FINAL TRANSCRIPT

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RSYS - Q1 2008 RadiSys Corporation Earnings Conference Call

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PRESENTATION

Operator

Welcome to the RadiSys Q1 earnings release with Scott Grout, CEO and President of RadiSys. As a reminder today, Tuesday, April 29th, 2008, 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 & CEO*

Thank you. Good afternoon and thank you for participating in our first quarter conference call. In this call we will review our financial and strategy results for the first quarter of 2008 as well as our outlook for the second quarter and then open the call up for questions. Participating on the call today are Brian Bronson, our Chief Financial Officer and myself, Scott Grout, President and CEO. Before we get started, I'd like to turn the call over to Brian for a caution about forward-looking statements.

Brian Bronson - *RadiSys Corporation - CFO*

Thanks Scott. Any statements in this call regarding future expectation 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 result toss differ materially from those in the forward-looking statements are discussed in our earnings release today, which may be found on our website and in our SEC filings including our 2007 10-K and our quarterly 10-Q. All information provided in this call is as of April 29th. RadiSys undertakes no duty to update any forward-looking statement to conform the statement to actual result or changes in the Company's expectations. In addition, we will be referring to certain non-GAAP financial measures during the call. For a reconciliation of our non-GAAP financial measures, please refer to our earnings release issued today, which is available on our investor relations section of our website. Now I'll turn the call back to Scott.

Scott Grout - *RadiSys Corporation - President & CEO*

Thanks Brian. I am very pleased with the results for the first quarter. First quarter revenues were $86 million and our non-GAAP income number was $57,000 or $0.00 per diluted share. We grew revenues by 29% over last year and we exceeded our first quarter revenue expectation as a result of higher revenues in our wireless business, as well as nice growth in our next-generation communications products, including ATCA and our media server products. I am encouraged by our progress on ATCA product deployments with demand increasing from a number of customers and applications. We also had a new customer install our market leading 10-gigabit ATCA platform into a live network earlier in the year for a new wireless application. We had a solid quarter of media server revenues as well, with particular strength in voice over IP conferencing applications. Consistent with our previous estimates, we expect our next-generation communications revenue, including ATCA and media server products to be at or above $80 million in revenues for 2008. We believe we are well on track to meet or exceed this target as we had strong ATCA revenue in the first quarter and we see this trend continuing into the current quarter.

As we stated before, these projections of course can very much be impacted by timing of our customers' deployment along with other external market factors. In the quarter, we also substantially completed the integration of the MCPD or modular communications platform division acquired from Intel last year and the results for this business were accretive to cash flow in the first quarter. The combined RadiSys and joining Intel team did just an outstanding job with this fairly large integration. I'm really pleased with how well the integration went and believe that we have now brought on a number of key new customers, market leading new products and a team of highly experienced staff to help enable our strategy.

In addition to the strength in our communications business, our commercial business grew 11% over the same quarter last year as a number of new commercial products also ramped into production. From a design win perspective, we were awarded wins from a number of new customers and some interesting application such as IP network switching, packet gap gateway, IP audio conferencing, test and measurement, military and medical. music on hold, network security and Wi max. I continue to be happy with the level of adoption of our broader market standard based products like ATCA, like COM E, like media servers and some of our other new products. On the new product introduction front, during the first quarter we announced the new ATCA duel OCTEON PLUS packet processing module, the 7220. This new product is an industry first to provide highest density gigabit interfaces with the significantly higher processing power and bandwidth access all in a single slot.

In the media server product family, we announced that our new CMF 9000 is the industry's first media server to offer N+1 redundancy, allowing for very high reliability in voice over IP conferencing applications. We believe that both products enable carriers to offer higher performance, lower cost and more reliable new communication services and application. In the commercial family of products, we introduced our new Procelerant Z500 module, a smaller pin out compatible variant of the COM Express. This new uses the new Intel Adam processor to deliver very energy performance in a small package, just perfect for the growing handheld and mobile equipment market. Returning back to our results for the first quarter, revenues by market were as follows. 77% or $66.1 million of first quarter revenues were from our communications networking market, which increased 35% year over year. This market includes wireless infrastructure, IP networking and messaging and other communications infrastructure. Wireless revenues were 38% of total revenues in the first quarter. We expect our wireless business to increase sequentially in the second quarter.

