SOUTHSIDE BANCSHARES INC
Form 10-Q
August 07, 2009

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2009

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ____________ to ____________

Commission file number 0-12247

SOUTHSIDE BANCSHARES, INC.
(Exact name of registrant as specified in its charter)

TEXAS	75-1848732
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1201 S. Beckham, Tyler, Texas	75701
(Address of principal executive offices)	(Zip Code)

903-531-7111
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer x
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

The number of shares of the issuer's common stock, par value $1.25, outstanding as of July 24, 2009 was 14,894,253 shares.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(in thousands, except share amounts)

ASSETS	June 30, 2009	December 31, 2008
Cash and due from banks	$45,205	$64,067
Interest earning deposits	3,824	557
Federal funds sold	-	2,150
Total cash and cash equivalents	49,029	66,774
Investment securities:		
Available for sale, at estimated fair value	216,869	278,378
Held to maturity, at cost	1,493	478
Mortgage-backed and related securities:		
Available for sale, at estimated fair value	1,052,318	1,026,513
Held to maturity, at cost	240,704	157,287
Federal Home Loan Bank stock, at cost	39,476	39,411
Other investments, at cost	2,064	2,065
Loans held for sale	6,069	511
Loans:		
Loans	1,016,967	1,022,549
Less: allowance for loan loss	(18,804)	(16,112)
Net Loans	998,163	1,006,437
Premises and equipment, net	46,062	42,722
Goodwill	22,034	22,034
Other intangible assets, net	1,280	1,479
Interest receivable	14,570	16,352
Deferred tax asset	3,208	2,852
Other assets	49,938	36,945
TOTAL ASSETS	$2,743,277	$2,700,238
LIABILITIES AND EQUITY		
Deposits:		
Noninterest bearing	$375,312	$390,823
Interest bearing	1,321,223	1,165,308
Total Deposits	1,696,535	1,556,131
Short-term obligations:		
Federal funds purchased and repurchase agreements	20,391	10,629
FHLB advances	80,512	229,385
Other obligations	3,962	1,857
Total Short-term obligations	104,865	241,871
Long-term obligations:		
FHLB advances	609,838	655,489
Long-term debt	60,311	60,311
Total Long-term obligations	670,149	715,800

Other liabilities	88,878	25,347
TOTAL LIABILITIES	2,560,427	2,539,149
Off-Balance-Sheet Arrangements, Commitments and Contingencies (Note 12)		
Shareholders' equity:		
Common stock - $1.25 par, 40,000,000 shares authorized, 16,656,514 shares issued in 2009 and 15,756,096 shares issued in 2008	20,821	19,695
Paid-in capital	145,301	131,112
Retained earnings	40,109	34,021
Treasury stock (1,762,261 and 1,731,570 shares at cost)	(23,545)	(23,115)
Accumulated other comprehensive loss	(392)	(1,096)
TOTAL SHAREHOLDERS' EQUITY	182,294	160,617
Noncontrolling interest	556	472
TOTAL EQUITY	182,850	161,089
TOTAL LIABILITIES AND EQUITY	$2,743,277	$2,700,238

The accompanying notes are an integral part of these consolidated financial statements.

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SOUTHSIDE BANCSHARES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)
(in thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Interest income				
Loans	$17,882	$17,767	$36,195	$36,063
Investment securities – taxable	289	390	608	1,070
Investment securities – tax-exempt	1,379	1,160	2,873	1,978
Mortgage-backed and related securities	16,075	12,020	32,479	23,993
Federal Home Loan Bank stock and other investments	48	214	152	476
Other interest earning assets	54	24	80	91
Total interest income	35,727	31,575	72,387	63,671
Interest expense				
Deposits	5,686	7,868	12,058	18,623
Short-term obligations	1,170	1,839	2,335	5,139
Long-term obligations	6,416	3,973	13,302	6,644
Total interest expense	13,272	13,680	27,695	30,406
Net interest income	22,455	17,895	44,692	33,265
Provision for loan losses	3,417	2,947	7,007	5,186
Net interest income after provision for loan losses	19,038	14,948	37,685	28,079
Noninterest income				
Deposit services	4,417	4,667	8,452	9,084
Gain on sale of securities available for sale	5,911	3,660	19,707	5,752
Total other-than-temporary impairment losses	-	-	(5,627)	-
Portion of gain (loss) recognized in other comprehensive income (before taxes)	(537)	-	4,190	-
Net impairment losses recognized in earnings	(537)	-	(1,437)	-
Gain on sale of loans	547	847	882	1,312
Trust income	574	619	1,137	1,212
Bank owned life insurance income	736	758	1,037	1,068
Other	745	736	1,529	1,561
Total noninterest income	12,393	11,287	31,307	19,989
Noninterest expense				
Salaries and employee benefits	10,460	8,806	20,944	17,519
Occupancy expense	1,565	1,427	2,983	2,815
Equipment expense	414	329	789	641
Advertising, travel & entertainment	494	496	1,003	960
ATM and debit card expense	361	304	660	592
Director fees	166	147	312	291
Supplies	206	206	418	383
Professional fees	455	353	1,085	787
Postage	192	182	380	366
Telephone and communications	363	257	644	515

FDIC Insurance	1,925	232	2,461	468
Other	1,687	1,594	3,126	3,299
Total noninterest expense	18,288	14,333	34,805	28,636
Income before income tax expense	13,143	11,902	34,187	19,432
Provision for income tax expense	3,255	3,223	9,401	5,159
Net income	9,888	8,679	24,786	14,273
Less: Net income attributable to the noncontrolling interest	(511)	(148)	(1,264)	(196)
Net income attributable to Southside Bancshares, Inc.	$9,377	$8,531	$23,522	$14,077
Earnings per common share – basic	$0.63	$0.59	$1.59	$0.97

Change in fair value of contingent consideration					(13,807)
Total operating expenses	289,152	313,603	429,054	864,061	819,320
Income (loss) from operations	(31,371)	48,666	21,873	(579,231)	(321,819)
Interest and other income, net	50,245	76,483	36,762	9,487	3,917
Interest expense	(24,165)	(26,996)	(12,927)	(7,406)	(18,619)
Realized loss due to impairment of marketable debt investments		(13,013)	(5,101)		
Loss on cost method investments				(5,328)	
Gain on extinguishment of debt	7,052		932		4,948
Gain on equity investments, net	215	592			
Income (loss) before income taxes	1,976	85,732	41,539	(582,478)	(331,573)
Provision (benefit) for income taxes	1,381	2,944	2,645	(1,324)	1,941
Net income (loss)	$ 595	$ 82,788	$ 38,894	$ (581,154)	$ (333,514)
Basic net income (loss) per common share	$ 0.01	$ 0.97	$ 0.44	$ (6.37)	$ (3.58)
Diluted net income (loss) per potential common share	$ 0.01	$ 0.87	$ 0.42	$ (6.37)	$ (3.58)
Weighted average basic common shares outstanding	83,840	85,525	89,146	91,167	93,103
Weighted average dilutive potential common shares outstanding	85,011	99,604	110,605	91,167	93,103

Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

This report contains statements that discuss future events or expectations, projections of results of operations or financial condition, changes in the markets for our products and services, or other forward-looking information. Our forward-looking information is based on various factors and was derived using numerous assumptions. In some cases, you can identify these forward-looking statements by words like may, will, should, expects, plans, anticipate believes, estimates, predicts, intends, potential or continue or the negative of those words and other compara words. You should be aware that these statements only reflect our current predictions and beliefs. These statements are subject to known and unknown risks, uncertainties and other factors, and actual events or results may differ materially. Important factors that could cause our actual results to be materially different from the forward-looking statements are disclosed throughout this report, particularly under the heading Risk Factors in Item 1A of Part I of

this annual report. You should review these risk factors for a more complete understanding of the risks associated with an investment in our securities. We undertake no obligation to revise or update any forward-looking statements.
The following discussion and analysis should be read in conjunction with our Selected Consolidated Financial Data and consolidated financial statements and notes thereto included elsewhere in this annual report.

Overview

We are a provider of communications networking equipment, software and services that support the transport, switching, aggregation and management of voice, video and data traffic. Our Packet-Optical Transport, Packet-Optical Switching and Carrier Ethernet Service Delivery products are used, individually or as part of an integrated solution, in networks operated by communications service providers, cable operators, governments and enterprises around the globe.

