

Ciena Corp (Q2 2025 Results)

June 5, 2025

Corporate Speakers:

- Gregg Lampf; Ciena Corporation; Vice President of Investor Relations
- Gary Smith; Ciena Corporation; President, Chief Executive Officer
- James Moylan; Ciena Corporation; Chief Financial Officer
- Scott McFeely; Ciena Corporation; Executive Adviser

Participants:

- Samik Chatterjee; JPMorgan; Analyst
- Simon Leopold; Raymond James; Analyst
- Amit Daryanani; Evercore; Analyst
- Ruben Roy; Stifel; Analyst
- Meta Marshall; Morgan Stanley; Analyst
- Adrienne Colby; Citi; Analyst
- Timothy Savageaux; Northland Capital Markets; Analyst
- Ryan Koontz; Needham & Co.; Analyst
- Karl Ackerman; BNP Paribas; Analyst
- David Vogt; UBS; Analyst

PRESENTATION

Operator^ Good day. And welcome to Ciena's Fiscal Second Quarter 2025 Financial Results Conference Call. (Operator Instructions)

Please note, this event is being recorded.

I would now like to turn the conference over to Gregg Lampf, Vice President of Investor Relations.

Please go ahead.

Gregg Lampf^ Thank you, Michael. Good morning. And welcome to Ciena's 2025 fiscal second quarter conference call.

On the call today is Gary Smith, President and CEO; and Jim Moylan, CFO.

Scott McFeely, Executive Adviser, is also with us for Q&A.

In addition to this call and the press release, we posted to the Investors section of our website an accompanying investor presentation that reflects this discussion as well as certain highlighted items from the quarter.

Our comments today speak to our recent performance, our view on current market dynamics and drivers of our business as well as a discussion of our financial outlook.

Today's discussion includes certain adjusted or non-GAAP measures of Cien's results of operations.

A reconciliation of these non-GAAP measures to our GAAP results is included in today's press release.

Before turning the call over to Gary, I'll remind you that during this call we'll be making certain forward-looking statements.

Such statements including our guidance, commentary and market dynamics and discussion of our opportunities and strategy are based on current expectations, forecasts and assumptions regarding the company and its markets, which include risks and uncertainties that could cause actual results to differ materially from the statements discussed today.

Assumptions relating to our outlook, whether mentioned on this call are included in the investor presentation that we'll post shortly after, are an important part of such forward-looking statements, and we encourage you to consider them.

Our forward-looking statements should also be viewed in the context of the risk factors detailed in our most recent 10-K and 10-Q, which we expect to file with the SEC by June 12. Ciena assumes no obligation to update the information discussed in this conference call whether as a result of new information, future events or otherwise.

As always, we will allow for as much Q&A as possible today, though, ask that you limit yourselves to one question and follow-up.

With that, I'll turn the call over to Gary.

Gary Smith^ Thanks, Gregg. And today, we delivered strong fiscal second quarter results including revenue of \$1.13 billion, which is at the high end of our guidance and demonstrates the strength both of our strategy and our execution. This performance reflects continued strong demand across all customer segments, geographic regions and our diversified portfolio. Notably, revenue from cloud providers stood out as a key driver in Q2.

Specifically, we achieved record direct cloud provider revenue in Q2 that comprised 38% of total revenue, growing 85% year-over-year and reaching more than \$400 million in a single quarter for the first time.

Really highlighting the accelerating investments in AI infrastructure and our leadership in addressing this demand.

Indeed, three of our top five customers this quarter were cloud providers, underscoring their sustained investments in AI infrastructure and network expansion.

Over the past quarter, market dynamics have not only validated our previous assumptions about customer network infrastructure spend, but have also reflected an accelerating demand environment that continues to ramp and exceed our expectations. And we believe this strength is differentiated for us as the market continues to evolve in our direction. Accordingly, orders in the quarter were again significantly greater than revenue.

And notably, we are on track for cloud provider orders to double in fiscal 2025 over last year as we benefit from the breadth and depth of our customer base in this critical segment. And I think this outstanding performance showcases our substantial market penetration in the AI-driven networking space, where we remain a very trusted partner for a wide range of network operators who are investing to scale their infrastructure for high-speed data center and cloud connectivity including for emerging applications and use cases.

To address this growing demand, we are deploying the entirety of our portfolio including optical systems and interconnects, routing and switching solutions, software and services. And as the global leader in high-speed connectivity, our WaveLogic technology remains a cornerstone of our competitive advantage.

Specifically, our WaveLogic six Extreme, 1.6 WAN technology maintains at least an 18- to 24-month competitive lead in the market.

