

NASDAQ:AAOI Q2 2025 Earnings Call Transcript

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Conference Operator | Operator:

Good afternoon. I will be your conference operator. At this time, I would like to welcome everyone to Applied Optoelectronics Second Quarter 2025 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speaker's remarks, there will be a question and answer session. To ask a question, you may press star, then 1 on your telephone keypad. To withdraw your question, please press star, then 2. To request operator assistance during the call, please press star then zero. Please note that today's event is being recorded. I will now turn the call over to Lindsay Savarese, Investor Relations for Applied Optoelectronics. Ms. Savarese, you may begin.

Lindsay Savarese | Investor Relations, Applied Optoelectronics:

Thank you. I'm Lindsay Savarese, Investor Relations for Applied Optoelectronics. I'm pleased to welcome you to AOI's second quarter 2025 financial results conference call. After the market closed today, AOI issued a press release announcing its second quarter 2025 financial results and provided its outlook for the third quarter of 2025. The release is also available on the company's website at ao-inc.com. This call is being recorded and webcast live. A link to the recording can be found on the investor relations section of the AOI website and will be archived for one year. Joining us on today's call is Dr. Thompson Lin, AOI's founder, chairman, and CEO, and Dr. Stephan Murray, AOI's chief financial officer and chief strategy officer. Thompson will give an overview of AOI's Q2 results, and Stephan will provide financial details and the outlook for the third quarter of 2025. A question and answer session will follow our prepared remarks. Before we begin, I would like to remind you to review AOI's safe harbor statement. On today's call, management will make forward-looking statements. These forward-looking statements involve risks and uncertainties, as well as assumptions and current expectations, which could cause the company's actual results, levels of activity, performance or achievements of the company or its industry, that differ materially from those expressed or implied in such forward-looking statements. In some cases, you can identify forward-looking statements by terminology, such as believes, forecasts, anticipates, estimates, suggests, intends, predicts, expects, plans, may, should, could, would, will, potential, or think, or by the negative of those terms or other similar expressions. that convey uncertainty of future events or outcomes. The company has based these forward-looking statements on its current expectations, assumptions, estimates and projections. While the company believes these expectations, assumptions, estimates and projections are reasonable, such forward-looking statements are only predictions and involve known and unknown risks and uncertainties, many of which are beyond the company's control. Forward-looking statements also include statements regarding management's beliefs and expectations related to the expansion of the reach of its products into new markets and customer responses to its innovations, as well as statements regarding the company's outlook for the third quarter of 2025. Except as required by law, AOI assumes no obligation to update these forward-looking statements for any reason after the date of this earnings call. to conform these statements to actual results or to changes in the company's expectations. More information about other risks that may impact the company's business are set forth in the Risk Factors section of AOI Reports on File with SEC, including the company's annual report on Form 10-K and quarterly reports on Form 10-Q. Also, all financial results and other financial measures discussed today are on a non-GAAP basis unless specifically noted otherwise. Non-GAAP financial measures are not intended to be considered in isolation or as a substitute for results prepared in accordance with GAAP. A reconciliation between our GAAP and non-GAAP measures, as well as a discussion of why we present non-GAAP financial measures, are included in the company's earnings press release that is available on AOI's website. Before moving to the financial results, I'd like to note that the date of AOI's third quarter 2025 earnings call is currently scheduled for November 6th, 2025.

Now, I would like to turn the call over to Dr. Thompson Lin, AOI founder, chairman, and CEO. Thompson?

Dr. Thompson Lin | Founder, Chairman and Chief Executive Officer:

Thank you, Lindsay, and thank you for joining our call today. While EPS came in below our expectations, primarily due to elevated operating expense, The inherent strength of our business fundamentals was apparent with strong year-over-year timeline growth and cost margin expansion. The rise in our operating expense is a direct result of strategy investment in R&D and SG&A expense, driven by increased business activity, including new customer qualification efforts for 800G and 1.6T As you can see from our results as well as some of our recent announcements, these expenditures are already translating into higher level of customer engagement, certifications, and ultimately revenue opportunities. During the quarter, we saw steady growth in our data center business. we complete our fourth volume shipment of high-speed single-mode 400G data center transceiver to recently engage major hyperscale customers. And we are seeing increased sequential demands for other hyperscalers for this product as well. We continue to make progress on customer qualification on our 800G product, and we continue to have confidence in the second half range in 800G sales. In our CATV business, we continue to see strong demand in this market, and we announced that we completed testing and certification with charters for plans to deploy our 1.8 GHz amplifiers and quantum NIMH remote management software. During the second quarter, we delivered revenue of \$103 million which was in line with our guidance range of \$100 million to \$110 million. We recorded non-GAAP gross margin of 30.4%, which was in line with our guidance range of 29.5% to 31%. Our non-GAAP loss per share of 16 cents was below our guidance range of a loss of 9 cents to a loss of 3 cents. due to larger than anticipated operating expense, as I mentioned earlier. Total revenue for our data center product of \$44.8 million increased 30% year-over-year and 40% sequentially, largely due to increased demand for our 100G and 400G products. Revenue for our 100G product increased 25% year-over-year while revenue for our 400G product increased 43% year-over-year. Total revenue in our CATV segment of \$56 million increased more than 8 times year-over-year. In line with our expectations, our CATV revenue decreased 13% sequentially of a seasonally strong Q1. and as we do two-world production to our Motorola-style amplifier products. With that, I will turn it over to Stephen to review the details of our Q2 performance and our Q3 study.