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We are a network specialist targeting the transition of disparate, legacy communications networks to converged, next-generation architectures, optimized to handle increased traffic volumes and deliver more efficiently a broader mix of high-bandwidth communications services. Our communications networking products, through their embedded software and our network management software suites, enable network operators to efficiently and cost-effectively deliver critical enterprise and consumer-oriented communication services. Together with our comprehensive design, implementation and support services, our networking solutions offering seeks to enable software-defined, automated networks that address the business challenges, communications infrastructure requirements and service delivery needs of our customers. Our customers face a challenging and rapidly changing environment that requires their networks be robust enough to address increasing capacity needs from a growing set of consumer and business applications, and flexible enough to quickly adapt to execute new business strategies and support the delivery of innovative, revenue-creating services. By improving network productivity and automation, reducing network costs and providing flexibility to enable differentiated service offerings, our networking solutions offering creates business and operational value for our customers.

Acquisition of Nortel Metro Ethernet Networks Business (the MEN Acquisition)

On March 19, 2010, we completed our acquisition of substantially all of the optical networking and Carrier Ethernet assets of Nortel s Metro Ethernet Networks business (the MEN Business). In accordance with the agreements for the acquisition, the $773.8 million aggregate purchase price was subsequently adjusted downward by $80.6 million based upon the amount of net working capital transferred to us at closing. See Issuance of Convertible Notes during fiscal 2010 below for information relating to our election to pay the aggregate purchase price in cash. As a result, we paid $693.2 million in cash for the purchase of the MEN Business.

In connection with the acquisition, we entered into an agreement with Nortel to lease the Lab 10 building on Nortel s Carling Campus in Ottawa, Canada (the Carling lease) for a term of ten years. The lease agreement contained a provision that allowed Nortel to reduce the term of the lease, and in exchange, we would receive a payment of up to $33.5 million. This amount was placed into escrow by Nortel in accordance with the acquisition agreements. The fair value of this contingent refund right was determined by Ciena to be $16.4 million and was recorded as a reduction to the consideration paid, resulting in a purchase price of $676.8 million. See Item 2 of Part I of this report for more information regarding the terms of the Carling lease and Nortel s recent announcement regarding the exercise of its early termination feature under the Carling lease, which resulted in a non-cash, unrealized gain of $13.8 million during the fourth quarter of fiscal 2010.

Rationale for MEN Acquisition

The MEN Business that we acquired is a leading provider of next-generation, communications network equipment, with a significant global installed base and a strong technology heritage. The MEN Business is a leader in high-capacity 40G and 100G coherent optical transport technology that enables network operators to seamlessly upgrade their existing 2.5G and 10G networks, thereby enabling a significant increase in network capacity without the need for new fiber deployments or complex re-engineering. The product and technology assets that we acquired include Nortel s:

- long-haul optical transport portfolio;
- metro optical Ethernet switching and transport solutions;
- Ethernet transport, aggregation and switching technology;
- multiservice SONET/SDH product families; and
- network management software products.

In addition to these hardware and software solutions, we also acquired the network implementation and support service resources related to the MEN Business.

We believe that the MEN Acquisition represents a transformative opportunity for Ciena. We believe that this transaction strengthens our position as a leader in next-generation, converged optical Ethernet networking and will

accelerate the execution of our corporate and research and development strategies set forth in Item 1 Business in Part I of this annual report. We believe that the additional geographic reach, expanded customer relationships, and broader portfolio of complementary network solutions derived from the MEN Business allow us to better compete with traditional, larger network equipment vendors. As a result of the MEN Acquisition, we added approximately 2,000 employees, including significant additional engineering talent, which nearly doubled our headcount. We expect that the resulting increased scale to our business will enable additional operating leverage and provide an opportunity to optimize our research and development investment toward next-generation technologies and product platforms.

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Integration Activities and Costs

We continue to make progress on integration-related activities in connection with the MEN Acquisition. We have completed our organizational structure, sales coverage plans, and decisions regarding the rationalization of our combined product portfolio. As described in Restructuring Activities below, we have also realized initial operating synergies from the MEN Acquisition. Significant and complex additional integration efforts remain, including the rationalization of our supply chain, third party manufacturers and facilities, the execution of our combined product and software development plan, and our reduced reliance upon and winding down of transition services currently being provided by an affiliate of Nortel.

Given the relative size of the MEN Business and the structure of the MEN Acquisition as an asset carve-out from Nortel, the integration of the MEN Business has been costly and complex. As of October 31, 2010, we have incurred $101.4 million in transaction, consulting and third party service fees, $8.5 million in severance expense, and an additional $12.4 million, primarily related to purchases of capitalized information technology equipment. We have also incurred inventory obsolescence charges and may incur additional expenses related to, among other things, facilities restructuring. We anticipate that we will incur approximately $58.0 million in additional integration costs during fiscal 2011. Any material delays or difficulties in integrating the MEN Business or additional, unanticipated expense may harm our business and results of operations.

In addition to the integration costs above, we incurred significant transition services expense during fiscal 2010, and expect to continue to incur significant expense into the second quarter of fiscal 2011. Transition service costs are reflected as a component of operating expense, principally general and administrative expense, and cost of goods sold. We are currently relying upon an affiliate of Nortel to perform certain critical operational and business support functions during an interim integration period that will continue until we can perform these services ourselves or locate another provider. These support services include key finance and accounting functions, supply chain and logistics management, maintenance and product support services, order management and fulfillment, trade compliance, and information technology services. These services are estimated to cost approximately $94.0 million per year, were we to utilize all of the transition services for a full year. The actual transition service expense will depend upon the scope of the services that Ciena utilizes and the time within which we are able to complete the planned transfer of these services to internal resources or other providers. We have also incurred and expect to continue to incur additional costs as we build up internal resources, including headcount, facilities and information systems, or engage alternate third party providers, while we simultaneously rely upon and transition away from these transition support services. The wind down and transfer of critical transition services, which we expect to complete in the second quarter of fiscal 2011, is a complex undertaking that presents a number of operational risks that could adversely affect our business and results of operations.

Effect of MEN Acquisition upon Results of Operations and Financial Condition

Due to the relative scale of its operations, the MEN Acquisition has materially affected our operations, financial results and liquidity. Our revenue and operating expense have increased materially compared to periods prior to the MEN Acquisition. As a result of the MEN Acquisition, we recorded $492.4 million in other intangible assets that will be amortized over their useful lives and increase our operating expense. See Critical Accounting Policies and Estimates- Long-lived Assets below for information relating to these items. Under acquisition accounting rules, we revalued the acquired finished goods inventory of the MEN Business to fair value upon closing. This revaluation increased marketable inventory carrying value by approximately $62.3 million, of which $48.0 million was recognized in cost of goods sold during fiscal 2010, adversely affecting our gross margin. See Note 2 of the Consolidated Financial Statements found under Item 8 of Part II of this report. As expected, our liquidity and cash and investment balance were significantly affected by our use of cash to fund the purchase price of the MEN Acquisition and resulting acquisition and integration expense, transition service expense and investments to support working capital related to the increased scale of our business. In addition, our private placements of convertible notes during fiscal 2010 resulted in additional indebtedness. See Liquidity and Capital Resources below and Note 15 of the Consolidated Financial Statements found under Item 8 of Part II of this report for more information regarding our convertible notes. These and other effects on our financial statements described below and elsewhere in this report may make period to period comparisons difficult.

Restructuring Activities

Since the MEN Acquisition, we have undertaken a number of restructuring activities. These actions are intended to reduce operating expense and better align our workforce and operating costs with market opportunities and product development and business strategies following the completion of our MEN Acquisition. In April 2010, we took action to effect a headcount reduction of approximately 70 employees, with reductions principally affecting our global product group and global field organization outside of the EMEA region. This action resulted in a restructuring charge of $2.1 million in fiscal 2010. In May 2010, we announced our reorganization of portions of our business and operations in the EMEA region. This action resulted in a restructuring charge of $7.1 million related to the reduction in head count of approximately 82 employees principally in our global field and supply chain organizations. As we look to manage operating expense and complete integration activities for the combined operations, we will continue to assess the allocation of our headcount and other resources toward key growth opportunities for our business and evaluate additional cost reduction measures.

