Finisar Corporation

Moderator: Jerry Rawls
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Operator: This is conference # 61562686.

Operator: Good afternoon, ladies and gentlemen. Welcome to the Finisar Corporation announces fourth 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 S. Rawls: Thank you, Jess, and good afternoon, everyone. We appreciate your taking the 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 following the call by dialing (855) 859-2056 for domestic, or (404) 537-3406 for international. And then enter the following prompt, the conference ID is 61562686.

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 annual and quarterly SEC filings. Actual events and results can 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 and then scroll down to Webcast Archives. Click on it, and you'll see a listing for today's fourth quarter 2017 earnings call.

I am pleased to announce that Finisar achieved all-time records for revenues and profits in fiscal year 2017. Revenues for the year were $1.45 billion, an increase of $186 million or 14.7 percent over fiscal 2016, and net earnings were up 111 percent to $231.7 million, an increase of $122.8 million over fiscal year '16.

Demand for our QSFP28 transceivers for data centers continued to be strong in the fourth quarter. QSFP28 revenues increased more than 30 percent over the prior quarter. However, our overall revenues declined 6.1 percent to $357.5 million, a decrease of $23.1 million. This decline was primarily the result of reduced telecom revenues from our Chinese OEM customers, plus the impact of the full three months of the annual telecom price erosion. And now I'll let Kurt review the rest of the numbers. Kurt?

Kurt Adzema: Thanks, Jerry.

Sales of datacom products decreased by $2.8 million or 1.1 percent compared to the third quarter. Sales of 100G QSFP transceivers for datacom applications increased over 30 percent compared to the prior quarter. However, this increase was more than off-set by lower demand for other datacom products, primarily 10G and below shortwave transceivers.

Sales of telecom products decreased by $20.2 million or 18.2 percent compared to the third quarter. This decrease was primarily due to lower revenues from our Chinese OEM customers and the impact of the full three months of the annual telecom price erosion.

In the fourth quarter, we had one 10 percent or greater customer.

Our top 10 customers represented 58.9 percent of total revenues compared to 57.4 percent in the third quarter.

Gross margin was 36.2 percent compared to 37 percent in the third quarter, primarily due to the impact of the full three months of the annual telecom price erosion.

Operating expenses were $71 million compared to $70.5 million in the prior quarter.

Operating income was $58.4 million or 16.3 percent of revenue compared to $70.4 million or 18.5 percent of revenue in the third quarter.

Net income was $57.5 million or $0.50 per diluted share compared to $67.2 million or $0.59 in the third quarter.

Weighted average diluted shares totaled 115.2 million. Weighted average fully diluted shares for the first quarter of 2018 are expected to be approximately 116 million.

Interest and other income was approximately $2.1 million in the fourth quarter.

Taxes for the fourth quarter were approximately $3 million. Taxes for FY '18 are estimated at approximately 6 percent.

Cash, cash equivalents and short-term investments increased $22.6 million to approximately $1.2 billion at the end of the fourth quarter.

Capital expenditures were approximately $47.8 million in the fourth quarter. We recently started construction of a third building on our Wuxi site, whose primarily use will be manufacturing. We expect to complete the construction of this building in the second half of calendar 2018. Capital expenditures for the first quarter of fiscal '18 are estimated to be approximately $45 million.

We've excluded from our non-GAAP results a number of charges or benefits that are either noncash or we consider outside our core ongoing operations. These totaled $72.7 million of benefits last quarter. If you include all these items as required under GAAP, we generated net income of $130.2 million or $1.13 per share compared to net income of $46.4 million or $0.40 per diluted share in the third quarter. That concludes my comments, and I'll turn it back to Jerry.

Jerry Rawls: Thanks, Kurt. We expect revenues for our first fiscal quarter of 2018 to be in the range of $330 million to $350 million. We expect telecom to account for most of this decline, primarily due to lower revenue at our Chinese OEM customers. We expect datacom will be relatively flat as revenue growth for 100G QSFP28 transceivers is offset by lower sales of 10-gigabit and 100-gigabit CFP2 Ethernet transceivers.

We expect first quarter gross margins to decline to approximately 35 percent, primarily due to our lower revenue levels.

We expect operating expenses to be relatively flat at approximately $71 million.

Non-GAAP operating margins are expected to be approximately 14 percent.

Earnings per diluted share are expected to be in the range of $0.37 to $0.43 per share.

Despite a challenging outlook in the near term with lower demand from our Chinese OEM customers, we are optimistic about the outlook for Finisar's fiscal 2018. We expect revenue growth to resume in our second fiscal quarter, primarily driven by the sales growth of 100-gigabit QSFP28 transceivers for the big hyper-scale data centers and sales of VCSEL arrays for 3D sensing.

