



Priming the Pump for Supercomm

TLAB is Our Proxy for What Is Good and Bad in Telecom These Days

Supercomm, Nextcomm or whatever it is called these days, is only two weeks away. More than any other conference, this one makes me reminisce for the good ol' days of telecom. Remember the booth babes, magicians, and acrobats of yesteryear? They are mostly a distant memory now (along with my big bonuses). Although these wildly good times are behind us, it is also becoming clear that this year's show will also signal that the worst times are also behind the telecom equipment group as well.

Because the wireless folks have their own shows, Supercomm focuses much more on wireline themes. Our view is that this year's show will feature:

1. FIOS and other fiber-to-the-home (FTTH) architectures
2. ROADMs (and tunable lasers)
3. The sudden resurgence of the long haul networks

We now discuss these three themes in some detail.

FTTH and ROADMs: Long Term Potential & Near Term Pricing Pressures

Tellabs (TLAB) remains a good proxy for the long-term potential mixed in with the near-term margin issues faced by those companies levered to the first two items on this list: FTTH and ROADMs. As the incumbent provider for Verizon's OTP (Optical Transport Protocol?) network build-out, TLAB is likely to benefit, at least on the top line, from this new, optical add-drop technology. This new ROADM product area is one of two major sources of margin pressure for TLAB (with the other being competitive pressure from ALU on FTTH). Despite these two sources of margin pressure, we have decided to make a bet on TLAB here with the intent of buying more on dips. Our view is that although the company will have trouble up-siding the EPS number, their assets have become fairly strategic thus increasing the likelihood that someone will want to buy the company. (In our mind, Cisco makes for the best fit but that company typically does not do acquisitions that large).

In addition to TLAB's takeover prospects, the CFO has been hinting lately that a large buyback may be in the works. Lastly, it would not be a shock to us if VZ rethinks the size of their FTTH build out early next year – we read the tealeaves are suggesting a more aggressive approach than the 18 million homes passed over 5 years to which they have already committed. Likely, a bigger goal may be in the cards given the higher than expected take rates they have enjoyed in their early deployments. Of course, we stand a



descent chance of being embarrassed if the company has to lower EPS guidance due to the margin pressures we have discussed. Based in part on this building margin pressure, TLAB saw two downgrades this past week resulting in some weakness in the stock as shown in Figure 1. We are prepared to buy more, however, if this contingency arises as we have only a half a bet on TLAB.



Figure 1: TLAB 5-Day Chart

ADCT's good results are the latest in a long string of positive indicators for FTTH. Folks, I think FTTH is here to stay and may likely become a worldwide phenomenon. Frankly, we are much less sanguine about the prospects for FTTC alternatives like the one AT&T is pushing. We worry that if AT&T ever decides to move more towards an architecture like VZ's, there is a chance for a 6 month disruption to the supply chain. Even though such a move would likely benefit TLAB in the long run, any pause will likely hurt in the near term. Still, we do not sense any *mia culpa* coming from AT&T regarding its choice of architecture until next year at the earliest.



Long Haul Demand Finally Returns After a 7-Year Hiatus

Intuitively (and through gentle but firm misguidance from the global media), I somehow had got it into my head these past few months that the resurgence of demand for long haul has been driven by video (that whole YouTube thing). But reading some of my peer's research recently has embarrassed me into realizing that while video remains an important driver, it has been the recent decrease in price of 10Gb/s interfaces for datacenters that has been the biggest driver for the resurgence of long haul transmission equipment. Even though this demand is likely sustainable for several more quarters, I have begrudgingly sold my CIEN stock following strong numbers and even better guidance. This decision was based entirely on valuation.



Figure 2: CIENA One-Month Chart

Conclusion

If you would like to meet me at Supercomm or want me to stop by your booth, please drop me an email at csarkar@balistes.com. I will be at the show on Wednesday and Thursday.