FINISAR CORPORATION

Moderator: Jerry Rawls
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4:00 pm CT

Operator: Good afternoon, ladies and gentlemen. And welcome to the Finisar Corporation First Quarter Fiscal 2017 Results Conference Call. Just a quick reminder, today's call is being recorded. And now at this time, I'll turn thing over to Mr. Jerry Rawls, Executive Chairman. Please go ahead Sir.

Jerry Rawls: Thank you (Tom) 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 Web site within eight hours. An audio replay will be available for two weeks by calling area code 888-203-1112 for domestic; or area code 719-457-0820 for international.

Then enter the ID number, 1833924. 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 that is presented. Unless otherwise indicated, all results discussed are on a non GAPP basis. A complete reconciliation of our GAPP to results may be found in our earnings press release and in the Investor Relations section of our Web site.

We have prepared some slides for today's earnings call. You can view them by connecting to the Investor Relations page of our Web site at finisar.com. Click on Investors. Then scroll down to Webcast Archives. And click. You'll see a listing for today's first quarter 2017 earnings call.

I am pleased to announce that Finisar achieved a new company record for revenues on our first quarter. Our sales were $341.3 million, an increase of $22.5 million or 7.1% over the prior quarter. This growth was primarily driven by strong demand for 100 gigabit per second transceivers in the CFP, CFP2, CFP4 and QSFP28 form factors.

In addition, demand for wavelength selective switches remained strong. Our non GAAP gross margins improved significantly to 33.1%. This increase was primarily due to a favorable product mix and the leverage we achieved with larger volumes and our vertically integrated manufacturing infrastructure.

The combination of higher revenues and better than expected gross margins resulted in non GAAP earnings per fully diluted share of 38 cents, up 31% over our fourth quarter EPS and up 65% over our first quarter a year ago.

Now, I'll let Kurt review the rest of the numbers. Kurt.

Kurt Adzema: Thanks, Jerry. Sales of telecom products increased by $22 million or 29% compared to the preceding quarter. This increase was due to higher sales of wavelength selective switches, coherent receivers, and 100 gig transceivers as well as a rebound in demand for other telecom products including amplifiers and 10 gig transceivers, both tunable and fixed wavelength.

Sale of Datacom products increased by $.5 million or .2% compared to the preceding quarter primarily driven by growth in demand for 100 gigabit transceivers including CFP, CFP2, CFP4, and QSFP28 form factors partially offset by a decline of the sale of transceivers for wireless applications and 40 gig transceivers.

Datacom revenue, excluding transceivers for wireless applications, increased 3.1% over the prior quarter. Sales of 100 gig transceivers for Datacom applications increased 21.8% over the prior quarter and 115.8% over the first quarter of the prior fiscal year.

In the first quarter we had two 10% or greater customers. Our top 10 customers represented 60.2% of total revenues compared to 56.4% in the preceding quarter.

Non GAAP gross margin improved to 31.1% compared to 30.6% in the preceding quarter primarily due to favorable product mix and the benefit of vertical integration over the larger volume.

Non GAAP operating expenses were $69.3 million compared to $66.2 million in the prior quarter. The increase was due to higher payroll taxes from the annual vesting of employee stock grants, higher legal expenses from two patent trials that completed in the quarter and higher employee compensation levels.

Non GAAP operating expenses as a percent of revenue decreased to approximately 20.3% of revenue compared to 20.8% in the preceding quarter.

Non GAAP operating income was $43.5 million or 12.8% of revenue compared to $31.2 million or 9.8% of revenue in the preceding quarter.

Non GAAP income was $41.8 million or 38 cents per diluted share compared to 31.8 million or 29 cents in the preceding quarter. Average diluted shares for non-GAAP purposes totaled 110.8 million.

For non GAAP purposes interest expenses for our $258 million, .5% convertible notes was approximately $323,000 in the fourth quarter.

This interest expense is the only impact of these converts on non GAAP earnings per diluted share as no shares are added to the fully diluted share counts.

Interest in other income was approximately $300,000 in the first fiscal quarter and is expected to be at a similar level in the second fiscal quarter.

Non GAAP taxes for the first quarter were approximately $2 million and non GAAP taxes for the second fiscal quarter in the remainder of the year are estimated between 4% and 5%.

Cash and cash equivalents and short term investments increased $31.3 million to $593.8 million at the end of the quarter.

Capital expenditures are expected to be about $30 million in the second quarter of fiscal 2017.

Weighted average fully diluted shares for the second fiscal quarter are expected to be approximately 112 million for non-GAAP purposes.

We have excluded from our non GAAP results a number of charges or benefits that were either non cash or what we consider outside of our core ongoing operating results. These totaled $17.9 million last quarter. If you include all these items as required under GAAP, we generated net income of $23.9 million or 22 cents per diluted share compared to net income of $13.1 million or 12 cents per diluted share in the preceding quarter.

That concludes my comments, and I'll turn it back to Jerry.

Jerry Rawls: Thanks, Kurt.