We have made really good progress with our high-powered VCSEL array program. We have received production purchase orders and expect to soon receive customer approval to ship meaningful volumes in our second fiscal quarter.

In addition, in the second quarter, we expect our 100-gigabit, 200-gigabit coherent CFP2 ACO transceiver and our ROADM line card to be fully qualified by a key OEM customer who supplies to the Verizon Metro upgrade. We are currently qualified at multiple other customers for our CFP2 ACO, and are in the qualification process with a number of additional new customers.

And with that, I'm going to turn it back over to Jess and open it up for questions. Jess?

Operator: At this time, I would like to remind everyone in order to ask a question, please press star and the number one on your telephone keypad. We will pause just a moment to compile the Q&A roster. Your first question comes from Patrick Newton with Stifel.

Patrick M. Newton: I guess, first, Jerry, you commented that you expect to see growth and sequential growth in fiscal second quarter driven by Hyperscale. I'm curious how you anticipate China will layer in, in your October -- I'm sorry, your July quarter -- your October quarter, I apologize.

Jerry Rawls: It's hard to tell. We have heard for a long time now 2017 was going to be a strong year in China. Well, I'll tell you so far, it has not been a strong year in China. I've heard from a number of Chinese OEMs that said the second half of this year will be a strong year. Well, we haven't seen much of that yet. So I think it's a little -- the crystal ball is a little cloudy with respect to China.

Now there's been some bright spots. There's been some announcements of some new upgrades. There's been announcements of new deployments of ROADMs, but most of the things that I've seen have been relatively limited. I would almost call them a field trial scale of deployments in the U.S.

Patrick M. Newton: OK, fair. And then I guess on the 3D sensing, good to hear that you have orders and expect meaningful production volumes in the second fiscal quarter. I'm curious if we look out into -- later into fiscal year '18, do you anticipate that your 4-inch wafer capacity is scalable?

Or do you believe that you're going to need 6-inch capacity? And if so, would that be done via foundry partners, internal or some combination of both?

Jerry Rawls: Well, we're going to ramp that 4-inch fab, and we're going to produce record volumes for us by a lot. As we move forward, my guess is that we to ramp capacity further, we're going to have to shift to 6-inch. And the question is exactly how we do that is unclear.

It may be by, through organic growth in an internal facility. It could be through outsourcing. There's lots of options at this point, but we are aggressively pursuing all of them.

Patrick M. Newton: And just one clarification for you, Jerry. You talked about meaningful production volumes in fiscal second quarter. Can you help us quantify that? What does that mean?

Jerry Rawls: It means that we're going to make -- and we're going to ship millions of devices.

Patrick M. Newton: And any revenue you could wrap around that?

Jerry Rawls: It's not -- second quarter is not going to be a big revenue quarter. It's going to be -- we're going to ship a lot of stuff, but it will be nothing compared to quarters after that.

Operator: Your next question comes from Troy Jensen with Piper.

Troy Jensen: Just to follow up here on Patrick with respect to China. Kurt, I was wondering if you could just kind of let us know what's baked in your assumptions. And maybe if you could tell us what peak China revenues have been. And maybe if you don't want to give peak, maybe like average recent quarterly China revenues. And then how much are you implying in your July guidance?

Kurt Adzema: Well, I'm not going to get into the exact revenue. I think we've talked about historically how the Chinese OEMs have been about 20 percent of revenue. And I think, at this point, we're significantly less than that.

I would say we're in the low teens, so depending on when that demand snaps back. Obviously, there's a lot of opportunity there. But in terms of our guide for Q1, obviously we're expecting it to continue to be challenging.

Troy Jensen: OK, fair. Well, two more questions for me on the 3D sensing. The capacity expansion that you're doing right now, is that 100 percent for high power? And to get into low power, would that be through a partnership?

Jerry Rawls: Everything we're doing today is high-power VCSEL array. Let me make a comment here. When I answered Patrick's question a while ago, I got -- in my mind, got off by a quarter. We don't -- in our first quarter, we're not going to have big revenues. Our second quarter, we expect big revenues.

Troy Jensen: The October quarter, you expect big revenues.

Jerry Rawls: Yes.

Troy Jensen: All right. Second quarter shipping or second fiscal quarter, Jerry?

Jerry Rawls: Second fiscal quarter.

Troy Jensen: OK, perfect. And then, Jerry, just one last question for you then I'll cede the floor. I know you've talked a lot this year about supply-demand imbalance with this datacom stuff. I'm sure the demand hasn't changed, but just curious to know if you're seeing more supply come on for QSFP28 given we have seen China slow down.