Issuance of Convertible Notes during fiscal 2010

On March 15, 2010, we completed a private placement of $375.0 million in aggregate principal amount of 4.0% convertible senior notes due March 15, 2015. The net proceeds from the offering were $364.3 million after deducting the placement agents fees and other fees and expenses. We used $243.8 million of the net proceeds to replace the contractual obligation to issue convertible notes to Nortel as part of the purchase price for the MEN Acquisition. The remaining proceeds were used to reduce the cash on hand required to fund the aggregate purchase price of the MEN Acquisition. On October 18, 2010, we completed a private placement $350.0 million in aggregate principal amount of 3.75% convertible senior notes due October 15, 2018. The net proceeds from the offering were approximately $340.4 million after deducting the placement agents fees and other fees and expenses. We used approximately $76.1 million of the net proceeds of the offering to repurchase in privately negotiated transactions approximately $81.8 million in aggregate principal amount of our 0.25% convertible senior notes due May 1, 2013. We intend to use the remainder of the net proceeds for general corporate purposes, which may include the repayment at maturity or further repurchase, from time to time, of a portion of our outstanding 0.25% convertible senior notes due May 1, 2013. See Note 15 of the Consolidated Financial Statements found under Item 8 of Part II of this report for more information regarding our outstanding convertible notes.

Global Market Conditions and Competitive Landscape

We continue to experience cautious customer behavior with respect to spending as a result of the sustained period of economic weakness and macroeconomic uncertainty. Broad economic weakness has previously resulted in periods of decreased demand for our products and services that have adversely affected our results of operations. We remain uncertain as to how long current macroeconomic and industry conditions will persist, the pace of recovery, and the magnitude of the effect of these market conditions on our business and results of operations.

At the same time we are experiencing challenging macroeconomic conditions, we have encountered an increasingly competitive marketplace. Competition has intensified, in part, due to our increased market share, technology leadership and global presence resulting from the MEN Acquisition. Following the MEN Acquisition, we have experienced increased customer activity and been afforded increased consideration and opportunities to participate in competition for network builds and upgrades, including in emerging geographies and new markets or applications for our products. Securing these opportunities often requires that we agree to aggressive or less favorable commercial terms and conditions, including financial commitments, that may require collateralized standby letters of credit resulting in an increase in our restricted cash. Competition has also intensified as we and our competitors more aggressively seek to secure market share, particularly in connection with new network build opportunities, and displace incumbent equipment vendors at large carrier customers. We expect this level of competition to continue and, as larger Chinese equipment vendors seek to gain entry into the U.S. market, potentially increase.

Despite challenging and competitive market conditions, we believe that a number of important underlying drivers represent significant long-term opportunities and growing demand for converged optical Ethernet networking solutions in our target markets. We believe that market trends including the proliferation of mobile web applications, prevalence of video applications and shift of enterprise applications to the cloud or virtualized environments are emblematic of increased use and dependence by consumers and enterprises upon a growing variety of broadband applications and services. These services will continue to add network traffic and consume available bandwidth, requiring our customers to invest in high-capacity, next-generation network infrastructures that are more efficient and robust, and better able to handle multiservice traffic and increased transmission rates. See Strategy set forth in Item 1 Business above in this report for information regarding our strategy and plan to capitalize on these market dynamics.

Financial Results

Revenue for the fourth quarter was $417.6 million, which represented a sequential increase of 7.2% from $389.7 million in the third quarter of fiscal 2010. Fourth quarter revenue reflects $255.6 million in revenue from the MEN Business and $162.0 million related to Ciena s pre-acquisition portfolio. Additional revenue-related details reflecting sequential changes from the third quarter of fiscal 2010 include:

Product revenue for the fourth quarter of fiscal 2010 increased by $29.0 million, reflecting a $33.0 million increase in sales of products from the MEN Business and a $4.0 million decrease in sales of Ciena s pre-acquisition products. Packet-Optical Transport revenue increased by

$40.3 million, reflecting a $31.2 million increase in sales of products from the MEN Business and a $9.1 million increase in Ciena s pre-acquisition Packet-Optical Transport products. Product revenue also reflects an increase of $5.9 million in software sales. These increases were partially offset by a $13.4 million decrease in sales of Packet-Optical Switching products and a $3.8 million decrease in sales of Carrier Ethernet Service Delivery products.

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Service revenue for the fourth quarter of fiscal 2010 decreased by $1.1 million, reflecting a $1.9 million decrease in sales of Ciena s pre-acquisition service offerings and a $0.8 million increase in service revenue from the MEN Business.

Revenue from the United States for the fourth quarter of fiscal 2010 was $210.1 million, a decrease from $229.7 million in the third quarter of fiscal 2010. This decline reflects a decrease of $30.3 million in sales of Ciena s pre-acquisition portfolio and a $10.7 million increase in sales of products and services from the MEN Business.

International revenue for the fourth quarter of fiscal 2010 was $207.6 million, an increase from $159.9 million in the third quarter of fiscal 2010. This increase reflects an increase of $32.2 million in sales of products and services from the MEN Business and $15.5 million in sales of Ciena s pre-acquisition portfolio.

As a percentage of revenue, international revenue was 49.7% during the fourth quarter of fiscal 2010, an increase from 41.0% in the third quarter of fiscal 2010.

For the fourth quarter of fiscal 2010, one customer accounted for greater than 10% of revenue, representing 15.2% of total revenue. This compares to two customers that accounted for 33.7% of revenue in the aggregate in the third quarter of fiscal 2010.

Revenue for fiscal 2010 was $1,236.6 million as compared to $652.6 million in fiscal 2009. Fiscal 2010 revenue consisted of $530.9 million from the MEN Business and $705.7 million in sales from Ciena s pre-acquisition portfolio. Fiscal 2010 revenue reflects increases of $406.5 million in Packet-Optical Transport, $127.2 million in Software and Services, and $104.0 million in Carrier Ethernet Service Delivery. These increases were partially offset by a $53.6 million decrease in Packet-Optical Switching. See Results of Operations- Fiscal 2009 compared to Fiscal 2010 below for additional information regarding annual results.

Gross margin for the fourth quarter of fiscal 2010 was 40.3%, an increase from 37.0% in the third quarter of fiscal 2010. Gross margin for the fourth quarter fiscal 2010 benefited from increased software sales. Gross margin for the third quarter was adversely affected by higher costs associated with the revaluation of acquired inventory from the MEN Acquisition described above. Gross margin for fiscal 2010 was 40.2%, as compared to 43.6% in fiscal 2009. Product gross margin was 40.9% in fiscal 2010, a decrease from 45.9% in fiscal 2009. Gross margin for fiscal 2010 reflects the adverse effect of the valuation of inventory, which resulted in a $48.0 million increase in cost of goods sold during fiscal 2010. Lower gross margin during fiscal 2010 also reflects less favorable product and geographic mix. Specifically, fiscal 2010 gross margin was adversely affected by a $53.6 million decrease in sales of Packet-Optical Switching products and geographic mix, including a higher concentration of international revenue as a percentage of total revenue.

Operating expense was $249.6 million for the fourth quarter of fiscal 2010, a slight increase from $243.6 million in the third quarter of fiscal 2010. Fourth quarter operating expense includes increased costs associated with variable sales compensation, the acceleration of certain research and development initiatives, and the build-up of internal resources in preparation for an exit from key transition services. These increased costs were partially offset by the non-cash, unrealized gain of $13.8 million related to our contingent refund right associated with the Carling lease described above. Operating expense for our third and fourth quarters of fiscal 2010 include $17.0 million and $18.1 million, respectively, in acquisition and integration-related costs associated with the MEN Acquisition. Operating expense for fiscal 2010 was $819.3 million, compared to $864.1 million in fiscal 2009. Operating expense for fiscal 2009 reflects a goodwill impairment charge of $455.7 million. Excluding the effect of this charge, the significant increase in operating expense during fiscal 2010 reflects the expanded scale of our business from the MEN Acquisition. Operating expense for fiscal 2010 also includes $101.4 million in acquisition and integration-related costs and a $74.6 million increase in amortization of intangible assets, as compared to fiscal 2009, as a result of the MEN Acquisition.