As our photonic line systems continue to be the de facto industry standard. Demand for our reconfigurable line system, RLS, continues to increase. And our interconnect business is also ramping with tremendous activity and demand including new awards with three additional major cloud providers this quarter alone. This momentum reflects the growing adoption of and our demand for our 400ZR and 800ZR coherent pluggable solutions as well as our 1.6T coherent light solution, which we will be sampling by the end of calendar 2025, with commercial availability in the first half of calendar 2026.

As cloud providers expand their data center architectures with scale-up and scale-out AI-related deployments, we are broadening and deepening our relationships with them.

In fact, we're addressing new data center-related applications, a strategy that we've spoken publicly about over the last few months and where we recently secured two wins. The first is a very strategic win, and it's for an application involving the connection of regional GPU clusters, which is something the industry has been talking about for some time.

For context, to support the massive scale and power requirements of AI training and inference traffic, data centers must become more distributed. And historically, these traffic flows were primarily inside the data center, but they are now across multiple data centers over greater distances that require high-capacity, low-latency links.

With that, we are excited to report that our coherent 800-gig pluggables and RLS photonics have been selected by a global cloud provider, who is investing in geographically distributed regional GPU clusters.

We will start to recognize revenue from this incremental opportunity later this fiscal year and ramping into 2026. And as one of the first vendors to address this application and with our coherent optical technology ideally suited for this type of connectivity, we expect to see more of these types of opportunities emerge, as cloud providers evolve their data center network architectures to support their II strategies. The second win is for a focused application inside the data center for out-of-band network management. These networks operate separately from the main data traffic network and provide remote access to monitor and manage data center systems.

We recently worked with a global cloud provider to codevelop a solution, based on our existing technologies, and this is designed to significantly reduce the complexities of these networks and streamline the management of its large-scale data center operations.

Now turning to service providers.

It's now been several quarters of an improving trend line with service providers as their network investments in high-speed infrastructure become more durable and sustainable following a long period of underinvestment.

We are seeing growth and strength across the board with service providers in core optical transport, routing and switching, software and services to address the connectivity needs of their own customer base and to support cloud providers growing bandwidth demands.

As a result, our business with Tier one North American service providers gained momentum in Q2. And we also had several new customer wins in both the Americas and international regions including Europe.

This momentum is driven in part by new fiber builds as well as MOFN.

In fact, all the record performance of direct DCI in the quarter, we also achieved an all-time record for MOFN activity in the first half of fiscal 2025, which further demonstrates really how we're supporting the strong nexus between service providers and cloud providers.

I also want to touch on the momentum of our software business.

I'll start with the Navigator Network Control Suite, which is our multilayer domain controller and this provides a comprehensive set of capabilities to help network operators plan, provision, monitor and troubleshoot their networks.

Orders for Navigator increased significantly in the first half of fiscal 2025 by more than 30% year-over-year, driven by increased investment and the unique capabilities of this micro services-based and differentiated platform.

Similarly, Blue Planet had a record performance in Q2, achieving its highest ever quarterly revenue at just under \$30 million. This milestone reflects the success of our deliberate transformation efforts over the past couple of years, positioning Blue Planet to better serve our customers' digital transformation needs and journey.

Today Blue Planet is at the leading edge of several large provider projects, particularly as the industry incorporates agentic AI and data-driven intelligence to drive transformation.

Before I turn the call over to Jim, I'd summarize by saying that we are very encouraged by the strong activity across all segments of our business.

In the context of favorable market dynamics and an accelerating demand environment, we have strong momentum that we are confident will drive continued growth.

In particular, we are very pleased with the validation from customers that we can strategically expand our market opportunity inside and around the data center, where high-speed connectivity is absolutely critical.

In the short term, and as we've been talking about for some time we are now seeing more AI traffic come out of the data center for training, as I mentioned earlier, and general monetization that's driving cloud traffic. An asset of technologies is ideally positioned to address these connectivity needs at scale.

With that, Jim, can you please provide us with updates on our financial performance in Q2 as well as our outlook.

James Moylan^ Thank you, Gary. Good morning, everyone.

As Gary noted, we delivered strong fiscal second quarter results. Total revenue in Q2 was \$1.13 billion. This included two 10%-plus customers, one cloud provider and one service provider.

Adjusted gross margin was 41%, in line with our guidance, driven by product mix, and to a lesser extent, the cost of tariffs.

During the quarter, we navigated a new and in the early days, a rapidly changing U.S. tariff environment.

We responded in real time with mitigation strategies to minimize the impact both on our customers and our P&L.

However as a result of the dynamic conditions as well as the need to adjust our billing systems and our customer systems, we absorbed a net impact to our bottom line in the mid-single-digit millions of dollars in the quarter.

Adjusted operating expense in Q2 was \$369 million. This was higher than expected, driven entirely by higher incentive compensation associated with very strong order performance in the quarter and our overall financial performance in the first half of the year, both trends which are expected to continue. Absent this higher incentive comp, OpEx is on our plan and our guidance.

