FINISAR CORPORATION

Moderator: Jerry Rawls
December 7, 2017
5:00 p.m. ET

Operator: This is conference # 61569772

Operator: Good afternoon, ladies and gentlemen. Welcome to the Finisar Corporation announces second 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, Kimberly, 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 8 hours. An audio replay will be available for 2 weeks following the call by dialing 1 (855) 859-2056 for domestic, or 1 (404) 537-3406 for international, and then following the prompts, enter the conference ID 61569772.

I need to remind 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 assumes 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 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 and scroll down to Webcast Archives and click. You'll see a listing for today's second quarter 2018 earnings call.

And now onto the quarter. In Q2, we experienced strong demand for our 100-gig QSFP28 transceivers. However, our overall revenues for the second quarter were $332.2 million, a decrease of $9.6 million or 2.8 percent compared to the first quarter of fiscal 2018. This decline was primarily due to lower revenues from our Chinese OEM customers. Also during the second quarter, we began shipping production quantities of our VCSEL arrays for 3D sensing. In addition, after the end of the quarter, we acquired an approximately 700,000 square-foot facility in Sherman, Texas for $20 million. This new site will be used to expand our manufacturing capacity for VCSELs using 6-inch wafers. We plan to begin volume production in our new Sherman facility in the second half of calendar year 2018.

And now I'll let Kurt review the rest of the numbers. Kurt?

Kurt Adzema: Thanks, Jerry.

Sales of datacom products decreased by $1.7 million or 0.7 percent compared to the first quarter of fiscal 2018, primarily from lower demand for 10-gig and below transceivers, 40-gig QSFP transceivers and 100-gig CFP Ethernet transceivers. This is partially offset by increase in sales of 100-gig QSFP28 transceivers as well as new revenues from VCSEL arrays for 3D sensing.

Sales of telecom products decreased by $7.9 million or 9.5 percent compared to the first quarter, primarily driven by lower revenues from our Chinese OEM customers.

In the second quarter, we had 2 10 percent or greater customers. Our top 10 customers represented 60.2 percent of total revenues compared to 62.5 percent in the first quarter.

Non-GAAP gross margin was 30.3 percent compared to 34.9 percent in the first quarter, primarily due to lower revenue levels, unfavorable product mix, and under-absorption of manufacturing cost at our Allen, Texas VCSEL fab. This under-absorption was primarily due to our shipping production quantities of our VCSEL arrays late in the quarter.

Non-GAAP operating expenses were $74.6 million compared to $73.2 million in the first quarter, primarily due to the impact of the annual merit increase that took effect August 1.

Non-GAAP operating income was $25.9 million or 7.8 percent of revenues compared to $46 million or 13.5 percent of revenue in the first quarter.

Non-GAAP income was $26.1 million or $0.23 per share compared to $45.8 million or $0.40 in the prior quarter.

Average diluted shares for non-GAAP purposes totaled 115.4 million.

Average diluted shares are expected to be approximately 116 million in the third fiscal quarter.

Interest and other income was approximately $2.4 million in the second quarter.

Non-GAAP taxes for the second quarter were approximately $2.2 million.

Non-GAAP taxes for the remainder of fiscal '18 are estimated at approximately 6.5 percent.

Capital expenditures were approximately $45.2 million in the second quarter.

Construction continues on the third building of our Wuxi, China manufacturing site. We expect construction of this building will be completed in the second half of calendar 2018.

Capital expenditures for the third quarter of fiscal 2018 are estimated to be approximately $50 million, not including the cost of the building we acquired in Sherman, Texas for $20 million as well as any uplift cost that we started to perform on the building during the quarter.

We excluded from our non-GAAP results charges or benefits that are either noncash or that we consider outside the core ongoing operating results. These totaled $20.2 million of charges last quarter.

If we include all these items as required under GAAP, we generated net income of $5.9 million or $0.05 per diluted share compared to net income of $19.9 million or $0.17 per diluted share in the first quarter.

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

Jerry S. Rawls: Thanks, Kurt.

We expect revenues for our third fiscal quarter of 2018 to be in the range of $325 million to $345 million.