We expect revenues for our second fiscal quarter of 2017 to be in the range of $355 to $375 million. We expect both Datacom and Telecom revenues to grow quarter-to-quarter.

We continue to see strong worldwide demand for telecom optical components due to the new long haul metro and wireless deployments by many major carriers. Demand from North America and China remain particularly strong from the metro buildouts in North America and both long haul and metro deployments in China.

In the second quarter we expect revenue growth for our Datacom products primarily from increased sales of 100 gigabit Ethernet transceivers.

Strong demand for wavelength selective switches and ROADM line cards will contribute to our Q2 telecom revenue growth. In addition, we expect increased lineside revenues for 100 gigabit per second and 200 gigabit per second coherent CFP2 ACO transceivers.

We are still sold out for a number of products and continue to add capacity to meet the strong demand. Some of our capacity expansion investments include 100 gig client side transceivers, QSFP28 wavelength selective switches, line cards, 25 gigabit lasers and our 100 gigabit and 200 gigabit coherent CFP2 ACO transceivers.

We expect second quarter non GAAP gross margin to improve again to approximately 34%.

We expect operating expenses to increase to approximately $71 million in the second quarter.

This increase is primarily from our annual salary merit increases that occurred on August 1st plus higher sales and marketing expenses related to increased revenue but partially offset by lower legal expenses.

Non GAAP operating margins are expected to improve again to between 14.3% and 15.3%.

Non GAAP earnings per diluted share are expected to be up again to between 44 cents a share and 50 cents a share.

We continue to believe that the long term growth prospects for our company and the optical communications industry are positive. In fiscal 2017, we expect to benefit from the ramp of many new products. Revenue growth will be driven by both, datacenter construction, 100 gigabit upgrades and the increased deployment of ROADMs and 100 gigabit per second, 200 gigabit per second coherent transceivers in Telecom long haul and metro markets.

It truly is a great time to be in the optical communication business. Finisar's revenue was primarily driven by growth in the global demand for bandwidth due to the increasing distribution and use of video, images and digital information.

In addition, Finisar benefits from the growth in cloud services which drives networking hardware upgrades of existing datacenters and the construction of new HyperScale datacenters. And with that, I'm going to turn it back over to Tom and open it up for questions. Tom.

Operator: Thank you, sir. And ladies and gentlemen, if you'd like to ask a question at this time it is star one on your touch-tone telephone. Please make sure your mute function is turned off to allow your signal to reach our equipment.

Again, that's star one at this time, if you would like to ask a question. And we'll take our first question from Patrick Newton with Stifel.

Patrick Newton: Yes, good afternoon, Jerry and Kurt. Thank you for taking my questions and congrats on the quarter. I guess just diving right in, on the gross margin side a very nice surprise on both the results and the guidance.

And I think in last quarter you'd said getting back to kind of 35% level would not happen in the near term. So I'm just curious, what was the biggest surprise with this metric? And do you think that you have the right mix, the right products and the right competitive dynamics that now perhaps 35% gross margin is realistic in the intermediate term?

Kurt Adzema: Well, I think there are two things that drove the better than expected gross margins in the quarter. I think the first was favorable product mix. I think not only did we sell more 100 gig transceivers than we expected but we had a meaningful decline in wireless transceivers which, as we've talked about in the past, have a less than average gross margin. So there definitely was a favorable mix component to that. And then I think the other thing was we had higher volumes than expected. And as Jerry pointed out, when we have higher volumes we benefit from our vertical integration strategy that differentiates us from others.

So I think it was the combination of the two that helped us get to the 33%. Obviously we're hoping that that continues to improve and we are guiding to 34% for our next quarter. So we are hopeful that the positive trend will continue, but as always we only give one quarter guidance.

Patrick Newton: Great. And I guess just shifting into some of the 100G commentaries specifically on the Datacom side, did you offset the 28? Can you help us understand the relative revenue contribution and then any commentary around capacity or the competitive dynamics in that market?

Kurt Adzema: Well I think what we said last time was that we expected QSFP28 to more than double this quarter. And it definitely did that. And again we expect that to be the major, one of the major growth drivers for the subsequent quarter.

And it's quite possible that that's going to double again or more in the quarter, in Q2. So I think that's a big growth engine for us and we are capacity constrained, as Jerry mentioned. And we're adding capacity as fast as we can on those products.

Patrick Newman: And then just last one for me...

Jerry Rawls: It's a strong area. You asked about competition. And there are a number of people that make products in that area but we have a great product. I mean it works well. We can build a lot of them. We sold most of them in Web 2.0. I guess the majority went to the Web 2.0 segment but there was a lot of them that went to the enterprise segment as well. So it's a great product and there is more demand right now than we can supply and I'm sure the whole industry can supply.

Patrick Newton: Great. And then just last one if I may, is on the ACO. I think you discussed it as contributing to your outlook on the Telecom side. Can you help us understand the relative size of that business right now or any type of output?