Dr. Stephan Murray | Chief Financial Officer and Chief Strategy Officer:

Thank you, Thompson. As Thompson mentioned, while EPS came in below our expectations primarily due to elevated operating expenses, The inherent strength of our business fundamentals was apparent with strong year-over-year top-line growth and gross margin expansion. The rise in our operating expenses is a direct result of strategic investments in R&D and SG&A expenses driven by increased business activity, including new customer qualification efforts for 800G and 1.6 terabit transceivers. As you can see from our results, as well as some of our recent announcements, These expenditures are already translating into higher levels of customer engagement, satisfaction, and ultimately revenue opportunities. In Q2, we delivered revenue of \$103 million, which was in line with our guidance range of \$100 million to \$110 million. We recorded non-GAAP gross margin of 30.4%, which was in line with our guidance range of 29.5% to 31%. Our non-GAAP loss per share of \$0.16 was below our guidance range of a loss of \$0.09 to a loss of \$0.03. This bottom line miss was due to higher than expected operating expenses in the quarter, mainly stemming from additional R&D and SG&A expenses in support of new customer opportunities. R&D expenses were up \$2.6 million compared to Q1. due mostly to increases in project expenses like prototypes and samples, which tend to be directly correlated with near-term revenue generation. As we've discussed in prior quarters, as customer demand for new products emerge or timelines get pulled in, R&D expenses necessarily increase to support the product customization and qualification efforts necessary to realize revenue from these new opportunities. In addition to R&D, SG&A costs also increased by \$2.5 million compared to Q1, which is mostly due to increased shipping costs as we imported certain products ahead of tariff increases and supported shipping of samples and prototypes to customers, along with expenses from the OFC trade show in April. Notably, tariffs were not a material factor to our income statement in Q2. Overall OPEX was also

