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JNPR - Q1 2017 Juniper Networks Inc Earnings Call

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APRIL 25, 2017 / 9:00PM, JNPR - Q1 2017 Juniper Networks Inc Earnings Call

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## PRESENTATION

### Operator

Greetings, and welcome to the Juniper Networks First Quarter Fiscal Year 2017 Financial Results Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

I would now like to turn the conference over to Ms. Kathleen Nemeth, Vice President, Investor Relations. Thank you, Ms. Nemeth. You may now begin.

### Kathleen Nemeth

Thank you, Operator. Good afternoon and welcome to our first quarter 2017 conference call. Joining me today are Rami Rahim, Chief Executive Officer; and Ken Miller, Chief Financial Officer.

Today's call contains forward-looking statements including statements concerning Juniper's business, economic and market outlook, strategy, future financial results, capital return program and overall future prospects. Actual results might differ materially from those projected in the forward-looking statement. Additional information that could cause actual results to materially differ from those in these forward-looking statements are listed in our most recent 10-K, the press release furnished with our 8-K filed today and in other documents that we file with the SEC from time



## APRIL 25, 2017 / 9:00PM, JNPR - Q1 2017 Juniper Networks Inc Earnings Call

to time. All statements made during this call are made only as of today. Juniper undertakes no obligation to update the information in this conference call in the event facts or circumstances change after the date of the call.

Beginning in the first quarter of 2017, we are now providing revenue commentary for our key customer vertical: cloud, telecom and cable, and strategic enterprise. And we no longer intend to provide revenue commentary on the service provider and enterprise market. For historical revenue information by vertical, please see our CFO commentary, which is furnished with the 8-K filed today.

Our discussion of the financial results today will include non-GAAP results. Reconciliation information can be found in the Investor Relations section of our website under Financial Reports. For important commentary on why our management team considers non-GAAP information a useful view of the company's financial results, please consult the press release furnished with our 8-K filed with the SEC today. (Operator Instructions)

With that, I will now hand the call over to Rami.

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### **Rami Rahim** - Juniper Networks, Inc. - CEO and Director

Thank you, Kathleen. Good afternoon, everyone. We are off to a positive start in 2017 and delivered strong year-over-year revenue and earnings growth in the March quarter. Total revenue was \$1,221,000,000, at the high end of our guidance range, and we saw year-over-year growth across all customer verticals. We delivered strong profitability metrics with year-over-year growth in non-GAAP operating margin, operating income and diluted earnings per share. We believe we are benefiting from our diversification strategy, and I'm pleased with our overall performance.

We believe the biggest trend that is driving our industry and our strategy as a company today is the cloud. As the industry evolves, cloud architectures are no longer the exclusive domain of the cloud providers. Customers across all verticals are developing strategies for moving to cloud service delivery models, and this aligns with our strategy to power the cloud transformation. I'm pleased with our year-over-year revenue growth of 25% in the cloud vertical and would point out that our cloud solutions are addressing the cloud transformation across all of our key verticals.

In the quarter, we continued to deliver on our innovation road map and announced 2 new solutions for the data center. In January, we announced Juniper Networks Unite Cloud, a transformative data center solution that gives enterprises a simplified way to create and manage hybrid multicloud environments. This solution delivers a secure and agile platform and is designed to reduce the total cost of ownership, while increasing long-term return on our investment for our customers.

At the OFC Conference in March, we introduced our data center interconnect solution Open Cloud Interconnect. This comprehensive DCI solution brings together our strengths across packet and optical domains to enable a diverse range of network operators to accelerate cloud service delivery while simplifying network operations.

Earlier this year, we were delighted and honored to receive Vodafone Group's most prestigious award for Supplier of the Year. Juniper is a strategic provider of IP routing and security technology for Vodafone, specifically for next-generation data centers, IP/MPLS backbone and mobile backhaul domains. We believe that our continued strategy to lead in network innovation in key areas such as automation, software-defined networks and network function virtualization will continue to enable our telco customers to build new and innovative business models going forward.

Now I'd like to summarize highlights across Switching, Routing and Security. In Switching, we saw continued data center strength with our QFX products family, which once again grew over 50% year-over-year and continues to increase as a percentage of our overall Switching portfolio mix. We are seeing continued traction in our QFX portfolio as customers across all vertical move to 100-gig, where we have industry-leading products.

Our Routing business grew year-over-year, driven by another strong quarter of PTX revenue growth as well as modest growth in MX. We continued to see healthy demand for our newest generation of MX line cards, which had a record shipping quarter in Q1.

Tremendous work have gone into a Security product portfolio that we are very proud of. Juniper's differentiated SDSDN strategy has been received very well by industry analysts and customers for its ability to detect and stop threats in a highly automated way. The innovative approach of viewing security as an open platform allows customers to leverage all existing security investments as well as their entire network infrastructure.



## APRIL 25, 2017 / 9:00PM, JNPR - Q1 2017 Juniper Networks Inc Earnings Call

At RSA, we announced new technology alliance partnerships with leading security providers that simplify deployment of Juniper's security solutions across several customer use cases. Our focus this year in Security is on building confidence and momentum with our partners and customers. We believe we are making good progress as evidenced by new logo wins with our newest security products. Several global trials are also underway with managed service providers using Juniper's secure cloud-managed enterprise solutions.

We saw year-over-year growth in Contrail and added several new customers in Q1, including a Tier 1 operator in Europe. There was a continued expansion of orders within our existing customer base as they increased their deployment footprint. We saw continued strength in our overall services business, which grew 14% year-over-year. I am particularly pleased with the momentum we are seeing in our professional services business, where we had a strategic win at a Tier 1 service provider in EMEA.

To summarize, we are executing well in a competitive environment and are proud of the strength in our products and services portfolio. The cloud is a massive paradigm shift that is reshaping all industries, and I'm excited about the opportunity we have in front of us. Looking at the remainder of 2017, we expect overall demand to be seasonal and believe our customer diversification is positioning us for growth as we navigate through volatile markets.