Our loss from operations was $81.2 million in the fourth quarter of fiscal 2010 and $99.6 million in the third quarter of fiscal 2010. Our loss from operations for fiscal 2010 was $321.8 million. This compares to a loss from operations of $579.2 million in fiscal 2009. Our net loss was $80.3 million, or $0.86 per share, in the fourth quarter of fiscal 2010, and $109.9 million, or $1.18 per share, in the third quarter of fiscal 2010. Our net loss for fiscal 2010 was $333.5 million, or $3.58 per share. This compares to a net loss of $581.2 million, or $6.37 per share, in fiscal 2009. Net loss and operating loss for fiscal 2009 reflect the effect of a goodwill impairment charge during the second quarter of fiscal 2009 described above.

We used $25.8 million in cash from operations during the fourth quarter of fiscal 2010. Changes in working capital provided $2.0 million and net losses (adjusted for non-cash charges) used $27.8 million. Cash used from operations includes payments of $12.7 million related to acquisition and integration-related expense and restructuring costs, of which $9.9 million was reflected in changes in working capital and $22.6 million was reflected in net losses (adjusted for non-cash charges). This compares with the use of $130.0 million in cash from operations during the third quarter of fiscal 2010, consisting of $108.9 million for changes in working capital and $21.1 million from net losses (adjusted for non-cash charges). Cash used from operations in the third quarter includes payments of $28.0 million related to acquisition and integration-related expense and restructuring, of which $8.8 million was reflected in changes in working capital and $19.2 million was reflected in net losses (adjusted for non-cash charges).

We used $229.0 million in cash from operations during fiscal 2010, consisting of $112.2 million for changes in working capital and $116.8 million from net losses (adjusted for non-cash charges). Cash used from operations includes payments of $91.7 million related to acquisition and integration-related expense and restructuring costs, of which $18.2 million was reflected in changes in working capital and $109.9 million was reflected in net losses (adjusted for non-cash charges). This compares with cash generated from operations of $7.4 million in fiscal 2009, consisting of $3.8 million in cash from net income (adjusted for non-cash charges) and cash of $3.6 million from changes in working capital.

At October 31, 2010, we had $688.7 million in cash and cash equivalents. This compares to $470.2 million in cash and cash equivalents and $0.2 million of short-term investments as of July 31, 2010.

As of October 31, 2010, headcount was 4,201, a decrease from 4,214 at July 31, 2010, and an increase from 2,163 and 2,203 at October 31, 2009 and 2008, respectively.

Results of Operations

Our results of operations for the periods in fiscal 2010 reflect the operations of the MEN Business beginning on the March 19, 2010 acquisition date. We reorganized our internal organizational structure and the management of our business upon the MEN Acquisition, and as described in Note 20 of the Consolidated Financial Statements found under Item 8 of Part II of this report, present our results of operations based upon the following operating segments:

Packet-Optical Transport includes optical transport solutions that increase network capacity and enable more rapid delivery of a broader mix of high-bandwidth services. These products are used by network operators to facilitate the cost effective and efficient transport of voice, video and data traffic in core networks, as well as regional, metro and access networks. Our principal products in this segment include the ActivFlex 6500 Packet-Optical Platform (ActivFlex 6500); ActivFlex 6110 Multiservice Optical Platform (ActivFlex 6110); ActivSpan 5200 (ActivSpan 5200); ActivSpan Common Photonic Layer (CPL); Optical Multiservice Edge 1000 series (OME 1000); and Optical Metro 3500 (OM 3500) from the MEN Business. This segment includes sales of our ActivSpan 4200® FlexSelect®Advanced Services Platform (ActivSpan 4200) and our Corestream® Agility Optical Transport System (Corestream) from Ciena s pre-acquisition portfolio. This segment also includes sales from legacy SONET/SDH products and legacy data networking products, as well as certain enterprise-oriented transport solutions that support storage and LAN extension, interconnection of data centers, and virtual private networks. This segment also includes operating system software and enhanced software features embedded in each of these products. Revenue from this segment is included in product revenue on the Consolidated Statement of Operations.

Packet-Optical Switching includes optical switching platforms that enable automated optical infrastructures for the delivery of a wide variety of enterprise and consumer-oriented network services. Our principal products in this segment include our CoreDirector® Multiservice Optical Switch, CoreDirector FS; and our ActivFlex 5400 family of Reconfigurable Switching Systems. These products include multiservice, multi-protocol switching systems that consolidate the functionality of an add/drop multiplexer, digital cross-connect and packet switch into a single, high-capacity intelligent switching system. These products address both the core and metro segments of communications networks and support key managed service services, Ethernet/TDM Private Line, Triple Play and IP services. This segment also includes sales of operating system software and enhanced software features embedded in each of these products. Revenue from this segment is included in product revenue on the Consolidated Statement of Operations.

Carrier Ethernet Service Delivery - includes the ActivEdge 3900 family of service delivery switches and service aggregation switches, as well as the ActivEdge 5100 family. These products support the access and aggregation tiers of communications networks and have principally been deployed to support wireless backhaul infrastructures and business data services. Employing sophisticated Carrier Ethernet switching technology, these products deliver quality of service capabilities, virtual local area networking and switching functions, and carrier-grade operations, administration, and maintenance features. This segment includes the metro Ethernet routing switch (MERS) product line from the MEN Business and our legacy broadband products, including our

CNX-5 Broadband DSL System (CNX-5), that transitions legacy voice networks to support Internet-based (IP) telephony, video services and DSL. This segment also includes sales of operating system software and enhanced software features embedded in each of these products. Revenue from this segment is included in product revenue on the Consolidated Statement of Operations.

Software and Services - includes our integrated network and service management software designed to automate and simplify network management and operation, while increasing network performance and functionality. These software solutions can track individual services across multiple product suites, facilitating planned network maintenance, outage detection and identification of customers or services affected by network troubles. This segment also includes a broad range of consulting and support services, including installation and deployment, maintenance support, consulting, network design and training activities. Except for revenue from the software portion of this segment, which is included in product revenue, revenue from this segment is included in services revenue on the Consolidated Statement of Operations.

Fiscal 2009 compared to Fiscal 2010

Revenue

The table below (in thousands, except percentage data) sets forth the changes in our operating segment revenue for the periods indicated:

	Fiscal Year					
	2009	%*	2010	%*	Increase (decrease)	%**
Revenue:						
Packet Optical Transport	$ 299,088	45.8	$ 705,551	57.0	$ 406,463	135.9
Packet Optical Switching	165,705	25.4	112,058	9.1	(53,647)	(32.4)
Carrier Ethernet Service Delivery	75,125	11.5	179,083	14.5	103,958	138.4
Software and Services	112,711	17.3	239,944	19.4	127,233	112.9
Consolidated revenue	$ 652,629	100.0	$ 1,236,636	100.0	$ 584,007	89.5

* Denotes % of total revenue

** Denotes % change from 2009 to 2010

Packet-Optical Transport revenue for fiscal 2010 reflects the addition of $409.6 million in revenue from the MEN Business. The addition of MEN Business revenue reflects $208.0 million of sales relating to ActivFlex 6500, largely driven by service provider demand for high-capacity, coherent transport, in support of 40G and 100G network infrastructures. Packet-Optical Transport revenue also benefited from the addition of sales from the MEN Business of $115.8 million of ActivSpan 5200, $39.1 million of CPL, $16.2 million of OM 3500, $15.5 million of legacy and other transport products and $15.0 million of ActivFlex 6110. Packet-Optical Transport revenue benefited from a $13.2 million increase in ActivSpan 4200 revenue during fiscal 2010, largely driven by metro network builds and latency sensitive applications. These increases were offset by an $11.5 million decrease in Corestream sales and a $4.8 million decrease in sales of legacy and other Packet-Optical Transport products.

Packet-Optical Switching revenue decreased reflecting a $53.6 million decline in CoreDirector revenue. Packet-Optical Switching revenue principally reflects our CoreDirector platform, which has a concentrated customer base. As a result, revenue can fluctuate considerably depending upon individual customer purchasing decisions. We believe Packet-Optical Switching product revenue was also adversely affected in fiscal 2010 by deferred customer purchasing decisions and the effect of carrier sales cycles as we effect a platform transition from CoreDirector to our next-generation, high-capacity ActivFlex 5400 family of Reconfigurable Switching Systems.