Some of your competitors are now focusing more on QSFP28 than they were other flavors, so just thoughts on supply-demand balance for the datacom stuff.

Jerry Rawls: Well, so far, there's still a shortage. And I hear people talk every now and then that says, "Oh, well, we're coming close to being supply equals demand," but that's not the behavior we see from the big customers. So -- but it will happen. It's inevitable at some point supply is going to catch up with demand. And our belief is it will happen in calendar year 2018 some time.

Troy Jensen: Understood guys. Good luck and congrats on the VCSEL.

Jerry Rawls: Thanks.

Operator: Again, if you'd like to ask a question, please press star one on your telephone keypad. Your next question comes from James Kisner with Jefferies LLC. Your line is open.

James Kisner: I guess just for the 3D sensing, first, here. So can we assume this is basically really primarily one customer and one application? Or are there multiple customers and applications that you're expecting here to ramp in the October quarter?

Jerry Rawls: We're engaged with a number of customers, but short-term revenue is going to be predominantly from one.

James Kisner: OK. That helps, so -- all right. So in QSFP28, maybe you could update us here on the split of LR versus CWDM4? My math usually I'm getting something like $75 million in revenue here for QSFP28.

I kind of want to verify that. And I guess sort of relatedly, what are you kind of anticipating in the coming quarter? How much capacity are you adding? And could we see a similar ramp in QSFP28 revenue in the July quarter?

Kurt Adzema: Well, I still think we're seeing a pretty strong presence of LR4 relative to CWDM4. And while we are adding capacity for both in Q1, I think the next large chunk of capacity for QSFP28 really comes online in Q2.So I think we will see an increase in QSFP28, Q1 over Q4, but we will see a larger capacity add in Q2 over Q1.

James Kisner: I mean, before, you guys said I think that you had more units of CWDM4 and then -- but still more revenue of LR4. It sounded like it was maybe a little more than half. But -- I mean, can you help us out a little bit more? And like is it 80 percent? Is it -- how much of this QSFP28 revenue really is LR4 at this point? I mean, I was also just curious what you think is really driving that demand.

Kurt Adzema: Well, again, I think what we can say is that exactly what you said, which is I think there's higher revenue for LR4 than CWDM4, but there's more units of CWDM4. But we're not going to get into the exact splits of all that.

James Kisner: Is it true this is driven by aggregation? What's truly driving LR4 demand? Because I know that the market research forecast for LR4 are generally pretty small numbers and just interested in its large demand. Can you elaborate on that a little bit?

Jerry Rawls: Well, LR4 is a 2-kilometer product. And for lots of people, 2 kilometers is a distance they need for a number of these large buildings or connections between buildings.

So I think we have all projected that CWDM4 is ultimately going to be the largest because it is the short-distance interconnect within the data center. But for longer distances, there are some extremes in these Hyperscale data centers where CWDM4 may not reach from one corner to another.

James Kisner: OK. Last one, and I'll pass. Just how big -- you've mentioned weakness in 10G and below. Maybe you just kind of parse there, like I assume most of that is -- you're talking about 10G datacom and not the wireless CIPRI stuff. But how big is 10G within datacom overall? And then maybe how big is wireless? And what are you expecting sequentially? Is that still declining or what?

Kurt Adzema: Yes. I think 10G is about 20 percent or so of datacom, and we expect that to continue to decline over time. And so it's more about kind of 10G SFP+ than some of the CIPRI stuff that you alluded to.

Operator: Your next question comes from Simon Leopold with Raymond James.

Simon Leopold: A couple of quick clarifications, if I might. On that QSFP28 business, you talked about the 30 percent sequential growth. I think that gets us to about $75 million. I just want to make sure I'm not compounding errors and that I'm in the ballpark?

Jerry Rawls: You're in the ballpark.

Simon Leopold: Great. And when you think of that business, can you talk at all about what kind of customer concentration you have in that? Is it significantly oriented towards one customer or well diversified?

Jerry Rawls: There's a lot of customers for it, but there's a lot more than one customer in terms of the big Web 2.0 guys and/or big enterprise OEMs. So we've -- it's not hundreds of -- not evenly split between hundreds, but it's evenly -- it's -- there's about half a dozen big customers.

Simon Leopold: OK. And back at the OFC trade show, you talked a little bit about some issues one of your competitors had that created an interoperability's problem. That was not your issue, but your product didn't work with their product. That was creating a disincentive for at least one OEM, smaller OEM to not buy your product. Has that issue been resolved yet?