I want to thank our customers, partners and shareholders for their continued support and confidence in Juniper. I also want to extend a very big thank you to our employees for their commitment and hard work, which plays a significant role in successfully executing to our strategy and creating value for all of our stakeholders.

With that said, I will turn the call over to Ken, who will review our quarterly financial results in more detail.

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### **Kenneth Bradley Miller** - Juniper Networks, Inc. - CFO and EVP

Thank you, Rami, and good afternoon, everyone. The results for the March quarter reflect strong year-over-year revenue and earnings per share growth. From a revenue perspective, all verticals increased year-over-year led by cloud, which increased 25%. We continued to see strong growth in our QFX product family, which grew over 50% year-over-year. We continued to see strength from our Services business, which grew 14% year-over-year driven by strong renewal and attach rates, as well as a recognition of previously deferred revenue from a telecom customer in Asia Pacific.

In reviewing our top 10 customers for the quarter, 4 were cloud, 5 are telecom or cable and 1 was a strategic enterprise. Of these customers, 2 were located outside of the United States.

Non-GAAP gross margin was within our guided range for the quarter. While non-GAAP service gross margin was strong year-over-year, non-GAAP product gross margin declined 2.2 percentage points. The year-over-year decrease was primarily due to customer mix as we expand our footprint with certain strategic APAC telecom and cloud customers, as well as the product mix sold into our cloud vertical. The decrease was partially offset by improvements in our cost structure and higher revenue volume.

Non-GAAP operating expenses were \$509 million, below our guided range for the quarter, reflecting our ongoing disciplined operating expense management. The year-over-year increase was primarily due to headcount costs related to acquisitions completed in fiscal 2016 and higher variable compensation. Non-GAAP earnings per share increased \$0.09 year-over-year, driven by higher revenue.

We had particularly strong cash flows from operations of \$545 million, up \$373 million year-over-year. The increase was driven by strong collections in the quarter, partially related to invoicing that occurred late last quarter. As expected, DSO rebounded and was 49 days. The reduction was primarily due to improved invoicing linearity this quarter. We continued to return capital to our shareholders, repurchasing \$125 million of shares and paying \$38 million in dividends during the first quarter.

Now I'd like to provide some color on our guidance, which you could find detailed in the CFO commentary available on our website. We remain committed to the financial principles we outlined last quarter. As a reminder, those principles are: We expect revenue growth for 2017; we are



## APRIL 25, 2017 / 9:00PM, JNPR - Q1 2017 Juniper Networks Inc Earnings Call

focused on earnings expansion with long-term consistency; and finally, we intend to maintain a healthy balance sheet and an optimized capital structure.

Although elements of our markets are challenged, we expect to grow revenue this year. We are pleased with our product portfolio and expect to see continued strength from our cloud vertical. For the remainder of the fiscal year, we anticipate gross margin levels similar to Q1 as we expect the customer and product mix dynamics to continue. Increased pricing for certain memory components could also present an additional headwind.

We intend to drive earnings expansion this year through focused execution and operating expense discipline. We also intend to drive to our long-term model of 39% non-GAAP operating expenses as a percentage of revenue this year, which is earlier than previously committed. We intend to return approximately 50% of annual free cash flow to our shareholders, inclusive of share repurchases and dividends.

In closing, I'd like to thank our team for their continued dedication and commitment to Juniper's success. Now I'd like to open the call for questions.

### QUESTIONS AND ANSWERS

#### Operator

(Operator Instructions) And now the first question is from Jess Lubert of Wells Fargo.

#### **Jess L. Lubert** - Wells Fargo Securities, LLC, Research Division - Director and Senior Equity Analyst

First for Ken -- sorry, for Rami, the Switching business was strong. I was hoping you could help us understand the pipeline of opportunities you're seeing with the QFX line offerings? And given these products only became available over the last few quarters, is it reasonable to think the business here can further strengthen as these opportunities mature? And then for Ken, I was hoping you could touch on the gross margin outlook. You previously talked about being comfortable with 63%. It looks like we'll be trending below that level for the year. Just wanted to understand if there's been a change in the competitive environment. What gives you confidence margins won't continue to deteriorate? And longer term, do you think we can get back to 63%, 64%?

#### **Rami Rahim** - Juniper Networks, Inc. - CEO and Director

Jess, it's Rami. Let me start, and then I'll hand it over to Ken. On the Switching side, certainly, we're very pleased of the performance we saw in Q1. A big driver of that performance is in the data center and has a lot to do with the deliberate focused strategy that we've had to the data center, which certainly applies to the large cloud providers, but also other verticals as I mentioned in my prepared remarks. Pretty much every one of our customer verticals now has a set of customers that's moving towards cloud architecture. The heart of that is the data center. We've always been in this space. We've always had a solution, but I would say that we've never had a solution that is this strong and had the breadth of capabilities, both from a software standpoint but also from an entire portfolio standpoint, the spine switches with the QFX10000 as well as the top-of-racks with the 5100, the 5200s, et cetera. Do I believe that there will be continued momentum? Yes, I -- we have, in our long-term model for this company's growth, been counting on and have provided you with color on where we see our Switching business to come in. And that is going to continue to be a big growth driver for the company in the year and longer term. I will also point out that there's another element of our Switching business, which is that EX product line and that is in the campus. And although the focus has been of the data center, we're really not taking our eye off the ball in the campus side. And in fact, we have this ability to leverage technologies that we have developed primarily for the data center, think of our fabric technologies in innovative ways for the campus. And that is actually starting to help us provide some differentiation to our customers for larger campus environments. And for that reason, we actually saw some pretty good momentum in EX business which helped overall Switching in the Q1 time frame. With that, Ken, you want to talk a little bit about quarter margins?