Carrier Ethernet Service Delivery revenue increased significantly, reflecting an $86.5 million increase in sales of our ActivEdge 3900 service-delivery switches and ActivEdge 5100 service aggregation switches in support of wireless backhaul deployments. Quarterly revenue for these products remains subject to fluctuation due to customer concentration and customer buying cycles. Carrier Ethernet Service Delivery revenue also benefitted from the addition of $9.6 million in sales of our MERS product from the MEN Business and an $8.2 million increase in CNX-5 sales in support of residential DSL.

Software and Services revenue increased primarily due to the addition of $86.6 million in maintenance support revenue and $20.8 million in installation and deployment services from the MEN Business. Segment

revenue also benefited from a $14.9 million increase in maintenance support revenue from Ciena s pre-acquisition portfolio and a $4.9 million increase in software revenue.

Revenue from sales to customers outside of the United States is reflected as International in the geographic distribution of revenue below. The table below (in thousands, except percentage data) sets forth the changes in geographic distribution of revenue for the periods indicated:

	Fiscal Year					
	2009	%*	2010	%*	Increase (decrease)	%**
United States	$ 419,405	64.3	$ 744,232	60.2	$ 324,827	77.4
International	233,224	35.7	492,404	39.8	259,180	111.1
Total	$ 652,629	100.0	$ 1,236,636	100.0	$ 584,007	89.5

* Denotes % of total revenue

** Denotes % change from 2009 to 2010

United States revenue increased primarily due to a $189.8 million increase in sales of Packet-Optical Transport products, principally as a result of the MEN Acquisition, a $94.1 million increase in sales of Carrier Ethernet Service Delivery products, and a $72.5 million increase in services revenue. These increases offset a $34.3 million decrease in Packet-Optical Switching revenue.

International revenue increased primarily due to a $216.7 million increase in Packet-Optical Transport revenue, principally as a result of the MEN Acquisition, a $49.8 million increase in services revenue and a $9.9 million increase in sales of Carrier Ethernet Service Delivery products. These increases offset a $19.4 million decrease in Packet-Optical Switching revenue.

While our concentration in revenue has lessened somewhat as a result of the MEN Acquisition, a sizable portion of our revenue continues to come from sales to a small number of service providers, particularly within our Packet-Optical Switching and Carrier-Ethernet Service Delivery businesses. As a result, our results are significantly affected by spending levels and the business challenges encountered by our largest customers. Moreover, our contracts do not have terms that obligate these customers to purchase any minimum or specific amounts of equipment or services. Our concentration of revenue can be adversely affected by consolidation activity among our large customers. In addition, some of our customers are pursuing efforts to outsource the management and operation of their networks, or have indicated a procurement strategy to reduce the number of vendors from which they purchase equipment. In April 2010, we were selected as a domain network equipment supplier by AT&T for its optical transport network and metro and core transport domains. Being named as a vendor in multiple technology domains under this program affords us an opportunity to forge a more collaborative technology relationship across these product platforms. Sales to AT&T were $128.2 million or 19.6% of our revenue in fiscal 2009 and $267.4 million or 21.6% of our revenue in fiscal 2010. We did not have any other customers accounting for greater than 10% of revenue in fiscal 2009 or 2010.

Cost of Goods Sold and Gross Profit

Product cost of goods sold consists primarily of amounts paid to third-party contract manufacturers, component costs, employee-related costs and overhead, shipping and logistics costs associated with manufacturing-related operations, warranty and other contractual obligations, royalties, license fees, amortization of intangible assets, cost of excess and obsolete inventory and, when applicable, estimated losses on committed customer contracts.

Services cost of goods sold consists primarily of direct and third-party costs, including employee-related costs, associated with our provision of services including installation, deployment, maintenance support, consulting and training activities, and, when applicable, estimated losses on committed customer contracts.

Gross profit as a percentage of revenue, or gross margin, continues to be susceptible to quarterly fluctuation due to a number of factors. Gross margin can vary significantly depending upon the mix and concentration of products, the mix of lower margin common equipment, geographic mix and the mix of customers and services in a given fiscal

quarter. Gross margin can also be affected by our introduction of new products, charges for excess and obsolete inventory, changes in warranty costs and sales volume. Gross margin can also be adversely affected by the competitive environment and level of pricing pressure we encounter. The combination of uncertain market conditions, recent constraints on customer capital expenditures and increased competition has resulted in a heightened customer focus on pricing and return on network investment, as customers address network traffic growth and strive to increase revenue and profit. Our exposure to pricing pressure has been most severe in metro and core applications for our Packet-Optical Transport platforms, which we expect will comprise a greater percentage of our overall revenue as a result of the MEN Acquisition. As a result, and in an effort to retain or secure customers, enter new markets or capture market share, in the past we have and in the future we may agree to pricing or other unfavorable commercial terms that result in lower or negative gross margins on a particular order or group of orders. These arrangements would adversely affect our gross margins and results of operations. We expect that gross margins will also be subject to fluctuation based on our level of success in driving cost reductions and rationalizing our supply chain and third party contract manufacturers as part of the MEN Acquisition integration activities.

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Service gross margin can be affected by the mix of customers and services, particularly the mix between deployment and maintenance services, geographic mix and the timing and extent of any investments in internal resources to support this business.

The tables below (in thousands, except percentage data) set forth the changes in revenue, cost of goods sold and gross profit for the periods indicated:

	Fiscal Year					
	2009	%*	2010	%*	Increase (decrease)	%**
Total revenue	$ 652,629	100.0	$ 1,236,636	100.0	$ 584,007	89.5
Total cost of goods sold	367,799	56.4	739,135	59.8	371,336	101.0
Gross profit	$ 284,830	43.6	$ 497,501	40.2	$ 212,671	74.7

* Denotes % of total revenue

** Denotes % change from 2009 to 2010

	Fiscal Year					
	2009	%*	2010	%*	Increase (decrease)	%**
Product revenue	$ 547,522	100.0	$ 1,009,239	100.0	$ 461,717	84.3
Product cost of goods sold	296,170	54.1	596,704	59.1	300,534	101.5
Product gross profit	$ 251,352	45.9	$ 412,535	40.9	$ 161,183	64.1

* Denotes % of product revenue

** Denotes % change from 2009 to 2010

	Fiscal Year					
	2009	%*	2010	%*	Increase (decrease)	%**
Service revenue	$ 105,107	100.0	$ 227,397	100.0	$ 122,290	116.3
Service cost of goods sold	71,629	68.1	142,431	62.6	70,802	98.8
Service gross profit	$ 33,478	31.9	$ 84,966	37.4	$ 51,488	153.8

* Denotes % of service revenue

** Denotes % change from 2009 to 2010

Gross profit as a percentage of revenue decreased due to lower product gross margins described below, partially offset by improved service gross margin.

Gross profit on products as a percentage of product revenue decreased due to a number of items relating to the MEN Acquisition that increased costs of goods sold during fiscal 2010. These items include the revaluation

of inventory described in Overview above, excess purchase commitment losses on Ciena s pre-acquisition inventory relating to product rationalization decisions, and increased amortization of intangible assets. Fiscal 2010 gross profit was also adversely affected by a lower concentration of Packet-Optical Switching revenue. These additional costs were offset by lower warranty and excess and obsolete inventory charges as compared to fiscal 2009. Gross margin for fiscal 2009 was negatively affected by a $5.8 million charge related to two committed customer sales contracts that resulted in a negative gross margin on the initial phases of the customers deployment.

Gross profit on services as a percentage of services revenue increased due to higher concentration of maintenance support and professional services as a percentage of revenue, and improved operational efficiencies.

Operating Expense

Research and development expense primarily consists of salaries and related employee expense (including share-based compensation expense), prototype costs relating to design, development, testing of our products, depreciation expense and third-party consulting costs.

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Sales and marketing expense primarily consists of salaries, commissions and related employee expense (including share-based compensation expense), and sales and marketing support expense, including travel, demonstration units, trade show expense, and third-party consulting costs.

General and administrative expense primarily consists of salaries and related employee expense (including share-based compensation expense), and costs for third-party consulting and other services.

Amortization of intangible assets primarily reflects purchased technology and customer relationships from our acquisitions.

