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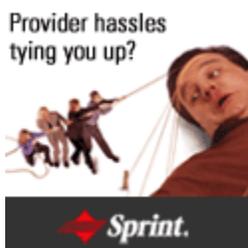
MANAGING THE MOUNTING COMPONENT STOCKPILE

by Vincent Ryan

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Fallout from a slow own in network expansion has trickled down the optical systems food chain into the components sector. The problem is the large inventory overhang that has stacked up on the shelves of the biggest manufacturers of optical systems. Now they're challenged to adapt to a new market.

Reduced demand is not only forcing optical component vendors to conserve cash and scramble for financing, but also to fundamentally shift their product and operational vectors. That means focusing on developing cost-efficient products instead of next-generation technology.



Although write-downs and write-offs cut into the optical components glut, they also muddied the waters because some of the written-off inventory could still be used, said Max Schuetz, analyst for Credit Suisse First Boston. That could mean a gray market in some of the lower-end components, which would drive prices down further than they already are.

Customized components used in products that have been discontinued by systems makers likely will be destroyed, Schuetz said. But standard products such as optical pump lasers and receivers are unlikely to face that fate. And obsolescence can take one to two years.

The first order of business for components manufacturers is conserving cash. With IPOs on hold, privately held vendors must cut their burn rate...to last until

The good news: While the inventory overhang is substantially more than what is showing up on OEM balance sheets (\$2.7 billion vs. \$4.3 billion when usable write-offs are included), the industry does not

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early 2003.

--Bob Pavey
Morgenthaler Ventures

need to work down all existing inventories for new orders to begin to grow, according to Schuetz.

Even after inventory is purged, however, component sales will be gradual and may never return to the levels of 1999, when problems in the structure of the optical supply chain were glossed over by a huge demand for products.

The first order of business for components manufacturers is conserving cash. With IPOs on hold, privately held vendors must cut their burn rate to "have enough runway" to last until early 2003, said Bob Pavey, general partner for Morgenthaler Ventures. "Everyone is re-examining burn rates and looking at raising capital at lower prices," he said.

Companies will get funded—Agility Communications' \$83 million round is a recent example—but there also will be rollups, mergers and outright failures. "There will be disorganization, but there are going to be increased opportunities for the survivors," said Stephen Montgomery, president of Electronicast, a market research firm specializing in components.

If a start-up has cash and is still in the early stage of designing or testing its first product, it may actually be at an advantage. Genoa, a start-up building a chip-based optical amplifier currently in alpha testing, doesn't have to worry about finding homes for its current generation of product, said Rick Gold, the company's president and CEO.

Emerging components manufacturers are being affected, however. Bandwidth9, a maker of tunable lasers whose product is currently in trial, has shifted its development resources away from a next-generation application. Instead of developing lasers for remote provisioning equipment, which allows a carrier to run multiple clients on the same wavelength, Bandwidth9 is concentrating sales and development on "tunable spares." Those lasers let carriers eliminate the cost of buying a backup circuit for each wavelength channel in a fiber. Bandwidth9's VCSEL diode enables one or two spares to back up 20 channels.

The shift in direction came at the behest of carriers seeking systems that will make running their networks more cost-efficient, said Hatch Graham, Bandwidth9's chairman, president and CEO.

"We can claim the tunable laser is the way of the future, but carriers have come back and said, 'Don't bring us [next-generation]; give us something that will help us be more cost-efficient now,'" he said. "They're saying that if it doesn't help in the next three quarters, let's wait."

That kind of hesitancy is rampant. Fewer incremental changes are being made to existing systems, and there is less interest in the next generation of data rates, Gold said. "Forty gigabits was on the tip of everybody's tongue one year ago," he said. "Now it's OC-192 and below."

Vendors want flexible, transparent products that improve the economics of optical systems, Pavey said. "The new conviction is that 40 gigabits is further out in the future," he said. "That means OC-192 will last longer, and OC-48 still has some life to it."

Customers of New Focus, a maker of passive and active components, want the company to drive down production costs and shorten lead times, said Ken Westrick, New Focus' president and CEO. In response, the company is taking steps such as integrating multiple functions into one package. For example, it is merging a polarization beam combiner with an isolator to reduce material and labor costs.

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The company's R&D spending is being cut as it backs off from certain development projects, Westrick said. Systems makers are still interested in talking about new technologies, but they are "more realistic" about what they're going to fund and have narrowed the number of projects they're engaged in, he said.

While a general recovery in the optical component market is unlikely before late fourth quarter 2002 or early first quarter 2003, Schuetz said, some product lines will improve faster than others. While there is a 15-month overhang for gigabit Ethernet transceivers, for instance, 10 Gb/s transponders and 2 Gb/s fibre channel transponders are sheltered from the inventory overhang and continue to receive new orders, Schuetz said.

Still other sectors may never recover because of lack of specialization or commoditization of product lines.

While system vendors' inventory levels are still high compared with historical averages, there have been indications during the past six weeks that component vendors should begin to turn up production again, Electronicast's Montgomery said.

OEM and carrier interviews conducted by Electronicast revealed that incumbent carriers are beginning to discuss and send out requests for quotation for use of coarse wave division multiplexing and DWDM in access networks, Montgomery said. "A year and a half ago that wasn't the case. We're seeing aggressive planning at the service provider level." Based on that information, Electronicast is advising clients that now is the time to increase production and not to wait until 2002.

Some component makers already are building over their order level, Montgomery said, citing one active component maker that is producing 20,000 units per month and only getting orders for 15,000. "It doesn't take any more energy or people, and if you're going to stamp out a wafer, it doesn't make a difference if you make one amount or another," he said.

Component makers with highly automated production can adapt more quickly to changes in demand, and that means better market economics and a changing of the guard for the market leadership.

"The optical components world is going to be like the semiconductor world—it's be going to be boom and bust," Pavey said. "This is just the first."

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