We expect revenues for datacom products, which include sale of VCSEL arrays to grow in the third quarter. We expect revenue growth for 100-gigabit QSFP28 transceivers, where we believe we are the largest supplier in the world. In addition, we will have growth from our VCSEL arrays for 3D sensing. This will be partially offset by declines in both 100-gig CFP and CFP2 Ethernet transceivers as well as declines in 40-gig and lower data rate transceivers.

We expect telecom revenues to decline compared to the prior quarter, primarily due to the impact of 1 month of the annual telecom price increases -- price decreases, excuse me, which typically take effect January 1. However, we did achieve full qualification of our CFP2 ACO coherent transceiver at a key OEM customer, and we still expect to finish qualification of the ROADM line card at that customer in late Q3 or early Q4.

In addition, we believe we are well-positioned in the China market for ROADMs as we are the largest supplier there for wavelength selected switches.

We expect third quarter non-GAAP gross margins to be approximately 30 percent to 31 percent as the benefit from the sales of additional VCSEL arrays is offset by the impact of 1 month of the annual telecom price decreases.

We expect operating expenses to be relatively flat at approximately $75 million. Non-GAAP operating margin are expected to be approximately 7.5 percent to 8.5 percent.

Non-GAAP earnings per diluted share are expected to be in the range of $0.21 to $0.27 per share.

While the near-term environment is a bit uncertain, we remain very optimistic about our long-term growth prospects. In particular, we are very excited about our recent purchase of the new facility in Sherman, Texas. We expect production of 6-inch wafers there in the second half of calendar year 2018.

We expect Finisar's VCSEL technology will be used in a variety of applications, including several high-volume uses in consumer and automotive. Finisar's rich history in this technology covers more than 2 decades. Two decades of research, development, design and manufacturing. It is gratifying to see those investments produce a new business area for Finisar.

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

Operator: Yes. Your first question is from Doug Clark with Goldman Sachs.

Douglas Clark: … grow sequentially. What was the assumed QSFP28 impact, is that expected to grow or decline?

Kurt Adzema: Doug, you cut out in the first part of your question. Could you please repeat it?

Douglas Clark: Sure. Sorry. Can you hear me now?

Kurt Adzema: Yes.

Douglas Clark: Okay. As part of the data, basically, I'm curious about the QSFP28 sales in the October quarter, and then expectation for the January quarter as well. Did it grow in January? And is it expected to, again, in January?

Jerry S. Rawls: The answer is yes, and yes.

Douglas Clark: Okay. And then as a follow-up to that, I guess, where that question comes from is a number of peers have talked about a bit of incremental price pressure competition as well as mix shift from LR4 to CWDM4. Any comment or insight on either of those 2 dynamics?

Jerry S. Rawls: Well, I think those are both dynamics that are going along in the market. And I think it depends on who your customer is. Depending on how severe the competition is and some customers have more stringent qualification requirements than others. So it does vary across the market. It's not uniform from customer to customer. But I think in general, we would say yes, there's a trend to work from LR4 to CWDM4.

Douglas Clark: Okay. And then my final question was on VCSEL. Just a clarification, and I assume they go hand-in-hand, but does the fact that you have production volume output imply that you achieved qualification at a key customer?

Jerry S. Rawls: I'm not sure I can really talk about that. We have some nondisclosure obligations that really limit what we ought to say about any customer in that market right now. But I'll tell you, we're producing as fast as we can and shipping everything we can make.

Operator: Your next question is from the line of Troy Jensen with Piper Jaffray.

Troy Donavon Jensen: First of all, for Kurt, on the gross margin side, I guess, that's kind of what surprised me the most in the quarter. So revenues were slightly below the low end of the guide. I think gross margins were well below the low end of the guide. Can you just explain why they were down so much? I think you may have mentioned it had to do with 3D sensing launch, but could we just dive into that a little bit more?

Kurt Adzema: Yes. I think what we talked about relative to our guidance, I'd say, the 2 things were an unfavorable product mix. So a lot of the growth came out of QSFP28, CWDM4. But I think as we talked about CFP, CFP2, Ethernet and dual rate were down more than expected. And as Jerry talked about, there's been a bit of a shift from LR4 QSFP28 to CWDM4. So part of it was mix shift. The other part of it, as we've talked about in the past, is that fabs have a lot of fixed costs. I'd say our fixed costs were a little higher than expected in the fab. And on top of it, we're not quite where we would like to be on yields. And so we didn't produce as many units as expected. And so consequently, that results in under-absorption.