With regard to profitability measures in Q2, we delivered adjusted operating margin of 8.2%, adjusted net income of \$61 million and adjusted EPS of \$0.42.

In addition, we generated \$157 million in cash from operations.

Adjusted EBITDA was \$117 million.

Finally, we ended the quarter with approximately \$1.35 billion in cash and investments.

During the quarter, we repurchased approximately 1.2 million shares for \$84 million.

We are on track for the repurchase of approximately \$330 million total in this fiscal year.

Some additional highlights from the quarter.

We had an excellent quarter in Optical.

As Gary mentioned, our WaveLogic technology remains a strong competitive advantage.

We added 24 new WaveLogic six Extreme customers in Q2, bringing the total to 49 within just two quarters of general availability. WaveLogic five Extreme and Nano also performed well with continued adoption among cloud customers and service providers.

We added 10 new WaveLogic five Extreme customers in Q2 for a total of 344 customers overall.

WaveLogic five Nano pluggables continued ramping, now shipping to 178 customers including both cloud providers and service providers.

Overall, our momentum with coherent pluggable optics was strong in Q2, and we remain on target to double our year-over-year revenue to at least \$150 million in fiscal 2025. Pluggables are proving to be a great complement to our Optical Systems business.

I also want to highlight the performance of our Routing and Switching business. This is being driven by AI momentum and an improving service provider environment.

In Q2, we secured a significant win with a Tier one service provider in India, where we displaced a major competitor in the access domain.

We also added eight new broadband customers in Q2.

Additionally, we introduced the first 800-gig router to our coherent routing portfolio, and we expanded our flagship wave router family with WaveLogic six Extreme capabilities, making it the industry's first generally available 1.6-terabit coherent router. All of this performance confirms that we have the right portfolio with best-in-class technology for our customers, who demand the highest performing connectivity for today's dynamic demand environment.

With that, let's turn to guidance.

Given recent developments, it appears that the tariff environment will continue to be dynamic.

For purposes of our guidance, however, we are assuming that the current tariff structure does not change. Under this current tariff structure, we expect the total cost of tariffs to be approximately \$10 million per quarter.

We expect to mitigate most of the quarterly impact as compared to Q2. Therefore, we believe the net effect to our bottom line in future quarters will be immaterial.

So for the fiscal third quarter, we expect to deliver revenue in a range of \$1.13 billion to \$1.21 billion.

We expect Q3 adjusted gross margin to be roughly in line with Q2. And we expect adjusted operating expense to be approximately \$370 million to \$375 million. Again, this includes higher incentive comp. Base OpEx is on our plan and on our guide.

While the geopolitical environment has fluctuated quite a bit during the past few months, strong demand dynamics continue to drive momentum in our business.

As a result, we have increased visibility and are in a position to update all three elements of our annual guide.

We now expect to deliver revenue growth of approximately 14% for fiscal 2025.

At the same time given the mix of products including a higher proportion of newly introduced solutions and the RLS, all of which are still ramping, we expect annual gross margins at the lower end of our previously assumed range of 42% to 44% for fiscal '25. And with respect to OpEx, we expect to be on plan and guide for our base OpEx for the fiscal year.

However, given our strong financial performance, particularly on orders and revenue, we expect an increase in incentive compensation of approximately \$10 million per quarter.

With that, we now expect operating expense to average \$360 million to \$370 million per quarter for the year. Michael will now take questions from the sell-side analysts.

Gary Smith^ Michael, before we do that, I'd just like to take a moment to acknowledge and recognize Jim's upcoming retirement. Given today will be last earnings call with us all. And as you know for the past 18 years and an incredible 70 earnings calls, Jim has been an incredible partner and member of our executive team with a lengthy list of significant contributions to the growth and the performance of our business.

We will certainly miss Jim's leadership and his wealth of knowledge, but importantly as well and I think I speak for all of you who know him on the call as well we'll miss his wit, his warmth and his humor, that makes working with him such a joy.

So while we'll be sad to see him go later this summer, we all wish him the very best in his well-deserved retirement.

James Moylan^ Thank you, Gary.

Gary Smith^ With that, we really will open up for calls from the sell-side analysts, please. Thank you, Michael.

QUESTIONS AND ANSWERS

Operator^ (Operator Instructions) And the first question comes from Samik Chatterjee with JPMorgan.

Samik Chatterjee^ I guess, Gary, if I sort of go back and -- from the last earnings call you already had indicated that you were seeing strong start in terms of orders to this quarter.

But when I listened to the commentary this morning, it just sounds more like you've seen probably more acceleration through the quarter with the cloud customers.