Kurt Adzema: Well, I think it's still relatively small for us and so I wouldn't say it materially contributes to that growth. We expect it to grow but it's not material as a percent of our overall Telecom business at this point. But it's an important product for us and we continue to work hard to get that product qualified at various customers and to ramp our production capacity.

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

Operator: We'll take our next question from James Kisner with Jefferies.

James Kisner: Hi. Thanks for taking my questions and congrats again on a good quarter and guidance.

Jerry Rawls: Thanks.

James Kisner: So I want to drilldown a little bit here on Telecom for a minute. So can you tell us how much WSS Group sequentially? And, based on what I'm hearing here, the Telecom stream didn't come from the new line card. Just to put the Verizon deployment, but does your guidance assume that that line chart is ramped and qualified?

Kurt Adzem: I think again, the WSS was strong. We had said we expected it to grow 10% and that grew meaningfully better than that. So that was obviously a key contributor to the growth in Telecom.

But we really saw a rebound a broad rebound in our Telecom products. As we talked about last quarter, we saw an unexpected decline in a variety of products last quarter but we expected those to rebound. And we factored those into our guidance.

So I'd say it was a pretty broad rebound on Telecom, WSS was certainly a key contributor. In terms of our forecast and factoring in some qualification on line card, certainly we have some revenue baked in that for the qualification.

But again, we don't expect that to have a huge impact until the subsequent quarter hopefully since if we get qualified this quarter, we'll only have a partial impact.

James Kisner: That's very helpful and so just shifting to Datacom for a second. I was hoping you'd maybe dimensionalize here is the decline in 40G. And I don't think you mentioned 10G, I'm wondering how that is trending and, what are you kind of assuming here for 40G and 10G as you go into this next quarter. Thank you.

Kurt Adzema: Sure. So 40 gig was down a little bit this quarter but I think the context you have to understand is last quarter was surprisingly strong in that business. We actually went back and saw that that was our second highest quarter in terms of 40G revenue on the Datacom side was last quarter.

And we all know that business tends to be quite lumpy. So even though 40 gig was down a little bit this quarter relative to an incredibly strong Q4, it was still up relative to Q3. In terms of future for 40 gig, our forecast for Q2, we're still very positive on 40 gig. We think it's going to will be flat but hopefully grow. And 10 gig grew a little bit last quarter. And, I think probably be more flattish this quarter. But both those products are still very important products in our product portfolio and the revenues are holding up quite well.

James Kisner: Thank you very much.

Operator: We'll take our next question from Alex Henderson with Needham.

Alex Henderson: Thanks a lot. Got a couple of questions, right. Just going back to quantifying the trajectory of WSS/ROADM products, was it up more or less than the overall Telecom? And was it the stronger performing segment or was it less than the rest of Telecom?

Kurt Adzema: Well, again I think you need to understand as I would say, it's a big part of Telecom but it did not grow as fast as the 30% we had for Telecom but from a dollar perspective it was a very large contributor, if that makes sense.

Alex Henderson: Thanks, that's great. The ACO products, and you talk about where you are in getting qualifications on the DSPs. There are seven DSPs out there. What have you qualified on?

Jerry Rawls: We are currently qualified with two OEMs who are shipping our product to their customers. And they use two different DSPs. We are in qualification with I think every other DSP that exists at some OEM.

So we're making progress against that arsenal of DSPs that we have to interoperate with. And we're making progress with the OEMs but it's, you know obviously slower than we had hoped.

Alex Henderson: Going back to the DSPs, just for a second. Are those in-house DSPs or those COTS DSPs?

Jerry Rawls: Oh, actually that's not true. The places we're qualified right now they are COTS DSPs.

Alex Henderson: That's great.

Jerry Rawls: We're in qualification with in-house DSPs but I don't think we're fully qualified anyplace than has an in-house DSP.

Alex Henderson: That's very helpful. Thank you very much. And going back to the margin mix that occurred, you're so far above what most people had been expecting on the gross margins and therefore the operating margins, that it's a pretty big perturbation to the model.

And I mean clearly at any point in time you could bring back in some of the wireless stuff. But if we assume the no wireless comes back and it just stays at this level on wireless, is there anything that would suggest your margin should regress?

Or should we in fact be thinking that this is kind of a new normal level here and, we got to be using that going forward with the potential that there could be a spike in wireless in any given quarter and given the lumpiness of it. I'm trying to be as general as possible but get some sense of whether this is the new norm.

Kurt Adzema: Well, again, I think we've talked for long time about historically our margins have been between 30 and 35%. And when we're going through these cycles where we have new products out there with better gross margins and our revenue is growing at a strong pace then we tend to be towards the upper end of that range and that's what we're seeing now.

I think, last year when we didn't have the newer products we were at the lower end of the range. So, I think we're very pleased with what margins we had last quarter and say we're very pleased with what we see as the outlook.

And, depending on how fast we continue to grow revenue and what the mix of that revenue is, we're hopeful that those margins can further improve.