Jerry Rawls: The particular issue with that one OEM has not been resolved. We expect it to be resolved shortly, but it's not an issue anywhere else that I know.

Simon Leopold: And then -- and at the beginning of the year, you did have an issue with your CFP products, with Huawei. And you talked openly about that, and you gave us an indication that it would take some time to resolve. Could we get an update on the conformance or acceptability of that product with Huawei?

Jerry Rawls: That product is now shipping.

Simon Leopold: Great. And then just last one, wrapping up on ROADMs and WSS combined. It sounds like you're optimistic about getting that certification for the Verizon initiative, and we've talked a lot about opportunities coming out of China.

My impression is that that's not an area where China had a lot of inventory. So if you could speak to the trends you're seeing in your ROADM, WSS products, either -- both this quarter as well as your outlook.

Jerry Rawls: Well, our outlook is really bullish on the WSS. And a lot of it is all based on China and what our expectations of China demand. There's been a couple of

ROADM deployments that have been announced and relatively small province upgrade, or provincial upgrades.

But we still think that it's going to be the sale of wavelength selective switches in China is a big opportunity. The OEMs there also export a lot of their systems, so there's a lot of our wavelength selective switches. And virtually, all of them historically, except for a couple of trials that were run last year, have ended up in the export market.

Simon Leopold: So is this an area where you're expanding production capacity? And where are you in terms of utilization or capacity today on WSS?

Jerry Rawls: We have expanded capacity and we have right now I would say we have a bit of capacity over what we're shipping.

Operator: Your next question comes from Alex Henderson with Needham.

Alexander Henderson: If I could just follow up on that last question. Can you just give us an indication of the direction of ROADMs and WSS sales in the quarter? Was it flat, up, down? And if you could give us some sense of the split between volume and price would be helpful, if you're willing to.

Kurt Adzema: So in Q4, WSS was down, and I think we talked a little bit about -- that was expected, right. We had, had an extremely strong quarter, especially with one key Chinese OEM in Q3. And so it was down because that order was not repeated. What were the additional questions, Alex?

Alexander Henderson, Needham & Company, LLC, Research Division - So it's down on volume as well as on pricing?

Kurt Adzema: Yes, it's down on volume and in pricing.

Alexander Henderson: And would you expect to be able to see sequential growth each quarter as we go out over the course of the year, and that now that it's (inaudible) and a rebound?

Kurt Adzema: I think is what Jerry has talked about, I think the primary driver that we see for that business and the out-quarters is around domestic deployment in China, and so we are still hopeful that that's going to happen, but we still don't have the exact clarity on the timing of that. So we'd say we're optimistic for growth in that business. But in the near term, we're not seeing growth.

Alexander Henderson: Yes. One other area that doesn't get talked a lot about but is not trivial is the SAN business. Can you just give us some directionally what that product area did in the quarter and what you're thinking?

Kurt Adzema: Yes. I think the SAN business was down some as expected in Q4, and I think we talked a little bit about that when we were giving guidance. I think we do see that kind of being relatively flat in Q1, though.

Alexander Henderson: OK, great and just to avoid being obtuse, the millions-of-devices comment that was for which quarter? You kind of made that comment before you went into the reset to the quarter of timing. I wasn't sure which quarter you meant. Is that the October quarter or the July quarter?

Jerry Rawls: Our second fiscal quarter.

Alexander Henderson: Second. And so you would describe millions of device units as being a large number?

Jerry Rawls: Well, it will be a lot more than that in the sequential quarter. But it's -- yes, it's a big number.

Alexander Henderson: Yes. I'm just trying to understand the mechanics of what you said. You said millions of units, and then you also said it's becoming a very large number, a big number, I think, was the wording you used. So is that kind of the run rate that you think is near-term peak and then it rolls back off into the -- what's normally a seasonally softer back end of the year?

Jerry Rawls: We're relatively new to the consumer business. There is a seasonality to it, and there's product introductions and there's Christmas season and there's a bunch of other stuff that goes into it that does affect supplier shipments. So I mean, we do predict some seasonality. But for right now, we are making everything we can make.

Alexander Henderson: Is it reasonable to think that you, over the course of the next 18 months, will get to a period where you're doing tens of millions of units in the quarter?

Jerry Rawls: No question.

Alexander Henderson: OK. That's very helpful. Wanted to ask you one more question on the CFP, CFP2 segment. There's a lot of talk about another round of price reduction here as we go into the mid-year time frame. So as we're looking at some of those legacy products, should we also be looking at both a volume decline as well as a price decline on a semiannual basis here?

