it was slightly down so I think all that growth really came from WSS last quarter.

Jerry Rawls: The one area that was pretty strong was our tunable XFP, and we are sold out of that.

Kurt Adzema: I think the main driver to your point, Alex, is the WSS.

Alex Henderson: Okay, so it was down on revenues and volume or just down on pricing?

Kurt Adzema: No, I think if you factor in pricing, it was probably flat on units if you assume the one-month average pricing rate.

Alex Henderson: That's it. Thank you very much.

Operator: And your next question comes from the line of Joseph Wolf of Barclays.

Joseph Wolf: I wanted to focus a little bit on gross margins. I know if you go through historically where margins have peaked. There have been periods where it was -- gross margin grew significantly because of specific product launches and I guess monopoly types of activity.

If you look at what's going on for the fourth quarter and the guidance, which seems to be pricing and a little bit of mix, how should we think about the opportunities with some of these new products coming out VCSELs and things like that and where margins can go from here for the next 12 to 18 months?

Kurt Adzema: I think as we always talk about, we only do one quarter gross margin guidance but gross margin the big factors for gross margin are revenue growth, product mix and obviously the competitive environment. So we are very excited, as Jerry talked about, some of these VCSEL 3D sensing applications and obviously depending on growth and volume, that could be quite nice for us.

So that can be helpful and QSFP28, as that grows on average, has a higher gross margin than our average gross margin so again, wavelength selective switch tends to be favorable product mix. So we have lots of opportunities out there that we are pursuing that could be additive to margin and it will obviously have to be balanced by what's going on in the competitive market.

Joseph Wolf: Okay, thank you. And then just a follow-up on some questions that have been with the VCSEL expansion and the CapEx. As you look at that CapEx and you said your shipping is going to be ramping in the second half, are you working on one application or are there multiple end markets where that are interesting right now to start with one area and potentially move further along into other consumer electronics and sorts of applications? Are you seeing designs for that already?

Jerry Rawls: We are working with dozens of customers that are in consumer-related industries, but some of our automotive; some are mobility devices. Most of them have some three-dimensional sensing as the goal but for different purposes sometimes but there is a lot of projects right now.

Joseph Wolf: And how independent -- if you don't sell all the pieces that would go into a module that would do 3D sensing, are you just selling independently or are you working with integrators on the other components that go into making these modules work?

Jerry Rawls: Well, there are integrators that will combine light sources, like our VCSELs, with photo detectors, with lensing, with special filters, with packaging, all of that and we supply into those integrators, where we are contracting for the ultimate customer.

Joseph Wolf: Okay. Thank you. Very helpful, Jerry and Kurt.

Operator: And your next question comes from the line of Troy Jensen of Piper.

Troy Jensen: A quick follow-up. James had asked the question, Jerry, about -- I think it was quality issues for QSFP28 LR4 and I thought your answer was more on CFP so can you just talk about any issues on the LR4 part?

Jerry Rawls: QSFP28 LR4 we sell to, I don't know, maybe hundreds of customers. And we are sold out and we're going to stay sold out for a long time and the product works really well. So I don't view there being an issue there.

Troy Jensen: Okay, understood. And just so I understand, Jerry, on 3D sensing, I think I heard two different answers. Do you believe in an inflection in this space; was that at the end of this calendar year 2017 or the end of FY18?

Jerry Rawls: No, I think the inflection is going to occur in the middle of the year 2017.

Troy Jensen: Middle of 2017. Would you say your conviction on that inflection happening now is higher than it was just a few months ago?

Jerry Rawls: Yes

Jerry Rawls: We have now shipped a lot of units and the truck is pulling up to the dock because we have to make subsequent shipments that are considerably larger than what we have already shipped and we're -- so it's rolling. My confidence in terms of the success of the project has grown. There is never a sure thing in this world but at least, at this point, it looks pretty good.

Troy Jensen: Awesome. All right, guys. Good luck this year.

Operator: And your next question comes from the line of Simon Leopold of Raymond James.

Mauricio Munoz: This is Mauricio in for Simon today. Can you guys talk about the ROADM opportunity in China? It looks like your visibility improved and wanted to know if you could talk about your expectations for the timing of the deployments volume-wise and maybe provide some qualifications from the revenue opportunity and the mix? By mix, I mean the more -- the route and select versus the more legacy broadcast and select?