APRIL 25, 2017 / 9:00PM, JNPR - Q1 2017 Juniper Networks Inc Earnings Call

**Kenneth Bradley Miller** - *Juniper Networks, Inc. - CFO and EVP*

Sure, sure. So the gross margin landscape is very dynamic as you know, Jess. There are many factors that impact our gross margin. Clearly, you mentioned pricing. I would say the pricing environment is always challenging. We have not seen a broad-based change in that pricing environment. Really what's impacting us in Q1 and for our outlook is really product mix and customer mix. From a customer mix perspective, we are seeing some opportunity to grow with some strategic customers in telecom and cloud, both domestically and abroad. We're taking advantage of that opportunity. That does put some modest pressure on some of our gross margins. In addition to that, from a product mix perspective, the strength that we're seeing in Switching, which is ahead of our expectations, switching within the cloud vertical in particular does have some modest pressure on our margins as well. Last but not least as it relates to our outlook, we are seeing some pricing pressure on memory. There are some memory components that are under pressure, and we expect that to be a factor for the rest of the year. From a long-term perspective, we remain focused on driving margin improvements. We continue to focus in our cost structure. As the software business picks up, we expect that to be a tailwind for our margins going forward. And obviously, our biggest driver is continuing to deliver product innovation to market and monetize that innovation. And the last thing I would say is while we are doing our best to maximize margin, we remain very focused on OpEx management and overall profitability. Our goal is to make sure that we have earnings expansion with long-term consistency, and that's what we're really focused on.

**Operator**

The next question is from Simona Jankowski of Goldman Sachs.

**Simona Kiritsov Jankowski** - *Goldman Sachs Group Inc., Research Division - MD and Senior Equity Research Analyst*

I had a follow-up on each of the questions that was just asked. So first for Rami, thank you for disclosing the cloud vertical. I did notice that there was a sequential decrease in your Routing revenues in the cloud vertical, and Routing missed expectations. So curious if that's because some of those customers are transitioning to QFX when they would have previously used routers. And do you expect your Routing business overall to grow with the cloud vertical? And then for Ken on the gross margin question, you had cited price pressure in the last 2 quarters, and this quarter that does not seem to have been a factor. So just wanted to see if that has in fact subsided. But on the flip side, when you're highlighting the [ COGS ] supplier issue and DRAM prices, is that something that you can quantify for us just so we understand the incremental impact?

**Rami Rahim** - *Juniper Networks, Inc. - CEO and Director*

Simona, I will start with the follow-up on Routing and Switching, and then I'll pass it over to Ken. So our Routing business is always dependent on large deals, large customers across the telco vertical and the cloud vertical. And for that reason, it's always been lumpy. And I think we're seeing some of that dynamic. More broadly, Routing as we all know now, as we have been talking about, we've sort of been predicting, is essentially a flattish type of overall market opportunity for Juniper and for our peers in this industry. We think that we can compete in that environment by taking some modest market share with really competitive products. That's true for telco, for enterprise, for cloud, for cable and all of our some strategic verticals. That's what's happening really in the cloud space as well. Where a lot of the growth is coming in from in the switch -- in the cloud providers is in Switching today. And we are clearly taking more than our fair share there. I think there's a -- the question underlying the question that you're asking is, is there some sort of a transition that's happening where architectures are moving from routing to switching and so on. The way I view it is that each of our key product sets, whether it be MX for programmable routing, the PTX for really lean core transport-oriented routing and the QFX for switching opportunities, they have a sweet spot. One is really targeted for the edge. One is for wide area. One is more for the data center. But even there, what happens is that the line starts to blur. And there will be some shifting, if you will, on the sort of edges of the use cases between each of these products. But those sweet spots continue to be very important and something that our customers largely respect. There will always be some level of cannibalization. But for the most part, I think the opportunity, in aggregate, with these 3 technologies under our belt is a growing opportunity.



## APRIL 25, 2017 / 9:00PM, JNPR - Q1 2017 Juniper Networks Inc Earnings Call

### **Kenneth Bradley Miller** - *Juniper Networks, Inc. - CFO and EVP*

From a pricing perspective, Simona, the pricing environment is always a challenging environment, has been for many, many years in this space. What I'd mention is we didn't see any specific broad-based deterioration beyond what we expected, right? We always expect pricing pressure, and it largely came in as we expected this quarter. What we did see though were some strategic selling insertion opportunities. I mentioned customer mix. We are definitely getting strategic in some of the international customers in particular in the telecom and cloud space. And these are customers that we're very deliberate with in regard to these deals. And we do expect margin to improve over time as our footprint expands. So that is -- does have a pricing impact. But again, it's at a very specific customer level. On the cost of memory side, it is a factor. Really the 3 factors I've mentioned that the cost per mix, the product mix and the cost of memory are all relatively weighted pretty evenly as far as our margin guidance of 62.5%, which I believe is still a pretty healthy margin guidance for the year.

### **Operator**

The next question is from Tal Liani of Bank of America.

### **Tal Liani** - *BofA Merrill Lynch, Research Division - MD and Head of Technology Supersector*

I have a question on Security and a question on dividends. Starting with dividends, you grow faster than Cisco. You take share in key markets. You generate very healthy cash flow. But your dividend yield is half that of Cisco. And the price discount -- the stock is trading at 20% discount to Cisco because of that. What's your philosophy? What's your strategy about dividend and the increase in the dividend yield? That's the first question. The second question is about Security. You have products and new dynamics, but the revenues were down 10% for the year, year-over-year. Can you discuss the outlook for 2017? What are the ups and downs? What are the puts and takes in security growth? And when do you see the inflection point of turning from declines to growth?