Jerry Rawls: There are a few of in the world of OEMs, there are a few who negotiate prices on a 6-month basis, not on a yearly basis. And I'll just tell you, prices never go up.

Alexander Henderson: Right. But it's my understanding that the Chinese tend to be more on a 6-month process, and it seems like there's price pressure in China. Is that a reasonable thing for us to be assuming for that segment of the market?

Jerry Rawls: I think that's reasonable.

Operator: Your next question comes from Michael Genovese with MKM Partners.

Michael Genovese: Great. Can you guys characterize the annual price declines on the telecom side, what you saw in those negotiations?

Kurt Adzema: I think what we said back in March is that where it was at the lower end of the 10 percent to 15 percent typical range.

Michael Genovese: OK. And then on the QSFP28, would you describe that -- would you still describe them as sold-out conditions? And if so, is the pricing there behaving like a typical sold-out condition? I mean, is the pricing holding up on QSFP28? Or is there any unusual pricing activity there given demand?

Jerry Rawls: Well, we are still sold out, and the prices have been stronger than we had predicted a year ago.

Michael Genovese: OK. That sounds good. And then Verizon for the ROADM and the CFP2 ACO, is this correct to try to say that the work has been done and you've done everything, and it's just a matter of getting on the approved vendor list in July, but all the heavy lifting is done and they just have to cross the Ts and dot the Is in July? Is that a fair way to think about it?

Jerry Rawls: I sure hope so. Everything we've done, we think all the reports have been done, all the testing has been done. And it is now there is some bureaucratic procedures that go through to get you on the AVL and into the Verizon system, but we think all the heavy lifting has been done.

Michael Genovese: OK. Then last one for me is I think in China, on transmission up until now, you've primarily just been on the client side. And what's your prognosis for getting into the line side in China in the future? And then also on the client side, do you think there's going to be a transition to QSFP28 in China at some point? And when would that be?

Jerry Rawls: And you're correct. Most of our business in China has been on the client side, except for our wavelength selective switches. Let's see. In the future, I think you will see a client-side shift towards QSFP28. I think it's happening sort of over around the world. What was the other one, Michael?

Michael Genovese: Well, just are you going to get -- do you think you'll (indiscernible) from the CFP2 ACO, would you have an opportunity in China?

Jerry Rawls: Yes. Well, we're going to -- the answer is we're going to sell CFP2 ACO all over the world. We're selling it anywhere we can. The question is going to be how much CFP2 -- how much ACO product is bought in China, and there will be some. At least heretofore, DCO has been their largest purchases.

Other than that, they built line cards for pluggable modules, DCO was the principal device that was procured. In the future, we would -- we hope to have much more sales besides the wavelength selective switch in the line side of that transport systems.

Operator: Your next question comes from Joseph Wolf with Barclays Capital.

Joseph Wolf: Question about the data centers. If you look at the progression in the sales for 100G, have the architecture-- it seems like there used to be more of a standard architecture that was being deployed and a lot more merchant devices being used, at least on the electronics one and the optics.

Are you seeing any of the more custom-designed activity? And do you think that will be different across the different Hyperscale guys? And do you see activity across the second tier or the smaller public web data centers?

Jerry Rawls: There are some important differences between large Web 2.0 cloud provider, cloud services companies. And their particular architectures that they have chosen and the particular hardware, the way they deploy it, yes, it leads to -- some customers use only one type product, and others use different ones and some -- and different mixes.

So it's not uniform at all. Let's see. The second tier tends to be more uniform. They tend to be pretty much to QSFP28, CWM4 and LR4, and you see a lot less nonstandard products or different sort of offerings or different architectures.

Joseph Wolf: Is everybody moving at the same trajectory right now in terms of growth? Or are you seeing -- is most of the 100G activity still at the larger customers, those six that you mentioned?

Jerry Rawls: Most of the 100G is still at the big customers.

Joseph Wolf: OK. And then I guess for Kurt, with the gross margin, there was -- I guess the way that I understood it, it was that more of the revenue side than the mix side for this quarter.

If we look forward for the rest of the fiscal year, how would you weigh those two components in terms of if you get a better mix, do you still need to hit over $350 million or $360 million in revenue to get back to the higher margins that you put up a couple of quarters ago?

Kurt Adzema: Well, I think mix is going to be very important, especially as it relates to the VCSEL array opportunity. So I think that will be a big driver depending on the volume of that and the associated yields and margins with that. So I think that will have a big impact, but volume is important.

We're a vertically integrated manufacturer, so I think it's important that we start to grow again, we'll start to get some leverage in manufacturing. It's very challenging. The last two quarters is volume has gone down. You've got to spread those fixed costs over less units. So the hope with revenues starting to increase in Q2, we'll start to get some leverage again out of the fabs and the factories.