unfavorably impacted by the rapid strengthening of the Taiwan dollar in the quarter. Slightly under 10% of the increase in OPEX was due to this currency fluctuation. Notably, we have recently seen some weakening of the NTD, so we believe the impact on Q3 will be muted. Our performance continues to be driven by strength in both our data center and CATV businesses, underscoring the strategic value of our diversified revenue streams. Our focused efforts on the key initiatives we set in motion over the past couple of years are translating into tangible business momentum and the long-term strength of our business. We've remained focused on enhancing the company's resilience, broadening our manufacturing capabilities, deepening customer engagement, strengthening supply chain diversity, and scaling our production capacity. During the quarter, we saw steady growth in our data center business. We completed our first volume shipment of high-speed, single-mode 400G data center transceivers to a recently re-engaged major hyperscale customer, marking the first significant shipments to this customer in several years. This milestone supports our expectations for increased transceiver sales in the second half of the year, driven by growing demand and ongoing U.S.-based capacity expansion. We also saw a notable increase in 400G demand from other customers as well. Also, as a reminder, the vast majority of our 400G business is for single-mode transceivers, which carry higher ASP and gross margin than is typical of short-reach transceivers based on multi-mode optics. We continued to make progress on customer qualifications on our 800G products. During the quarter, one of our major hyperscale customers completed an extensive audit of our factory in Taiwan and approved this factory for 800G production. This was a positive step forward, and we're approaching what we believe are the final stages for securing 800G product qualification. And we believe the factory qualification demonstrates their intent to move forward with our products. We continue to believe that we will produce meaningful shipments of 800G products sometime in the second half of 2025, likely in late Q3 or Q4. The schedule is constrained by our ability to build and qualify production capacity. We believe that the demand for 800G is strong, and we expect that when our production is ready, we will see a fairly quick ramp in revenue for 800G. While immaterial to our overall revenue, we did record some revenue for the second quarter in a row for our 800G products related to deliveries for customer qualification activity. In our CATV business, we continued to see strong demand in Q2. On our past several earnings calls, we have discussed the continued shipments of our 1.8 GHz amplifiers for one of our major MSO customers. Our recent press release gives additional details on our 1.8 GHz amplifier deployments with Charter, who has been a valued, long-standing customer of ours. Early in the quarter, we completed testing and certification with Charter for our 1.8 GHz amplifiers and QuantumLink remote management software. We also recently announced plans for deployment of these products in Charter's network. Our products are designed to help them continue to deliver the capacity and speeds that their customers need and expect. We shipped a significant quantity of 1.8 GHz amplifiers to Charter in the quarter, and demand continues to be robust. In addition to Charter, we have six other MSO customers who have already begun to order and deploy our 1.8 GHz products or are in various stages of qualification of these products. We are very excited to see the broad-based appeal of our amplifiers and QuantumLink software across our potential customer base. Feedback from customers has been that our amplifiers are game-changing in terms of performance, ease of setup, and control and monitoring capabilities. And we feel very good about our prospects with these six customers, in addition to our very strong position with Taro. During the second quarter, tariffs had less than a \$1 million impact on our income statement. While tariff developments continue to evolve, one thing remains certain. Products manufactured in the U.S. are not subject to tariffs. This makes having a cost-effective domestic production a strategic advantage. As it relates to tariffs, also as I mentioned on our Q1 earnings call, while we do utilize some imported components in our transceivers, many key components, like our laser chips, are already manufactured in the U.S. Importantly, in our 800G and 1.6 terabit transceiver designs, less than 10% of the value of the components used is currently sourced from China, and we have a pathway as we scale production to further reducing this China content, ultimately to near zero. We also are in discussion with several key suppliers about onshoring their production to the U.S. to support a robust domestic supply chain. As part of our strategic efforts during the second quarter, we made good progress on adding production capacity for 800G and higher transceivers at our existing facility in Texas. This initiative was part of the strategic plan we outlined earlier this year at OFC for adding production capacity for 800G and higher transceivers in both our US and Taiwan factories. We remain on track to achieve the targets that we laid out. As a reminder, we expect this will culminate later this year with what we believe will be the largest domestic

production capacity, expected to be approximately 40,000 transceivers per month, or roughly 40% of our overall capacity for these advanced 800G optical transceivers. It's important to note that we will be able to accommodate this expansion in our current Texas facility footprint. This initial US based production is currently on track for beginning production later this summer. Equipment has begun to arrive for this expansion and bring up is ongoing. Further, by mid 2026, we continue to expect to be able to produce over 200,000 pieces per month, with the majority produced in Texas. Just to reiterate, We currently have three manufacturing sites, one here in Sugar Land, Texas, where our headquarters is, one in Ningbo, China, and one in Taipei, Taiwan. As you may have heard me say at OFC, we expect to increase total production of 800G and 1.6 terabit products by eight and a half times by the end of the year, and we are dedicated to achieving this goal. During the quarter, We are pleased to have received a 10-year, \$2 million incentive from the City of Sugar Land, Texas Office of Economic Development for the onshoring of our manufacturing as we look to expand our manufacturing footprint in the area. Having achieved this economic incentive package, this opens the door for us to finalize these negotiations and begin construction. We also made continued progress in outfitting our Taiwan facility for increased production, as I mentioned earlier. One of our potentially largest customers recently qualified this facility for production of 800G after having previously qualified it for 400G production. With the factory qualified for both 400G and 800G, we currently expect that this customer could become a greater than 10% customer in Q3. As I mentioned on our last earnings call, we signed an agreement to lease an additional building in Taiwan late last year, which we began outfitting in Q1, and which we continued to outfit further in Q2 in order to increase production of our 100G, 400G, and 800G data center transceivers and CATV products there. Turning to our second quarter results, our total revenue was \$103 million, which more than doubled year over year and increased 3% sequentially off a strong Q1, and was in line with our guidance range of \$100 million to \$110 million. During the second quarter, 54% of revenue was from CATV products, 44% was from data center products, with the remaining 2% from FTTH, telecom, and other. In our data center business, Q2 revenue came in at \$44.8 million, which was up 30% year-over-year and 40% sequentially. Sales of our 100G products increased 25% year-over-year while sales for our 400G products increased 43% year-over-year. In the second quarter, 70% of data center revenue was from 100G products, 20% was from 200G and 400G transceiver products, and 9% was from 10G and 40G transceiver products. Looking ahead to Q3, we expect a sequential increase in our data center revenue driven by continued growth in our 100G and 400G products with the possibility of layering some additional increased 800G revenue late in the quarter. In our CATV business, CATV revenue in the second quarter was \$56 million, which was up more than eight times year-over-year and, in line with our expectations, was down 13% sequentially from a record Q1. This significant year-over-year increase is due to the continued ramp in orders for our 1.8 GHz amplifier products. As we explained on our last earnings call, we expected a modest pullback sequentially in CATV revenue as we retooled production to our Motorola-style amplifier products. As I mentioned earlier, we are pleased to have completed testing and received certification for both our Motorola and GameMaker-style amplifiers from Charter Communications and announced their plans to deploy our 1.8 GHz amplifiers and QuantumLink remote management software. As a reminder, Dicom International continues to play an important role in supporting the end-to-end experience for ongoing installations as we utilize their logistics services to continue to support our products. Looking ahead to Q3, we expect record or near-record revenue in our CATV business. Now turning to our telecom segment. Revenue from our telecom products of \$1.9 million was down 34% year-over-year and 18% sequentially. As we have said before, we expect telecom sales to fluctuate from quarter to quarter. For the second quarter, our top 10 customers represented 98% of revenue, up from 94% in Q2 of last year. We had two greater than 10% customers, one in the CATV market, which contributed 54% of total revenue, and one in the data center market, which contributed 34% of total revenue. In Q2, we generated non-GAAP gross margin of 30.4%, which was in line with our guidance range of 29.5% to 31%, and was up from 22.5% in Q2 2024, and compared to 30.7% in Q1 2025. The year-over-year increase in our gross margin was driven primarily by our favorable product mix, including growth in our CATV revenue, as well as growth of our newer generation data center products. Looking ahead, we continue to expect that our gross margin will improve as we see the impact of manufacturing efficiencies in our CATV production and improving product mix. We remain committed to our long-term goal of returning our non-GAAP gross margin to around 40% and continue to believe that this goal is achievable. Total non-GAAP operating expenses in the second quarter were \$42.1 million, or 41% of