But just maybe if you can talk about the linearity of the orders with the cloud for the quarter because over it sounded more sort of optimistic than what we heard from you 90 days ago. And in terms of visibility, how do you think about visibility beyond FY '25? You're talking about doubling of orders?

And how do you think about sustainability of that kind of growth or investments from them into fiscal '26? And then a quick follow-up.

Gary Smith^ That was a pretty comprehensive question. Thank you, Samik.

So I think in direct answer to the first part of that, I think we saw strong order flows in Q1. That continued in Q2 and probably accelerated in Q2 and the activity. And I'd say two things about it.

One, service providers, nice steady increases underpinned all of that, and I think that's very sustainable and durable. And then the cloud, I think we're seeing a step function here in demand.

We're seeing cloud growth in terms of traffic flows. And then we're seeing these incremental opportunities as well that are emerging regional GPU cluster one that I talked about specifically today is really incremental to our thought process for the year. And I would also say that, that momentum both on service providers and on the cloud players is continuing into Q3.

So -- and this exceeds our expectations for the year.

I think given this notion around traffic coming out of the data center, to both do training and for monetization, we are beginning to see that for sure in addition to these other applications.

So I think at this stage, obviously it's early to predict next year and the 3-year piece, I think it's reasonable to assume that given the step function in demand, I think we will revise the 3-year guidance when we get to the end of this year.

Obviously not appropriate to do that now.

But I think what's behind your question there, Samik, is this a long-term trend?

And I think the answer to that is absolutely yes.

Samik Chatterjee^ Got it, got it. And for my follow-up, on the gross margin side, and I know mix is sort of impacting this year, but one of the concerns that we hear from investors is as you ramp on pluggables, and this year, you also have the coherent light products ramping next year.

Is that a headwind in terms of mix to the overall margin -- long-term margins for the company? Can you just address that concern if there is a change in terms of the longer-term thinking for gross margins for the company, just given where the expansion opportunities that you are pursuing. And before I pass it over to you, Jim, thank you for your help all of these days.

James Moylan^ Thanks for the question, Samik.

We've always said that mix is the single most important element of our gross margin number in any given quarter. And that certainly affected us in Q2 and likely will affect us in Q3.

As we look out, though, we really are not backing off our view that mid-40s percentage is the right gross margin for us, at least as a target, and we think we can get there in a couple of years.

What's happened in this quarter is that we have exceedingly high demand for pluggables and our new reconfigurable line system.

Both of those are at lower than corporate average margins for slightly different reasons. The RLS, the reconfigurable line system, has always been based on a razor-razor blade type pricing model. And so when we sell a lot of ROS without a lot of capacity adds, we are going to enjoy lower margins than our mid-40s. That's just a fact.

It's becoming the industry standard.

It's a good thing for future margins because we will sell the capacity, at least most of the capacity, to go into those line systems.

So that by its very nature, will improve over time.

On the pluggable side, what I'd say there is that we are in the very early stage of ramping our pluggables business.

It's going to be -- we said at least \$150 million this year.

It's -- we're 20% of the market, it's going to grow.

That share is going to grow. And our cost points are not as good as we'd like them to be. They will -- those cost points will decline over time and our margins will improve.

We're also going to generate -- going to introduce the next generation of plugs, the 800-gig plug, an 800ZR, ZR plus, all of that generation will come out. And those should be higher performance and better gross margin.

So there is a path to getting to gross margins, is not going to happen in Q3. And I think it will definitely start to happen in next year.

Scott McFeely^ The other dimension on mix is WaveLogic six extreme part of our system business. Gary talked about the momentum that we had in that -- in his prepared remarks. That's in the early stages of ramp as well.

So it has the same dynamic as the pluggables, lots of levers to pull on operational supply chain efficiencies and design cost reduction that you do over the life cycle of the product, and that will naturally lift the margins in those parts of the portfolio.

Gary Smith^ The other thing I would just add to add to all of that is, Samik, we're -- given what we're seeing around the dynamics of demand, and how sustainable that is, given what Jim and Scott have talked around the gross margin mix, being a bit of a headwind in the short term for us.

We're confident we'll get through that.

We've done that before, that makes us even more confident in our operating margin targets for getting into those mid-teens as we get to '27. And I think we'll see continued improvement both in the second half of this year and also in 2016 on the journey.

Operator^ And your next question comes from Simon Leopold with Raymond James.

Simon Leopold^ And Jim, thank you as well for all the service and certainly appreciate getting a full year's heads up on your retirement.

So a nice glide path without a shock to the system.

So grateful for that as well.

So I wanted to see if maybe we could unpack the top customers a bit. And then you mentioned three out of five were cloud and the two 10% customers, one being service provider, one cloud.

I guess what I'm trying to get a better sense of is what were the more specific percentage contributions from the two over 10%? And how much of overall revenue is coming from the top five customers in the quarter?