Joseph Wolf: OK. And then just finally on China, Jerry, you were very clear about not expecting this to recover in the bigger parts of the country. But do you -- are you close at all to thinking that you're kind of at the bottom in China? And I guess as you look at that going forward, I guess how -- what kind of indicators are you looking for there besides just obviously sales?

Jerry Rawls: Well, one of the things that is often deceiving is forecasts from the Chinese OEM base because their forecast aren't always -- they don't always reflect reality as reality then comes along. But what we look at mostly is sort of backlog, incoming order rate, what are the commitments that customers are making for product shipments.

And I would say they went down in the fourth quarter. I mean, we saw the incoming order rate drop, but it's flattened out. And this -- I think our first quarter will be -- it's stabilized right now. Now will it start increasing? Well, we think it will. But tune in next quarter, and we'll talk about it.

Operator: Your next question comes from Doug Clark with Goldman Sachs.

Douglas Clark: First is a follow-up, Jerry, to a comment that you have made earlier about big capacity coming online or may have incurred on the QSFP28 in the fiscal second quarter. Can you give us a sense for what the magnitude of that incremental capacity is versus what you have today?

Kurt Adzema: I think we've talked in the past about adding $15 million or so per quarter of capacity. I think -- just given some lumpiness, I think we're seeing less than that in Q1. But I think we'll see more than that hopefully in Q2.

Douglas Clark: Got it. OK. That's helpful. and then another clarification in the question on the China WSS opportunity. Now I know the orders that have been in place recently were quite small. I was just curious if you're explicitly participating in those or waiting for larger orders to come?

Jerry Rawls: So, our WSSs will be used in some of these early deployments, are smaller deployments that we've read about. So we are optimistic anytime they use ROADMs in domestic Chinese networks because they're developing experience. They're learning how to manage these networks. Their network operating systems, they're working out the bugs. And that -- but eventually, the deployments will be huge.

Douglas Clark: Got it. OK. That makes sense. And then, Kurt, question for you. Just inventories on the balance sheet kind of took another step up higher this past quarter. Can you talk a little bit about inventory management and what's causing that increase?

Kurt Adzema: Well, obviously going into the quarter, we thought that it was going to be a stronger quarter. And so there's various lead times for inventory that we had placed, and so we had to take delivery of that, even though we didn't have the revenues to match that.

But we think it's all good inventory, and we think we'll use it. And it's just a matter of kind of burning through some of that stuff. So I don't think it's especially worrisome to us. But inventory is cash, so we try to minimize that as much as possible.

Douglas Clark: OK. And actually that brings me to my final question, which is just on the cash balance continues to grow. You mentioned in a few different contexts, perhaps VCSEL, using cash in certain ways. Can you talk about some of the opportunities that, that cash might afford for you guys?

Kurt Adzema: Well, again, I think when we did the capital raise back last December, I think ultimately, we wanted to provide flexibility, and then that could mean investing in more organic growth as well as looking at acquisitions as well.

So I think we'll continue to aggressively look at that and try to find the right opportunities. But at the same time, it's always hard to get two parties to agree. So I would say we'll continue to be active about that, but we'll only do deals if it makes best sense for us and best sense for our shareholders.

Operator: Your next question comes from Dave Kang with B. Riley.

Dave Kang: First, clarification. Did you say for Verizon qualification of ROADMs and ACOs by July quarter? Did I hear that correctly?

Kurt Adzema: No. We said the second quarter in Jerry's remarks.

Dave Kang: OK. So in the previous call, you said first quarter, so what gives you confidence that this will happen in the second quarter?

Jerry Rawls: Well, the customer moved it out, and it wasn't a technical issue. It's not a product problem. It has to do with a transition in -- with Verizon. And they're in charge of the inflection points and these transitions, so we take orders.

Dave Kang: Got it. And speaking of orders that you received for VCSELs, for 3D sensing, is that the VCSEL dies? Or -- and if so, then should we expect gross margin to be nicely over 50 percent?

Jerry Rawls: Well, the gross margins we think will be attractive, above our corporate average, we hope. But the real issue is going to be yields. If our yields are good, our margins will be good. If our yields are -- et cetera, you got -- you understand. But we're optimistic that our yields will be better than our corporate average.

Dave Kang: Right. But the question was the orders that you received, was that for dies or not?

Jerry Rawls: Right. The major program that we're working on today, we are only a supplier of die.