revenues, which compared to \$26 million, or 60% of revenue, in Q2 of the prior year. While operating expenses increased this quarter, as I discussed at length earlier, the rise is a direct result of strategic investments in R&D and G&A expenses driven by increased business activity. Looking ahead, we expect non-GAAP operating expenses to be in the range of \$41 million to \$44 million per quarter. Non-GAAP operating loss in the second quarter was \$10.8 million, compared to an operating loss of \$16.2 million in Q2 of the prior year. GAAP net loss for Q2 was \$9.1 million, or a loss of 16 cents per basic share, compared with the GAAP net loss of \$26.1 million, or a loss of 66 cents per basic share, in Q2 of 2024. On a non-GAAP basis, net loss for Q2 was \$8.8 million, or 16 cents per share, which compared to our guidance range of a loss of \$4.8 million to a loss of \$1.7 million, or non-GAAP income per share in the range of a loss of 9 cents to a loss of 3 cents. This compares to a non-GAAP net loss of \$10.9 million, or 28 cents per basic share in Q2 of the prior year. The basic shares outstanding used for computing the earnings per share in Q2 were \$56.8 million. For the full year, we continue to expect achieving positive non-GAAP net income is possible. Turning now to the balance sheet, we ended the second quarter with \$87.2 million in total cash, cash equivalents, short-term investments, and restricted cash. This compares with \$66.8 million at the end of the first quarter of 2025. We ended the quarter with total debt, excluding convertible debt, of \$54.3 million, compared to \$46.1 million at the end of last quarter. Post-quarter, we announced a new revolving loan facility with BOK Financial of \$35 million, which we intend to use to meet some of our working capital needs going forward. As of June 30, we had \$138.9 million in inventory, which compared to \$102.3 million at the end of Q1. The increase in inventory is almost entirely due to purchases of raw materials to be used in production of our products over the next several months. During the quarter, we completed our ATM program, which raised \$98 million net of commissions and fees. As we have discussed previously, we intend to use these proceeds to continue to make investments in the business, including new equipment and machinery for production and research and development use, including the earlier mentioned production expansion in Texas. We made a total of \$38.8 million in capital investments in the second quarter, which was mainly used for manufacturing capacity expansion for our 400G and 800G transceiver products. On our last couple of earnings calls, we have discussed our plans to make sizable CapEx investments over the next several quarters as we prepare for increased 400G, 800G, and 1.6 terabit data center production in 2025. For the year, we continue to expect between \$120 million and \$150 million in total capex. While these costs could be impacted from the tariffs, given the evolving nature, it is difficult to predict what type of impact or by how much. Notably, we source equipment from all over the world, including both from domestic and international locations. We will continue to do our best to minimize any impacts. It remains evident that U.S.-based production is a priority for our customers, and we are fully committed to building out this capacity. Moving now to our Q3 outlook. We expect Q3 revenue to be between \$115 million and \$127 million, accounting for a modest sequential increase in CATB revenue as well as a sequential increase in data center revenue. We expect non-GAAP gross margin to be in the range of 29.5% to 31%. Non-GAAP net income is expected to be in the range of a loss of \$5.9 million to a loss of \$2 million and non-GAAP earnings per share between the loss of 10 cents per share and a loss of three cents per share using a weighted average basic share count of approximately 62.3 million shares. With that, I will turn it back over to the operator for the Q&A session.