Excluding the effect of the goodwill impairment charges in fiscal 2009, increased operating expense for fiscal 2010 principally reflects the increased scale of our business resulting from the MEN Acquisition on March 19, 2010. The table below (in thousands, except percentage data) sets forth the changes in operating expense for the periods indicated:

	Fiscal Year					
	2009	%*	2010	%*	Increase (decrease)	%**
Research and development	$ 190,319	29.2	$ 327,626	26.5	$ 137,307	72.1
Selling and marketing	134,527	20.6	193,515	15.6	58,988	43.8
General and administrative	47,509	7.3	102,692	8.3	55,183	116.2
Acquisition and integration costs		0.0	101,379	8.2	101,379	100.0
Amortization of intangible assets	24,826	3.8	99,401	8.0	74,575	300.4
Restructuring costs	11,207	1.7	8,514	0.7	(2,693)	(24.0)
Goodwill impairment	455,673	69.8		0.0	(455,673)	(100.0)
Change in fair value of contingent consideration		0.0	(13,807)	-1.1	(13,807)	100.0
Total operating expenses	$ 864,061	132.4	$ 819,320	66.2	$ (44,741)	(5.2)

* Denotes % of total revenue

** Denotes % change from 2009 to 2010

Research and development expense was adversely affected by $13.9 million in foreign exchange rates, primarily due to the weakening of the U.S. dollar in relation to the Canadian dollar. The $137.3 million increase primarily reflects increases of $65.6 million in employee compensation and related costs, $34.6 million in professional services and fees, $17.4 million in facilities and information systems, $12.2 million in depreciation expense and $4.9 million in prototype expense related to the development initiatives described above.

Selling and marketing expense benefited by $1.6 million in foreign exchange rates primarily due to the strengthening of the U.S. dollar in relation to the Euro. The $59.0 million increase primarily reflects increases of $41.8 million in employee compensation and related costs, $6.4 million in travel-related expenditures, $4.3 million in facilities and information systems and $2.8 million in professional services and fees.

General and administrative expense increased by $21.9 million in consulting service expense, $17.7 million in facilities and information systems expense and $11.7 million in employee compensation and related costs.

Acquisition and integration costs are related to the MEN Acquisition. As of October 31, 2010, we have incurred $101.4 million in transaction, consulting and third party service fees. We expect to incur approximately $58.0 million in additional expense relating to acquisition and integration activities in fiscal 2011, a significant portion of which will be recognized as operating expense.

Amortization of intangible assets increased due to the acquisition of additional intangible assets as a result of the MEN Acquisition. See Note 2 to our Consolidated Financial Statements in Item 8 of Part II of this report.

Restructuring costs for fiscal 2010 primarily reflect the headcount reductions and restructuring activities described in the Overview Restructuring Activities above.

Goodwill impairment costs reflect the impairment of goodwill and resulting charge incurred in fiscal 2009 as described in Note 4 to our Consolidated Financial Statements in Item 8 of Part II of this report.

Change in fair value of contingent consideration is related to the contingent refund right we received relating to the Carling lease entered into as part of the MEN Acquisition. As a result of a change in circumstances and outcome probabilities during the fourth quarter of fiscal 2010, we recorded a $13.8 million change in fair value. See Notes 2 and 23 to our Consolidated Financial Statements in Item 8 of Part II for additional information relating to the early termination of the Carling lease.

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Other items

The table below (in thousands, except percentage data) sets forth the changes in other items for the periods indicated:

	Fiscal Year					
	2009	%*	2010	%*	Increase (decrease)	%**
Interest and other income, net	$ 9,487	1.5	$ 3,917	0.3	$ (5,570)	(58.7)
Interest expense	$ 7,406	1.1	$18,619	1.5	$11,213	151.4
Loss on cost method investments	$ 5,328	0.8	$	0.0	$ (5,328)	(100.0)
Gain on extinguishment of debt	$	0.0	$ 4,948	0.4	$ 4,948	100.0
Provision (benefit) for income taxes	$(1,324)	(0.2)	$ 1,941	0.2	$ 3,265	(246.6)

* Denotes % of total revenue

** Denotes % change from 2009 to 2010

Interest and other income, net decreased as a result of a $9.5 million decrease in interest income due to lower interest rates and lower invested balances. Decreased interest and other income, net also reflects a $2.0 million charge relating to the termination of an indemnification asset upon the expiration of the statute of limitations applicable to one of the uncertain tax contingencies acquired as part of the MEN Acquisition. These items were partially offset by a $3.8 million gain due to the positive effect of foreign exchange rates on assets and liabilities denominated in currency other than the relevant functional currency, and a $2.5 million non-cash gain related to the change in fair value of the redemption feature associated with our 4.0% convertible senior notes due March 15, 2015. See Notes 7 and 15 to the Consolidated Financial Statements found under Item 8 of Part II of this report for more information regarding the issuance of these convertible notes and the fair value of the redemption feature contained therein.

Interest expense increased due to our private placements during fiscal 2010 of $375.0 million in aggregate principal amount of 4.0% convertible senior notes due March 15, 2015 and $350.0 million in aggregate principal amount of 3.75% convertible senior notes due October 15, 2018. See Note 15 to the Consolidated Financial Statements found under Item 8 of Part II of this report.

Loss on cost method investments during fiscal 2009 was due to the decline in value of our investments in two privately held technology companies that were determined to be other-than-temporary.

Gain on extinguishment of debt for fiscal 2010 resulted from our repurchase of $81.8 million in aggregate principal amount of our outstanding 0.25% convertible notes in privately negotiated transactions for $76.1 million. We recorded a gain on the extinguishment of debt in the amount of $4.9 million, which consists of the $5.7 million gain from the repurchase of the notes, less $0.8 million of associated debt issuance costs.

Provision (benefit) for income taxes increased primarily due to a decrease in refundable federal tax credits.

Fiscal 2008 compared to Fiscal 2009

Revenue

Revenue for fiscal 2009 reflects the weakness, volatility and uncertainty presented by the global market conditions that we encountered during the year. Our fiscal 2009 revenue reflects cautious spending, primarily among our largest service provider customers, as they sought to conserve capital, reduce debt or address uncertainties or changes in their

own business models brought on by broader market challenges.

The table below (in thousands, except percentage data) sets forth the changes in our operating segment revenue for the periods indicated:

	Fiscal Year					
	2008	%*	2009	%*	Increase (decrease)	%**
Revenue:						
Packet Optical Transport	$ 447,542	49.6	$ 299,088	45.8	$ (148,454)	(33.2)
Packet Optical Switching	270,458	30.0	165,705	25.4	(104,753)	(38.7)
Carrier Ethernet Service Delivery	60,499	6.7	75,125	11.5	14,626	24.2
Software and Services	123,949	13.7	112,711	17.3	(11,238)	(9.1)
Consolidated revenue	$ 902,448	100.0	$ 652,629	100.0	$ (249,819)	(27.7)

* Denotes % of total revenue

** Denotes % change from fiscal 2008 to fiscal 2009

Packet-Optical Transport revenue decreased primarily due to decreases of $108.1 million in Corestream and $40.9 million in legacy transport and data networking systems. These declines were primarily due to unfavorable market conditions as described above. In spite of these market conditions, revenue from our ActivSpan 4200 was unchanged during fiscal 2009.

Packet-Optical Switching revenue decreased reflecting a decline in CoreDirector revenue. We believe the decline in CoreDirector revenue was due to unfavorable market conditions and constrained spending. Revenue for this segment is subject to significant fluctuations due to its highly concentrated customer base.

Carrier Ethernet Service Delivery revenue increased due to a $33.8 million increase in sales of our ActivEdge 3900 service-delivery switches and ActivEdge 5100 service aggregation switches in support of wireless backhaul deployments. This increase was partially offset by a $19.2 million decrease in CNX-5 sales.

Software and Services revenue decreased primarily due to a $10.9 million decrease in deployment services due to lower sales volume and installation activity.