Dave Kang: Got it. And then just lastly, on China. So I guess China Telecom has started the deployment, maybe small, and I guess China Mobile is second half. First of all, is that true? And second question is have you been qualified into both operators?

Jerry Rawls: Well, it's not the operator that qualifies us. It's the system provider that qualifies us. They qualify their ROADM rack into China Mobile or China Telecom. And yes, we are qualified.

Dave Kang: For both?

Jerry Rawls: For both.

Dave Kang: Got it. And Kurt, last question. How much was depreciation and amortization?

Kurt Adzema: I think it was around $24 million or so.

Dave Kang: Got it. And just one more. Just -- you gave us CapEx estimate for first quarter, but what about for the rest of the year? I assume that may trend down a little bit.

Kurt Adzema: Yes, I think so. We said about $45 million for this quarter. I would say Q2 will probably be in the same range, and then it will start to trend down maybe by $5 million a quarter after that.

Operator: Your next question comes from Dmitry Netis with William Blair & Company.

Dmitry Netis: Jerry, I wanted to go back to the comments on the ROADM opportunity in China. You seem to indicate that some kind of field trials that are going on right now, but we have all read about this China Telecom ROADM tender.

Do you mind maybe talking a little bit about how big this could be? Is that a trial, really, that's going on? Or is that a real deal type opportunity that's unfolding right now as we speak? And if so, when will that become a meaningful driver for you since you mentioned you're qualified at it?

Jerry Rawls: Well, we'll get business out of it, but it's not going to be a huge driver. And I don't know the exact number. I just know that our guys that are on the ground in China say that these are provincial deployments and not very large. And -- so does that mean we'll get likely hundreds?

I don't know, if we got 1,000 wavelength selective switches out of it, we might think it was a very good deal. I mean, heretofore they've had other regional deployments or provincial deployments as they -- and we've gotten hundreds, but not thousands of the wavelength selective switches into each one.

Dmitry Netis: And just to clarify, it is WSS, it's not a ROADM line card that you're shipping?

Jerry Rawls: Correct. We don't supply any ROADM line card. All the OEMs in China build their own line cards. So they buy wavelength selective switches, and then they either build or buy their own Erbium Doped Fiber Amplifiers, et cetera, and they package it themselves.

Dmitry Netis: OK, that's helpful. And then similarly on the China Mobile packet transport network opportunity, are you exposed to that at all? Or is that something that doesn't concern you?

Jerry Rawls: Well, we hope we will end up supplying client-side devices that go into one of the OEMs, but we don't have much exposure on the line side in that one.

Dmitry Netis: And the client side, you mean CFP modules or CFP2 modules?

Jerry Rawls: Correct.

Dmitry Netis: OK, helpful. And then if I may, and then I have to ask you one, Jerry, and then one last one for Kurt on the margin side. But as you look out into 400G market potentially, I don't know, you tell me how long that will take, but we all know it's coming, right?

One of the major modules sort of competing for that market is this 400G-DR short-reach effort which appears to be a coherent technology. And so that potential could start eating into this QSFP28 LR4 optics. How are you thinking about it? Or how are you positioned to capture this 400G-DR opportunity?

Jerry Rawls: Well, 400G is a big deal for everybody right now. I mean, all the customers are talking about it. They all -- but there's still a little bit of a controversy in the industry between the QSFP-DD form factor and the OSFP form factor.

And it's not unanimous, and so there's going to be a fair volume of both of those. Our expectations is we're going to be an important player in both. And whether -- two things are what, DR and LR or DR and -- what's the other one? Anyway, suffice to say, we expect to be an important supplier in 400G.

Dmitry Netis: Which would imply you would need to partner with somebody who'll purchase kind of -- some sort of an acquisition for a coherent technology, right, but still (contributes) (to) that margin.

Jerry Rawls: Well, I don't -- I wouldn't say that. I mean we make a coherent laser today. We make the coherent receiver. We make all the optics. We make all the coherent optics for our CFP2 ACO. They run at 200G 16QAM. So we feel pretty good.

I mean -- but to do the 56G PAM4 is -- not many lasers around that can handle that today. So there's a few. We've built some demonstrations, and we've had some of our customers written papers at OFC and presented papers that used our lasers at those speeds. So the existence proof is there, but we're not in volume production of anything like that yet.

Dmitry Netis: OK. Jerry, that's very helpful. Kurt, just one last one real quick on the margin front. Is the kind of high 30s kind of exit rate this year, is that still a target that you can still get there given kind of the low volumes here in the first quarter and potentially a snapback as you go through the year, well, starting in October?