Conference Operator | Operator:

Operator?

Conference Operator | Operator:

We will now begin the question and answer session. To ask a question, you may press star then one on your telephone keypad. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star then two. At this time, we will pause momentarily to assemble the roster.

Conference Operator | Operator:

And our first question will come from Ryan Koontz of Needham.

Conference Operator | Operator:

Please go ahead.

Ryan Koontz | Analyst, Needham & Company:

Great. Thanks for having me on, and congrats on a nice quarter. Can we start with cable TV? How are you feeling about customer inventories? For a while there, you were capacity constrained. Are you still looking to expand that in your conversion over to the Motorola housings? And lastly, do you still have plans to enter the node market? Any rough timing on when that might happen? Thank you.

Dr. Stephan Murray | Chief Financial Officer and Chief Strategy Officer:

Yeah, great questions, Ryan. Thanks for asking. So relative to, let's see, the first question is relative to our capacity. We're not exactly switching to the Motorola. That's a little bit of a misstatement there. We're producing both Motorola and GameMaker. In the quarter, though, we'd already produced a significant quantity of GameMaker, so we needed to produce enough inventory of Motorola. to have both products available as our customers' needs evolve. So we've pretty much completed the inventory build-out on those two, and now we're going to be sort of managing both of those platforms going forward. So we will continue to have production of both Motorola and GameMaker moving forward. As we mentioned in our prepared remarks a minute ago, we do expect to see some modest sequential increase in the cable TV business. So we continue to ship those amplifier products, both platforms, as well as the QuantumLink software and some of the accessories that go with it, as we mentioned in our prepared remarks. With respect to the Node, yeah, we do expect to have the Node product launching in Q4. And, you know, it will take some time, as with the amplifiers, to go through the qualification process. But I do expect that to be generating revenue, if not in Q4, certainly by Q1. I think I answered all your questions if I didn't.

Ryan Koontz | Analyst, Needham & Company:

That's great. Then quickly, flipping to data center, on the 800-plus transceivers, how many engagements do you have there with Tier 1s on the 800-plus?

Dr. Thompson Lin | Founder, Chairman and Chief Executive Officer:

I would say right now we have a minimum of three, the Tier 1 potential pickups. And right now the good news is I think we'll start volume manufacturing either in this quarter or next quarter. But more importantly, it's 1.6T. I think we expect to start volume manufacturing maybe around June, July next year. I think that's really good news for us because we've been working with several customers for 1.6T. So right now, I think we've got two, three series of engagements. Not only for sampling, but we are talking about some kind of volume manufacture in Q2, Q3. That's why we really need to increase the capacity in Taiwan, especially in the United States.

Dr. Stephan Murray | Chief Financial Officer and Chief Strategy Officer:

And, Ryan, just to emphasize what we said before, just to be clear, the production capacity that we're building for 800 gig will also work for 1.6. It's a combination of both. So, you know, all the production expansion activity that we're undergoing now can be used for either of those platforms.

Dr. Thompson Lin | Founder, Chairman and Chief Executive Officer:

Yeah, the only difference is just the equipment. So it's 1.6T to 1G per laptop. But 400G and 800G can be shared, too, because they are all 100G per lambda. So right now, the information equipment for assembly can be shared. 400G, 800G, or 1 by 60. The only difference is testing between 100G to 200G per reference. That's it.

Ryan Koontz | Analyst, Needham & Company:

Gotcha. Helpful. Thanks so much, Thompson. Thanks, guys. Appreciate it.

Conference Operator | Operator:

Thank you.

Conference Operator | Operator:

The next question comes from Simon Leopold of Raymond James. Please go ahead.

Simon Leopold | Analyst, Raymond James:

Great. Thank you for taking the question. The first thing I wanted to ask you about was the level of vertical integration you've achieved within the data center business. And where this is going is I think at one point you were sourcing, buying EML lasers from others and had been ramping your own production or plans to ramp. Just want to get a better understanding of, one, are you doing EMLs or silicon photonics? And, two, are you insourced or outsourced, and what's the trajectory of insourcing?