James Moylan^ Yes. The largest customer was a cloud customer, it was 13% to 14%.

I don't have the precise number right here.

So 13% and the second one was our service provider, AT&T at 10.4%. The top 5, I'd have to quickly calculate, but it would -- I'll do that and get back to you, Simon.

Simon Leopold^ Okay. And then just I'll ask a follow-up while you're looking at those numbers.

In terms of some of the trends from these cloud customers, so comfortable that visibility has improved, it sounds like a good trend.

I know we're not ready to provide guidance for fiscal '26.

But I guess folks are trying to trying -- what's sort of the sustainability of this?

Do this -- you get a better sense that we'll see a broadening base of contributions from cloud both direct and indirect that it should continue to grow next year. How should we think about the longer-term trend beyond the end of fiscal '25?

Gary Smith^ As I'm sure you can appreciate, obviously we don't want to get ahead of ourselves into giving sort of detailed guide for '26.

But clearly, with the kind of dynamics that we're seeing, Simon, I think about it, you've got a broadening application base.

I talked about the GPU clusters earlier and the inside the data center focused application there. And you've also got a broadening amount of cloud providers.

We've had significant new wins over the first half of the year.

More and more of these cloud providers, not just the large four are now really leaning into the network. And so I think you've got a broadening set of players, and you've got a deepening set of applications, which obviously gives us confidence in the sustainability and durability of it. And given the the magnitude of the scale out, we've got very good visibility with a number of them about their long-term plans. And we're also co-creating with them as well.

So that gives us increased visibility and confidence as well as we go forward.

James Moylan^ The two big wins that Gary spoke about earlier, both of which have applicability outside of the original customers. The regional GPU clusters in particular, is something that the industry has been talking about for years. And now the demands for data flows inside the data center has brought that phenomenon about.

So this is a big trend for us.

We think it will be at least considered, if not adopted by other cloud providers.

And the -- inside the data center connectivity is being looked at by other cloud customers as well.

So both of those have applicability outside of the original customers. And the answer to your question, Simon, the top five customers were 45% of revenue.

Operator^ And your next question comes from Amit Daryanani with Evercore.

Amit Daryanani^ I guess I have two as well. Maybe just to start with -- when I think about the 14% growth outlook for the year, can you just talk about what are you sort of assuming from a growth basis in cloud versus telco for the year? And then really if I kind of look at what you're implying for October quarter specifically, I think you're implying it's going to be up low single-digit sequential around \$1.2 billion.

So would that imply that a lot of the auto momentum you're seeing right now is more likely to convert to revenues in fiscal '26 versus the back half of this year?

Gary Smith^ Yes, quick answer to that, I mean yes.

I mean given the scaling demand, we're not going to be able to -- and a lot of it is scheduled for out further because of the size and scale of it.

So we're certainly, I think, going to be going into 2026 with an increased backlog.

I think that's where you're going with this. And that's -- that's absolutely a reasonable assumption.

We are ramping our supply chain pretty strongly. And we started that last year, and we're continuing to increase that.

So we can address that because we do think it's very sustainable, and we've got good visibility to it.

So we are going to go into 2026 even with the increase to sort of 14% growth in the year, we're still going to be leaving the year with a larger backlog than when we entered it. That's for sure.

Amit Daryanani^ Super helpful. And if you could spend a little bit of time on this, the pluggable opportunity, and you talked about you're deploying your pluggable optics with one of these distributed GPU clusters.

Can you just talk about what distance are these pluggables being used for right now? And if I think longer term, beyond the \$150 million number you talked about, how big do you think this market can be and where do you think your market share could eventually get in that space.

Gary Smith^ Okay. Let me take the second part of that, and then I'll pass Scott to give you some more on the sort of architectural side.

I would say that we've been engaged with multiple players over this kind of architecture where because of power and space constraints, they cannot get all of the GPUs in a single data center.

So this is the first one that we've seen, and we believe we're one of the first deployments like that, and it's just a couple of the regions, and it is hundreds of millions of dollars of both 800-gig pluggables and line system.

So in terms of sizing, it's pretty material.

And this is one player just beginning to roll this piece out.

So this is a very sizable and substantial opportunity for us.

Scott McFeely^ Yes.

In terms of the overall pluggable piece, you need to differentiate sort of our pluggable participation in sort of the classic [material] campus DCI, which is the 80 kilometers plus kind of domain with this regional GPU clustering application that we're talking about.

In the latter case, what we're really talking about here is a simple way to think about it is an express overlay network between GPU clusters, that has massive capacity, reaches 100- to 150-kilometer type range, requires resilience latency, requires WDM, and is right in the sweet spot of coherent technologies.