Troy Donavon Jensen: Okay, understood. And then on the 3D sensing for the new facility, talk about a second half production ready. Would that be in time for second half Smartphone launches? Or is there a timeframe...

Jerry S. Rawls: I don't have any idea when second half Smartphone launches are going to be.

Troy Jensen: If you think about a Q4 launch though, Jerry --if you think about a Q4 launch for the Smartphone guys, having your production up in the second half, does that give you enough time to get qualified to get in?

Jerry S. Rawls: I sure hope so.

Troy Jensen: Okay. Just kind of stay tuned there?

Jerry S. Rawls: Well, it's going to be tight no matter what. So the answer is we've got to execute flawlessly and based on everything that we've learned so far and getting up and online and in production. And I know it's not a slam dunk, I'll tell you.

Troy Donavon Jensen: Yes. All right. Understood. Last question, I'll cede the floor. Could you just give as an update on the CEO search?

Jerry S. Rawls: Our Search Committee, our Board of Directors is very active. Our search firm is very active, and we have interviewed a number of candidates, all of which were very capable people because they had been screened by professional search firms. And so I think we're making progress. I don't have anything other than that to report.

Operator: Your next question is from the line of Patrick Newton with Stifel. (Operator Instructions)

Patrick Newton: Jerry and Kurt, I'm shocked if your search is active but my phone hasn't rang yet. In all seriousness, I guess to follow-up on the 3D sensing questions. Two follow-ups there, one is what was the revenue contribution in the quarter? And then how should we think about 3D sensing, what's baked into both the January and even April quarter as your yields start to improve?

Kurt Adzema: As we talked about before in the quarter we just finished, we started to ship in small volumes towards the end of the quarter. So it was low single-digit millions. In terms of forecasting on a go-forward basis, obviously, we're going to have a full quarter of production. And we're working hard and making progress on our yields. But our customers prefer that we don't disclose the exact number that we've put out there.

Patrick Newton: Okay. And then, I guess, pertaining to the new facility you talked about how you have to execute flawlessly, can you walk us through what that execution is? What's the lead time on equipment? Your epitaxial process, et cetera? And the reason I ask is your time to market seems to be well ahead of what somebody like (AMS) has communicated with their own vertical integration process.

Jerry S. Rawls: Well, the nice thing is for us is we've got a beautiful facility that was a semiconductor fab before, so it's very large clean rooms. And what we have to do is we just got to buy a lot of equipment and put it in there. We have our MOCVD reactors that are on order. And they're moving in that direction. I mean, the lead times on them are more than half a year, but we got a place for them. And then there's a whole series of fab equipment from our litho to our etching to our metal depositions, et cetera. So there's a lot of equipment that has to come together then we have to put it online, do all the plumbing. And then secondly, it's a 6-inch wafer process. And we have never processed 6-inch wafers. Now we have people in the company that have processed 6-inch wafers at prior employment, but it will be a new experience for Finisar. So it will be challenging.

Patrick Newton: Great. And then just one more, if I may. Kurt, on gross margin, you've consistently indicated mix is the largest impact. You've also communicated that annual pricing negotiations negatively impact the April quarter. I guess, as we kind of take an intermediate-term view of gross margin, do you see mixed tailwinds from improved 3D sensing ROADMs or some new product that could aid results in the intermediate term? Or conversely, could we see ongoing challenges from mix shift to more CWDM4 lower 40G or competitive pressures? And the reason I ask is, I think 30 percent is historically been a pretty sticky gross margin for the company?

Kurt Adzema: Again, we don't provide guidance beyond the quarter that we're in. I think you're right, there's a lot of factors that could help improve margin, certainly improving our yields for our VCSELs and production out of that facility could have a nice impact for us. And as you also point out, there is, in the Q4, you will have also the telecom price erosion for the full 3 months. And as Jerry talked about, there is a shift going on where most of the growth you're seeing is out of CWDM4, which has lower gross margins than LR4. So, I'd say there's a variety of factors moving around, and we certainly don't provide guidance beyond the quarter we're in. But we're obviously working very, very hard to try to improve the yields out of our Allen VCSEL fab and that can certainly could be a positive driver for us to help offset some of those negatives that you also talked about.