Kurt Adzema: Well, again, we don't provide margin guidance beyond the next quarter, which we've provided. Certainly, if we get the increase in volume and are successful with some of those 3D sensing that Jerry has talked about that should be helpful towards margin. But we're not going to give guidance to margin beyond the quarter that we're in.

Operator: Your next question comes from Richard Shannon with Craig-Hallum Capital.

Richard Shannon: Maybe I'll follow up on a much earlier question regarding pricing in the datacom space. Jerry, I think you were asked the question, about CWDM4 pricing, I didn't recall whether it was referring to the 2-kilometer, 10-kilometer device.

But maybe I'll ask one specifically on 2-kilometer. How is the pricing coming there, both in current status as well as how difficult is the pricing getting on a forward basis, looking out at least two quarters?

Jerry Rawls: Well, as I pointed out in an earlier question, the pricing has been better for us than we predicted a year ago. So it's held up, and that's a reflection of the fact that there's a shortage in the industry, and demand exceeds supply. We expect that's going to continue to be the case and until we have a balance and the supply catches up with demand.

We think that's likely to happen sometime in 2018. And we project that when that happens, prices are going to come down. And it's your guess as to how much of an imbalance there might be on the other side then and how those prices will hold up or not.

Richard Shannon: OK. As you see the pricing in the 2-kilometer area, do you expect that to still remain a favorable gross margin product area for you, at least corporate average?

Jerry Rawls: It's uncertain.

Richard Shannon: OK, I think that's helpful. I just want to get a sense what's going on there -- maybe switching over to 3D sensing. Jerry, do you have any sense of what --

at least with your initial customer or early customers here, what kind of share you're getting?

Jerry Rawls: No. I don't actually know that. There's a lot of secrecy that surrounds this first project.

Richard Shannon: Yes. I've been hearing that as well, not surprising. And a follow-up on that topic, Jerry, when do you get a sense of when your next customers will fall in line here? Is it -- I assume it's beyond the October quarter. Can you give us a sense of when we start to see material contribution outside your lead customer?

Jerry Rawls: I wish I could answer that. We have engagements with a number of customers now and we're supplying devices, but we don't yet have any firm commitments. So it's then a wait and see for us. We're aggressively trying to make sure we can build high-power VCSEL arrays in the configurations, and each customer has its own configuration.

There's no common approach to this thing. And we're trying to make sure that we enable them to be able to do their testing and their system development, et cetera, and -- but at this point, it's really hard for me to pick a quarter in which this is likely to -- where customer number two is likely to take off and start buying millions of units from us. I do expect that it will happen in the next year to 18 months though.

Operator: Your next question comes from Tim Savageaux with Northland Capital.

Timothy Savageaux: Just want to go back on kind on the 3D sensing comments and see if I understood them properly. Jerry, what I heard you saying before you kind of made your correction was maybe a few million units in the July quarter, in fiscal Q1, moving to tens of millions or a much bigger number in fiscal Q2.

Jerry Rawls: Correct.

Timothy Savageaux: OK. That's correct. Great. Then I wanted to follow up with that about basically connecting the dots between unit volumes and revenues. I think -- at least my operating assumptions here has been around kind of a low singledigit ASP here. But I wonder if you'd like to provide any commentary on, just ballpark, what our expectation should be there?

Jerry Rawls: I don't think I should talk much about pricing in this forum, but our expectation it's going to be a good product. We hope that our yields are really good. We have every indication from all the runs that we've made so far.

I mean, we have now shipped, I don't know -- we sure already shipped tens of thousands of units, maybe -- probably more than 100,000 units, actually. And we're making progress. Yields are respectable, but not as good as we project they'll be. And all of that has a lot to do with what our margins are going to end up on this product.

Timothy Savageaux: OK, artfully dodged. Well, let me follow up on that margin topic. You do have competitors talking about gross margin in excess of 50 percent. And given that you're vertically integrated versus an outsource model, one might think you would have that potential as well, although potentially offset by a cost dynamic at four inch versus six inch, and there's where the yields come in.

But am I kind of thinking about that the right way when you say if our yields are good? Can you reach that 50 percent level? Or is that maybe a bit of a stretch?

Jerry Rawls: I'd rather not go there. Our margins will be respectable. We don't necessarily expect them to be heroic, but we sure expect them to be respectable. So I'd like to leave it at that.

Operator: That's all the time that we have for today's question session. With that, I'll turn it over to Jerry for closing remarks.

Jerry Rawls: Thank you, (Jess), and thank you to everyone who tuned in today. We appreciate your taking the time to spend with us, and we hope we get to talk to you again one quarter from now. Good day.

Operator: This concludes today's conference call. You may now disconnect.

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