So it's what we've been talking about for a long time which is a power becomes a bigger constraint, they need to distribute these GPU clusters. Capacity goes up, that's going to create more opportunities for coherent.

And this is an instantiation of that.

It's coming across as pluggable opportunities at 800-gig, and it's coming across as line systems, all incremental to the use cases that we've been pursuing in the past.

Operator^ And your next question comes from Ruben Roy with Stifel.

Ruben Roy^ Scott, you probably just answered this question.

But just so I understand on the GPU cluster opportunity.

It seems to me from the prepared remarks and what you just said that you're uniquely positioned given that you have both the line systems and the pluggables. And that's part of this new architecture that some of the folks are thinking about.

Is that the right way to think about it?

Scott McFeely^ Yes.

I think over time the opportunity we believe is big enough that there'll be multiple binders at play.

But with our leadership in coherent and as we said, RLS being sort of the de facto standard for line systems, we are certainly going to get our unfair share or the bulk of the early move on this piece.

So we're quite excited about it.

We've been working on it with the lead customer for some time around looking at the feasibility and super focused on delivering to it.

Ruben Roy^ Great. And as a quick follow-up for Gary, I wanted to talk about Blue Planet.

It's shown quite a bit of momentum over the last several quarters. And you talked a little bit, Gary, about agentic AI and some of the things that some of your customers are thinking about.

I'm wondering if you could just kind of delve into that a little bit AI opportunities longer term?

And any detail on use cases that you're talking to your customers about? And how are you thinking about that in terms of growth going forward?

Gary Smith^ Yes.

If you think about the sort of software assets that we've got that are strategically embedded on the service provider side, you've got Navigator around that sort of the main piece was a complete sort of micro services-based architecture. And then, as you know we had a kind of a lot of learning around Blue Planet being a micro services software platform for OSS. And I think we're seeing a lot of momentum now on the Blue Planet side.

We're very focused on things like the inventory, confederation of inventory.

And you think about that strategically, you basically get to have the data set within the service providers of what is out there. And really, without that, it's very difficult to have agentic AI if you haven't understood what the whole inventory of your network is.

So we're sort of, we believe, uniquely placed to be able to leverage that into the future. And that's what we're focused on developing and engaging with a number of very large service provider customers on.

We've got a great position in a number of those large service providers, and we've got the right architecture that will scale up for that.

It's early days.

But basically, we're in a tremendous position from a relationship and a trusted partner point of view and from an architecture point of view, Ruben, to really leverage that into something where we become the de facto data management for the allows and facilitates the agentic AI.

Operator^ And your next question comes from Meta Marshall with Morgan Stanley.

Meta Marshall^ Great. Maybe just a second kind of on the routing wins that you guys were talking about. Just wanted to get a sense, you guys have invested a lot in that business over the past few years.

It was kind of one of the service provider wins kind of one of the finally kind of seeing some of the benefit of that investment? And then maybe just secondly, I get the question in ahead of time.

Just on installation capacity, are you guys seeing kind of more requests for installation capacity just as kind of your increase in revenue point to kind of an increased need for capacity increases.

Gary Smith^ So I think on the routing and switching side, Meta, I think it's is completely aligned with the service provider journey. And I think one view of what's happened with service providers over the last few years, they've really underinvested in a lot of their core infrastructure because they've been very focused on, first of all, COVID, then supply chain whiplash and challenges around that and then 5G, where they've had to invest enormous amounts of money and capital and focus on 5G, and that's largely not worked out from a profit generating point of view.

So I think we're at a point now where they're returning to, I think, a very sustainable sort of scalable investment thesis, and that includes routing and switching. And I think the two go hand-in-hand. And I think with the service provider uptick that we're seeing now investment in new routing and switching applications and a number of new wins.

So that's encouraging for us. And I think that will absolutely continue. To your point about EF&I, which I think is a very important point for a couple of reasons.

One, the increased shipments, we've got really good visibility to what's happening with those shipments. And we are the EF&I partner for a lot of our large customers including the cloud customers.

So we have good visibility to what's happening. And I will say to you that that's in balance. And the need for EF&I is going to go up exponentially similar to the ramping of our supply chain and demand, and we're seeing a lot of activity across the board for EF&I, both in service providers and in the cloud, obviously to help in store this massive amount of investment over the next few years.

Scott McFeely^ I mean just to continue on in the running and switching piece.

I mean we've been very encouraged by the number of logo wins that we've had over the last number of quarters. Logo wins, obviously our precursor to orders or precursor to revenue.

In line with the sort of service provider dynamics, the order book on running and switching for the last number of quarters has been quite a bit in excess of the revenue piece. To put a dimension to that, orders in the first half of the year and running and switching were greater than 75% of the total orders last year for renting and switching.

So there's momentum there, and we would expect that to flow through to revenue with a strong second half.