Operator: Your next question is from the line of Dmitry Netis with William Blair & Company.

Dmitry G. Netis: Jerry, maybe to start kind of a high-level question first. Can you give us sort of lay of the land there on the hyperscale side of the business? I mean, several peers have seen a bit of air pockets this past quarter, are you seeing the situation improving at all? I know there's been a transition, mainly that there are LR4 to CWDM4 that you've been discussing. Is that really the main issue here? Is there something else going on? And when can we see sort of the inflection? Or when can we be exiting that air pocket, if at all?

Jerry S. Rawls: Well, from our standpoint, I would say that our Web 2.0 sales are still doing pretty well. We saw a substantial increase in the quarter. We're expecting an increase again in Q3. So our revenues have been up pretty consistently quarter-to-quarter for, I don't know, I can't even -- as far as I can remember. So we are still -- we're still bullish on the market. And it's clearly one of those segments that is driving the company.

Dmitry G. Netis: Okay. And then if we just sort of look at the QSFP28, you were guiding for $100 million sort of type run rate business exiting this quarter. Just curious, did you hit that number? You may have said that, so apologies if I missed it. If you did, that would have implied sort of 17, 20-ish type percent growth rate from the prior quarter. So can you confirm that? And then would that type of growth rate continue to persist into the January quarter? Or should we expect a bit of a slowdown there?

Kurt Adzema: I think we talked about last quarter expecting QSFP28 revenues altogether to be about $100 million in our Q2, and I would say it was in that ballpark. And we certainly expect it to grow meaningfully in this next quarter. So we continue to add some capacity, especially as it pertains to CWDM4. And so I would expect the growth we're going to see is really going to be in CWDM4 in Q3, and that is what is helping to offset probably what we won't see as some erosion, continued erosion in 10-gig, 40-gig and CFP, CFP2 Ethernet.

Dmitry G. Netis: Got you. And then last question, if I may. The top 2 customers, was one a U.S. customer and another, a China customer, can you comment on that?

Kurt Adzema: We can't comment on who the customers were.

Dmitry G. Netis: Okay. And so maybe I will just ask the question on China then. Knowing who your big customer is in China, what are you seeing on the ground? It's -- what your sales people are seeing or telling you? Is there a recovery anywhere in sight? When can we see that potentially? What's the expectation right now on China and your top customer? As far as inventory.

Jerry S. Rawls: I was just in China visiting with our top customers. And I found that in the Web 2.0 space, there was optimism about 2018. But in the OEMs, there was not so much. The biggest story that I heard from the OEMs was that 2019 was going to be a particularly good year as infrastructure for 5G wireless started to roll out. And there would be a lot of optics procured in 2019. But 2018 from the OEMs was nothing to write home about.

Dmitry G. Netis: And do we know if the inventory is kind of at the levels where you will start to pick up more of a kind of a run rate business going forward? Or we still have -- some potential inventory overhang here?

Jerry S. Rawls: Well, I think most of the inventory has worked out. I can point to 1 customer. I think still has some lingering inventory. But the issue is, the run rate for 2018, may not be -- it's lower -- it's going to be nowhere like the 2016 run rate. That was clear.

Operator: Your next question is from the line of Alex Henderson with Needham & Company.

Alexander Henderson: Great. Just to clarify that last statement. When you say nowhere near CY '16, I assume you mean nowhere near the growth, you're not talking about in absolute dollars, you're talking about growth?

Jerry S. Rawls: I'm talking about absolute dollars. I don't think -- from the indications I got from some of our Chinese customers, I wouldn't expect that 2018 will be as large as 2016.

Alexander Henderson: All right. And you're still up, though, relative to '17 in that calculus?

Jerry S. Rawls: Not so. That's not clear.

Alexander Henderson: Okay.

Jerry S. Rawls: There's some that have more -- seem to have more confidence than others, but I didn't come away with a warm and fuzzy feeling about our 2018 from -- in China demand.