Revenue from sales to customers outside of the United States is reflected as International in the geographic distribution of revenue below. The table below (in thousands, except percentage data) sets forth the changes in geographic distribution of revenue for the periods indicated:

	Fiscal Year					
	2008	%*	2009	%*	Increase (decrease)	%**
United States	$ 590,868	65.5	$ 419,405	64.3	$ (171,463)	(29.0)
International	311,580	34.5	233,224	35.7	(78,356)	(25.1)
Total	$ 902,448	100.0	$ 652,629	100.0	$ (249,819)	(27.7)

* Denotes % of total revenue

** Denotes % change from 2008 to 2009

United States revenue decreased primarily due to a $90.0 million decrease in sales of Packet-Optical Transport products, principally as a result of lower Corestream sales, an $87.0 million decrease in sales of Packet-Optical Switching products and a $4.7 million decrease in sales of software and services. These decreases were partially offset by a $10.2 million increase in sales of Carrier Ethernet Service Delivery products.

International revenue decreased primarily due to a $58.5 million decrease in sales of Packet-Optical Transport products, a $17.8 million decrease in sales of Packet-Optical Switching products and a $6.5 million decrease in sales of software and services. These decreases were partially offset by a $4.4 million increase in sales of Carrier Ethernet Service Delivery products.

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Certain customers each accounted for at least 10% of our revenue for the periods indicated (in thousands, except percentage data) as follows:

	Fiscal Year			
	2008	%*	2009	%*
AT&T	$ 227,737	25.2	$ 128,233	19.6
BT	113,981	12.6	n/a	
Total	$ 341,718	37.8	$ 128,233	19.6

n/a Denotes revenue representing less than 10% of total revenue for the period

* Denotes % of total revenue

Gross Profit and Cost of Good Sold

The tables below (in thousands, except percentage data) set forth the changes in revenue, cost of goods sold and gross profit for the periods indicated:

	Fiscal Year					
	2008	%*	2009	%*	Increase (decrease)	%**
Total revenue	$ 902,448	100.0	$ 652,629	100.0	$ (249,819)	(27.7)
Total cost of goods sold	451,521	50.0	367,799	56.4	$ (83,722)	(18.5)
Gross profit	$ 450,927	50.0	$ 284,830	43.6	$ (166,097)	(36.8)

* Denotes % of total revenue

** Denotes % change from 2008 to 2009

	Fiscal Year					
	2008	%*	2009	%*	Increase (decrease)	%**
Product revenue	$ 791,415	100.0	$ 547,522	100.0	$ (243,893)	(30.8)
Product cost of goods sold	371,238	46.9	296,170	54.1	(75,068)	(20.2)
Product gross profit	$ 420,177	53.1	$ 251,352	45.9	$ (168,825)	(40.2)

* Denotes % of product revenue

** Denotes % change from 2008 to 2009

	Fiscal Year					
	2008	%*	2009	%*	Increase (decrease)	%**
Service revenue	$ 111,033	100.0	$ 105,107	100.0	$ (5,926)	(5.3)
Service cost of goods sold	80,283	72.3	71,629	68.1	(8,654)	(10.8)

Service gross profit	$	30,750	27.7	$	33,478	31.9	$	2,728	8.9

* Denotes % of service revenue

** Denotes % change from 2008 to 2009

Gross profit as a percentage of revenue decreased due to lower product gross margins described below, partially offset by improved service gross margin.

Gross profit on products as a percentage of product revenue decreased due to less favorable product and geographic mix, including fewer sales of Packet-Optical Switching products as a percentage of total revenue, increased charges related to losses on committed customer sales contracts and higher charges relating to warranty. Gross profit as a percentage of revenue for fiscal 2008 reflects a $5.3 million increase in product cost of goods sold related to the revaluation of the acquired inventory from our acquisition of World Wide Packets. See Note 2 to the Consolidated Financial Statements in Item 8 of Part II of this report.

Gross profit on services as a percentage of services revenue increased due to higher sales of maintenance contracts as a percentage of services revenue. Services gross margin remains heavily dependent upon the mix of services in a given period and may fluctuate from quarter to quarter.

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Operating expense

The table below (in thousands, except percentage data) sets forth the changes in operating expense for the periods indicated:

	Fiscal Year					
	2008	%*	2009	%*	Increase (decrease)	%**
Research and development	$ 175,023	19.4	$ 190,319	29.2	$ 15,296	8.7
Selling and marketing	152,018	16.8	134,527	20.6	(17,491)	(11.5)
General and administrative	68,639	7.6	47,509	7.3	(21,130)	(30.8)
Amortization of intangible assets	32,264	3.6	24,826	3.8	(7,438)	(23.1)
Restructuring costs	1,110	0.1	11,207	1.7	10,097	909.6
Goodwill Impairment			455,673	69.8	455,673	100.0
Total operating expenses	$ 429,054	47.5	$ 864,061	132.4	$ 435,007	101.4

* Denotes % of total revenue

** Denotes % change from 2008 to 2009

Research and development expense benefited by $5.3 million in favorable foreign exchange rates primarily due to the comparative strength of the U.S. dollar in relation to the previous year. The resulting $15.3 million net increase principally reflects an increase in prototype expense of $15.4 million. Other increases include $5.4 million in facilities and information systems expense, $2.8 million in depreciation expense, and higher employee compensation cost of $0.6 million, including a $2.6 million increase in share-based compensation expense. These increases were partially offset by decreases of $4.8 million in consulting services expense, $2.7 million in technology related expenses and $0.8 million in travel expense.

Selling and marketing expense benefited by $2.8 million in favorable foreign exchange rates primarily due to the comparative strength of the U.S. dollar in relation to the previous year. The resulting $17.5 million net change reflects decreases of $7.8 million in employee compensation cost, $3.0 million in travel-related costs, $2.9 million in marketing program costs and $2.4 million in consulting services expense. These decreases were partially offset by a $1.2 million increase in facilities and information systems expense.

General and administrative expense benefited by $0.5 million in favorable foreign exchange rates primarily due to the comparative strength of the U.S. dollar in relation to the previous year. The resulting $21.1 million net change reflects decreases of $6.1 million in employee compensation cost, $4.1 million in consulting services expense, $1.7 million in facilities and information systems expense, and $0.7 million in technology-related expense. Expense for fiscal 2008 included $7.7 million associated with the settlement of patent litigation.

Amortization of intangible assets decreased due to certain intangible assets reaching the end of their useful life and becoming fully amortized during fiscal 2009.

Restructuring costs during fiscal 2009 were primarily related to a headcount reduction of approximately 200 employees, the closure of our Acton, Massachusetts research and development facility and revisions of estimates related to previously restructured facilities. Restructuring costs for fiscal 2008 principally reflects costs associated with a workforce reduction of 56 employees during the fourth quarter.

Goodwill impairment reflects an impairment charge of $455.7 million in the second quarter of fiscal 2009. Based on a combination of factors, including the macroeconomic conditions described above and a sustained decline in our common stock price and market capitalization below our net book value, we conducted an interim impairment assessment of goodwill during the second quarter of fiscal 2009. The conclusion of this assessment was the write-off of all goodwill remaining on our balance sheet.

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Other items

The table below (in thousands, except percentage data) sets forth the changes in other items for the periods indicated:

	Fiscal Year					
	2008	%*	2009	%*	Increase (decrease)	%**
Interest and other income, net	$36,762	4.1	$ 9,487	1.5	$(27,275)	(74.2)
Interest expense	$12,927	1.4	$ 7,406	1.1	$ (5,521)	(42.7)
Realized loss due to impairment of marketable debt investments	$ 5,101	0.6	$		$ (5,101)	(100.0)
Loss on cost method investments	$		$ 5,328	0.8	$ 5,328	100.0
Gain on extinguishment of debt	$ 932	0.1	$		$ (932)	(100.0)
Provision (benefit) for income taxes	$ 2,645	0.3	$(1,324)	(0.2)	$ (3,969)	(150.1)

* Denotes % of total revenue

** Denotes % change from 2008 to 2009

Interest and other income, net decreased due to lower average cash and investment balances and lower interest rates. Lower cash balances primarily relate to the repayment at maturity of the $542.3 million principal outstanding on our 3.75% convertible notes during the first quarter of fiscal 2008 and our use of $210.0 million in cash consideration and related expenses associated with our acquisition of WWP in the second quarter of fiscal 2008.

Interest expense decreased primarily due to the repayment of 3.75% convertible notes at maturity at the end of the first quarter of fiscal 2008.

Realized loss due to impairment of marketable debt investments for fiscal 2008 reflects a loss related to commercial paper investments in two structured investment vehicles (SIVs) that entered into receivership during the fourth quarter of fiscal 2007 and failed to make payment at maturity. These SIVs completed their restructuring activities during fiscal 2008 and, as of the end of fiscal 2009, we no longer held these investments.

