

Technology: Insights from the Optical Show, Day 1

- Sentiment from this week's optical trade show is mixed; an improving end market fuels optimism, yet oversupply at the components level leads to an unfavorable pricing environment.
- We favor components vendors with exposure to high-growth segments including high-speed optics and ROADMs; bendable fibers provide a catalyst for FTTx deployment in multiple dwelling units (MDUs) and drive growth for fiber connectivity gear.
- Data points collected at the show are positive longer-term for ADC Telecom, Finisar, JDSU, Opnext, and Optium.

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Summary

We are attending the OFC/NFOEC trade show this week in San Diego. Attendance at this show now primarily emphasizes optical components for communications and networking; the number of system vendors exhibiting has trailed off dramatically to one, with only Fujitsu in attendance this year. We think investor attendance has dropped off since last year's brief euphoria following the IPOs of Optium (OPTM, \$7.38, O-S) and Opnext (OPXT, \$5.02, M-S) which were trading near their 52-week highs; customers have since implemented "lean" inventory management initiatives and many have seen decelerating sales growth and revenue declines, leading in part to the current depressed valuations. As in recent years, the themes seemed to focus on optics tied to network upgrades, cost reduction, and manufacturing in scale.

Market research data suggests improving end market demand. Market researchers Ovum-RHK estimate that the global optical networking market grew by 18% in 2007 to \$14.2 bl, growing for the fourth consecutive year since the Optical Bubble burst in 2000; while the pace of growth slows, Ovum-RHK forecasts a healthy 9% CAGR for 2006-2012 off a healthy base of over just over \$12 billion, with 11% growth to \$15.7 bl in 2008. Similarly Ovum-RHK estimates that the total addressable global optical components market grew 7% to \$5.0 bl in 2007, and forecasts a 10% CAGR for 2006-2012 off a base of \$4.7 bl, with 11% growth in FY2008 to \$5.7 bl. While we don't ascribe to a rising tide floats all boats philosophy, end market growth should benefit vendors with exposure to high growth areas.

We derived a few data points from our conversations with components and communications equipment suppliers at the show:

- **Bendable fibers drive growth for connectivity gear:** While Corning (GLW, \$24.22, NR) out-promotes competitors and dominates the headlines with its recently announced bendable fiber dubbed ClearCurve, others have offered similar products for years including OFS and Draka Comteq. We think ADC Telecom (ADCT, \$14.07, O-S) has incorporated bendable fibers from Draka in drop cables, enclosures, and connectivity gear optimized for MDUs (multiple dwelling units such as condominiums or apartment buildings), which has been tested and approved for use by Verizon. The newer technology saves labor, addressing one of Verizon's pain points, and likely facilitates the deployment of Verizon's FiOS (and other carriers') Fiber to the Premises initiative to the 25% or more of Verizon's subscribers that live in MDUs, and could signal upside to its FTTx connectivity business (26% of FY08E sales in our estimates).
- **High-speed optics at 40G now table stakes, 100G (not) around the bend:** Vendors are expanding 10G offerings to address an increasing array of both datacom and telecom applications, and 40G is now a table stakes item; vendors and carriers alike speak of the next leap to 100G yet we think technology limitations and price will limit its appeal for several years. 10G and 40G optics represent two of the three highest growth segments in the industry and we favor vendors with exposure to both including Finisar (FNSR, \$1.93, O-S), JDSU (JDSU, \$13.65, M-S), Opnext (OPXT, \$5.02, M-S), and Optium (OPTM, \$7.38, O-S), all of which we recently initiated coverage on (see our February 21, 2008 in-depth reports).
- **ROADMs (reconfigurable optical add/drop multiplexers) go mini:** Advances in ROADM technology have become a staple at the show and this year is no exception with vendors touting improved performance including support for 40G and in the future 100G wavelengths, for a greater number of wavelengths, and mini-ROADMs cost optimized for simple 2-degree add/drop, and more price stringent metro applications. ROADMs round out the top three growth areas in the

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space and we favor Optium (ROADM as a growth engine) and JDSU (market share leader); Finisar now also has exposure via its announced partnership with start-up Nistica (see our February 27, 2008 edition of MK Tech Bytes).