Alex Henderson: And one last question and I'll cede the floor. There was a lot of discussion about the Web 2.0 adoption of 25 gig, 50-gig, 100-gig architectures starting in 3Q. But it looks like that slowed a little bit because of the lack of availability of Intel Nic Cards.

If that's the case, should we be thinking that the 10 gig, 40 gig is going to take a little longer before it starts to roll over? Or, is that inconsistent with your viewpoint? How do we think about the mechanics around those two pieces?

Jerry Rawls: I think you're, I think you're right. I mean, that's the way we view it, is that 100gig rollout, the 25 gig lanes and the Web 2.0 space has been, the demand is really strong don't get me wrong.

And, but on the other hand, the difficulties they're having with a number of components, maybe that contributes to the reason that our 40 gig business remains as strong as it is. Ten gigabits is still strong mostly in enterprise datacenters.

Alex Henderson: Okay. One last question. I figured I forgot to ask this before. The Intel announcements of their silicon photonics with the Indian ((inaudible)) right on the silicon substrate.

Any thoughts on whether that's interesting or competitive and how it might impact you? And then I'll cede the floor. Thank you very much.

Jerry Rawls: I think it's interesting. I think if they accomplish what they are targeting, I mean somebody deserves a Nobel Prize. It's difficult and smart people have been working on this for 20 or 25 years and if they can make a breakthrough, it's huge.

Alex Henderson: So any impact?

Jerry Rawls: Well, I think it will impact the industry. I mean in theory it will impact. It will have an effect on their economics of building things, if they can build everything planer.

And I think that's really positive but I don't, it's not positive for us. It's really positive for them. I think it'd be a great technology to have if you can do it but I'll just assure you that there is a lot of skepticism in the industry right now about whether it really can be done.

Alex Henderson: Perfect. That's what I was looking for. Thank you.

Operator: And we'll take our next question from Troy Jensen with Piper Jaffray.

Troy Jensen: Hey, great quarter and guide gentlemen. A quick question now. Within the Datacom, two parts here. How much of the business is 40G right now or 40 and 10G? If you could help us out, that would be great.

Kurt Adzema: Yes. 40G is about 20% of Datacom at this point.

Troy Jensen: Okay. And then on the QSFP28, can you just help us out with the bulk of the flavors that's driving the revenues right now. Is it the CWDMs or the SR4s or, what would you say?

Jerry Rawls: Most of what we're selling today, probably the biggest volume is LR4 followed by CWDM, followed by SR4.

Troy Jensen: That's what I thought. And Jerry, this last one for you. Its a month or two before we start the annual negotiations. Just curious to know if you've had any thoughts on what the pricing environment would look like with supply shortages.

Jerry Rawls: Well, I'm sure, you can predict our expectations in an industry where there are shortages everywhere. I would sure hope that our competitors aren't going to think that they have to buy market share by lowering their prices when they can't deliver the products that are on order today. So I hope that it means that we have some price, more price stability in the industry.

Troy Jensen: Yes, they're all saying the same thing so hopefully that plays out. Good luck and congrats again on the great results.

Jerry Rawls: Thanks.

Operator: And again, ladies and gentlemen if you'd like to ask a question today, it is star one on your touch-tone telephone. That's star one to ask a question. We'll go next to Simon Leopold with Raymond James.

Simon Leopold: Great. Thank you for taking my question. A couple of things I wanted to dive into. One, I want to go back to the gross margin discussion. Historically, I've had the impression that the Datacom gross margin was typically two or three points above your corporate average and Telecom maybe typically five or six below.

And obviously with the step up this quarter, I just want to understand if there is some kind of, first of all, my assumptions have been valid and second is how that might be changing. I presume products like WSS are very helpful to the Telecom. So any color you can give us on how to think about gross margin by segment?

Kurt Adzema: So I think your assumptions historically has been correct and the fact that I think a couple of years ago certainly that was the case where I think the Datacom margins were running higher than Telecom.

But I think for, we've been saying it for a while now that I think they are kind of within spitting distance of each other at this point. Obviously, it's highly dependent on the products that we're talking about and both, Datacom and Telecom.

I have products that have margins meaningfully higher than our current margins and meaningfully lower. So it's really a product-by-product basis but right now I would say they are roughly equivalent.

Simon Leopold: Great, appreciate that. And you mentioned earlier some strength from the Web 2.0 or WebScale customers. I think in the past you've talked about it bouncing around 10 to 15% of revenue. How did that group of customers fair this quarter?

Kurt Adzema: I think in general, oh, I'd say, some up, some down. As we've talked about in the past, this is pretty lumpy. So you know, we talked a little bit about 40 gig being down a little bit and that's primarily the Web 2.0. But I'd still say they've been at approximately the same level.

But as Jerry pointed out, we sold a lot more QSFP28 where some of that is going to the Web 2.0. So I'd say in general, it's been approximately the same percentage for us but we certainly are optimistic on that business and expecting it to grow meaningfully.

Simon Leopold: And then, sorry.