Alexander Henderson: Just a couple of pieces. Could you talk about the ROADM business in the quarter? Was it flat, down, up, sideways? And what are your expectations there?

Jerry S. Rawls: It was up.

Alexander Henderson: Up a little? Up a lot?

Jerry S. Rawls: Well, it was up. I don't know, 10 percent quarter-to-quarter.

Alexander Henderson: So are you starting to see a pickup in demand in China? Or you're picking up a demand as a result of rest of world? Where is the growth coming from?

Jerry S. Rawls: There's a fair amount of it comes from China. But the rest of the world, we have a lot of customers that are not only European and Japanese as well. So I mean, it's not like we think that the wavelength selective switch business is booming, but it's doing okay. And I don't think that from everything I learned in China that the 2018 is necessarily going to be a big year for ROADMs. It's going to be -- there will be ROADMs procured and there will be regional deployments or provincial deployments, but no big scale rollout is expected.

Alexander Henderson: Okay. And then on the 10-gig, can you parse between the tunable telecom products and the datacom products list?

Kurt Adzema: I'm not sure. 10-gig on the datacom side is kind of in the mid-teens percent of datacom. And I would say on the telecom side, 10-gig is probably around 30 percent of telecom.

Alexander Henderson: Yes. And that really wasn't -- thanks for the data, but it wasn't what I was asking, is there a difference in the trajectory of the 2 is what I was asking. Is tunables declining as well as the datacom 10-gig? And everybody assumes 10-gig, 40-gig, datacom's declining, but I guess, I was looking for a read on the tunables.

Kurt Adzema: Yes, I'd say 10-gig tunable has been relatively flat, but I think we're starting to see signs that there might be some decline coming on in the next couple of quarters.

Alexander Henderson: Okay, that's helpful. And just going back to the ramp in VCSELs. Obviously, you don't want to talk about too granular but can you give us a sense of what kind of band of capacity you would have if you get to reasonable production yields? Is it a $30 million to $40 million kind of business quarterly? And assuming the second fab doesn't come onstream?

Jerry S. Rawls: I would -- the capacity that we're building down there is going to -- would for us be more than $100 million a quarter in revenue.

Alexander Henderson: That's with the new capacity coming on stream in the 6-inch fab, right?

Jerry S. Rawls: Correct.

Alexander Henderson: So excluding that, is it 30 to 40, and then the rest would be the other, is that the right way to think about it?

Kurt Adzema: In what period Alex, when you say 30 to 40?

Jerry S. Rawls: When you say excluding, what are we excluding?

Alexander Henderson: Well, I'm assuming you're producing on 4-inch fab today and you're not ramping that capacity substantially since you're going to a 6-inch capacity. So I'm assuming most of the volume that you're doing today is on that 4-inch fab, and therefore, that has some limited capacity until the -- there are some limits to how much that could go to before you get the other production up and running. And it sounds like it's like 30 to 40, and then when you add the sort of 6-inch, it take you up towards 100 plus.

Jerry S. Rawls: I don't think we've ever said it could be as much as 40 million a quarter. I think I once said that if we hit the yields that we're targeting, we could probably do 30 million a quarter out of that Allen fab. But that's probably as good as we're going to get down there. Maybe we'll surprise ourselves. That's not perfect yields, but those are reasonable yields. We're not at that yield level yet. And -- but we're making progress every week.

Alexander Henderson: So a couple of quarters to ramp that towards that level, is that the right way to think of it?

Jerry S. Rawls: I can't predict that. It may be 2 quarters and it may be 4 quarters.

Alexander Henderson: Going back to the gross margin question, and I apologize for the laundry list of questions here, but the gross margin pressure associated with the fab coming onstream, when I look at the hit in the quarter, how much of it was from that? How much of it was from pricing pressure on 100-gig? How much of it was from mix shift? Could you help us a little bit more on that granularity between those?

Kurt Adzema: Those were all very big factors, honestly. So I think, and I'm not going to provide any more granularity. All 3 of those were material factors: the revenue being down, the mix being unfavorable and then, obviously, the cost in Allen.

Alexander Henderson: But was pricing in 100-gig a factor as well?