### **Rami Rahim** - *Juniper Networks, Inc. - CEO and Director*

Thanks, Tal. Let me start, and I'll start with the Security question. And then I'll pass it on to Ken to talk a little bit about dividends and the dividend strategy. Well first, there has been and there continues to be tremendous amount of work that's happening inside of Juniper to increase the competitiveness of our products overall, the solution in -- the solutions in security, the feature releases and the new code [ drops ] that we're making our -- coming out on a very regular basis. And the thing that gives me the confidence in our ability to stabilize and then recover and then grow this part of our business is the fact that when I look at key metrics, like the performance of new products with the newer capabilities that we have introduced into the market over the last, let's say, 6 to 9 months, there's growth there. There is in fact momentum. The feedback from our partners, our customers is positive. And there is in fact sales achievements in revenue growth that we are seeing in that part of the business. It's just not that enough to offset the decline in some of the older products. So eventually, I think the math starts to work in our favor. We need a little bit of patience and a lot more of the very hard work that I know that has gone across the entire company right now to get this back to stability and then to growth. And I expect in the second half of the year that we can get to growth. I will just point out that the big part of the focused effort right now is on rebuilding confidence, rebuilding the channel. And of course, one win at a time, including new logos that we have discussed in the Q1 time frame. I think we can get this back on track.

### **Kenneth Bradley Miller** - *Juniper Networks, Inc. - CFO and EVP*

Yes. As we've previously committed to, the 50% of free cash flow is what we're comfortable with for this year. That'll be inclusive of both share repurchases and dividends. And we'll look to be optimistic with our share buyback programs throughout the year. That said, we're always looking to optimize our capital structure. And we will reevaluate things as things change. For example, our financial performance, our cash needs as well as our valuation will all be factors into some reevaluation of our capital return program. In addition, we've obviously paid attention to what's going on with the new administration, with tax repatriation and/or tax changes. So those could be other factors that we'll have to consider when and if they come to fruition.





APRIL 25, 2017 / 9:00PM, JNPR - Q1 2017 Juniper Networks Inc Earnings Call

**Operator**

The next question is from Kulbinder Garcha of Crédit Suisse.

**Kulbinder S. Garcha** - *Crédit Suisse AG, Research Division - MD*

Can I just (inaudible) one question (inaudible) this year? For the vertical (inaudible) cloud (inaudible) enterprise, can you speak about any trends we should be aware of? For example, could the cloud business start facing difficult compares and start to decelerate? Is that something we should think about at some point as we start exiting maybe 2017 here? And then on the telco side, I think it was better than we thought. Can you just give us some details behind what drove that in Q1?

**Rami Rahim** - *Juniper Networks, Inc. - CEO and Director*

Kulbinder, it's Rami. So let me start. First of all, I think the most important thing here is diversification. It's not just about cloud, it's not just about telco. It's really about broadening and making sure that we are diversified really along 3 dimensions. First is in the technology. So it's Routing, Switching, Security. Second is in the telcos -- I'm sorry, the verticals, telcos and cloud and so forth. And then -- and also, it's about geos. So for example, we're starting to see good momentum or early momentum with the cloud providers in Europe. We're starting to see also early momentum with the cloud providers in Asia-Pacific. So that diversification strategy has paid off well for us in the last couple of years, and I expect it to continue to pay off well for us. Any one of these verticals is going to be lumpy, right? I just mentioned, for example, Routing has always been somewhat lumpy as it pertains to the cloud vertical or the telco vertical, and I would expect that to remain the same going forward. Anything you want to add, Ken?

**Kenneth Bradley Miller** - *Juniper Networks, Inc. - CFO and EVP*

No.

**Rami Rahim** - *Juniper Networks, Inc. - CEO and Director*

Okay. Thanks for the question.

**Operator**

Our next question comes from Jeff Kvaal of Instinet.

**Jeffrey Thomas Kvaal** - *Instinet, LLC, Research Division - Analyst*

A question and a clarification. I think in the past, you all had talked about 3% to 6% revenue growth as a CAGR. I'm wondering if that is something that applies to this year? And if so, what are the puts and takes to the low and high end of that range? And secondly, Ken, at one point you had sort of passed on the chance to endorse 63% as a longer-term model. But then you said you think some of the new contracts that you've won in Asia and in cloud will grow the margins over time. So I'm wondering if we continue down a little bit on that long-term model.

**Kenneth Bradley Miller** - *Juniper Networks, Inc. - CFO and EVP*

Gross margin?





APRIL 25, 2017 / 9:00PM, JNPR - Q1 2017 Juniper Networks Inc Earnings Call

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**Kathleen Nemeth**

Yes, revenue.

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**Kenneth Bradley Miller** - Juniper Networks, Inc. - CFO and EVP

Yes. So let's talk about revenue first, and I'll talk about the numbers. And then, Rami, maybe you could talk about what would put us on the high end and low end of that range. So at this point based on what we see today, we are comfortable with the 3% to 6%, which is our long-term model. In fact, I would say we're comfortable with kind of the midpoint of that range for this year. So that's really the numbers we're looking at for this year. As far as overachievement or underachievement, clearly we're seeing a lot of strength in the cloud space as well as in the Switching business. And telco and routing remains a challenging market, and we think it'll be relatively flattish for us and maybe some modest growth in that sector in those technologies. From a gross margin, again, I mean, it's dynamic. 0.5 of a margin point is difficult to get right at every quarter. I do think that we have some lumpiness in revenue as well as margin ahead. Customer mix and product mix will be up and down. The Q1 result was very much in line with our expectations and the guidance we put out there. I do think 63% for the year is not out of the question. However, I think it's prudent for us to plan the P&L and focus on earnings growth even with margin headwinds continuing. So that's really what we've been basing a lot of our guidance on now.

