FINAL TRANSCRIPT

Thomson StreetEvents℠

RSYS - Q3 2010 RadiSys Corporation Earnings Conference Call

Event Date/Time: Oct. 26. 2010 / 9:00PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

Scott Grout
RadiSys Corporation - President and CEO

Holly Stephens
RadiSys Corporation - Finance and IR Manager

Brian Bronson
RadiSys Corporation - CFO

CONFERENCE CALL PARTICIPANTS

Rich Valera
Needham & Company - Analyst

George Notter
Jefferies & Company - Analyst

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by and welcome to the RadiSys third quarter earnings conference call with Scott Grout, President and CEO of RadiSys. As a reminder, today, October 26, 2010, this call is being recorded. Later, we will conduct a question and answer session. (Operator instructions.)

Mr. Grout, please go ahead.

Scott Grout - *RadiSys Corporation - President and CEO*

Thank you, Tiffany. Good afternoon and thank you for participating in our third quarter conference call. In this call, we will review our results for the third quarter, as well as our outlook for the fourth quarter and full year, and then we will open the call up for questions, as usual. Participating on the call today are Holly Stephens, Finance and Investor Relations Manager; Brian Bronson, our Chief Financial Officer; and again, myself, Scott Grout, President and CEO.

Before we get started, I'd like to turn it over to Holly for a caution about forward-looking statements.

Holly Stephens - *RadiSys Corporation - Finance and IR Manager*

Thanks, Scott. Any statements on this call regarding future expectations for the business of RadiSys constitute forward-looking statements that involve a number of risks and uncertainties. We caution you not to place undue reliance on these statements. Factors that could cause actual results to differ materially from those in the forward-looking statements are discussed in our earnings release today and in our SEC filings, most recently in our 2009 Annual Report on Form 10-K.

All information provided in this call is as of today. RadiSys undertakes no duty to update any forward-looking statement to conform the statement to actual results or changes in the Company's expectations. In addition, during the call we will refer to some non-GAAP measures. We've provided a GAAP to non-GAAP reconciliation for these measures in our earnings release issued today.

Now, I'll turn the call back over to Scott.

Scott Grout - *RadiSys Corporation - President and CEO*

Thanks, Holly.

So, our third quarter revenues were $75.2 million, with next-gen revenues of $30.9 million, up 42.5% year-over-year. On a year-to-date basis, our next-gen revenues have been $90.1 million, up 22.5% over the last year, as more of our customer programs ramp into production and deployment.

Gross margins for our Media Server, ATCA platforms and application solutions continue to be strong, while margins for our legacy and larger volume ATCA Blade-only business continues to be under pressure. You will continue to see us put more of our investment and growth focus on our more valuable software and system-level solutions.

For example, in the quarter we announced our new LTE Security Gateway, or SEG product, targeted at providing security solutions for new, all-IP wireless networks. Our LTE SEG is built upon our industry's leading ATCA carrier-grade platform, with five times the performance of existing enterprise-focused solutions.

The SEG provides user authentication, data integrity and encryption for IP-based wireless networks and can be deployed as a standalone solution or integrated into other wireless network elements. Our security gateway is now under evaluation by a Tier 1 equipment maker and will be available for trials in the fourth quarter and commercially available in the first half of next year.

Other key developments for us in the quarter included, in our Media Server business, we released our new Interactive Mobile Media Server, or IMMS solution, to a Tier 1 China-based equipment maker to begin trials. IMMS, as you might recall, is built upon our industry-leading IP Media Server and is targeted at innovative, new revenue-generating services in the wireless arena.

In addition, another global Tier 1 equipment maker went live with our RadiSys CMS-9000 with China Mobile. We were also awarded other new business for our IP Media Server products in color ring back tone, conferencing and network announcement applications.

Moving to our ATCA products, we won new business of notable size in a military application for unmanned vehicle reconnaissance. In this application, ATCA will be used for high performance computer control and image display. This win is meaningful for us in that it validates our strategy of bringing robust, high capacity ATCA systems into military applications.

Other new ATCA application wins in the quarter include LTE evolved packet core, IPTV, and wireless access location. A number of these program awards were in China as this geography continues to grow for us.

Within our commercial business we were awarded new COM Express business across all three geographies in medical imaging, defense, and networking applications. In addition, a Tier 1 enterprise infrastructure provider in North America began production of a new network switching and routing solution using RadiSys' high-performance COM Express products.

Returning to our results for the quarter, our top five customers in the third quarter, in alphabetical order, were Cisco, GE Healthcare, NEI, Nokia Siemens Networks, and Phillips Healthcare. Collectively, these five customers represented 64% of our revenue in the quarter, with 42% from Nokia Siemens Networks.