Dr. Stephan Murray | Chief Financial Officer and Chief Strategy Officer:

Sure. So the answer to that first question, you know, are we doing EMLs or silicon photonics, is we're doing both platforms. We do have our own production capacity for EMLs. but we also do buy e-mails externally. We've talked about this in the past as well, but just to reiterate, most of our customers require us to have multiple sources. Even if one of those sources is internal, we're usually required to have a second source as well, which you can imagine is prudent for risk management purposes. So not everything is insourced, but we're insourcing what we can based on our customer commitments. And again, the silicon photonics, the lasers that are used there are CW lasers. We also produce those in-house as well. And I think I answered your question there. Did you have another one, Simon?

Dr. Thompson Lin | Founder, Chairman and Chief Executive Officer:

I forgot the second one. Let me add a few more points. One, I think we are increasing all the high-power CW lasers for silicon photonics to maybe 2.5 million lasers per month by sometime next year. So right now, we're in-house capacity is 100G EML. We should have 200G EML sometime soon in next year. For sure, the high-power laser for signal photonics and VEXO. The other new project is a 200G photo detector. So this is all manufactured, 1% in Houston. Now, VEXO will be manufactured by our partner in Taiwan. The other is we have one new project is to develop special signal photonics with our big hospital. For sure, we don't do signal photonics, but we involve the design, the testing, the assembly. Yeah.

Simon Leopold | Analyst, Raymond James:

Where I was trying to go with the question was to try to get a better sense of one of the elements to help the gross margin move towards that long term of 40. So, What I was trying to tease out in this question was the degree that you're outsourcing today versus a change towards more vertical integration in the future as a lever for gross margin improvement. So maybe the question's off base, and maybe I'm going down the wrong path. More bluntly, what will help the gross margin improve?

Dr. Thompson Lin | Founder, Chairman and Chief Executive Officer:

Yeah, I think the key is this way. Right now we're doing two-inch wafers. But we go to 3-inch wafer, the cost will reduce by, I don't know, 50%, 60%. Then we go to 4-inch wafer by end of next year. This is a major, much bigger cost saving than what you are talking about. I think right now, yes, we are only maybe using 30% to 40% of our lasers. But we are using, I would say, two-thirds of our laser, okay? It's... But it will depend on customer by customer. Some customers prefer older AR lasers. Some customers prefer 50-50. So that's why it's different. But more important is the cost sound of AR laser change from 2-inch to 3-inch to 4-inch.

Simon Leopold | Analyst, Raymond James:

That's really, really helpful. And then I want to follow up on the cable TV side. You've talked to us about production capacity on data center. and I'm just wondering whether or not we need a better understanding of your production capacity, if there are constraints on cable TV. And the other aspect is just understanding whether – I assume you've got visibility into channel inventory, because I think when customers deploy your amplifiers, you would know when they're turned up. I believe that's the case. I'm just trying to get a sense of how much of your – revenue is perhaps not deployed yet and somewhere in the channel just to assess the risk of slowing from a channel buildup. Thank you.

Dr. Stephan Murray | Chief Financial Officer and Chief Strategy Officer:

Right. So let me touch on one thing real quick, kind of the tail end of your last question regarding gross margin expansion, and it relates to the cable TV business as well. There is still significant cost savings that we expect to achieve over the next few quarters in the cable TV business. That business is not yet hitting its gross margin targets, but we have a pathway to get there. The other thing that will help on the cable TV side relative to gross margin is a greater impact on software. As part of our revenue mix software will come in with a significantly higher. You know gross margin Level so a couple other things to add on the gross margin line even though that's sort of a follow on to your previous question Regarding the manufacturing capacity for cable TV. We're pretty much I've said this before I mean we're pretty much at the level that we expect to be at our goal is with cable TV production is really to kind of match what we see all of our customers' aggregate demand being, and we're more or less there. We had a little bit of a pullback last quarter. As we retooled, we're expecting a sequential increase this quarter, and that's about the same level that we were at the prior

quarter. So we're kind of at that level right now. Regarding channel inventory, you know, yes, we do have a pretty clear line of sight into what the customer is using. You know, we're very comfortable with the level of inventory that we have. And as we discussed in our prepared remarks, it's not just one customer that we have. We have multiple customers now that are buying these products. And, you know, we have a number of other customers in the pipeline. As we talked about, we have six different customers that are either buying or you know, in various stages of qualification of the products right now. So, you know, we're pretty comfortable with the inventory that we have in the channel. It is substantial, but it's in line with our customer's demand in aggregate.