Revenues from our IP networking and messaging submarket were 14% of total revenues for the quarter. We currently expect our IP networking and messaging revenues to increase sequentially in the second quarter, but as we've discussed before, we do expect the legacy component of this business to continue to decline as it nears end of life in 2009. As I mentioned earlier, I am encouraged by the growing strength in our ATCA and media server products. ATCA revenues continue to grow in the first quarter, driven by some of our design wins moving to deployment with our customers. As I mentioned previously one of our customers deployed our 10-gigabit ATCA platform into a live network early in the year. In addition, one of our new customers in Asia recently announced a carrier grade communication server for IMS and NGN, which uses our new ATCA Promentum CPU blade. With our ATCA platform, the server offers the industry's highest scalability for subscriber capacity.

Also one of our telecom customers recently announced contracts from for all IP voice core application that included our ATCA Promentum processor blade. This helps our customer increase network capacity and speed while reducing the overall system cost and achieving fast time to market. Our media server revenues were also strong in the first quarter, as I mentioned, and we saw growth in the our North America conferencing business in particular. We are seeing growth potential in such areas as media server applications, as IP based conferencing, messaging, call center, voice services and interactive voice recognition. These applications are all important as the market moves from a TDM to IP paradigm. Here IP media servers play a significant role. We are also leveraging our success in North America in the media server business, like conferencing, into Europe and Asia while using our global sales team across the portfolio of media server products.

Moving to our commercial market 23% or $19.9 million of first quarter revenues were from our commercial systems market which grew 11% year-over-year. The commercial market includes medically imagining, diagnostic system, test and measurement, transaction terminal, semiconductor, CapEx and military. Medical systems were $8 million in the first quarter or 9% of total revenues. We currently expect our second quarter commercial revenues to be at somewhere to the first quarter as we are seeing some economic softening in the medical and testing measurement markets. As previously, discussed in the second half of last year, we were awarded new business with a new top tier medical imagining customer. Our development program with this customer is proceeding well and we currently expect to see production revenues from this new customer beginning in the second half.

Our top five customers for the quarter in alphabetical order were Converse, Danaher, Fujitsu, Nokia Siemens Network and Phillips Healthcare. Collectively these top five represented 57% of our revenue for the quarter with Nokia Siemens Networks representing 39% of first quarter revenue. Fujitsu entered as a new top five customer for us in the quarter and as a meaningful new ATCA customer for RadiSys that came with MCPD. From a geographic perspective, we continue to show good balance and diversity with 29% of revenues from North America, 39% from Europe and 32% from Asia-Pacific. With that, I'd now like to turn the call back to Brian, who will give you additional information about our first quarter financial results and some projections for second quarter and full year.

Brian Bronson - *RadiSys Corporation - CFO*

Thanks Scott. Our revenue for the first quarter was $86 million and our net loss for the quarter was $6.3 million or $0.28 per share. Our non-GAAP net income was $0.1 million or $0.00 per diluted share. Our first quarter results include $1.1 million of tax provisions for Canadian currency and Canadian statutory rate changes. Approximately $750,000 was due to U.S. dollar strengthening relative to the Canadian dollar in the month of March. We have Canadian dollar denominated deferred tax assets and when the currency fluctuates relative to the U.S. dollar, we have to take those changes as a discreet tax item in the quarterly tax rate. In addition, the Canadian statutory rate changed from 32 to 31 effective January 1st, 2009. We adjusted our deferred tax asset balances down by approximately $350,000. These tax provisions were not included in our previously issued guidance for the first quarter and, without these items ,we would have exceeded our non-GAAP EPS guidance for the quarter.

Our first quarter GAAP gross margin percentage was 22.7 and our non-GAAP gross margin rate increased to 27.7. Our gross margin rate increased sequentially due to the strength in our next-generation communication products, specifically our ATCA media server business. We currently expect our second quarter gross margin percent to be up again over the first quarter, due to continued strength in our new products as well as the completion of the acquisition transition services expenses at the end of the first quarter. R&D and SG&A expenses totaled $25.5 million in the first quarter. Non-GAAP R&D and SG&A expenses totaled $23.2 million, which was up about $500,000 from the prior quarter and from our previous guidance. The increase was the result of higher incentive compensation expense for employees tied to better operating result relative to original projections. We currently expect second quarter total non-GAAP R&D and SG&A expenses to be down slightly from the first quarter, as our annual salary increases are more than offset by the completion of transition services expenses related to MCPD.