NSN continues to be a very strategic customer for us, with revenues diversifying nicely beyond legacy products to include meaningful new business in ATCA and IP Media Servers. Again this quarter, over 25% of our NSN business is coming from our next-gen products, and we expect this percentage to continue to increase over time.

Finally, before I turn the call over to Brian, I wanted to highlight a new addition to our Board of Directors. Niel Ransom joined as Board member in August and brings extensive background in communications networking, including serving as the past

CTO of Alcatel Networks, as well as serving on the Boards of a number of highly successful public and private technology companies. Niel will also chair our new Technology and Market Development Committee of the Board that will focus on organic and inorganic growth opportunities for the Company. We are very pleased to have Niel join as a member of our team.

With that, I'd now like to turn the call over to Brian to talk a bit more about third quarter results and projection for the fourth quarter.

Brian Bronson - *RadiSys Corporation - CFO*

Thanks, Scott. As Scott previously mentioned, our third quarter revenue was $75.2 million and our next-gen revenue was $30.9 million, up 42.5% year over year. On a year-to-date basis, our next-gen revenues were $90.1 million and up 22.5% year-over-year.

We delivered non-GAAP EPS of $0.16, which was inline with our previous expectations. And on a GAAP basis, we had earnings of $0.09 per diluted share.

Our Q3 non-GAAP gross margin rate was 32.8% and up from the second quarter. The sequential increase is mainly due to lower manufacturing costs related to the outsourcing of production. We expect our fourth quarter non-GAAP gross margin to be up nicely to between 34% and 35%. This range is sequentially higher than the gross margin rate in the third quarter due to expected growth in our next-gen products, as well as favorable product mix inside of next-gen. In addition, our legacy communications networking revenues are declining sequentially, which have much lower gross margin rates.

So, while Q4 is a very real example of what is possible longer term for corporate gross margins, I do expect Q1 2011 gross margins to be lower, i.e. 32% to 33%, due to meaningful, ongoing declines in our legacy gross margins and overall product mix. I also expect medium-term gross margins to continue to fluctuate between 32% and 35%.

But, to be clear, we continue to target long-term corporate gross margins of between 35% and 40%. Our next-gen business continues to command gross margins of 40% to 50% but, again, it can fluctuate up or down inside that range, depending on the mix of Media Server versus Solutions versus ATCA systems, as well as ATCA Blades.

We expect that our legacy communications business will have gross margins in the low 20s in the fourth quarter, down from the high 20s earlier this year, and we expect that it will most likely be in the teens in 2011. And our commercial business gross margins have been operating in the mid-20s during 2010, and we anticipate they will drop to the low 20s in 2011.

So, you can see that, strategically, we are marching towards a higher gross margin rate but, in the medium term, our overall gross margins will go up and down and be sub-optimized while we try and effectively manage the glide path down on our legacy businesses.

Moving over to operating expenses, non-GAAP R&D and SG&A expenses totaled $19.8 million, which is around the same level as the prior quarter. We currently expect that our fourth quarter non-GAAP in R&D and SG&A expenses will be up around $300,000 from the prior quarter, at the midpoint of our guidance range. The increase is mainly related to sales and marketing expenses tied to our annual sales meeting that will occur in November.

Non-GAAP operating income was $4.8 million, or 6.4% of revenues in the third quarter. This compares to 5.9% in the second quarter and the 4.8% in the same quarter last year. We expect our fourth quarter non-GAAP operating income percent to be around the same level as Q3; again, at the midpoint of our guidance range.

Net non-operating expense, which includes interest income, interest expense and other non-operating items, was $458,000 in the third quarter. We currently expect our non-operating expense to be around $450,000 again in the fourth quarter.

Our non-GAAP tax rate was 3.6% in the third quarter. We continue to project a low rate as all of our taxable earnings are being generated in foreign jurisdictions with lower tax rates. We currently expect our fourth quarter non-GAAP tax rate to be around 5% and are using an assumption of 25% for our GAAP tax rate

We did have two tax items that resulted in a net favorable tax benefit of approximately $1 million that were excluded from non-GAAP results in the third quarter. Specifically, we reversed approximately $1.4 million of income tax liability that was previously accrued for uncertain tax positions. And partially offsetting this, we accrued $400,000 of income tax liability related to a different uncertain tax position. Both of these are non-cash items and they only affect the levels of our deferred tax assets.