Dr. Thompson Lin | Founder, Chairman and Chief Executive Officer:

And, Simon, let me add a few more points. So, going now, next year we are very comfortable. We should have more than 10 customers next year. And going now, based on the feedback from this customer, I think the real demand from this customer next year is, I would say minimum \$300 million to \$350 million. And because the shipping is by ship, so usually it takes more than six, seven weeks. That's why we need inventory in the U.S. because the customer demand is like three to five days. So we can say we got an order that we manufacture in Taiwan, and then shift here, it will easily take two, three months. It doesn't work for this cable TV industry, okay? So that's the purpose to meet the customer demand. But really, the demand is pretty big, all right? Just next year, that's the number we see right now, \$300 to \$350 million, real demand, all right, for this customer in, I would say, U.S., Canada, all right?

Conference Operator | Operator:

Great. Really appreciate you taking all the questions.

Conference Operator | Operator:

The next question comes from Michael Genovese of Rosenblatt. Please go ahead.

Michael Genovese | Analyst, Rosenblatt Securities:

Thanks very much. So on the prepared remarks, there was a lot of talk about qualification activity, 400 and 800G. It sounds like with this customer who should become a 10% customer in the third quarter and beyond, I guess I just wanted to ask, and then somebody else asked about sort of engagement with other Tier 1s. But I just wanted to ask sort of very specifically if there's qualification activity going on at 400G and above with other customers besides that one that I think you spoke a lot about on the call.

Dr. Stephan Murray | Chief Financial Officer and Chief Strategy Officer:

Absolutely. 100% yes. All three of those that Thompson mentioned earlier are in qualification at various stages.

Michael Genovese | Analyst, Rosenblatt Securities:

And are those all existing customers or anybody brand new to the company?

Dr. Stephan Murray | Chief Financial Officer and Chief Strategy Officer:

Those are all existing customers. I want to be sure that we're not mischaracterizing this. We also have a number of engagement with smaller Tier 2 operators as well. So it's not just like those are the only customers that we have, but all three of those customers are existing customers. Yeah, it's not really Tier 2.

Dr. Thompson Lin | Founder, Chairman and Chief Executive Officer:

It could be Tier 1. Depending on where you draw the line. I know, because based on the investment they announced, the next year it could become Tier 1, Tier 2.

Michael Genovese | Analyst, Rosenblatt Securities:

Okay, great. And then I'm on the guide for the cable TV to be sort of near an all time high in in three queue is does that is that more than one customer? Or is that, you know, still to the the primary customer only?

Dr. Stephan Murray | Chief Financial Officer and Chief Strategy Officer:

More than one customer?

Michael Genovese | Analyst, Rosenblatt Securities:

Yeah, great. And I just want you know, I think my question might have been answered on the last question, but I just want to verify that I heard it correctly. Was that \$300 to \$350 million that Thompson was talking about, that's a cable TV revenue target for 2026? Is that correct? Yes.

Dr. Thompson Lin | Founder, Chairman and Chief Executive Officer:

But this is only Charter. The Charter plus more than 10 are the customers.

Michael Genovese | Analyst, Rosenblatt Securities:

Right. And any sense of how much of that is, you know, I imagine the large majority of that's amplifiers, but is there any significant amount of nodes in there?

Dr. Stephan Murray | Chief Financial Officer and Chief Strategy Officer:

There should be some no business as well, but we haven't broken that out for you.

Michael Genovese | Analyst, Rosenblatt Securities:

And then I thought Simon's questions about the gross margins were super helpful. But I guess now I'm just wondering about the timing maybe of, you know, not all the way to 40%, but maybe like mid-30s. Is there any kind of timing expectation you'd want to set there, or is it like a one quarter at a time wait and see?

Dr. Stephan Murray | Chief Financial Officer and Chief Strategy Officer:

No, I mean, I think, you know, our guide right now, as you can see, is kind of consistent around 30%. It's going to take us a couple quarters to see a bigger impact from 800G business and the impact of some of the cost reduction efforts and increased software revenue that we talked about on the cable TV side. So a few quarters to get, you know, kind of the next uptick in gross margin.

Dr. Thompson Lin | Founder, Chairman and Chief Executive Officer:

Yeah, I would say maybe Q2 or Q3, especially Q. As you see, the bond is picking up very strongly in the next quarter, every quarter. Then 1.60, I said we'll start valuing in, I would say, June, July next year. And KWTP growth rate will improve too. So I would say, yeah, Q2, Q3 next year. But our target is 40%. So we hope we could be there by next year or early 2027. That's our target.