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**Rami Rahim** - Juniper Networks, Inc. - CEO and Director

I just want to add to that. I completely agree with everything Ken just said. When you're operating in an environment where your customer mix is changing, the technology is changing, we're seeing a geo mix change as well and in certain strategic initiatives, like penetration to the cloud, were even ahead of where we expect it to be right now, predicting gross margins can be somewhat tricky. With that said, there are a number of activities across the company right now all focused on improving gross margins. And we're running the business, as Ken just mentioned, with the assumption that current levels are going to be here for a while, just in case. So that's, I think, the way that you should think about how we're running the business and the dynamics of the industry that we operate in right now and our strategy as it pertains to those dynamics.

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**Operator**

The next question is from Rod Hall of JPMorgan.

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**Roderick B. Hall** - JP Morgan Chase & Co, Research Division - VP and Senior Analyst

I wanted to just check on cloud revenue. You guys had said I think your target was 24% of company revenue by 2019. And obviously, you've blown through that, assuming it's the same basis that we're talking about. So is it the same basis, I guess? And then if it is, what sort of longer-term target do you have for a proportion of the company revenue given the trajectory? And then along the same lines, could you talk about that cloud revenue this year? I -- the disclosure shows it sequentially increasing every quarter last year. Is that likely to be the case again this year? Can you just kind of help us understand what you expect from the trajectory there?

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**Rami Rahim** - Juniper Networks, Inc. - CEO and Director

Yes, Rod, let me start -- and I'll start with the second question, and then Ken can talk a little bit about the baseline. I know we've now just recategorized how we're reporting our numbers, so a little bit of explanation will probably be helpful. Will there be consistent sequential growth throughout the year in any vertical? Honestly, it's very difficult to predict that. Because all of our verticals, cloud included, remains -- it's going to be lumpy. The fact that we are now in both Routing and Switching in any one vertical, Security to a lesser extent, but Routing and Switching, helps to offset some of that lumpiness, but I expect that the lumpiness will exist and will remain in effect. The good news is I'm still -- I still feel very good about our ability



APRIL 25, 2017 / 9:00PM, JNPR - Q1 2017 Juniper Networks Inc Earnings Call

to compete in the cloud vertical, how close we are to our customers in the cloud vertical, our ability to understand their requirements, their architecture and the kinds of innovation that we need to put in place to participate in the cloud vertical. And on all of those counts, I feel very good.

**Kenneth Bradley Miller** - *Juniper Networks, Inc. - CFO and EVP*

Yes. And as it relates to our baseline, you have the numbers right. So we disclosed 19%, moving to 24% of our revenue. That would be a growth rate of 10% to 13%. We did recast the verticals, and the cloud vertical actually is now up a couple of points. So actually, the 19% turns to 21% of our business in 2015 was cloud, so the target would move up a couple of points as well to 26% of our business. Growth rate targets remain the same. However, we are seeing a higher pickup in the cloud than we expected. So we're clearly on outpacing those growth rates at this point in the model.

**Operator**

Our next question is from Aaron Rakers of Stifel.

**Aaron Christopher Rakers** - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

And I hate to follow up on another cloud question, but as we're now focused on that vertical and we can see the dynamics separately in your results, I'm curious if you could help us understand the concentration -- or the diversification, rather, of your customer base within that vertical? And how would you characterize your visibility in that vertical relative to your traditional service provider or enterprise vertical?

**Rami Rahim** - *Juniper Networks, Inc. - CEO and Director*

Yes. We can talk about cloud all day long, because it's a -- it really is such an important vertical for us and it's a very deliberate part of our strategy. So no problem at all, Aaron. First, when you think about the cloud opportunity, I want to emphasize again that it really touches every vertical that -- I'm talking about the cloud opportunity all up. There are certainly those that were born the cloud, the large cloud providers. There are those that have aspiration to become cloud providers, think of the telcos and the cable operators that are now rearchitecting their networks to deliver cloud services. And then there are those enterprises that see the value in moving workloads and applications to the cloud. All of these are an element of our cloud strategy. The way in which we approach each can be -- can vary a little bit. So for example, our large cloud provider customers have an ability to do a lot of the software development on their own, but then we develop a really innovative technologies like Contrail, our SDN controller, to essentially help automate and secure cloud for the enterprise and for the telco and cable space. That's just to say that all of these verticals really apply. Now if the question is specifically around sort of our ability to predict the performance -- our performance in the cloud provider vertical itself, I think any 1 quarter -- a quarter here and there, you're going to see lumpiness, you're going to see variations in the performance just based on their appetite to spend and the -- where they are in certain projects and certain deployments. But generally speaking, when we talk to them, when we see industry reports, when we understand their own plans and we see their own performance, I mean, you see how they are performing in their respective markets, we feel good about the fact that they will continue to rely on networks as a foundation of their business and we also feel good about our ability to satisfy their networking requirements. It's a very competitive environment, but I feel very confident in our technology.

**Operator**

The next question is from Jim Suva of Citi.



## APRIL 25, 2017 / 9:00PM, JNPR - Q1 2017 Juniper Networks Inc Earnings Call

**Jim Suva** - Citigroup Inc, Research Division - Director

The majority of the Q&A has been focused on the products and the new segments, which is fair now that we're getting towards the end of the conference call. Could you touch briefly on Security? I don't think I've heard it mentioned much about how should we view the Security segment within Juniper and kind of the trajectory? It's kind of been rough last year in Security division when we look about year-over-year growth.

**Rami Rahim** - Juniper Networks, Inc. - CEO and Director

Sure, Jim. So I did mention earlier the fact that Security right now, there's quite a lot of effort that has gone into improving our products, making them competitive, differentiating in the solutions that we offer to our customers. And I think we're seeing very good momentum in -- specifically in the newer technologies and solutions we've introduced into the market. I mentioned the fact that there is a concerted effort right now in terms of go to market -- marketing, rebuilding our channels and rebuilding confidence in our customers and our partners' mind where we have, quite frankly, lost some of that confidence. That's where the effort is. The only additional thing I will say is that there are really strong synergies between Security and the rest of our portfolio. Those synergies are on the cost side, where we tend to leverage a lot of the software development as well as the silicon technology across Routing and Switching into Security. And increasingly, we're seeing, actually, very solid revenue synergies. If you think about what our SDSN, Software Defined Secure Network, strategy is all about, it's about enabling our customers to use their network infrastructure in an intelligent way to provide a secure fabric, a very secure fabric to prevent, essentially, their infrastructure, their data, they're workloads from being compromised. That is essentially enabling us to sell Security along with Routing and Switching, and the data center or in the campus. So -- I mean, that's the other really important element of how we're approaching Security that I think is important for you to understand.