Jerry Rawls: Well, I will tell you the latest info we've got from different service providers and different equipment builders is that there will be some broadcast and select and some route and select. We originally thought -- go back a year, we thought that by the end of 2016, tenders would have been issued for deployments very early in 2017. Well, it didn't happen. It got pushed out.

We supplied a fairly large number of units, hundreds and hundreds of ROADMs of wavelength selective switches for field -- what we would call in the US, field trials, they would call them small deployments in China. We then thought that these tenders would be issued in -- right after the first of the year.

That didn't happen. Then we said we thought it would happen right after Chinese New Year; well, that hadn't happened and our latest input says it's probably a second half event. The tenders may occur between now and July, at least we are hoping for that, but we are assured by officials at the service providers and in the equipment companies that it's coming. And the only issue is going to be at which pace that they deploy them.

Automating the optical network is a new adventure for the service providers in China. Learning how to control and manage the networks is a complicated task for them and so they are walking through it one step at a time and I'm -- we are disappointed obviously that they haven't been able to deploy earlier but I don't think that has dampened our enthusiasm for that business in that market because the volumes are potentially so large.

Mauricio Munoz: Thank you. Then on the Verizon metro project, do you now expect qualification on a major OEM for these 100 Gig metro initiatives? And I think you mentioned the timing was earlier in FY18; did I get that right?

Jerry Rawls: Yes.

Mauricio Munoz: Okay, then given that the bulk of your ROADM revenues currently come from sales of WSS and other components employed to make a blade, how should we think in terms of revenue and profit margins once you start obtaining qualifications on this -- on the North American project where different than China, OEMs in the North America, they seem to be adopting the entire ROADM blade rather than outsourcing WSS and building their own solution in-house?

Jerry Rawls: Well, that's exactly what we are doing and what we have been in qualification for the last year-and-a-half, trying to qualify our ROADM blade. So it is a complete ROADM blade with WSS, channel monitor, DWP processor, memory, software, you name it. It's an interface to their system -- to their network management system.

We have been disappointed that we have been unable to qualify before now but we think we have made it through all of the hurdles. We think we now have an acceptable device that is functional and all of the very exacting system tests that are going to be run, we think have been run. So we are very optimistic now that we will actually achieve AVL status and be able to ship in production quantities, in -- I don't know, probably the second quarter of our FY18.

Mauricio Munoz: So what is the revenue margin profile of sending the entire blade versus just selling subcomponents, WSS and other components?

Jerry Rawls: Well, it's interesting that, for us, we find that the selling the entire blade, the gross margins -- the prices are twice as high as selling the wavelength selector switch but the gross margins are actually a little bit lower. They are close but they are lower. And that's partly because we have to buy pump lasers and build VCSELs; we don't make pump lasers.

We then wrap a lot of sheet-metal and some circuit boards into this package as opposed to very exotic optics that go in a wavelength selective switch. And so the combination of all of that, selling the sheet-metal and the circuit board, along with VCSELs, means at the end of the day, we get -- though the prices higher, the gross margin is a bit lower.

Mauricio Munoz: Thank you so much.

Operator: Again, if any participant has a question, please press star one on your telephone keypad. I would now like to introduce the next person with a question, Mr. Richard Shannon of Craig-Hallum.

Richard Shannon: Just a few for me and I will start probably one for Jerry on 3D sensing. You talked about a big pick-up in the second half of the year and from some other answers you gave to previous questions, it sounds like you're having a breadth of customers driving this. Can you characterize that a little bit more? Is it dominated by any particular one or is this more broad? And also if you could lay out the competitive landscape there as you see it right now, that would be great to hear. Thanks.

Jerry Rawls: Well, the biggest factor for us is the QSFP28 and we do sell it to hundreds of customers, but the top few dozen are all in-the-cloud services businesses. They are operating these hyperscale data center so that is the biggest pressure that we see and that is the biggest demand that's going to stay, we think, strong for quite some time.

Yes, there are some other parts of our business in 2018 that are going to be strong. We have talked a lot about the 3D sensing and the VCSELs side and that has exciting possibilities. We think our qualification for our ROADM line card and our CFP2-ACO, finally, for the Verizon project is, again, an exciting prospect for us and again, for increased revenue. We just think there's a lot of things between the wavelength selective switches and our QSFP 100 Gig, in general, we think FY18 is going to be good.

Richard Shannon: Okay and I apologize, Jerry, I may have misspoke with the essence of my question, specifically, regarding 3D sensing. So I apologize if I misstated that but can you lay out the competitive landscape there and the breadth of demand you are seeing in that area?