Jerry Rawls: And only one thing I would interject on Web 2.0 is that is my view is we'll end up 15 to 20% of our total revenue. I mean that's where we were and that's where we've been.

But one of the things that I think you have to keep in mind or I would remind you is that we have number, we're the number one company in the Web 2.0 space.

You could name every one of these big cloud service providers and all the optics demand they have, we supply way more than anybody else in the industry.

Simon Leopold: Great, appreciate that. And then I just wanted to see if you could talk a little bit about your current views on China as a market and both that the 100 gig duration in the metro bills.

And then you've talked in the past about adoption of switch architectures and WSS ROADM opportunities. Love to hear an update as to what you see of the timeline for the operators in

China for deployment, as well as how you would quantify the opportunity specifically for Finisar. Thank you.

Jerry Rawls: The service providers in China are today benefiting from infrastructure spending by the government and they are upgrading their networks to 100 gigabits.

We're not deploying ROADMs yet. The automation of optical networks using ROADMs has just not arrived in China. But they have run field trials and they are running field trials in the second half of this year.

And deployments are I was going to use the word promised but deployments are predicted in a big way in calendar year '17. So that is the new day for us, is the day that ROADM start getting used in the phone systems and phone networks in China.

Now, and we benefit a lot from a 100 gigabit deployment in China. A lot of our competitors benefit from all the components that they supply. The lasers, the receivers, modulators, all the components that get soldered onto the line cards by the big OEMs over there.

It' a big market today and it's big because of Chinese upgrades. But it's also big because the world's telephone networks are all, when they do upgrades anywhere in the world, they upgrade to 100 gigabits. I mean that's just sort of a standard today's upgrade.

And so a lot of what the Chinese OEM sell is for export to a lot of third world countries in particular as well as some of the European countries, so.

Operator: We'll take our next question from Michael Genovese with MKM Partners.

Michael Genovese: Great, thanks. Congratulations on the great quarter and guide guys. I wanted a follow-up on that last question with China, because it's my impression that right now you're probably benefiting a lot from 10G in China.

And, I thought that with a 100G in China that they were looking for dual rate CFPs and I didn't think that you sold those. And obviously you don't sell the discrete components. So I just wanted to know whether my impression is right but also just going forward for your greater participation in China.

Is it WSS that we should primarily focus on? Or are there other products over the next one to two years that you could get into China for the first time including, you know, possibly CFP2ACO?

Jerry Rawls: Let's see. First of all, you're incorrect. We sell a lot of dual rate CFPs, CFP2s. We sell a lot more than 10 gigabits in China but I think the biggest opportunity in China in the future is the deployment of ROADMs.

Michael Genovese: Okay, that's super helpful. And then my only other question is just on the guide for the sequential 7% growth at the midpoint. Should we equally distribute that between Datacom and Telecom or do you think one will grow more than the other?

Kurt Adzema: That's always a tough question. I think on a percentage basis, I think they could each grow with roughly the same percentage but I think since Datacom is roughly 70% of the business from a nominal dollar perspective, my guess is Datacom will grow more, if that makes sense.

Michael Genovese: Got it. And actually just to go back to the last question. Just speaking about China, I appreciate that answer. But on just, what's going on with 10G in China and, things like SFPs and SFP pluses?

Is there still very strong demand there and is that going to go away as, as there's even more 100G into China? Or do you think 10G Telecom will stick around in China for a long time?

Jerry Rawls: Well, I think it's going to stick around. A lot of 10 gig is going to be used in wireless, in the wireless front haul and wireless backhaul as well. I don't anticipate 10 gig demand is going to drop-off substantially in China.

Michael Genovese: Great. It's a great seeing everybody in the industry doing so well. So congratulations again and keep it up.

Jerry Rawls: It's a great time.

Operator We'll take our next question from Joseph Wolf of Barclays.

Joseph Wolf: Thanks guys. I was wondering if you could go into some of the comments on supply constraint and the comments you made on pricing and keeping things under control.

Could you just go into some where you think you've got, where your supply constraint is versus the other players in the industry? Is everybody constrained at the same level?

And does your CAPEX Q2 perhaps components where you've got a considerable advantage and unlocking some of that capacity constraint will lead to even better margins?

Jerry Rawls: I think the latter is our strategy. We're investing in products that we think we know, have better than average gross margins for us and where the demand is strong. And we are selectively not investing in some other segments which are less profitable. So I think that any...

Joseph Wolf: Any color you could give...

Jerry Rawls: ...any businessman would make the same decision.

Joseph Wolf: At a broad level that's great. Are there any specifics you could give us where you think you're going to make a bigger investment in some of the competition and you're or where you would be pulling back?

Jerry Rawls: I don't know, I could say we're making a bigger investment than the competition. I mean 100 gigabit everything is hot. And so we're all expanding capacity in any 100 gigabit flavor that we sell.

We're not investing as much in 10 gigabits but I won't tell you that there are no specific segments of 10 gigabit we're investing in. I mean Wavelength selectives, which is where we're investing a lot there but I don't know if that's, that we're investing more than our competitors.