**Jim Suva** - Citigroup Inc, Research Division - Director

And my follow-up, the turnaround for the sustainable revenue growth. You mentioned a lot of effort put into it. When should we see the fruit of those efforts start to bear?

**Rami Rahim** - Juniper Networks, Inc. - CEO and Director

Yes. So I think that we are -- we're in the process of stabilizing right now. The newer products are growing. The older products are declining. The math is not working for overall growth. This year, I think, is going to be a critical year for us as we get back to stability and growth probably in the latter half of the year.

**Operator**

The next question is from Vijay Bhagavath of Deutsche Bank.

**Vijay Krishna Bhagavath** - Deutsche Bank AG, Research Division - VP and Research Analyst

I have a bigger-picture question, Rami, which is Juniper and Arista are comparable in market cap now. Can you please -- I mean, my view is how would you benchmark cloud activity per employee versus your peers, such as Arista, who have significantly lower headcount versus Juniper? And then also any thoughts on exiting underperforming areas, such as Security, to just improve overall fundamentals, better allocate the resources to the more productive product portfolio?

**Rami Rahim** - Juniper Networks, Inc. - CEO and Director

Vijay, I mean, I'll just say that we understand that we operate in a competitive environment, that we have competitors that are larger, we have competitors that are smaller than us. The key to our success is to focus. And if you look at what we have done over the last couple of years, there has been an incredible amount of effort put into streamlining our business, putting our product portfolio to areas where we know that we can



APRIL 25, 2017 / 9:00PM, JNPR - Q1 2017 Juniper Networks Inc Earnings Call

invest to compete effectively. And I think we're demonstrating our ability to do just that. The new products that we have now delivered into the market space, especially in the domain of the PTX routing, in our QFX switching, in the new MX line cards that we have introduced, are all essentially doing as we expected. They're growing nicely across our key verticals. And that's what you can consider that -- that's what you can expect more from us in the future. I think there was the second part of the question that I've now forgotten.

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**Kathleen Nemeth**

(inaudible)

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**Vijay Krishna Bhagavath** - *Deutsche Bank AG, Research Division - VP and Research Analyst*

Yes. I think the second part of the question was any thoughts on exiting underperforming areas such as Security, and then putting the resource into product portfolios that are selling in the market.

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**Rami Rahim** - *Juniper Networks, Inc. - CEO and Director*

Yes, I appreciate that question. Of course, I have to always, as CEO of the company, evaluate the performance of any one of our products, technology areas and businesses. I would just say that with -- as it pertains to Security, which is I think what your question is about, the focus of this period of time is on turning around this business. The data points that we're getting from our customers, our partners are all very positive at this point. And the synergies are really good. The cost synergies and our ability to leverage technology actually enables us to achieve a differentiation and very solid efficiency in how we develop the technology underlying Security. And then there's the revenue synergies on top of that. So that's how I'm thinking about it right now.

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**Operator**

The next question is from Tim Long of BMO Capital Markets.

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**Timothy Patrick Long** - *BMO Capital Markets Equity Research - Senior Equity Analyst*

Maybe we could touch on the Services business for a minute. Talk a little bit -- it sounds like renewal and attach rates have been pretty strong for last few quarters here. Understatement, it was a catch-up in the quarter. But could you just talk a little bit about sustainability of the success there and can we expect this to keep kind of outgrowing product? And then also related to that, how we should think about gross margin leverage as that business continues to grow?

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**Rami Rahim** - *Juniper Networks, Inc. - CEO and Director*

Yes. Thanks for the question. So the Service business continues to be a highlight for us. It's a very healthy business for us. On the revenue side, the key is, what you mentioned, the attach rates, the renewal rates. And the focus there over the past several quarters is really starting to pay off as we're seeing the revenue growth consistently do well. As you mentioned, we did benefit this quarter from approximately \$15 million of revenue that came off of the balance sheet. So you now have to factor that in as you start thinking about the rest of the year. But I do expect Security, after you normalize -- I'm sorry, Services, after you normalize for that \$15 million, to be up quarter-on-quarter kind of back to our sequential patterns that we normally see in this business. From a longevity perspective, I would expect Services to outpace product but not to the same degree that it has over the last several quarters. It will eventually start to normalize closer together on a growth rate perspective. Gross margin-wise, numbers we've been posting lately, the 63% to 64%, is really what we're focused on going forward.



APRIL 25, 2017 / 9:00PM, JNPR - Q1 2017 Juniper Networks Inc Earnings Call

### Operator

The next question is from Jayson Noland of Robert W. Baird.

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**Jayson Noland** - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Ken, just a housekeeping, book-to-bill if you haven't given it. And then a broader question on Security, Rami, if you could -- the press release cites some weakness in High-End SRX, if you could talk about that a little bit. And then the opportunity in virtual SRX, it looks like you've put some marketing dollars behind that recently.