Jerry Rawls: Well, demand at this point is dominated by very few customers. The number of prospects and the number of projects that we are working on that don't have a lot of demand yet where we are supplying prototypes, samples, small volumes, et cetera, for testing and for their building up systems, there are dozens and dozens of customers that are in that bag.

So obviously, it's a market that we think is going to have legs. The real question is going to be what are the apps that people are going to write once they have this ability to do -- precision 3D sensing, where they can do facial recognition at even some distance.

We are not a company that's going to write apps, but this is one of those things there's going to be a lot of people who will be turned loose, that are going to be trying to write apps for this capability. So I'm -- anyway, there's a lot of excitement generally in the people that are working in this field and if any of their estimates of the future come true, there aren't enough VCSELs capacity in the world to take care of this.

Richard Shannon: Okay, great. That's great to hear, Jerry. Thank you. Another question on the CFP2-ACO. I might have missed the entire essence of your prepared remarks there but if you could clarify how many qualifications you have now? How many you might expect over the next quarter or two and then given the expectations of what kind of share you might be able to generate looking a year out or so, do you think? Any perspectives would be great.

Jerry Rawls: I think the qualifications to date are approximately 10 and we've got a number more that are in process. And share in the future is really hard to predict. There aren't many suppliers and we're -- we'll be the largest Company in the industry. We won't start with the largest volume on this particular product area but as the largest supplier in this industry, we usually get recognized for that and we get a fair amount of attention so we will generate substantial volume in that market.

Richard Shannon: Okay, fair enough. My last quick question and I'll jump out of line here for your guidance in April quarter, can you characterize how much you're expecting from ROADM specifically at Verizon and or from the ACOs?

Kurt Adzema: I think, as Jerry said, for the ROADM line cards and the ACOs with a key OEM and Verizon, we don't expect to be qualified until Q1 so there's not going to be material revenue in Q4.

Richard Shannon: Okay, just wanted to make sure. Thank you. That's all for my questions, guys.

Operator: Your next question comes from the line of Tim Savageaux, Northland Capital Markets.

Tim Savageaux: Question kind of on the historic seasonality on the telecom side and relative growth rates in telecom and Datacom? I think last year, you saw a similar type decline in telecom in Q4 sequentially, maybe with some different drivers and maybe that's why I had your model down overall sequentially for Q4 here, heading in. But I wondered, it looks like even with that declined sequentially in telecom, you're going to be up mid-20s on a year-over-year basis.

So I wonder if you can compare the two sequential declines on the telecom side, the one you saw last year versus this year, obviously at higher levels? And then that brings the fiscal year in at 20 percent something growth on the telecom side versus low teens Datacom. I wonder if you expect leaving 3D sensing aside, that kind of mix of growth rates to change as you look forward into FY18?

Kurt Adzema: Well, there's a lot of questions in your question. I think the simple answer is the place where we have the most visibility in this business and we think is the biggest growth driver is QFP28 which is Datacom. So we expect Datacom growth to be strong in FY18. I think when you look at some of these opportunities that Jerry talks about, whether it's wavelength selective switches and domestically in China or the metro deployments at Verizon.

Obviously, if we go and we execute on those, where we really haven't sold WSS in China domestically or had these calls, then that's a greenfield opportunity and that can add a lot to it. But as we have seen, there's some risk on the timing and on the sensing.

So I'd say we're most confident actually probably on the Datacom side because we really do believe QSFP28, the demand is very strong. We expect it to continue to be strong and we are adding significant capacity throughout the fiscal year and so we really think that's going to be the number one driver for us.

Tim Savageaux: Okay, so it sounds like you are based on expectations for maybe those growth rates to reverse, not talking about absolute levels but to the extent telecom grew faster, significantly faster than Datacom in 2017, it sounds like you would expect that to potentially reverse in 2018 subject to some of these kind of qualification fairly binary issues that you discuss?

Jerry Rawls: I think you are right. We expect the Datacom business in 2018 to be stronger.

Tim Savageaux: And Kurt, the other question was about Q4 seasonality in telecom this year versus last year. Is there any commentary that you have?

Kurt Adzema: I don't have all the breakdown of the revenue this year versus last year. Obviously, last year, we were at the higher end of the 10 percent to 15 percent range for annual ASP reductions, so I think that had more impact last year. I think this year, as we talked about it, it's obviously the price erosion although again, that was at the lower end this year.