Our competitors have stepped up their capital spending a fair amount over the last few quarters and so I don't know how we are currently differentiating about where we're investing relative to everyone else because I don't know exactly where everyone else is investing. I just know they're spending more money.

Joseph Wolf: Okay, that's helpful. And then I guess, I know we've talked about gross margin in different formats during the Q&A. But I'm wondering if you go forward and you think about getting back to a higher gross margin level, how much of this quarter or how much of the move from 31 to 34 is a mixed question? How much is capacity or how much more can you squeeze out on those two different vectors?

Kurt Adzema: It's always hard to break that out but I'd say approximately that one point that was related, maybe a little bit more than a point was related to mix and, a little less than a point was related to leverage in the facility but those are hard calculations to isolate.

Joseph Wolf: Okay, that breakdown is actually helpful. Thank you very much. I'll pass it on.

Operator: We'll take our next question from Dmitry Netis with William Blair.

Dmitry Netis: Great. Thank you guys, appreciate it. Couple of questions. Vis-à-vis that broad rebound in Telecom that you mentioned, would you be able to isolate that regionally to being more weighted to China or North America? I mean as most of that potential upside came from China, can we say that? Or was it broad-based, spread broad-based across all the regions?

Jerry Rawls: We had increases, particularly in China and in North America. And we don't, we have some Telecom OEMs that are in Europe, not many but a few. The rest of the world has got, it's pretty sparse.

Kurt Adzema: Yes, I mean I think again, when we talked about last quarter, the fact that again Telecom was surprisingly down meaningfully last quarter. And we talked out some of that just being timing issues and timing of pulls and stuff like that.

So again just like I told you not to read too much about the decline last time, I wouldn't necessarily extrapolate off of a 30% growth this quarter but like I said, we expect our overall business to grow meaningfully this quarter and we expect telecom to grow meaningfully and contribute to that this quarter.

Dmitry Netis: Okay, all right. And one of the things that I think last quarter that was a bit of a surprise. Well, wasn't a surprise really but just you incurred some issues qualifying the ROADMs and potentially that's still a North America event at this point in time.

But talk a little bit where we are on that qualification. Have you passed the qualification issues? Those behind you now and you're ready to ship this, full speed?

Jerry Rawls: Well, very it varies. We have a big project where we're trying to qualify a line card that will end up in Verizon metro system. And we are not yet qualified. We're in what is known as system verification tests and we're not, we haven't squeezed through that hole in the wall yet.

We're making progress but every time you run into a bit error from some rare condition and believe me, the systems guys drag up some rare conditions under which your device has to operate further.

You know, turn the power off and on a thousand times in a second and you can't take any bit errors. Or they drop it on the floor. And you can't take any bit errors. Or whatever the torture where they want to apply to it.

But we're working our way through it. We're making progress. The changes have not been hardware. They have been just changing software and firmware and tuning. So I believe we're closing in.

But we're really late. Our expectations were that we were going to be fully qualified some number of quarters ago and we're not yet. But I'm still optimistic and it's common. In calendar year '17 we're going to have substantial revenue from it.

Dmitry Netis: Okay, calendar ‘17. So that was my sort of follow-up. It’s, you’re not really projecting that into your guidance yet for Q2?

Jerry Rawls: Right.

Dmitry Netis: Okay, fair enough. And then lastly, maybe or one and two more questions. One on the Wuxi China facility. Could you remind us what type of products are being manufactured there? Datacom? Telecom? A mix of both worlds?

You know, where you are on the ramp up of these products. Just sort of a full review of that facility there.

Jerry Rawls: Wuxi has been a wonderful story for us. We have about 5,000 people there. We, f you recall, we now have a 600,000 square foot manufacturing building. Actually two 300,000 square feet buildings side-by-side.

But we make Telecom products. We make Datacom products. We make lot of 100 gig products. We typically make more difficult products. A lot of telecom is, does get made there because we have really good engineering support.

And a lot of these complicated Wavelength division, multiplexed tosses, tunable tosas, all these assemblies are really quite difficult and really quite complex. And so the assembly of those things and the tuning of all that is one of the specialties that Wuxi has.

In addition, they built all the optical assemblies for our wavelength selective switches. So anyway, we’re really proud of Wuxi and what they’ve accomplished and they are anytime we move a product to Wuxi from some remote location where we’re doing some work, they make a heck of an impact in terms of the cost reduction on those items.

Dmitry Netis: All right. Well great to see that transition had worked to your expectations or better. And then maybe lastly then on the 100 gig side and the pricing environment there, it sounds like the margins are holding up quite nicely just yet.

And there is obviously a competitive dynamic developing around 100 gig and Web 2.0s and most of the RFPs that are pretty aggressive as far as what they ask for on the price per gigabit. So can you comment, a pretty benign sort of environment at this point in time and on 100 gig and when potentially what's your expectations going forward?