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**Rami Rahim** - *Juniper Networks, Inc. - CEO and Director*

Yes. Thanks for the question Jayson. Let me start with that, and then I'll pass it on to you, Ken. The High-End SRX is -- it addresses a market opportunity that's primarily geared towards telecom providers, especially in the mobile space. And that part of the business is just going to be lumpy. It's going to have fluctuation depending on build-out for typically Tier 1 service providers. The other thing is we have not refreshed that part of our portfolio for some time, but we're working on a road map to do so that I think will eventually contribute to that business. The virtual SRX, I mean, that's an example of how we're -- we think about our strategy on a couple of different time horizons: there is the here and now and how our customers are typically building out their security posture today, and then there is what we expect in the future. Clearly, as the perimeter around the enterprise disappears as workloads and applications move to the cloud, the security architecture has evolved and virtual security offerings become far more important. And we actually have a really differentiated virtual security solutions, the virtual SRX, that is in the market, that is gaining good traction, but it's still a small market opportunity for this period of time. It's an example of innovation that we believe will help us in the second horizon of our strategy in the sort of 2-, 3-, 4-, 5-year time frame.

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**Kenneth Bradley Miller** - *Juniper Networks, Inc. - CFO and EVP*

Yes, and -- on the book-to-bill question. As our business continues to evolve and deferred revenue grows over time, we the commentary around deferred revenue as a more meaningful demand metric, so we've decided not to disclose book-to-bill anymore on a quarterly basis. We will be disclosing backlog on an annual basis going forward in addition to the deferred revenue details.

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**Kathleen Nemeth**

And [ I should add, ] Jason, that's in line with our peers in terms of that book-to-bill metric. [ Disclosing ] that metric, yes.

### Operator

The next question is from Simon Leopold of Raymond James.

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**Simon Matthew Leopold** - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Great. A couple of things I wanted to ask. One is, in the release you talked about some -- I guess, some problems you had with a particular product and some COGS reversals. Could you elaborate a little bit on what happened there and whether or not that affected any revenue, whether it caused any delays and how you're remediating that in terms of timing? And then the thing I was trying to understand on -- back to the cloud. I'm wondering if your cloud vertical has a similar mix or how the mix compares relative to your overall? In terms of percent of revenue coming from Routing, Switching and Security, how does that mix look for the cloud vertical in particular?



## APRIL 25, 2017 / 9:00PM, JNPR - Q1 2017 Juniper Networks Inc Earnings Call

**Rami Rahim** - Juniper Networks, Inc. - CEO and Director

Well, on the -- let me start with the second one, and Ken you might need to help me with this one, Switching versus Routing mix in the cloud. Now we know that if, like I have mentioned I think a couple of times on this call, the business is going to be lumpy, and it's going to be lumpy both in Switching and in Routing. The growth -- a lot of the growth in the Q1 time frame, for example in the cloud vertical, came in Switching. But in the past, there were quarters where it has actually come in more in the Routing. In terms of mix, we had -- I don't know if we've provided that detail.

**Kenneth Bradley Miller** - Juniper Networks, Inc. - CFO and EVP

Yes, so historically, what we talked about is the cloud vertical mix was largely in line with the Juniper overall mix -- so Routing Switching, Security. As Juniper goes, the cloud vertical is largely mirroring that. As we're seeing more success in Switching, we are seeing some of that mix shift towards Switching faster in that vertical than some of the other verticals.

**Simon Matthew Leopold** - Raymond James & Associates, Inc., Research Division - Research Analyst

That's exactly what I was looking for.

**Kenneth Bradley Miller** - Juniper Networks, Inc. - CFO and EVP

I believe what you're referring to...

**Rami Rahim** - Juniper Networks, Inc. - CEO and Director

Okay, great.

**Simon Matthew Leopold** - Raymond James & Associates, Inc., Research Division - Research Analyst

Yes. No, and then on the -- yes.

**Kenneth Bradley Miller** - Juniper Networks, Inc. - CFO and EVP

I'm sorry. On the cost of goods sold information, sorry, on the GAAP results, I think you're talking about a supplier component remediation costs that we had, and it actually started in Q4. Well, we are working with our customers and a third-party supplier. Certain products are -- have a clock signal component defect. This is just kind of an industry-wide, fairly well- situation. We did take the charge in Q4 and we tried up that charge this quarter. We do believe we're handling it very effectively with our customer base and managing through the situation.

**Simon Matthew Leopold** - Raymond James & Associates, Inc., Research Division - Research Analyst

And has that affected your revenue at all? Have you pushed out any sales because of that? That was what I was trying to get at.

**Kenneth Bradley Miller** - Juniper Networks, Inc. - CFO and EVP

No, no. It does not have impact on revenue. It's really more about a proactive approach we're taking to make sure it doesn't have an impact on customers from a quality perspective. We have not seen any actual cloud issues to date, but we want to make sure we avoid those going forward. And it has not had any impact on revenue.



APRIL 25, 2017 / 9:00PM, JNPR - Q1 2017 Juniper Networks Inc Earnings Call

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**Operator**

The next question is from Mitch Steves of RBC Capital Markets.

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**Mitch Steves** - *RBC Capital Markets, LLC, Research Division - Associate*

I'm just kind of wondering kind of the QFX family, I know it was up 50% this quarter and year-over-year. How do we think about the [ refresh ] cycle there, and how long should this kind of outsized growth last?

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**Rami Rahim** - *Juniper Networks, Inc. - CEO and Director*

Yes, thanks for the question, Mitch. It's honestly very difficult to answer the question, just because the volume of customers that we now have that are buying QFX is from across all verticals is very large. And I don't know if you can really put any patterns to it. The one pattern I would -- sort of out there is just the 100-gig adoption. Where there are large data center deployments that require 100-gig connectivity, that's where Juniper just differentiates even more. This is where the density of our products, our routing stack, the logical scale of our QFX technology, starts to really stand out. And for that reason, if you look at our Switching growth, especially as it pertains to the data center over the last few years, have been quite good. Now if you narrow your analysis and you look specifically on market share in the over 10-gig connectivity space, there, we're taking market share even faster. And that's just, again, because of the fact that where there are high-performance networking problems to be solved, we tend to just stand out among our peers in the industry.