Stock-based compensation expense was $2.5 million in the first quarter and flat with the fourth quarter. We expect stock-based compensation expense to be around the same level again in the second quarter. Our first quarter net nonoperating income, which includes interest income, interest expense and other nonoperating items was $876,000, which is down from $1 million in the fourth quarter, due to lower yields on our investments partially offset by positive cash flow in the quarter. We currently expect net nonoperating income to decrease in the second quarter to zero, due to lower yields and lower cash balances given the buy back of our 2023 convertible notes as well a higher interest rate tied to our new 2013 convertible notes. Our first quarter tax rate was 0.3% and our non-GAAP tax rate was 96%.

As I mentioned previously, the tax rate in the first quarter was impacted by discreet items associated with Canadian currency relative to U.S. dollar and Canadian statutory rate changes. We currently expect our GAAP tax rate to be around 12% and our non-GAAP tax rate to be around 28% for the rest of the year, which makes our full-year tax rate unchanged from prior guidance at 10% for GAAP and 35% for non-GAAP. However this can vary significantly depending on our revenue and earnings mix for the year, currency fluctuations and any discreet items related to FIN-48. Most importantly, we are not in a tax paying position so changes in the rate only drive changes to the balance of our deferred tax assets and do not impact cash. Our basic weighted average shares increased to 22.1 -- 22.2 million excuse me, in the first quarter from 22.1 million in the fourth quarter. We expected our basic share count to be around 22.3 million in the second quarter. Our diluted weighted average shares used for non-GAAP earnings were 22.8 million in the first quarter.

Taking into consideration the remaining 2 million of shares associated with our 2023 convertible notes and the 4.2 million shares associated with our new 2013 convertible notes, the diluted net income threshold has changed. For net income of $1.3 million or less, our diluted shares exclude the effect of both our convertible notes and the associated interest income add back to earnings, as the effect would be anti-dilutive. For net income of $1.4 million to $1.7 million, only the 2023 convertible notes have a dilutive impact with the associated interest added back of $119,000. For net income of $1.8 million and above, both convertible notes have a dilutive impact with an associated interest add back of $432,000. As we buy back the 2023 convertible notes, these thresholds will continue to change.

Moving to the balance sheet, cash flow from operating activities was $8.1 million and we ended the quarter with $118.3 million of total cash and investments, $59 million of cash and cash equivalents, and $59.3 million is long term investments, which consist solely of auction rate securities. Auction rate securities are variable rate debt securities that have long term maturity with the interest rate being reset through auctions that are typically held every seven, 28 or 35 days. All of our ARSes are collateralized by student loans and currently have a triple A credit rating. Repayment of student loans is at least 90% backed by the U.S. Government under FFELP. Until February 2008, the student loan ARS market was liquidity. However in mid February, a substantial number of auctions failed as there was not enough demand to sell the entire issue at auction. The failure of these auctions do not affect the collateral underlying the ARSes.

Based on current market conditions, we believe that it is likely that auctions related to the student loan ARS market may continue to be unsuccessful, at least for the near term, which has limited our ability to access these funds. We anticipate that the liquidity of the ARS will continue to be restricted until there is a successful auction, until another market for the ARS develops or until the ARS are called by the issuer. Earlier this month our independent broker informed us that they have developed a model that estimated the fair market of our securities as of March 31st to be 5.5% or $3.4 million lower than the investment balance of $62.8 million as of the end of February, primarily due to lack of liquidity. In determining a discount factor for each ARS, the model weighted various factors including their high credit quality, maturity, probability to be called, lack of liquidity, comparable securities of the issuer, if any, and cash flow projections. We consider declines in ARS fair market values due to lack of liquidity to be a temporary impairment and, thus, reported an unrealized loss on investment of $2.2 million net of tax in the shareholders equity section of the balance sheet in the first quarter.

Based on the current cash on hand, our future cash projections and our existing line of credit, we will be able to fund ongoing operations and purchase the remaining $47.5 million of our 2023 convertible notes in November of this year. Regarding the cash outlook, we currently expect cash flow from operating activities to be around $3 million to $5 million in the second quarter. Our trade receivables decreased by $14.3 million to $56.2 million from the fourth quarter related today lower revenues and improved DSO. DSO for the first quarter was 60 days, which is down five days from the fourth quarter due to higher collection levels due to record shipments in the fourth quarter. We expect DSO to stay in the low to mid 60s in the second quarter. Inventory increased to $30.1 million in the first quarter from $23.1 million in the fourth quarter, due to the expected inventory purchases associated with our acquisition as well as higher in-source bills associated with the ramp in ATCA production. The inventory turns were 8.3 which is down from 12.6 turns in the prior quarter. We exclude intangible amortization in cost of goods sold when calculating turns. We expect our second quarter inventory balance to be about flat to slightly down from the first quarter.