Jerry Rawls: A hundred gig is clearly a competitive marketplace. We have competitive products in virtually everything that we make. But we make really good products and they perform at a very high level. And we run the biggest optical factories in the world.

And so we have economics of scale. And as Kurt pointed out earlier, as our volumes increase, we have leverage. And so, we're in a great position with respect to cost of 100 gig products. And when there is a shortage in the world, prices don't decline, normally don't decline as fast as the customers would like them to.

I mean, every customer wants prices to go down really, really fast but I will tell you that in order to assure their revenue streams, in many cases they just have to have a steady supply from guys like us. And so supply becomes more important than the price in many cases.

Operator: And we'll take our next question from Dave Kang with R. sorry, B. Riley.

Dave Kang: Thank you. Good afternoon. First regarding CAPEX. So I believe the first quarter was $30 million. What should we expect for second quarter as well as for fiscal '17?

Kurt Adzema: Sure. So we had expected the CAPEX to be close to $30 million this quarter but it was less. So to be clear, it was closer to 20 million. That was primarily two things. We had some expenditures associated with some fit out of an additional space in our Malaysia facility and that rolled from Q1 to Q2.

And then also we had some timing of receiving some high dollar amount equipment into one of our laser fabs. That also got pushed. So neither of those had impact on our capacity but did push, made our CAPEX this quarter be closer to $20 million than $30 million.

For this quarter we expect approximately $30 million of CAPEX. And I'd say for the remaining part of the fiscal year we'd expect about $30 million of CAPEX per quarter.

Dave Kang: Got it. And then specifically on WSS, sounds like you had a little bit more than 10% last quarter. Are you kind of targeting similar capacity expansion this quarter?

Kurt Adzema: Yes.

Dave Kang: Got it. And then on the ACO, I just wanted to make sure, I think you talked about maybe shipping a few hundred units in first quarter. And are you still quite confident about shipping, you know, meaningful revenue by end of this year? I guess that would be by fiscal third quarter or maybe fiscal fourth quarter at the latest?

Jerry Rawls: Well that depends on what meaningful revenue is. I mean, 1 million or 2 million a quarter, not so meaningful to us. But, our expectations are always qualifications that were in, we'll all yield a revenue stream that's going to be quite a few millions of dollars per quarter.

So I will not predict again which quarter we're going to get qualified at some of these major OEMs. But I will, but I'm certain it's coming and I think calendar year '17, we're going to see meaningful revenue. I means tens of millions of dollars from our CFP2ACO.

Dave Kang" Got it. And just regarding your two 10% customers. I assume they are the same 10% customers as of, from the fiscal '16. What percentage of sales pretty comparable to last year's numbers as well?

Kurt Adzema: I'm not sure of the exact question you're asking. Our top customers are same top customers that we've had in the past. What's the second part of your question?

Dave Kang: They were like around what 12% to 13% something like that in fiscal '16 and just wondering if they were kind of comparable in first quarter as well?

Kurt Adzema: Yes, that's not, those aren't numbers. That wouldn't be breakout but needless to say both those customers have been strong.

Dave Kang: Got it, all right. Thank you.

Operator: We'll take our next question from (Jorge Reves) with Craig-Hallum.

(Jorge Reves): Thanks for taking my questions and congratulations on the great results. So most of my questions have been answered. So first housekeeping question though. Did I hear correctly that you expect the tax rate to be between 4 to 5% for the rest of the year?

Kurt Adzema: The non GAAP tax rate, yes 4 to 5% for the rest of the year, yes.

(Jorge Reves): Okay. And then, so on line cards specifically, it sounds like, based on a question by a gentlemen, ahead of me, sounds like you're not expecting (line card) contribution on your October guide.

But I wonder if you can work us through a process of adding capacity and get into production on line cards specifically. Is it similar to that we assess this where you have to, you know, get the production in Wuxi, China for which you have to hire staff, train staff and also add equipment?

If that's the case and you're not qualified at this point, what gives you confidence that we can see some revenues, for example, in the January quarter?

Jerry Rawls: Well, we make line cards today in Wuxi, China. We have major OEMs who buy line cards from us that include Wavelength selective switches and Urbian built fiber amplifiers and channel monitors and software and all the stuff.

I mean they're complicated line cards and they are expensive. So we make them, we make them every quarter. That business is actually doing quite well right now with other customers. But these are systems around, they go into systems around the world but for my knowledge, none of them are going into Verizon systems right now.

So the one we're all focused on is trying to qualify a line card that will go into ROADM rack for Verizon and be, so that we can participate in, excuse me in our 100 gig metro upgrade.

But for us, it will be built at Wuxi. We have a whole infrastructure there that can build these. We have actually built dozens of these Verizon line cards already.

So we've got processes. We've got people, jigs and fixtures. We know how to do it. It's not capital intensive in that the capital goes into building the Wavelength selective switch. That's where, that's the most capital intensive part. But the line card itself is, you know, it is sheet metal. It's a circuit board.