Kurt Adzema: Pricing is always a factor. And then, obviously, varies by products. So as Jerry said, we're starting to see more competitive pricing on the QSFP28 side. But I'd say the other 3 factors were bigger in the quarter we just finished.

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

Timothy Paul Savageaux: A couple of questions here. First, on the telecom side. I wonder if you could talk to the magnitude of contribution you're expecting from your ACO qualification in January. I would have at least thought significant enough to maybe make October sort of a trough quarter in telecom. I wonder with increasing ACO contribution and your expectations on the ROADM side, do you think January has a chance to be a trough quarter on the telecom side? And if you could talk to again some sort of order of magnitude for ACO contribution in January?

Kurt Adzema: I would say, ACO in terms of Q3 is the result of the qualification that Jerry mentioned. We expect it to be up but still not up as much as we'd like it to be, so it's not huge yet. We obviously expect it to have a bigger impact over time. But I would not say it's having a big impact in Q3. Obviously, we expect to have a bigger impact in Q4. I think the flip side of that is that Q4 will have the 3 full months of the telecom price reduction. So we're not providing guidance for revenue growth in telecom in Q4, but obviously, those are 2 key factors. But I would say, we don't have -- in our guidance, we don't have a lot of impact from the recent qualification of the ACO at the one key customer baked in.

Tim Savageaux: Got it. And then over to the 3D sensing side. I just want to clarify one thing you were discussing earlier with regard to current capacity, which you've said before and given your gross margin performance, we'll assume that your yields aren't where you'd like them to be and probably gauge the capacity that way in terms of where you're able to ramp near term. Did you say you're adding an incremental $100 million per quarter? Let's say, everything goes right out in the second half of calendar '18 or you'll get to a total of $100 million in capacity, including the forage?

Kurt Adzema: To be honest, we're still figuring out that. As Jerry talked about, we've ordered a lot of the long lead time items. So we're still finalizing what the exact equipment set is going to be and how many wafers we're going to be able to add to capacity. Obviously, capacity is only part of the equation. You have to have capacity and then obviously, you have to have a customer. So I'd say, it's still a little bit early for us to start predicting revenues in the second half of the year. But needless to say, we have with adding Sherman, assuming we execute as we'd like, we're going to have significant increase in the second half of the year and capacity, and be able to both be making VCSELs on 4-inch out of Allen as well as 6-inch out of the Sherman.

Timothy Paul Savageaux: Okay. Well, $100 million was your number, not mine, but either way. Let me finish on that by asking about investments in that capacity. You've talked to your current capital budget not including the facility investment in Sherman. I think looking at the type of capacity we're thinking about adding an investment here in total is bordering on $100 million. I wonder if you can sort of make a comment on that other $100 million number? And finally, it would seem to be regardless of NDAs and everything else that you're committing here in a few seconds to invest $100 million in a new facility. Without having received production qualification from your major customer, that would seem like a strange thing. Does it seem strange to you as well?

Jerry S. Rawls: Well, you made a big assumption there.

Timothy Paul Savageaux: Which one?

Kurt Adzema: Alex, let me ask your first question and I'll answer your second question. Sorry, Tim. Sorry. So we spent $20 million on the building. We talked about that. We're going to have to do some level of uplift on the building to fit out some things, so my guess is we'll spend at least another $20 million on that and we expect to spend over $100 million on top of that on equipment over the coming, let's say, year. So that gives you a sense of the amount of money that we're investing. And I think in terms of -- we obviously have some confidence based on our interactions with our variety of customers in both consumer and automotive that this is going to be a very important space for us, and we feel very good about our relative position in this space, and that's why we're making the investments.

Timothy Paul Savageaux: Okay, if I could just squeeze one more in there. This is maybe Alex-like, but anyway, if you had unlimited capacity right now based on the demand that you're seeing, what could you ship in a quarterly basis?

Jerry S. Rawls: We don't have unlimited capacity.

Kurt Adzema: Well, if we had unlimited capacity we could ship unlimited amount. Sorry, we're not going to go into what the end demand from the customer is. Our customers would prefer us not to disclose those level of information.

Operator: Your next question is from the line of Richard Shannon with Craig-Hallum.