Capital expenditures were $2.2 million and depreciation expense was $1.5 million in the first quarter. We purchased fixed assets associated with the acquisition during the quarter. I expect both cap expenditures and depreciation expense to be about $2 million in the second quarter, as about $500,000 of our MCPD capital purchases move into the second quarter. Our cap cycle time was 37 days in the first quarter, which was up five days from the fourth quarter. The increase is mostly attributed to our higher inventory balance associated with the MCPD inventory purchases. We expect cash cycle time to remain in the 30s. Regarding our convertible debt, we repurchased $52.5 million of our 2023 convertible senior notes below par. The remaining balance of $47.5 million is classified as short-term debt as it will be most likely put to us in November of this year unless the stock price is north of $23.57.

In addition, we completed an offering for $55 million of convertible senior notes due February 15th, 2013. The notes will be convertible into RadiSys common stock at a conversion price of approximately $13.03 per share or 4.2 million shares. The conversion price represents approximately a 27% premium to the closing price of RadiSys common stock on February 6, 2008. The notes will bare interest at a rate of 2.75%. In connection with this offering, we entered into a cap call transaction with an affiliate of the underwriter for this offering. The cap call transaction is expected to reduce the potential dilution upon conversion of the notes by about to $42.5 million, so we brought the conversion price up from $13 to $23. The net proceeds to us from this offering were approximately $42.4 million, after giving effect to the cost of the cap call transaction and underwriting and related fees. Now I'll turn the call back over to Scott to talk about the outlook for the second quarter and the full year.

Scott Grout - *RadiSys Corporation - President & CEO*

Thanks Brian. Regarding our outlook for the second quarter and for 2008, 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 second quarter revenues to grow sequentially from the first quarter to between $86 million and $94 million. We expect second quarter results to be a loss in the range of $0.23 to $0.15 per share and non-GAAP net income to be between $0.06 and $0.11 per diluted share. Our projected non-GAAP results exclude a loss of $0.29 to $0.26 per share, primarily attributable to the impact of amortization of acquired intangible assets and stock-based compensation expense. For the year, we project total 2008 revenues will grow at a rate in the high single digits to low double digits from the prior year. Within this overall growth rate with expect wireless revenues to be up at similar level in 2008 as they were in 2007. We expect our legacy products specifically in our IP networking and messaging market to continue to decline as expected. And finally, we expect our new strategic higher margin products to show nice growth from the prior year.

We are making good progress in the deployment of our new products including ATCA media servers and COM Express products. In addition, we substantially completed the integration of our Intel MCPD business and I continue to be pleased with new customers, the new products and new employees that we brought on as part of the acquisition. We believe our strategic investments, along with our customer traction and product wins, have us positioned for longer term growth in our target markets. With that, I would like to thank you for participating on the call today. And I believe we are ready to open the call up for questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS) The first question comes from the line of Matt Petkun from D. A. Davidson & Company. Your line is open.

Matt Petkun - *D.A. Davidson & Company - Analyst*

Thanks so much. Nice quarter. So looking at the commercial part of the business, Scott, that was -- or not the commercial but the IP network and messaging business, was the sequential decline there primarily due to some of your existing contracts that are moving towards end of life?

Scott Grout - *RadiSys Corporation - President & CEO*

Definitely, yes.

Matt Petkun - *D.A. Davidson & Company - Analyst*

Okay. And then looking at the balance sheet, obviously, cash flow is going to be a real area of focus for us over the next couple of quarters. Brian, is there any way you can offer along with your $0.06 to $0.11 in pro forma guidance, a general sense of what you think you can do in terms of cash flow from operations next quarter?

Brian Bronson - *RadiSys Corporation - CFO*

Yes. I mentioned $3 million to $5 million.

Matt Petkun - *D.A. Davidson & Company - Analyst*

I missed that. And then just finally, talking about your -- obviously the business with your largest customer, that appears to remain quite steady. Have you learned anything in terms of their integration with Nokia and Siemens and what that has meant in your overall level of visibility for the remainder this year?