Michael Genovese | Analyst, Rosenblatt Securities:

Okay, perfect. I'll pass it on. Thanks again. Thank you.

Conference Operator | Operator:

Once again, if you would like to ask a question, please press star, then one. And our next question will come from Dave Kang of B. Riley FBR. Please go ahead.

Dave Kang | Analyst, B. Riley FBR:

Yes, thank you. Good afternoon. First question is regarding receivables. So they went up, what, like \$50 million, over \$50 million last quarter, first quarter, and now it's another approximately \$40 million. Can you go over the dynamics, why receivables are going up? I'm assuming that's related to cable TV customers?

Dr. Stephan Murray | Chief Financial Officer and Chief Strategy Officer:

I mean, a lot of it is. Receivables are going up because business is going up, right? We more than doubled our revenue over last year, so naturally receivables are going to go up as well. We talked about the dynamic as well, but because we wanted to get some of the cable TV products in particular into the country and ready to be staged, ready for customer acceptance, we have offered some extended payment terms to certain customers in that channel chain to be able to accommodate that additional amount of revenue so that it's here when the customers need it. So, I mean, that's the story. Increased revenue, slightly larger payment terms equals increased receivables.

Dave Kang | Analyst, B. Riley FBR:

Got it. And then just a question on gross margin. Can you talk about the difference between transceiver versus a cable TV? Right now you're at 30%. Maybe what the difference is, and then your long-term 40%, what the margins will be for cable TV and transceivers?

Dr. Stephan Murray | Chief Financial Officer and Chief Strategy Officer:

Yeah, so cable TV right now is kind of in the low to mid 30% range. And obviously the transceivers are below, you know, 30% at this point, so that they average out to be around 30%. I think we can get, I mean, we've been pretty consistent that our expectation for gross margin in cable is to get above 40%. And we think we can achieve that. So that's where that is heading. With respect to the transceivers, again, mid to upper 30% is, I think, where it can be, such that we can blend out to around 40%.

Dr. Thompson Lin | Founder, Chairman and Chief Executive Officer:

Especially the 1.6T, the cost of margin should be more than 40%. The A under G should be close to 40%. That's why we say the cost margin should be 35% to 40% by the end of next year.

Dave Kang | Analyst, B. Riley FBR:

Got it. And my last question is regarding that major customer qualifying your facility. So what's left for, I guess, when companies say our 400 gig, 800 gig products are qualified, what else is left, I guess? And how long does it typically take between facility qualification versus product qualification?

Dr. Stephan Murray | Chief Financial Officer and Chief Strategy Officer:

Right. So 400G is already qualified. We talked about the first volume shipments occurring this quarter. I mean, last quarter, the quarter that we're reporting on Q2. So that's already happened. 800G, there's really not much that has to happen. But as we discussed in our prepared remarks, we have to have production capacity available for 800G, meaningful production capacity available for 800G. before, you know, there's any need for them to give us the green light to go ahead and produce. We're pretty close to that right now. You know, we outlined our targets at OFC, and we're sticking to that. We're tracking pretty well to those targets. So really what has to happen is we've got to have enough production capacity to be able to accept meaningful orders for them to finish the qualification.

Dr. Thompson Lin | Founder, Chairman and Chief Executive Officer:

So basically, and so I think this quarter, this customer may maybe become 10% customer. And by Q4, I would say 400G may become our biggest revenue creator for data center, bigger than 100G in Q4. So you can see how fast the 400G revenue is coming up in these years. But for sure, the 800G will become the biggest contribution to by, I would say, Q2 next year, for sure Q3. So you can see overall how fast the revenue, and revenue is not going down, okay? Don't take me wrong. I'm saying 100G will stay the same amount, but 400G will be so strong in Q3, Q4, and Q4, 400G will become the biggest, even bigger than 100G. But at the same time, by Q2, Q3 next year, AIG will be even bigger than 400G, okay? That's my point.

Conference Operator | Operator:

Got it. Thank you.

Conference Operator | Operator:

At this time, we have no further questions, and I will turn the call over to Dr. Thompson Lin for closing remarks.

Dr. Thompson Lin | Founder, Chairman and Chief Executive Officer:

Again, thank you for joining us today. As always, we want to extend a thank you to our investors, customers, and employees for your continued support. As we discussed today, we believe the fundamental driver of long-term demand of our business remains robust, and we are in a unique position to contribute. drive value from this opportunity. We look forward to seeing many of you at upcoming investor conference. Thank you.

Conference Operator | Operator:

The conference has now concluded. Thank you for attending today's presentation and you may now disconnect.