But then as Jerry mentioned, we expect to sell less 100G CFP modules into China, partially driven by some of these technical issues that we are working through right now. That we hope to have resolved probably by the end of the quarter and start to see the benefit of having those resolved next fiscal year.

Tim Savageaux: Got it. And final question for me. Clearly as you've noted, your cash balance increased pretty significantly in the quarter due to the convert. I think there is an assumption here that you were looking to do something with that cash over time. I wonder if you can update us with your views on the potential attractiveness of consolidation in the industry?

And maybe with an eye toward addressing some of the qualification issues on the telecom side that you have been struggling with or really, any other way do you want to approach it? How are you thinking about consolidation here, now that you've got the converted in the back?

Jerry Rawls: I think consolidation is an attractive idea in our industry. The optics industry, forever, has been too fragmented. There's too many competitors and too many of us with too small a market share. We are the largest in the industry but our market share is less than 20 percent.

And that's not really a healthy industry so I think consolidation, in general, is good and the issue is -- and we obviously did a big convert to build our cash balances so that we are prepared in case we encounter or pursue some opportunity for consolidation.

I can't speak to the possibilities or the probabilities. I can only tell you we are clearly open to the idea we find the idea attractive but it's all about -- at the end of the day, it's all about price. It's price and how do you get the shareholders of both companies to come out with an advantage for both, right? It can't be a zero-sum game, so -- and that's often difficult to achieve.

Tim Savageaux: Best of luck with that. Thank you, guys.

Operator: Your next question comes from the line of Michael Genovese, MKM Partners. As a reminder, please be brief with your questions. You may ask one question and two follow up questions.

Michael Genovese: To start with just a clarification is QSFP28, you have some of it accounted in Datacom and some of it accounted in telecom?

Jerry Rawls: Negative. All of QSFP28 is in Datacom.

Michael Genovese: Okay, because I thought about earlier, you talked about CFP as a telecom product in China, so I thought maybe you have…

Jerry Rawls: We do sell versions of CFP that our ethernet which a single 25 – four lanes of 25 Gig and then we sell four lanes of 28-gig that allows the overhead for forward error collection which is more sonnet rates.

Michael Genovese: Got it. Great. On the…

Jerry Rawls: Rather than considered in telecom.

Michael Genovese: Okay, perfect. On the QSFP28, you mentioned being sold out in the hyperscale market. Are you also sold out in the Chinese market as well?

Jerry Rawls: We are sold out in the product area, regardless of where the demand comes from. So it's the same product that we sell in Asia that we sell in the U.S. or in Europe and it's just a matter we had more -- we have a lot more orders for that product than we can possibly build.

Michael Genovese:Okay and then finally for me. I see a lot of positives for FY18 here, but also, we did miss the numbers and the guidance that we just put up out I was just wondering if you could reconcile -- I've heard maybe some CFP weakness and some pricing declines, annual pricing declines. Are there any other reasons or how would you describe the reasons for the miss?

Kurt Adzema: Well, I don't know if I'd call Q3 where we grew three percent a miss but certainly, as Jerry pointed out, Q3 was a little lighter than expected. It was primarily because 100 Gig CFP into China was less than expected. I think that was the result partially because we thought there were going to be some orders in the last week just prior to Chinese New Year that didn't happen and then secondly, as Jerry has already talk about, we had some technical glitches that we are working through and that affected that. So that is the story on Q3.

I think the story on Q4 is, again, we're still working through those technical issues. We think they will get resolved hopefully by the end of the quarter but obviously, it's affecting Q4 and I think also, as we talked about, there is kind of the typical Q4 seasonality issues that are out there, both in terms of Chinese New Year but also in terms of the price erosion.

So I don't think it's that big a difference. Obviously, we're disappointed but at the same time, we are very optimistic about FY18 and we resolve these issues and we continue to grow QSFP28 and some of these other things start to kick in, in the second half of the year. We think FY18 could be a very good year.

Michael Genovese: Perfect. Great answers. Sounds -- I agree. It sounds like it could be. Thanks again.

Operator: And that's all the time that we have for questions today. I would now like to turn the call back over to Mr. Rawls for closing remarks.

Jerry Rawls: Thanks, Karen. And thanks everyone for tuning in today. I hope you will be able to join us again in three months for our fourth-quarter call. Have a good day.

Operator: Thank you for joining us today. That does conclude today's call. All participants may now disconnect.

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