Operator^ And your next question comes from Atif Malik with Citi.

Adrienne Colby^ It's Adrienne Colby for Atif.

I was hoping we could go back to gross margin.

I think last quarter, you had been expecting gross margin to trend up from the Q2 levels into the second half and the back half of the year.

So I just wanted to understand better what's changed, perhaps the production scaling of the 400ZR is trending differently from expectations.

We've talked about the product mix impact.

So I think that's well understood.

But just trying to understand what's shifted in that outlook?

James Moylan^ Yes. You'll recall that our original guide for the year on gross margins was 42% to 44%.

We're now saying that it's going to be at the low end of that range, and it is essentially that demand for two products, in particular, have greatly exceeded our expectations, the RLS systems and our plugs. And as I've discussed, both of those are currently below corporate average gross margins.

We do have a path to improvement, and you should see improvement in gross margins, certainly next year.

Q3 is probably going to look more like Q2 and probably a little improvement in Q4.

But again, as Gary said earlier, we're committed to improving those gross margins and to getting our operating margin back to the 15% to 16% level by the end of the 3-year period.

Adrienne Colby^ And then I was just hoping we could talk about the MOFN opportunities. Maybe talk a little bit more about your pipeline.

I know you've said that this is one of your strongest quarters in terms of order.

Specific, you're seeing some expansion beyond India.

I know that's been an area where you've had significant traction.

Gary Smith^ We're seeing a lot of MOFN activity in India.

It's not translated to a massive amount of revenues yet, but we've taken the order and it will.

We're seeing MOFN activity throughout the globe. And I think it's just really -- it goes hand-in-hand with the whole cloud build-out. They can't build everywhere with their own network, and so it's augmented by these MOFN opportunities.

We're seeing that in North America as well. There's been some, as you know large announcements around some of the larger carriers partnering there with Lumen and Zayo, et cetera.

We're seeing that reflected in pretty much all parts of the globe.

Asia outside of India.

We're beginning to see that on Europe.

We're seeing activity is the largest amount of activity that we've seen, and it really just goes hand-in-hand with the overall strategic plans for these cloud providers.

Operator^ And your next question comes from Tim Savageaux with Northland Capital Markets.

Timothy Savageaux^ Congrats on the results and increased outlook.

I had a question on the cloud front. And Gary, I think you mentioned a step which I think you're referring to demand.

It looks like you saw another major change in the quarter, and that's diversification of your cloud business among several providers.

It seems like your top customers, the smallest percentage of that total bucket that it's been in a while or at least in recent history.

And I wonder if you could talk about that trend of customer diversification within cloud and whether you expect to see that continue? I know it can be kind of lumpy.

I'd be interested in your thoughts overall on that.

Gary Smith^ Yes. That's a good point, Tim.

I mean I'd say overall, we're seeing -- we start with the sort of four known -- the hyperscalers they were.

We're seeing increases in all four.

Step function increases in all four cloud (inaudible) directly with us and also through things as I was talking just with MOFN as well.

So it's all consistent with that.

And then we're seeing them really -- and I think it's a sort of hierarchical flow is how I think about it. They've been very focused, obviously on power and GPUs and scaling all that.

Now it's about scaling it out. And it's now about the network. And they're very focused, all of them on making sure that the network does justice to all this massive investment that's gone on in compute.

So I think this is the phase that we're entering out, and that's why we're seeing it across all of the hyperscalers.

As you say, it's lumpy in a summer, leaning in more than others, but they're all I think Shanghai step function increase in the importance of the network. And then you've got a whole other set of players as well that has expanded out from a cloud point of view that are now leaning in our network. And so you've got a broadening out.

It's not just the large four anymore.

It's a much larger group of players that are now recognizing that if they're going to monetize and to optimize their GPU investments, it's all about the network. And that's why we think it's very diversified, durable and sustainable. And it's all about high-speed connectivity. That's really what it's about.

Operator^ And your next question comes from Ryan Koontz with Needham & Company.

Ryan Koontz^ I wanted to follow up on your comments around tariff mitigation and and your different levers there around supply chain, customer surcharges. And if you can kind of broadly characterize how negotiations are going with your customers there in terms of passing some of those costs along, \$10 million hit from tariff doesn't sound like that much relative to the big scheme.

James Moylan^ Yes. Any discussion of tariffs is going to have to be caveated by the fact that we only know what the regime in place is now and it could very well change soon.

But under the regime in place now and given all the exemptions that are in the current regime, we are likely to experience a cost of about \$10 million per quarter.

Now if other schemes come in place and the potential for tariffs go up, we do have a range of things that we could do.

We could move manufacturing operations.

We could change some flows in our supply chain.

We can do a number of things like that, which would reduce it.