Our non-GAAP diluted weighted average shares were 28.5 million, which includes 3.8 million shares related to our convertible notes. Our third quarter GAAP diluted shares were 24.4 million. We project our diluted shares to be 28.6 million for non-GAAP results and 24.5 million for GAAP results in the fourth quarter. When calculating EPS for net income over $2.9 million, the convert shares and the interest income add-back of $456,000 to net income should be included in the calculation.

Moving to the balance sheet, DSO was 53 days in the third quarter, which is about the same DSO that we had in the second quarter. Giving the timing of shipments this quarter, specifically 15% shipped to date versus 21% shipped at the same time last quarter, I do expect DSO to increase into the low 60s in the fourth quarter. Our fourth quarter is more backend loaded due to some supply constraints.

Our inventory balance was $18.4 million at the end of the third quarter, which is down from $28.3 million at the end of the third quarter last year, and up from $17.1 million in the second quarter.

As we have discussed previously, the industry supply shortages required us to build a few million dollars of buffer inventory. I expect our inventory to go up another couple of million in the fourth quarter to support ongoing buffer levels and then begin to decline in the first half of 2011.

Our cash flow from operations was $4 million during the third quarter, and our year-to-date cash flow was $19.3 million compared to $14.9 million for the same period last year.

We ended the third quarter with $133.3 million of cash, and this is up from $92.1 million in the same quarter last year, and up from $122 million in the prior quarter. This reflects the paid off line of credit to UBS and the re-class of the restricted cash to simply cash. We currently expect an operating cash burn in the fourth quarter of up to $5 million. This is solely attributable to the timing of quarterly shipments mentioned previously and the ongoing inventory buffer requirements to ensure continuity of customer supply as certain component shortages continue to be a challenge.

I also wanted to let you know that we've filed an F3 Registration Statement today, or will today, for $100 million of common stock or other securities. This is simply a refresh on an extension to our current shelf, which is $95 million that will expire on November 7th of this year.

With that, I'll turn the call back over to Scott to talk about the revenue and per share outlook for the fourth quarter.

Scott Grout - *RadiSys Corporation - President and CEO*

Thanks, Brian. So, regarding our outlook for the fourth quarter, please note that this is our view as of today and it is a forward-looking statement, subject to risks and uncertainties as discussed previously, and in our press release made available earlier today.

We currently expect our fourth quarter revenues to be between $68 million and $72 million. We expect our next-gen product revenues to grow to around $33 million. At this level we predict our next -- 2010 next-gen revenues to be up 20% over 2009.

While we have market demand to support this projection, our fourth quarter next-gen revenues could be a few million higher or lower as we continue to experience spot shortages or delays on some components.

Our legacy, or traditional communications networks product, revenues are expected to be between $17 million and $20 million in the fourth quarter, which represents a decline for the full year of 33% to 36% over 2009 and down over 19% sequentially.

We currently expect our fourth quarter non-GAAP EPS to be between $0.12 and $0.17, and our GAAP EPS to be between breakeven and $0.05.

So overall, we continue to see strong growth in our next-generation business as customer deployments expand across a wide range of applications. While our next-generation platform deployments continue to advance, we are also adding new solutions such as IMMS and LTE Security Gateway on top of our platforms to give customers an even more complete set of solutions. We believe we are poised to see longer-term gross margin expansion and operating leverage as our new products and solutions grow, while our older legacy business continues to roll off.

So, with that, I'd like to thank you for participating and open the call up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator instructions.) Your first question is from the line of Rich Valera of Needham & Company.

Rich Valera - *Needham & Company - Analyst*

Thanks. Good afternoon, gentlemen.

Scott Grout - *RadiSys Corporation - President and CEO*

Hey, Rich.

Brian Bronson - *RadiSys Corporation - CFO*

Hey, Rich.

Rich Valera - *Needham & Company - Analyst*

A question on the gross margin. You guided for a pretty impressive ramp in gross margin in the fourth quarter, and that sounds like you expect it to drop back down in the first quarter. But I'm wondering, on a year-over-year basis, it looks like you'll do about 33% for a pro forma gross margin in 2010. How should we think about 2011 relative to that level for a gross margin?

Brian Bronson - *RadiSys Corporation - CFO*

That's a good question. So, I -- and the reason why I felt compelled to signal into Q1, of course, visibility is limited. We don't -- I'd prefer to get really into February and talk about the full year. But, I do think it's similar levels to 2010, around 33%. I think, again, the opportunity to expand as we go through the year.

As we've been talking about the last couple of quarters, we just have these ongoing sequential declines in the gross margin rate, with our legacy businesses particularly. And despite ongoing growth in our next-gen business at 40 or 50 points, all its doing is sort of offsetting the legacy gross margin decline right now.

Rich Valera - *Needham & Company - Analyst*

Got you. And in terms of the top line trajectory, obviously you've got the same conflicting trends on the top line. Can you at this point say anything about where you think overall revenue might be in 2011 relative to 2010?

Brian Bronson - *RadiSys Corporation - CFO*

Yes. Nothing specific other than, for me, no change in -- we've been talking about a next-gen growth of 20% plus a year. Still feel good about that. And I think really, in many ways, no change on the legacy side. A 20% plus decline there, right? So, the good news is about 2011 is that next-gen should overtake legacy. And so, that for us has been an inflection point. I know for many investors have been waiting for that inflection point to come and in 2011 that'll happen.

Rich Valera - *Needham & Company - Analyst*

And I guess with respect to the gross margin, I think a lot of folks had thought that, as this transition was taking place, you would see some nice gross margin improvement. And it sounds like, at least over the medium term, we're not really looking for that. Has the legacy gross margin kind of decelerated or declined faster than maybe you had thought a ways back?

Brian Bronson - *RadiSys Corporation - CFO*

Definitely.

Scott Grout - *RadiSys Corporation - President and CEO*

Yes.

Brian Bronson - *RadiSys Corporation - CFO*

Definitely. Yes. I mean, I would have never called -- and a bunch of reasons for it. But the bottom line, just think about our legacy coms business went from, again, high 20s earlier this year. It'll be in the teens a year later. I would have never called that a year or two ago.

Rich Valera - *Needham & Company - Analyst*

Right.

Brian Bronson - *RadiSys Corporation - CFO*

Yes.

Rich Valera - *Needham & Company - Analyst*

Right. Okay.

Brian Bronson - *RadiSys Corporation - CFO*

So -- but I want to make sure it's crystal clear. And I like the line of thinking because our next-gen business, again, just to beat it to a pulp, is operating as expected and planned. The gross margins are 40 to 50 as we've been calling it, so--.

Scott Grout - *RadiSys Corporation - President and CEO*

So, growth looks like it should for next-gen and margins look like it should for next-gen.

Rich Valera - *Needham & Company - Analyst*

Right. Okay. That's helpful.

Brian Bronson - *RadiSys Corporation - CFO*

And I guess the full reconciliation, Rich, just to -- sorry to interrupt. The legacy revenue actually doing about as expected and, in some cases, even a little bit better. But the gross margin, again, surprise.

Rich Valera - *Needham & Company - Analyst*

Right. Okay. And then on your new LTE Security Gateway, you mentioned in the release that this was kind of done in response to some of your TEM customers. Can you give anymore color on that? I mean, do you have one or more TEM customers that plan to sell this on an OEM basis? Could you give us any more color on that?

Scott Grout - *RadiSys Corporation - President and CEO*

Yes. So, the intent to the Security Gateway is to be sold on a broad basis to a number of different TEMs. We have a big Tier 1 TEM that is evaluating the product today and should go to trial in Q4 and deployment beginning of next year, assuming that trials go well. We are talking with a number of other TEMs right now and getting favorable response to the concept of adding Security Gateway capability on top of the platform. So, the real intended market for this is the major equipment providers, and seeing good traction thus far with the product announcement.

Rich Valera - *Needham & Company - Analyst*

Great. And one final one for me, if I could. You mentioned that the variability around the fourth quarter next-gen revenue. Is that -- really, is it mainly product -- or I should say supply constrained or is there sort of also issues around timing of your customers' deployments, which seems to be an issue with that business as well?

Scott Grout - *RadiSys Corporation - President and CEO*

No, predominantly or exclusively product -- or material availability. And I can say just a comment on that. Material availability got better in Q3 from Q2, and it is better in Q4, but there still are some spot shortages that we're working on. So, the market demand to support the range is very good and it's really going to be about material supply. And our OPS team has done just a phenomenal job clearing shortages.

Brian Bronson - *RadiSys Corporation - CFO*

Yes. I think the only difference would be, too -- and I'm sure -- I think everybody heard earlier a potential for a cash burn in the fourth quarter. Again, really timing. We've been able to, despite supply chain shortages, to figure out a way to collect enough time in the quarter. This will be a quarter, again, with X amount shipped in the quarter that we just won't be able to collect it by 12-31 and the cash flow will spill into Q1.

Scott Grout - *RadiSys Corporation - President and CEO*

Yes.

Rich Valera - *Needham & Company - Analyst*

But you would expect, then, with this sort of timing that maybe it would go cash flow positive again then in Q1.

Brian Bronson - *RadiSys Corporation - CFO*

Oh, even more so.

Rich Valera - *Needham & Company - Analyst*

Yes.

Brian Bronson - *RadiSys Corporation - CFO*

Yes. Even more so, yes.

Rich Valera - *Needham & Company - Analyst*

Yes. Sure.

Brian Bronson - *RadiSys Corporation - CFO*

I mean, this has in many ways been the first burn in isolation in years.

Rich Valera - *Needham & Company - Analyst*

Sure.

Brian Bronson - *RadiSys Corporation - CFO*

And it's obviously not because of our operating performance. It's the working capital, right, and the timing of it.

Rich Valera - *Needham & Company - Analyst*

Sure.

Scott Grout - *RadiSys Corporation - President and CEO*

Yes.

Rich Valera - *Needham & Company - Analyst*

Okay. Thanks for taking my questions.

Scott Grout - *RadiSys Corporation - President and CEO*

Thanks, Rich.

Operator

(Operator Instructions.) Your next question is from the line of Jody Farquhar of Jefferies.

George Notter - *Jefferies & Company - Analyst*

Hi. It's actually George Notter at Jefferies.

Brian Bronson - *RadiSys Corporation - CFO*

Hi, George.

George Notter - *Jefferies & Company - Analyst*

Hi, guys. I -- the question I -- just getting back to the gross margin discussion on the legacy products.

Scott Grout - *RadiSys Corporation - President and CEO*

Sure.

George Notter - *Jefferies & Company - Analyst*

I'd love to dig in there a little bit more. I mean, is that -- is it more than -- larger than expected decline in margins. Is that a function of volume? Is it a function of pricing pressure? I mean, I'd love some more flavor for what's going on in there.

Brian Bronson - *RadiSys Corporation - CFO*

Well, I mean, that's a combination of the above. I mean, in the legacy business, it's simply just pressure by customer and dual source commoditized. I mean, we're -- it is a board that could be source elsewhere. And of course, where we have it, ability to supply it and they're willing to take the gross margins, we'll obviously do it because it is economically positive. But again, it's -- every quarter it's going to continue to drop until it's gone.

George Notter - *Jefferies & Company - Analyst*

Got it. Are there specific programs or projects with customers then that you can point to that are no longer economically positive pieces of business that you could peel out of? I know certainly there have been different programs that you guys have done that with in the past. Could that be a source of improvement in margin structure potentially?

Scott Grout - *RadiSys Corporation - President and CEO*

So, that could improve margin structure but, as Brian said, it is economically positive to us. So, it does deliver OI. It does deliver cash. I imagine as some programs get to very near end of life, us making that call at that time would be the right thing to do. But certainly, gross margin cosmetics impact us, but it is positive cash flow, positive OI for us and still the right business to take.

George Notter - *Jefferies & Company - Analyst*

Got it. Okay. And then--.

Brian Bronson - *RadiSys Corporation - CFO*

Of course, as you heard from Scott, too, I mean, you could -- as you'd expect us to do, we do look at product line and customer profitability and EVA and all those things. And that's the conundrum. It adds every quarter, but you don't like the gross margin rate, so--.

George Notter - *Jefferies & Company - Analyst*

Got it. Okay. Could you talk a little bit about M&A opportunities? I know at one point there was a lot of interest in going out and looking at other players in the space, rolling up some others out there. I mean, is there still a thought to do that? What's your perspective on M&A at this point?

Scott Grout - *RadiSys Corporation - President and CEO*

So, absolutely still an area of high interest and high activity for us. So, we've got a team, including Brian and myself, VP of Business Development, CTO, that are dedicating lots of time to go out and look at target companies. So, that continues to be a priority for us.

The funnel has been really good. And we're working hard to make sure that what we look at is strategic, continues in the direction that we're taking, more toward solutions, and being careful that what we do is accretive and we've got a good sense of being able to turn it into a success. So, got kind of a long answer, but continues to be very important and an area of focus, and like the funnel that we're seeing.

George Notter - *Jefferies & Company - Analyst*

Got it. Okay, fair enough. Thanks very much.

Scott Grout - *RadiSys Corporation - President and CEO*

Okay. Thanks, George.

Brian Bronson - *RadiSys Corporation - CFO*

Yes.

Operator

And that was our final question. This concludes our question and answer session. Mr. Grout, are there any closing remarks?

Scott Grout - *RadiSys Corporation - President and CEO*

Just want to thank everybody again for participating in the call and see many of you throughout the quarter. Thank you.

Operator

This concludes today's conference call. You may now disconnect.