It's a channel monitor and Wavelength selective switch, you put them altogether and button it up. And you've got to, and then you have to terminate a lot of fiber.

There's a fair amount of labor that goes into building line cards because of the fiber (welding) and the fiber terminations. But we're in pretty good shape where it comes to line cards.

(Jorge Reves): That's very helpful to share your thoughts. And that's all for me guys. Thanks.

Jerry Rawls: Thank you.

Operator: And ladies and gentlemen, star one if you do have a question at this time. We'll go next to Tim Savageaux with Northland Capital Markets.

Tim Savageaux: Hi, good afternoon and congrats on the nice results.

Jerry Rawls: Thank you.

Tim Savageaux: I have a couple of questions, really about kind of expectations heading into the quarter and how things turned out. And I think last quarter you indicated expectations for growth on both the Datacom and Telecom side.

Sequentially, you really didn't see that on the Datacom side. I wonder if you could provide any color about kind of why that might have remained flat. And, I say this rely on the go-forward guidance where, if you do see kind of equal percentage increases, you'd be breaking out of this, kind of 240ish million range the Datacom business has been in for a couple of years. And I wondered if you could talk to what the drivers of that might be?

Kurt Adzema: Yes, well I think when you look at last quarter Datacom, we had expected Datacom to grow overall at a higher rate. And I'd say the main thing that was significantly unexpected decline in the wireless business.

And as we talked about in the past, that business has again lower gross, significantly lower gross margins than the other parts of our business and that's what helped us with our margins.

So that, I think that's part of it. Again, I think we thought 40 gig would be more flat. It was down a little bit, so, but again, that was coming off of a quarter where it was our second highest quarter in 40 gig ever.

So again, that business tends to be lumpy because it tends to go into the Web 2.0. So I'd say 40gig was a little less than expected. Wireless was significantly better than expected.

As we go to the Telecom side, I think again, we had predicted our rebound after last quarter when we gave our guidance. I would just say some of these things just bounce back a little bit better than expected. And so it was again, the Telecom growth was really pretty broad based rebound in growth.

Tim Savageaux: And then as you look forward on the Datacom side, it would seem like, that you're seeing some, nice growth in 100 gig both QSFP28 and CFP. And at this point you don't really expect much in the way of negative offset from 10 and 40-gig. And for that to remain flat. And maybe for some of that growth to show through on a sequential basis. I don't know if that's the right way to look at it. And well, I'll leave it there.

Kurt Adzema: I mean clearly we expected the growth in the quarter on the Datacom side to be based on the CFP, CFP2 as well as QSFP28. I think as I mentioned, we expect QSFP28 could double again or more than double again this quarter.

So both those products we expect to see growth and strengthen. I think 10 gig and 40 gig will be, more likely more flattish. But again those can vary quarter-to-quarter by a couple of million dollars.

But, again, we think those businesses have legs and we're not reading into any one quarter down or any one quarter up and neither of the 10-gig or the 40-gig Datacom business so.

Tim Savageaux: And just to follow-up real quickly, would it be fair to say that 10 gig Datacom was also flattish in the quarter that you're just reporting?

Kurt Adzema: It was actually up a little bit.

Tim Savageaux: Up a little bit, okay.

Kurt Adzema: Yes.

Tim Savageaux: So, one final question on the CFP2ACO, I think you guys mentioned expectations for shipping hundreds to shipping several times that in the current quarter I've been imagining that that didn't happen.

I wondered if you could comment on whether we're seeing expectations push out a little bit for the CFP2ACO. Because had you shipped several times, we'd be talking to a few hundred units, we'd be talking about more than 1 to 2 million bucks.

So I think to talk about kind of expectations there on the CFP2ACO side, whether the timing is maybe a little bit different than you might have thought?

Jerry Rawls: Well, it's clearly different than what we had thought. It's slower than we had expected because we haven't qualified and most of the OEMs where we're in our qualification testing right now.

We shipped about 100 units in the quarter. And the real issue is you got to get through all these qualifications and you got to get on the AVL And we're I think we're within shouting distance of completing a number of them.

We've completed two so far but I'm not, it's just taking longer than anybody predicted and it just, we're going to get there. We've got, well I mean, we get some customers have come back and pat us on the back and tell us how great our product is and blah, blah, blah.

But that's great but we need to be on an AVL and we need purchase orders. So do expect that after, by the end of our fiscal year, I think we're going to be shipping meaningful quantities. I do believe we will be qualified at some of the bigger OEMs.

And, so we're still diligently working on these (nits-n-nats) of these qualification programs.

Operator: Ladies and gentlemen, that is all the time we have for questions today. Mr. Rawls, I'd like to turn the call back over to you for any closing comments.

Jerry Rawls: Well (Tom) thank you very much. And everybody, we appreciate you tuning into our second quarter conference call, excuse me, our first quarter conference call today. We hope you will be able to join us again three months from now. And I hope you have a good day. Thanks.

Operator: And ladies and gentlemen, this does conclude today's conference. We appreciate your participation.

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