With respect to passing on to customers, it's going to be a complicated situation because not in all cases, are we going to actually pass a tariff along to them.

In some cases, it might result in some price increases -- general price increases, et cetera.

So all of those things -- that's about as far as we're willing to go today.

But we think that the net cost to our bottom line is going to be immaterial going forward.

Ryan Koontz^ Got it. And Gary, if I could follow up on your momentum in pluggables or maybe for Scott, on CR.

Is this still dominantly driven by cloud operators? Or are you seeing much service provider traction? Where are we in the service provider option cycle for your pluggable CR products?

Scott McFeely^ Yes. From a CR perspective in terms of that application, Ryan, it is dominated by the cloud in terms of the volume. Pluggables have existed forever in terms of service provider deployments for different reasons, for modularity, and we do ship our plugs into service providers, but the volume for ZR is dominated by the cloud.

Operator^ And your next question comes from Karl Ackerman with BNP Paribas.

Karl Ackerman^ I have two, and I'll just ask them at the same time if I may. You indicated that mix of pluggables and line systems are the biggest driver of margins.

First, does the increased backlog exiting 2026 assume a higher mix of transponder blades.

Second, on pluggables, clearly, volume plays a larger role here.

But you did speak about a several hundred million dollar opportunity from your initial player.

So could you discuss where you are on having a fully integrated coherent transceiver giving your IP across VSPs, SerDes and electro-optics.

James Moylan^ The short answer to your first question is yes.

We will be selling more capacity next year. That's one of the reasons why we can have confidence that our margin will go up next year. Gross margin and operating margin for that matter.

Scott McFeely^ Yes. And on the second one, from a capability perspective, all the major seminal ingredients, we own our own IPR on. And as we ramp it over time a greater, greater proportion of the mix will be on our own components, and that is part of the cost improvement plan.

Operator^ (Operator Instructions) Your next question comes from David Vogt with UBS.

David Vogt^ Jim, congratulations. Good luck. Maybe one to start with you, Jim.

So obviously you've spent some time talking about sort of the dynamic with RLS and pluggables.

Can you kind of remind us again, should we expect something similar to what we saw maybe in fiscal '18, '19 and '20 from a systems and transponder capacity perspective, recognizing that obviously COVID was a little bit different, but is that the kind of way we should think about the trajectory of capacity additions and the impact on gross margins going forward?

And then I have a follow-up more specifically on margin.

James Moylan^ You'll recall we had an exceptionally high margin in 2020. That was because COVID did sort of reduced the level of activity with respect to new networks, and so in order to get the capacity that they needed, all of our customers turn to adding capacity to existing line systems. And so we generated, I think, a 48 point-something percent gross margin in one or two quarters of 2020.

I don't -- we don't foresee that kind of move in the next three years.

We do see though a move back to the mid-40s just based on the fact that all of the things we've talked about, WaveLogic 6, the fact that we're coming out with a new generation of pluggables, which will be higher performance and better gross margin and our cost position on the basic 400ZR will improve.

So for all those reasons, we do have confidence the gross margins will improve as we move through the next year or two.

David Vogt^ Got it. And that's helpful. And as a follow-up, if I just maybe take your commentary that the gross margin guide is going to be at the low end, but you're taking the revenue guide to the high end or above the high, excuse me, to 14%. That's largely sounds like driven by RLS systems and pluggables. Just quick math, it looks like sort of the incremental profitability is -- I know it's below corporate average, but it seems like it's pretty materially lower in the low double-digit range.

Can you kind of help us understand what's going on there? Obviously you're talking about -- and even that's adjusting for the mitigation strategies from tariffs and the impact of the quarter. Just trying to understand the magnitude of how the pluggables and the RLS revenue is impacting the gross margin for the balance of this year.

James Moylan^ Well you've done some math.

I'm not going to confirm it.

But what I will say is this, we think that given the mix of products in Q3, it's going to be maybe a little higher than gross margin in Q2, but probably in the same range.

We do see improvement in Q4.

Gary Smith^ Thank you very much for listening. Jim?

James Moylan^ Okay. This is Jim.

I'll be retiring from Cien at the end of August, and this is there for my last call as Gary said, as CFO.

I've greatly enjoyed getting to know all of you, and I wish you well in all of your future endeavors.

I also look forward to seeing many of you at the end of this month in New York and Boston, that will be fun, and I'm looking forward to it.

For those of you who are in the enviable position of having recommended Ciena for purchase, I believe you made a good call a great call actually.

For those of you who are not yet in that position. There is still time to get in on what I believe is a very bright future for this company. Good luck to all.

Gregg Lampf^ Thank you, Jim. Thank you, everyone.

We look forward to connecting with you over the next few weeks.

Operator^ The conference has now concluded. Thank you for attending today's presentation.

You may now disconnect.