- **Moving up the value chain:** JDSU announced a functionally integrated line card ("superblade") planned for Q4:CY08 incorporating elements previously sold as discretely including a "nano" (mini) ROADM, power and wavelength monitor, and optical amplifier, all under common software control. We think functional integration makes sense for customers sourcing the discrete components from JDSU, but wonder if the solution will have broader appeal as systems vendors typically choose best-of-breed components and sub-systems to differentiate their products. In our view the jury is still out, yet if successful, other components vendors may follow-suit, and the up-market approach (from components and sub-systems to line cards) could contribute to margin improvement in JDSU's OptComm business, though would not likely move the needle much before CY09.
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Recommendation

Sentiment from this week's optical trade show is mixed; an improving end market fuels optimism, yet oversupply at the components level leads to an unfavorable pricing environment. We favor components vendors with exposure to growth segments: high-speed 10G and 40G optics including JDSU, Finisar, Opnext and Optium; ROADMs, including Optium and JDSU, and now Finisar with its announced Nistica partnership. Corning has raised awareness on bendable fibers, also available from other fiber vendors, which we think provides a catalyst for FTTx deployment in multiple dwelling units (MDUs) and could drive growth for ADC Telecom's fiber connectivity gear.

ADDITIONAL INFORMATION AVAILABLE UPON REQUEST

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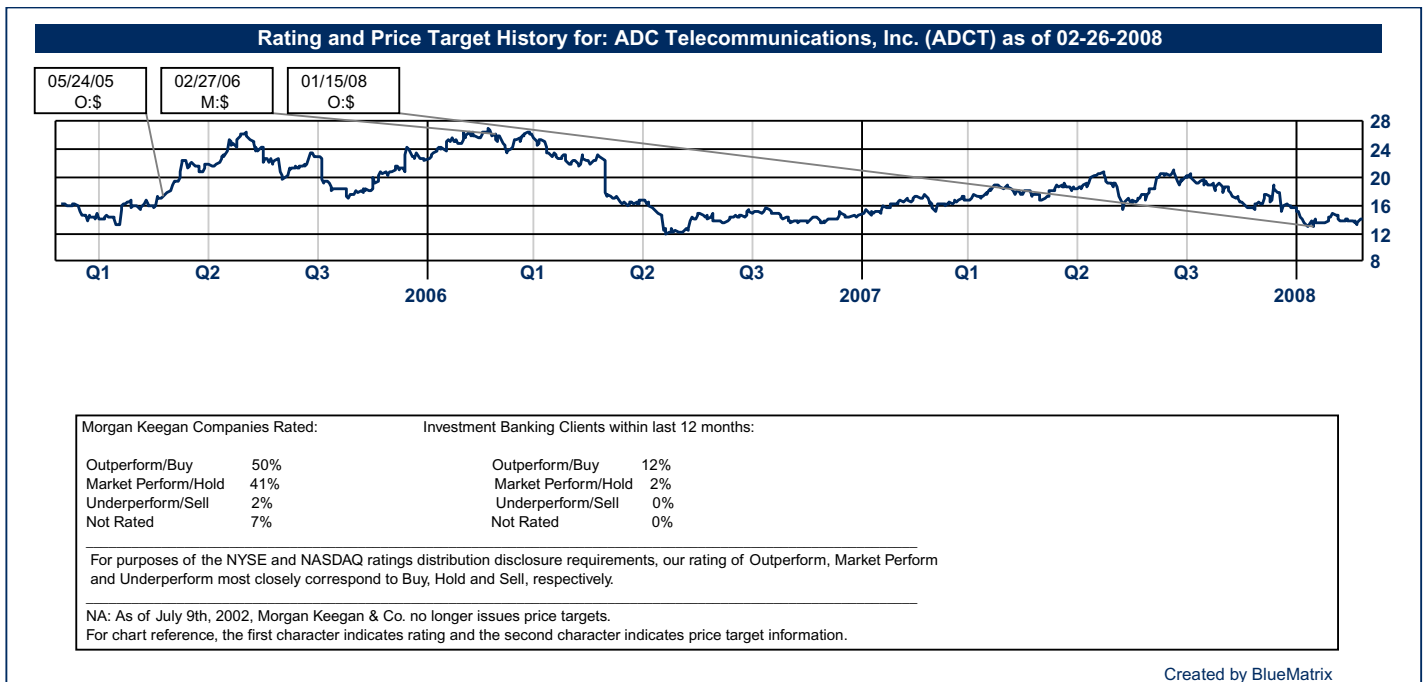
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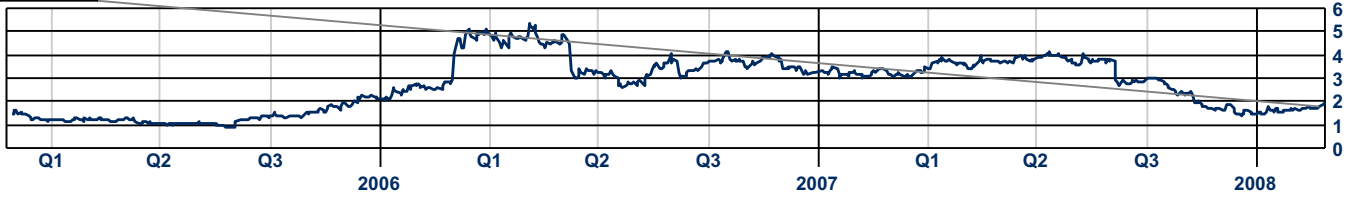
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Rating and Price Target History for: Finisar Corporation (FNSR) as of 02-26-2008