Richard Shannon: I'm traveling today, so I may have missed a little bit of the call. I apologize if I'm repeating some questions. I just wanted one quick clarification and a follow-up question. First of all, on the topic of yields that impacted your October quarter gross margins, was that specific to one product area like 3D sensing? Or was that more broad, can you help me clarify that, please?

Kurt Adzema: It was specific to yields on the VCSEL arrays.

Richard Cutts Shannon: Okay. That's what I thought. Just wanted to make sure. And my second question is related to 100-gig datacom. Can you give us some thoughts on the relative trajectory of pricing? It seems like it's got more aggressive in the second half of the year. How do you expect those curves to continue into next year? How you see the supply-demand environments? And are there any unusual patterns coming from the large data center guys U.S. or otherwise that might be impacting near term or longer term into next year revenue patterns?

Jerry S. Rawls: Well, I think as I've said before, pricing this year is actually been okay in 100-gig datacom. Pricing that sounds really bad is in calendar year '18, when there's a number of suppliers who have never supplied in this industry, who are promising production capacity at some very low prices. The $64 question is will they be able to deliver. So -- and if they can, there are going to be some -- the prices next year are going to be a lot lower than they are in 2017.

Richard Cutts Shannon: Jerry, do you feel like some of those potential suppliers are credible to the large hyperscale guys? Are they kind of nipping at the heels?

Jerry S. Rawls: That's hard to say. They're not -- most of them don't have much of a track record. But that doesn't say they're not credible. And I don't think I should comment about my competitors much, but it's going to -- 2018 will be an interesting year in the Web 2.0 space.

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

Simon Leopold: I wanted to follow-up on this pricing comment. Historically, for the optical component industry, we throw around that 10 percent to 15 percent annual reduction, which is not specific to products but a broad statement. Given your product mix, customer mix, how would you characterize the kind of pricing pressure you expect to see in calendar '18?

Jerry S. Rawls: I think in the telecom world, negotiations are going on as we speak. And we would expect that the 10 percent to 15 percent in telecom is still the range that we'll see next year. The real question is going to be in that big segment of the data center market, which is the 100-gigabit and what happens to the prices there. And I would say, there's a chance that they will be more than 15 percent declines. But it's like I said, we're going to wait and see. Right now, we're still shipping everything we can build.

Simon Matthew Leopold: Okay. The other thing I wanted to ask about is really from an industry perspective, your view of the addressable opportunity for the 3D sensing. So not specific to what you think you're necessarily going to ship, but help us understand how you're sizing the market opportunity in 2018? And presumably, I want to ask about 2019 since given the timing of the ramp of the new facility, I have to imagine you're thinking about '19 already?

Jerry S. Rawls: 3D sensing is potentially gigantic. If all the customers in the consumer space and the automotive space really build systems and deploy them as they are -- they have indicated to us recently, then no matter how big this building is that we just bought, and we fill it full of equipment, it's unlikely that we can supply all of the demand that we'll need to supply. So I mean, it's measured in billions of dollars. And it's really hard to project today that's how many of these applications are people really going to field. But I'll just tell you, we're building arrays for a lot of different people in both mobile and in automotive, some of them are quite small arrays and some of them are gigantic arrays.

Simon Matthew Leopold: And one last one, in terms of customer verticals, specifically for the QSFP28 products that you sell, I presume that you have more leverage or more exposed perhaps than others to OEM-type customers as opposed to direct web scale. And I imagine that this makes your business somewhat more resilient in terms of encroachment, in terms of pricing, I just want you to get a sense of how we should think about your mix of customers for those products and whether or not my statement is reasonable?

Jerry S. Rawls: We sell more to the web scale than we do to OEMs. But you're right, OEMs are an important market segment for us. And generally, the OEMs have substantially higher qualification requirements. So some of the Chinese competitors are unable to actually get their products qualified.

Operator: This will conclude today's conference. You may now disconnect.

Jerry S. Rawls:

Kimberly, thank you, and thanks to everybody for tuning in today. We appreciate you taking the time to spend it with us, and we hope you'll be able to join us again 3 months from now. Have a good day.

Operator: Thank you. Have a great day.

END