Loss on cost method investments during fiscal 2009 was due to the decline in value of our investments in two privately held technology companies that were determined to be other-than-temporary.

Gain on extinguishment of debt reflects our repurchase of $2.0 million in principal amount of our outstanding 0.25% convertible senior notes due May 1, 2013 in an open market transaction. We used $1.0 million of our cash to effect this repurchase, which resulted in a gain of approximately $0.9 million.

Provision (benefit) for income taxes decreased primarily due to refundable federal tax credits made available by recent economic stimulus tax law changes. Availability of refundable credits expired on December 31, 2009.

Operating Segment Profit (Loss)

Segment Profit (Loss)

Segment profit (loss) is determined based on the revenue, cost of goods sold and research and development costs for the relevant segment. The table below (in thousands, except percentage data) sets forth the changes in our segment profit (loss) for the respective periods:

	Fiscal Year			
	2009	2010	Increase (decrease)	%*
Segment profit (loss):				
Packet-Optical Transport	$21,535	$67,357	$ 45,822	212.8
Packet-Optical Switching	60,302	15,173	(45,129)	(74.8)
Carrier Ethernet Service Delivery	(9,575)	28,074	37,649	(393.2)
Software and Services	22,249	53,432	31,183	140.2

* Denotes % change from 2009 to 2010

Packet-Optical Transport segment profit for fiscal 2010 reflects increased sales volume resulting in additional product gross profit, partially offset by increased research and development costs due to the MEN Acquisition.

Packet-Optical Switching segment profit declined due to decreased sales volume resulting in reduced product gross profit, and increased research and development costs.

Carrier Ethernet Service Delivery segment profit improved significantly due to increased sales volume resulting in additional gross profit, partially offset by increased research and development costs.

Software and Services segment profit improved due to increased sales volume and improved gross margin, both of which resulted in additional gross profit, partially offset by increased research and development costs.

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The table below (in thousands, except percentage data) sets forth the changes in our segment profit (loss), including the presentation of prior periods to reflect the change in reportable segments, for the respective periods:

	Fiscal Year			
	2008	2009	Increase (decrease)	%*
Segment profit (loss):				
Packet-Optical Transport	$110,905	$21,535	$(89,370)	(80.6)
Packet-Optical Switching	151,084	60,302	(90,782)	(60.1)
Carrier Ethernet Service Delivery	(17,764)	(9,575)	8,189	46.1
Software and Services	31,679	22,249	(9,430)	(29.8)

* Denotes % change from 2008 to 2009

Packet-Optical Transport segment profit decreased primarily due to lower sales volume, increased charges related to losses on committed customer sales contracts and higher charges relating to warranty resulting in lower gross profit. In addition, segment profit was reduced by increased research and development costs.

Packet-Optical Switching segment profit decreased primarily due to lower sales volume, resulting in reduced gross profit, partially offset by decreased research and development costs.

Carrier Ethernet Service Delivery segment loss improved primarily due to increased sales volume, resulting in higher gross profit, and decreased research and development costs.

Software and Services segment profit decreased due to lower sales volume, resulting in lower gross profit, and increased research and development costs.

Liquidity and Capital Resources

At October 31, 2010, our principal sources of liquidity were cash and cash equivalents. The following table summarizes our cash and cash equivalents and investments (in thousands):

	October 31,		Increase
	2009	2010	(decrease)
Cash and cash equivalents	$ 485,705	$ 688,687	$ 202,982
Short-term investments in marketable debt securities	563,183		(563,183)
Long-term investments in marketable debt securities	8,031		(8,031)
Total cash and cash equivalents and investments in marketable debt securities	$ 1,056,919	$ 688,687	$ (368,232)

The decrease in total cash and cash equivalents and investments during fiscal 2010 was primarily related to the following:

$693.2 million related to the purchase price for the MEN Acquisition;

$76.1 million for the repurchase of a portion of our 0.25% convertible senior notes due May 1, 2013;

$51.2 million for equipment, furniture, fixtures and intellectual property

$24.5 million transferred to restricted cash related to as collateral for our standby letters of credit; and

$229.0 million cash used from operations, consisting of $112.2 million for changes in working capital and $116.8 million from net losses (adjusted for non-cash charges). Cash used from operations includes payments of $91.7 million related to acquisition and integration-related expense and restructuring costs, of which $18.2 million was reflected in changes in working capital and $109.9 million was reflected in net losses (adjusted for non-cash charges).

These payments were partially offset by our receipt of $364.3 million in net proceeds from the private placement of $375.0 million in aggregate principal amount of 4.0% convertible senior notes due March 15, 2015 and $340.4 million in net proceeds from the private placement of $350.0 million in aggregate principal amount of 3.75% convertible senior notes due October 15, 2018. See Notes 2 and 15 to the Consolidated Financial Statements under Item 8 of Part II of this report for more information regarding the MEN Acquisition and our issuance of convertible notes during fiscal 2010.

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Based on past performance and current expectations, we believe that our cash and cash equivalents and cash generated from operations will satisfy our working capital needs, capital expenditures, and other liquidity requirements associated with our existing operations through at least the next 12 months. As expected, the investment in working capital for fiscal 2010 reflects the increased scale of business as the result of the MEN Acquisition and the lower net working capital transferred to Ciena at closing, which resulted in a purchase price adjustment following the closing. We regularly evaluate our liquidity position and the anticipated cash needs of the business to fund our operating plans as well as any capital raising opportunities that may be available to us.

The following sections set forth the components of our $229.0 million of cash used by operating activities for fiscal 2010:

Net losses (adjusted for non-cash charges)

The following table sets forth (in thousands) our net losses (adjusted for non-cash charges) for fiscal 2010:

	Year ended October 31, 2010
Net loss	$ (333,514)
Adjustments for non-cash charges:	
Gain on extinguishment of debt	(4,948)
Amortization of premium on marketable debt securities	574
Change in fair value of embedded redemption feature	(2,510)
Change in fair value of contingent consideration	(13,807)
Depreciation of equipment, furniture and fixtures, and amortization of leasehold improvements	42,789
Share-based compensation costs	35,560
Amortization of intangible assets	127,018
Deferred tax provision	700
Provision for inventory excess and obsolescence	13,696
Provision for warranty	15,353
Other	2,296
Net losses (adjusted for non-cash charges)	$ (116,793)

Working Capital

Accounts Receivable, Net

Excluding the addition of $7.1 million of unbilled receivables recorded upon completion of the MEN Acquisition, cash used by accounts receivable, net of allowance for doubtful accounts receivable, was $218.2 million from the end of fiscal 2009 through the end of fiscal 2010 due to higher sales volume. Our days sales outstanding (DSOs) increased from 65 days for fiscal 2009 to 100 days for fiscal 2010. The significantly increased DSOs for fiscal 2010 reflect the timing of the MEN Acquisition and the effect on this calculation of having only a partial year of revenue from the MEN Business. Utilizing annualized fourth quarter revenue for purposes of this calculation would have resulted in DSOs of 74 days.

The following table sets forth (in thousands) changes to our accounts receivable, net of allowance for doubtful accounts receivable, from the end of fiscal 2009 through the end of fiscal 2010:

	October 31,		Increase
	2009	2010	(decrease)
Accounts receivable, net	$ 118,251	$ 343,582	$ 225,331

Inventory

Excluding the addition of $146.3 million of inventory recorded upon completion of the MEN Acquisition, cash consumed by inventory for fiscal 2010 was $41.0 million due to increased inventory levels to support a higher sales volume. Our inventory turns decreased from 3.4 for fiscal 2009 to 2.3 for fiscal 2010 primarily due to effect of the mid-year MEN Acquisition. The significantly decreased inventory turns for fiscal 2010 reflect the timing of the MEN Acquisition and the effect on this calculation of having only a partial year of cost of goods sold from the MEN Business. Utilizing annualized fourth quarter product cost of good sold, inventory turns would have been 3.1 days.

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During fiscal 2010, changes in inventory reflect a $13.7 million reduction related to a non-cash provision for excess and obsolescence.

The following table sets forth (in thousands) changes to the components of our inventory from the end of fiscal 2009 through the end of fiscal 2010: