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## **RSYS - Q3 2009 RadiSys Corporation Earnings Conference Call**

**Event Date/Time: Oct. 27. 2009 / 9:00PM GMT**



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## CORPORATE PARTICIPANTS

**Scott Grout**

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**Holly Stephens**

*RadiSys - Manager - Finance & IR*

**Brian Bronson**

*RadiSys - CFO*

## CONFERENCE CALL PARTICIPANTS

**Matt Petkun**

*DA Davidson - Analyst*

**George Notter**

*Jefferies & Co. - Analyst*

**Ted Jackson**

*Cantor Fitzgerald - Analyst*

**Ted Moreau**

*- 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 27th, 2009, this call is being recorded. Later, we will conduct a question and answer session. (Operator Instructions)

Now, thank you, Mr. Grout, please go ahead, sir.

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**Scott Grout - RadiSys - President & CEO**

Thank you, Barrett. 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 then open the call up for questions. Participating on the call today are Holly Stephens, Finance and Investor Relations Manager, Brian Bronson, our Chief Financial Officer, and myself, Scott Grout, President and CEO.

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

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**Holly Stephens - RadiSys - Manager - Finance & IR**

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 our SEC filings most recently in our 2008 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.



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

**Scott Grout** - *RadiSys - President & CEO*

Thanks, Holly. So revenues were in line with our projections, and we delivered better-than-expected gross margins, earnings and cash flow in the third quarter, as a result of continued cost improvements in our operations. In addition, we had another strong design win quarter, with several notable awards, including a new North American tier-one customer that plans to use our ATCA platform for their wireless messaging application and a win with a China-based tier-one customer that plans to use our media server in a new video service application.

Within our operations and engineering organizations, we continue to make very good progress on the previously announced initiatives to increase our operational efficiency and global capabilities that we expect will expand our operating margins over time.

Turning to the more significant product and business highlights for the quarter, in our media server product family, we were awarded a key new design win with an existing tier-one customer in China. This award was for an integrated media processing platform that will be used by mobile service providers to deliver advanced 3G video services.

Over time, we expect that new video services will be a driver in our next-generation communications products. In September, we also announced the addition of new 3G features for our media server product family, enabling two-way interactive mobile video. Our media server offers a broad range of IP video processing features for video telephony applications, including mobile video conferencing, video ringback tones, video mail and interactive voice and video response.

With the addition of the new media processing capabilities, our media servers now support a service providers 3G video processing needs with one common voice over IP infrastructure.

Shifting over to our ATCA product family, yesterday we announced a comprehensive new ATCA 4.0 initiative. ATCA 4.0 is our fourth generation of ATCA products, designed to support emerging high-bandwidth communications applications, such as 4G, LTE, broadband and video. A first in the marketplace, our fully integrated 40-gig ATCA platform features the latest technology in the industry, incorporating a 40-gig back plane and switching capability with backwards capability to a broad range of 10-gig technologies.

As equipment makers focus on building products for high-bandwidth mobile networks, our 4.0 platform will provide them with the latest advances in high-speed switching, power and cooling that are required for these demanding new applications. We also announced that we are partnering with Aricent and 6WIND to deliver application-ready ATCA platforms for LTE Evolved Packet Core. Through this collaboration, we can deliver our market-proven ATCA platform, a comprehensive LTE signaling stack and efficient data path software in one integrated solution that lowers development risk for our customers and reduces time to market significantly, sometimes by as much as 18 months.

During the third quarter, we were awarded new ATCA business in messaging, deep packet inspection, security gateways, voice over IP probe, session border controller and unmanned aerial vehicles. Specifically, the messaging win was of notable size, with a new tier-one customer for us in North America. The unmanned vehicle win is for a new customer's universal ground control station, used for unmanned aerial reconnaissance drones.

Our ATCA 4500 10-gigabit compute processing module was production released in the second quarter and in the third quarter deployed in customer trial networks. This product is ideal for control plane and server functions for LTE wireless infrastructure, DPI, IPTV, IP multimedia subsystems and defense applications.



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Finally, in our commercial business, we were awarded a sizable new COM Express win by a leading enterprise service provider in North America for a network switching application. We also won new COM Express business in the third quarter across a range of applications, including military, session border controller and home automation systems.

Further, the team won new rack mount server medical imaging business with an existing tier-one medical customer in the quarter. Moving on to our customers, our top five customers in the third quarter in alphabetical order were Cisco, Danaher, Miltope, Nokia-Siemens Networks and Philips Healthcare. Collectively, these top-five customers represented 65% of our revenue in the quarter, with 42% from Nokia-Siemens Networks. From a geographic perspective, 30% of the quarter's revenues were from North America, 24% were from Europe and 46% were from Asia. We continue to see good market strength in our business in Asia.

With that, I'd now like to turn the call over to Brian, who will talk a bit more about our third quarter results, as well as projections for the fourth quarter.

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**Brian Bronson - RadiSys - CFO**

Thanks, Scott, and good afternoon. Our third quarter revenue was \$70.4 million, which, as expected, was down 30% from the prior year and 10% from the prior quarter. Revenues were sequentially down due to reduced demand in our traditional wireless business and lower next-generation communications revenue relative to an exceptionally strong second quarter. Our GAAP gross margin percentage was 29.4% and was up 2.8 percentage points year over year. Our non-GAAP gross margin rate was 32.1%, up 1.4 percentage points year over year, and close to two points better than we previously expected.

The increases were mainly due to our improving mix of higher-margin products and better-than-expected manufacturing and operational POS. We currently expect our fourth quarter gross margin percent to be around the same level as the third quarter's rate at the midpoint of the guidance range.

GAAP R&D and SG&A expenses totaled \$21 million in the third quarter. Non-GAAP R&D and SG&A expenses totaled \$19.3 million, which was down \$3.3 million, or 14% from the prior year and \$800,000 from the prior quarter. Our expenses were lower than we previously expected, due to our ongoing focus on expense control, as well as timing of project expenses.

We currently expect that our total R&D and SG&A expenses will be up sequentially by approximately \$900,000 in the fourth quarter, due to timing of engineering projects and sales-related expenses, as well as higher incentive and commission expense due to higher operating results. Net, non-operating expense, which includes interest income, interest expense and other non-operating items was \$400,000 in the third quarter. We currently expect our non-op line to be an expense of \$500,000 in the fourth quarter.

Our non-GAAP tax rate was a negative 16.7% in the third quarter. As we have stated previously, our tax rate can fluctuate quarter to quarter as changes occur to our projected income by jurisdiction and other discrete items.

The rate was much better than we originally expected, due to favorable findings with regard to our third quarter transfer pricing and R&D tax credit studies. That is, we were able to put back more foreign deferred tax assets on our balance sheet. We currently expect our GAAP and non-GAAP tax rates to be around 10% in the fourth quarter, but, again, our tax projections can vary significantly.

Our basic weighted average shares increased to 23.6 million in the third quarter from 23.4 million in the second quarter. Third quarter non-GAAP diluted weighted average shares were 27.8 million, which includes 3.8 million shares related to our convertible notes. We project our weighted average basic shares to be 24 million for GAAP results and our dilutive shares to be 28 million for non-GAAP results in the fourth quarter.

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DSO was 48 days in the third quarter, compared to 47 days in the second quarter. Despite an increasingly difficult environment to collect receivables, we had yet again another great collection quarter. I do expect DSO to increase back up to the mid 50s as shipment linearity changes, along with our revenue mix.

As anticipated, net inventory increased approximately 1.8 million from the second quarter due to our buffer build associated with our manufacturing outsource work. I continue to believe that we will reduce inventory by \$5 million to \$10 million from today's levels when the manufacturing transition is complete. Cash flow from operations in the quarter was also better than expected, finishing at \$2.3 million, and we ended the quarter with \$92.1 million of cash and cash equivalents.

We currently expect our operating cash flow to be positive in the fourth quarter. So if you take our \$92 million of cash and cash equivalents and add \$21 million which is due from UBS in about eight months, I view our total cash and investment position to be approximately \$113 million.

Based on treating our 2013 convertible debt as equity, our current market cap and our fully diluted shares, we are trading at approximately 1.6 times cash, or \$4 per share in cash. Now, I'll turn the call back over to Scott to talk about the revenue per share outlook for the fourth quarter.

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**Scott Grout** - RadiSys - President & CEO

Thank you, 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 fourth quarter revenues to be between \$72 million and \$78 million. Revenue is expected to increase sequentially from the third quarter due to increased demand for our next-generation communications products. We currently expect fourth quarter GAAP results to be between a loss of \$0.07 and income of \$0.01. Non-GAAP EPS is expected to be between \$0.10 and \$0.16 per share.

So I continue to be pleased with the level of new awards and deployments we're seeing for our next-generation products. This year, we gained entry into several new strategic tier-one accounts, grew our revenues and design wins in Asia and are continuing to gain share in our next-generation communications products.

I am also very excited about our new product announcements in our ATCA and media server businesses. In addition, we continue to make substantial enhancements to our operational and financial models and we are in a great position to leverage these enhancements with our market leadership position and new product developments.

With that, I would like to turn -- thank you for participating in the call today, and, Barrett, I think we are ready to turn the call over to questions. Barrett, are you with us?

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## QUESTIONS AND ANSWERS

### Operator

Absolutely. (Operator Instructions). And, Mr. Grout, our first question comes from the line of Matt Petkun.

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**Matt Petkun** - *DA Davidson - Analyst*

Hi, good afternoon. Scott, just looking at the top five customer list, obviously, some new names or names that have been newer for the last few quarters, I think the one that catches us most obviously as a new entry is Cisco. Can you talk about that? Was that through maybe some M&A that Cisco had done, where they worked their way in, or is maybe Cisco thinking differently about how they build products?

**Scott Grout** - *RadiSys - President & CEO*

So, as you might expect, we can't talk an awful lot about it due to NDA, but Cisco in fact was a top-five customer. It came to us for a new application that they are working on. What we saw was initial field trial deployments this quarter. It'll probably pause for a little bit and then, depending on the success of that field trial, would expect to see them come back for us.

**Matt Petkun** - *DA Davidson - Analyst*

Okay, great. And when we see new customers like this and not even Cisco in particular, but just the new announcements that you're talking about in general, I'm assuming that most of this is intended to be what would ultimately fall into your next-generation COMs networking bucket.

**Scott Grout** - *RadiSys - President & CEO*

That's correct, Matt.

**Matt Petkun** - *DA Davidson - Analyst*

Okay, and how are you accounting for the new win that was a COM Express deal, but it looks like it's actually going into the network switching market, as well. That's not really a commercial deal, is it?

**Brian Bronson** - *RadiSys - CFO*

It'll actually go in, depending on the flavor of the deal, it goes actually into the end market, how we report. So if it's a COM deal it goes in the COM space, and vice versa.

**Matt Petkun** - *DA Davidson - Analyst*

Okay, so just because I've historically thought of that as one of your commercial product offerings, it wouldn't be fair to categorize it as such.

**Brian Bronson** - *RadiSys - CFO*

Yes.

**Scott Grout** - *RadiSys - President & CEO*

Correct.

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**Matt Petkun** - *DA Davidson - Analyst*

Okay, great. That's all for me right now. Great quarter, guys. Impressive control of costs and it looks like I guess maybe one question would be just directionally, revenues up in Q4. Is that more seasonality, which you've historically seen some seasonality, or do you see something that could be -- when you talk about your revenue mix shift, which is one of the things I think the Street's really focused on, do you see that we may be near the inflection point, or there's still -- when I look at the revenues from Nokia, it looks like there's plenty of room to go there.

**Scott Grout** - *RadiSys - President & CEO*

So, Matt, it's a little bit murky in terms of can we draw or connect points? I think the one thing we do feel good about is growth in our next-generation revenues, starting to pick up for us.

**Brian Bronson** - *RadiSys - CFO*

Definitely, definitely.

**Matt Petkun** - *DA Davidson - Analyst*

And those numbers were actually down this quarter. Are you saying kind of for Q4 that looks better than Q3?

**Brian Bronson** - *RadiSys - CFO*

Yes, yes.

**Scott Grout** - *RadiSys - President & CEO*

Correct.

**Brian Bronson** - *RadiSys - CFO*

And remember, too, Matt, we had a particularly strong first half, particularly second quarter strong, and so some of this is just timing of shipments, as well.

**Matt Petkun** - *DA Davidson - Analyst*

Okay, and I assume a chunk of the lumpiness this quarter could be attributed to the media server platform, which was very strong in the first half, or is that not a safe assumption?

**Brian Bronson** - *RadiSys - CFO*

I think it's fair to assume that when we talk about next-gen COMs being up, it's both media server and ATCA.

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**Matt Petkun** - *DA Davidson - Analyst*

Okay, but I'm talking about the Q3 downtick. How much of that was just across the board in your next-gen COMs business and how much of that was more attributed to the media server platform?

**Brian Bronson** - *RadiSys - CFO*

More media server, but both, some of both, depending on your reference point.

**Matt Petkun** - *DA Davidson - Analyst*

Okay, so the margins were pretty healthy, even though we saw a good downtick in your highest-margin product category.

**Brian Bronson** - *RadiSys - CFO*

Yes.

**Matt Petkun** - *DA Davidson - Analyst*

Okay, great. Congratulations.

**Brian Bronson** - *RadiSys - CFO*

Thanks, Matt.

**Operator**

Thank you. Next question comes from the line of George Notter.

**George Notter** - *Jefferies & Co. - Analyst*

Hi, guys. Thanks very much. Wanted to ask about customers as well, here. I noticed if heard you correctly, Fujitsu and NEC then I think popped out of your top five customer list, sequentially. Is that just lumpiness or timing of projects, or is there something else going on there?

**Scott Grout** - *RadiSys - President & CEO*

Much more lumpiness and timing. So you would expect to see the two through five customers vacillating a little bit. They're all in a similar range, but no material change for those two customers.

**George Notter** - *Jefferies & Co. - Analyst*

Got it.

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**Brian Bronson** - *RadiSys - CFO*

And of course, Scott, George, obvious for you, but for some of the folks that are new to the story, I mean, this is really what you should see here and take away, is that as these design wins ramp into production, you've seen the sundry of new names in the story in the last year or two, so expect to continue to see that as they deploy.

**George Notter** - *Jefferies & Co. - Analyst*

Got it. And then any more flavor for the win in China. You said it was an existing tier-one customer in China. Is that a service provider customer? Is that an OEM? Any more flavor for that would be helpful. Should we think about that application in tracking with the 3G build in China? What's the thought there?

**Scott Grout** - *RadiSys - President & CEO*

So it is with an OEM, an existing partner that we work with, sort of an expansion of product for video services on 3G and other networks.

**George Notter** - *Jefferies & Co. - Analyst*

Got it. And that should ramp then with 3G build in China? Is that fair?

**Scott Grout** - *RadiSys - President & CEO*

So probably a little offset to that. So we'll probably see deployment mid-year-ish, I think, next year.

**George Notter** - *Jefferies & Co. - Analyst*

Got it. Okay, great. Thanks very much.

**Scott Grout** - *RadiSys - President & CEO*

Okay, thank you, George.

**Brian Bronson** - *RadiSys - CFO*

Thanks, George.

**Operator**

Thank you. Next question comes from the line of Ted Jackson.

**Ted Jackson** - *Cantor Fitzgerald - Analyst*

Thanks very much. I've got a couple of questions, and congratulations on your quarter.

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**Scott Grout** - RadiSys - President & CEO

Thanks, Ted.

**Brian Bronson** - RadiSys - CFO

Thank you, Ted.

**Ted Jackson** - Cantor Fitzgerald - Analyst

Your commercial business was actually quite strong relative to what it's been the last few quarters. It's essentially been down-ticking since the third quarter of last year and I was kind of curious in terms of what's driving that, what would we expect in terms of that business going forward? Is this some kind of one-time kind of blip? Is this going to be stable from this level? Perhaps we're seeing some improvement in the economy that's coming through to your business?

And then tertiary to that is going back into the gross margin. I'm a little surprised that margins held as well as they did and did as well as they did, with the COM business going down and the commercial going up, if you could have maybe a quick margin discussion relative to commercial and some of the COM business, I'd appreciate it.

**Scott Grout** - RadiSys - President & CEO

Okay, great, so Ted, let me take the question on commercial business. So as we've talked about in other quarters, that business was previously hard hit by economy. So medical systems and test and measurement and a couple of the other end markets that we sell into were pretty hard hit Q1, Q2 and Q3 -- I'm sorry, Q1 and Q2. I think a relatively strong Q3. What I would say is I think we're seeing it stabilize now and the freefall or the significant fall that we saw across these end markets I think has stabilized. So I would expect on a go-forward basis not to see additional decline, but I think it's holding in there well. From a gross margin and mix standpoint, Brian, do you want to chat about that?

**Brian Bronson** - RadiSys - CFO

Yes, and maybe just one follow-up too on the commercial side, too. I think since you guys get to see the specifics by quarter, commercial in the second quarter was a little under \$13 million and then it just really hit bottom there. In the third quarter, we're actually up sequentially, did about \$16.5 million. I would argue Q4 might be a little bit different in general, though. It's somewhere between the second and third quarters for revenue range. That for me is kind of the bottom as we move forward and we'll get more visibility down the road.

As it relates to margins, particularly given some of our -- we talked about manufacturing difference and operational, two different buckets because we're making progress, as we talked about before, on lowering our cost structure. In addition to that, we're starting to reap some of the fruits of our labor around reducing things like excess and obsolete inventory accruals, lowering warranty costs. You'll see that when the Q comes out in two weeks. But just kind of across-the-board better process improvement has led to lower cost.

**Ted Jackson** - Cantor Fitzgerald - Analyst

Great.

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**Brian Bronson** - *RadiSys - CFO*

Is that helpful?

**Ted Jackson** - *Cantor Fitzgerald - Analyst*

Very helpful.

**Brian Bronson** - *RadiSys - CFO*

Thanks.

**Ted Jackson** - *Cantor Fitzgerald - Analyst*

My last question, just on the 40-gig product announced yesterday, those aren't commercially shipping now. When would you expect that to move to GA?

**Scott Grout** - *RadiSys - President & CEO*

So there's a number of different products that make up the 40G platform. I would expect us to be in prototype and start shipping in 2010 timeframe and comes out anywhere from between sort of early in the year throughout the year.

So in active dialogue with a lot of customers now about the 40G platform working to drive design wins consistent with product availability.

**Ted Jackson** - *Cantor Fitzgerald - Analyst*

Can you give us just some examples as you move to 10-gig to 40-gig, of some of the markets that that opens up for you and new types of applications that RadiSys can now go and attack and get design wins for?

**Scott Grout** - *RadiSys - President & CEO*

Yes, so it does two things for us. One is it increases the competitiveness of 10-gig, so the applications that we do with 10-gig today a number of them are made more effective, more efficient, more cost effective by moving to a 40-gig platform. I would say LTE is a big driver for us and video is a big driver for us in 40G product portfolio, overall.

**Ted Jackson** - *Cantor Fitzgerald - Analyst*

Great. Thanks very much.

**Scott Grout** - *RadiSys - President & CEO*

Okay, thanks, Ted.

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**Brian Bronson** - *RadiSys - CFO*

See you, Ted.

**Operator**

(Operator Instructions). Your next question comes from the line of [Ted Moreau].

**Ted Moreau** - *Analyst*

Hey, guys. How's it going.

**Scott Grout** - *RadiSys - President & CEO*

Hi, Ted.

**Ted Moreau** - *Analyst*

Just kind of curious, kind of going back to the analyst day you had in August and the disclosure of seeking out maybe some M&A opportunities. I'm just wondering if what you've seen in the pricing environment lately, looking at what Cisco is paying for Starent is a pretty aggressive premium. So just wondering what you're seeing there, and then also if the pricing has been aggressive, has that caused you to reassess any of the markets?

**Scott Grout** - *RadiSys - President & CEO*

So M&A remains in line with what we talked in the analyst day, so we're pretty active. Lots of good ideas out there, lots of engagement taking place. So that continues. Our basic objectives remain the same, as well. I think we're getting a little bit better sense of outlook for some of these businesses, which has progressed relatively well since we got together and talked last time.

With respect to price, I would expect there will be impact to price expectations, because some of these deals that just got pulled off. Our desire and I think our commitment is to make sure we pay fair price for anything. So I would expect it could have some impact on discussions, but finding the right business, strategically getting together, giving them a reasonable price and growing from there we still see as very feasible to do.

**Ted Moreau** - *Analyst*

And then kind of shifting gears a little bit, I had seen a report or a Reuters story or something that said that Ericsson's looking to slash purchasing costs by 50% over the next five years, and then on their recent earnings call they had mentioned the use of more common hardware platforms in an IP environment. Have you heard or seen any actions out of Ericsson opening up as a potential ATCA opportunity?

**Scott Grout** - *RadiSys - President & CEO*

So we do do some work with Ericsson, sort of working with partners, so they integrate a whole solution together that might include the solution from one of our customers today to sort of get ATCA into the product portfolio. Their desire for significant cost reduction is pretty similar to what we see across our customer base and the number way that that gets attacked is with better technology and better cost structure in the basic solution itself.

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So Ericsson continues to be a major player in the segment. We do have reasonable dialogue with them. Our hope is at some point there is direct opportunity with them as well, but at this point nothing direct.

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**Ted Moreau** - - Analyst

Okay, and then could you also talk about maybe what you're seeing in the tier-two OEM market from an ATCA potential and what you're seeing on the market size there? I'd heard recently that maybe the market size for tier twos is almost as big as the tier-one opportunity. Could you add any color there?

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**Scott Grout** - RadiSys - President & CEO

Yes. Good question, Ted. So over the last couple of years we have seen just significant traction with tier twos. It ends up being -- ATCA ends up being a very good model for them to get fast time to market, get the product out for lower R&D costs. So we've been fortunate to close quite a bit of business with the tier twos. In the last quarter, we brought on another tier two that we've coveted for a while, so in general I would say the rate of adoption has been good and continues to be good.

The first half of the year this year I think we had second highest design wins ever and good tier two traction took place there, as well. So rate of adoption has been good and continues to be good. And I think to the extent you see some of these big acquisitions taking place, that will be I think ultimately a vehicle for us getting stronger position in some of the tier ones.

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**Ted Moreau** - - Analyst

Okay, great. Thanks for taking my questions. Have a good one.

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**Scott Grout** - RadiSys - President & CEO

Thanks, Ted.

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**Brian Bronson** - RadiSys - CFO

Thanks, Ted.

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**Operator**

Thank you. And, sir, I'm showing no further questions or comments at this time.

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**Scott Grout** - RadiSys - President & CEO

Okay, thank you, Barrett. I want to thank everybody for participating on our conference call, and looking forward to touching base with all of you over the next couple of months. Thank you.

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**Operator**

Thank everyone for joining today's conference call. You may now disconnect.

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