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**Operator**

Our next question is from Mark Moskowitz of Barclays.

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**Mark Alan Moskowitz** - *Barclays PLC, Research Division - Research Analyst*

Just a quick clarification here. Did you guys comment on the cloud with respect to is it accretive to the model from a gross margin or operating margin perspective? Just kind of curious if gross margin is lower, but maybe on the operating margin side is better? And then my actual question is, Rami, I want to get a sense here. Just given the greater transparency around the cloud business and the better momentum, is this why back in early March, you announced the extended organizational focus related to R&D with Kevin and Andy? Does this mean -- does this really mean you need to have a little more focus in terms of servicing your legacy customers, but also your cloud customers from a technology road map perspective longer term?

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**Rami Rahim** - *Juniper Networks, Inc. - CEO and Director*

Yes, sure. Let me start on the organizational piece. I don't think I would view this from the standpoint of it being specific to any one vertical. I have -- I just reached the conclusion that having a flatter organization will result in an ability to execute with more consistency, to move faster with fewer layers in the organization, to address what is a very dynamic market opportunity. As it pertains to the cloud provider themselves, we have sort of understood the recipe for how to succeed there for quite a long period of time, where it really has to be an engagement model that is at the engineer-to-engineer level. Now we are connected with them on a first-name basis down throughout the entire organization. And that's really what's required to achieve the necessary understanding of the direction of their architecture and what has enabled us to be successful.

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**Kenneth Bradley Miller** - *Juniper Networks, Inc. - CFO and EVP*

Yes, from a cloud vertical margin perspective, I would just state that from a gross margin perspective that the primary driver within the cloud vertical would be product mix, not the cloud vertical itself. So as it shifts more towards Switching, which is what we're seeing now and what we



APRIL 25, 2017 / 9:00PM, JNPR - Q1 2017 Juniper Networks Inc Earnings Call

kind of expect to see for the rest of the year, that would have a detriment to the telco vertical as an example, which is predominantly Routing. But it's not because of the customer itself, it's really more the product mix going into that vertical. From an operating margin perspective, we really don't take the operating margin down to vertical. Most of our costs, most of our OpEx is really shared across all our verticals, we don't segregate it between vertical. So you would see the same -- if you were to allocate it out, you would see a similar profile in the margins, in the gross margin, because everything is will be relatively equally and revenue proportionate. And I would say, although it is -- as it shifts to Switching, you are seeing some margin pressure there, it's very healthy margins. We're very comfortable with the cloud vertical and the mix within the cloud vertical. And the fact that we are ahead of schedule in some of our transitions into the high-performance Switching into that vertical, and that's really a good thing overall.

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### Operator

Our final question comes from James Faucette of Morgan Stanley.

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**James Eugene Faucette** - *Morgan Stanley, Research Division - Executive Director*

Most of my questions have been answered, so a couple of longer-term strategic questions. First, how do think about -- back to questions Simona asked earlier in the call about the ability to choose between Switching and Routing. How do you think about the opportunity for things like virtual Routing, et cetera? And how does that [ attach ] to the strategy? And then the second thing is in terms of use of capital, where does your acquisition strategy stand today? Or how does that fit within your use of capital? And then my last question just on operating expenses obviously, you've continued to control those very well. How should we think about the development of OpEx going forward?

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**Rami Rahim** - *Juniper Networks, Inc. - CEO and Director*

Thanks, James. Your voice was kind of choppy, so I hope that I got the questions all correctly. You can tell me if I didn't. First in virtual routing, and I will extend that to include virtual routing, virtual security, there is certainly an element of our -- of the networking industry all up that can be addressed with virtual technology as opposed to just hardware. Typically, these are going to be more service oriented. They're going to be at the edge of the network. It's very difficult to solve a large core opportunity or a data center spine opportunity with just software or just virtual products. And that obviously is where Juniper has excelled historically. It's where our differentiation mostly had existed in the past. Having said that, as the world moves towards cloud architectures and our customers have the ability to deliver services, using a cloud service delivery model, that presents an opportunity for us to start to offer virtual versions of our products, like virtual security being an example of that. It's specifically going to be for more scale-out type of applications. Think of the CPE space, where the physical CPE business is a -- has generally been a small revenue generator for Juniper. Now as the industry transitions to a virtual equivalent model to the CPE space, we view this in fact as a great opportunity for us to go and to participate in. From an M&A standpoint, no new news there, other than we continue to look at M&A strategically as a way of accelerating the strategy that we have talked to you about in the past and we're executing on today. So we don't want to -- we're not looking at this to get into adjacent markets. We want to look at this from a standpoint of really accelerating a strategy that we're existing -- we are operating in today. And then last but not least is on the operational expenditures, Ken, I'll let you close on that.

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**Kenneth Bradley Miller** - *Juniper Networks, Inc. - CFO and EVP*

Yes. So we're very pleased with our Q1 OpEx results, which came in below the guidance despite the annual reset of variable compensation and kind of typical seasonal patterns and fringe costs. We've very, very happy with our performance. We are targeting 39% of OpEx as a percentage of revenue for the year, which is aligned with our long-term target, but actually ahead of schedule. So we're also very pleased with that OpEx discipline going forward. We're always looking to drive efficiencies. But it's beyond efficiencies. We're also looking to make sure we align our workforce to our long-term strategy and make sure that we're able to deliver growth going forward as well. So we believe we can accomplish all of those objectives while keeping R&D expansion in mind throughout the way.



## APRIL 25, 2017 / 9:00PM, JNPR - Q1 2017 Juniper Networks Inc Earnings Call

**Kathleen Nemeth**

Thanks, James. And unfortunately, that is all the time we have today. We'd like to thank each of you for your participation, and we look forward to speaking with you next quarter.

**Operator**

Ladies and gentlemen, this does conclude today's teleconference. You may disconnect your lines at this time, and thank you for your participation.

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