02/21/08
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Outperform/Buy	50%	Outperform/Buy	12%
Market Perform/Hold	41%	Market Perform/Hold	2%
Underperform/Sell	2%	Underperform/Sell	0%
Not Rated	7%	Not Rated	0%

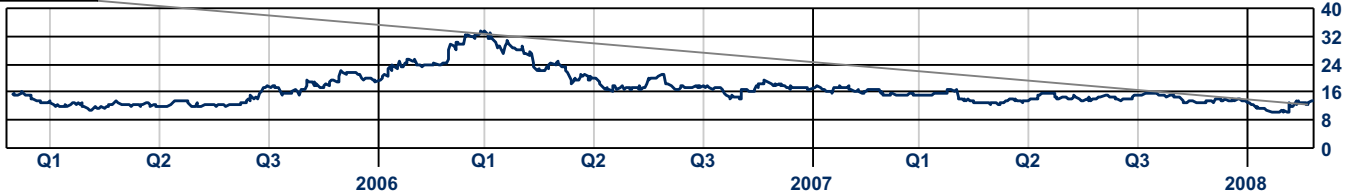
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Rating and Price Target History for: JDS Uniphase Corporation (JDSU) as of 02-26-2008

02/21/08
I:M:\$



Morgan Keegan Companies Rated:		Investment Banking Clients within last 12 months:	
Outperform/Buy	50%	Outperform/Buy	12%
Market Perform/Hold	41%	Market Perform/Hold	2%
Underperform/Sell	2%	Underperform/Sell	0%
Not Rated	7%	Not Rated	0%

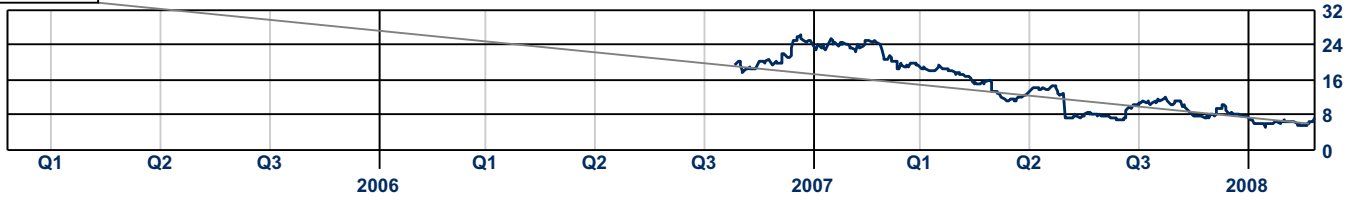
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Rating and Price Target History for: Optium Corporation (OPTM) as of 02-26-2008

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Market Perform/Hold	41%	Market Perform/Hold	2%
Underperform/Sell	2%	Underperform/Sell	0%
Not Rated	7%	Not Rated	0%

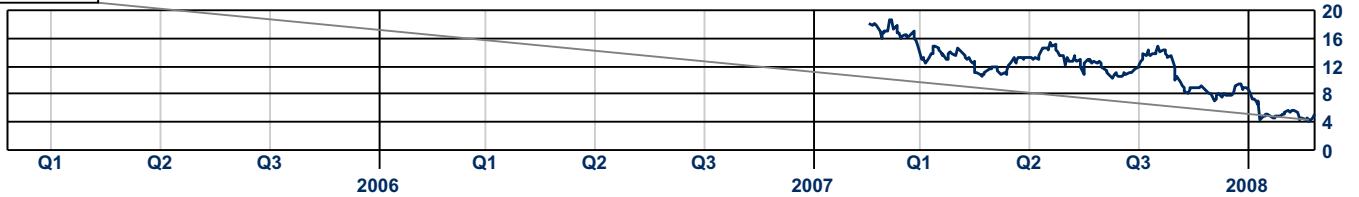
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Market Perform/Hold	41%	Market Perform/Hold	2%
Underperform/Sell	2%	Underperform/Sell	0%
Not Rated	7%	Not Rated	0%

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