Scott Grout - *RadiSys Corporation - President & CEO*

So business continues to progress pretty well with them. Integration, from our perspective, of the two entities is going well. Our visibility into their end business remains pretty strong so we engage not just with the procurement organization but also some of the end using business unit. I do think in net we have bump in business relative to where we would have been, because of the combined demand between Nokia and Siemens. So in that, we are pretty happy with how things are going there.

Matt Petkun - *D.A. Davidson & Company - Analyst*

That's all for me for now.

Brian Bronson - *RadiSys Corporation - CFO*

Thanks Matt.

Operator

The next question comes from the line of Ted Jackson with Cantor Fitzgerald. Go ahead sir.

Ted Jackson - *Cantor Fitzgerald - Analyst*

Hi Scott, Brian. Three questions is I missed the CapEx number you gave.

Brian Bronson - *RadiSys Corporation - CFO*

$2.2 million.

Ted Jackson - *Cantor Fitzgerald - Analyst*

And then what was depreciation in the quarter, not amortization, just depreciation?

Brian Bronson - *RadiSys Corporation - CFO*

$1.5 million and both go into $2 million in Q2. $2 million CapEx and $2 million amortization.

Ted Jackson - *Cantor Fitzgerald - Analyst*

And then lastly, moving over to the media server business, it sounds like you've had a pretty decent quarter. You're starting to maybe see some growth out of that business. Can you give us an update in terms of sort of where you are relative to that being a bottom line contributor and maybe some sense in terms of when you see it becoming something accretive to the bottom line? I know you are not talking to it in hard numbers, but just kind of talk around it for us, that would be great.

Scott Grout - *RadiSys Corporation - President & CEO*

I can talk about top line a little bit and throw it over to Brian in terms of accretion. Top line we are seeing some strength. Q1 was pretty good. Outlook for Q2 is good. North American conferencing is strong. We are starting to see some of the benefits of worldwide sales force in Asia and in Europe. Team is pursuing some new applications for media server as well. So in general I think state of the market is pretty good for us and our market share position market position overall remains pretty strong. Comments?

Brian Bronson - *RadiSys Corporation - CFO*

Yes. As it relates to -- the business is contributing to the bottom line, and I guess if you go back and look at the original guidelines for accretion at the time of the deal, we are not quite there yet, but and really that was -- since it was an all cash deal, it was about the interest that we were earning in the bank. So but it is contributing now, which is nice.

Ted Jackson - *Cantor Fitzgerald - Analyst*

It's a profitable business.

Brian Bronson - *RadiSys Corporation - CFO*

It's a profitable business for us.

Ted Jackson - *Cantor Fitzgerald - Analyst*

Great. I'll step out of line.

Brian Bronson - *RadiSys Corporation - CFO*

Thanks Ted.

Operator

Your next question comes from the line of Andrew Spinola with Needham and Company.

Andrew Spinola - *Needham and Company - Analyst*

Thank you. Brian, on the auction rate securities, can you tell us what the maturities on those securities are?

Brian Bronson - *RadiSys Corporation - CFO*

Well, that's a good question. We are still working through it now, but range of maturities that we think average 10, 12 years and that's again if everything holds but we are still obtaining that data from our provider.

Andrew Spinola - *Needham and Company - Analyst*

So at this point you really are looking for alternative ways to unload these or to reauction?

Brian Bronson - *RadiSys Corporation - CFO*

Yes.

Andrew Spinola - *Needham and Company - Analyst*

And the interest rate is generally what on these types of securities? Is it off of LIBOR?

Brian Bronson - *RadiSys Corporation - CFO*

Yes. It varies, but on average it's either T-bill plus, call it 100 to 150, or LIBOR plus 100 and it can actually range all the way up to 250.

Andrew Spinola - *Needham and Company - Analyst*

And that hasn't been reset since the failed auctions?

Brian Bronson - *RadiSys Corporation - CFO*

It has. So we have various resets and we do have a piece of our portfolio that is reset to zero.

Andrew Spinola - *Needham and Company - Analyst*

Okay.

Brian Bronson - *RadiSys Corporation - CFO*

As I'm sure many of you have read about.

Andrew Spinola - *Needham and Company - Analyst*

Can you tell us roughly what the interest income you'll expect off the $55 million or whatever it is exactly that's been moved to long term investments?

Brian Bronson - *RadiSys Corporation - CFO*

Right now it's about 230 basis points.

Andrew Spinola - *Needham and Company - Analyst*

230 basis points. That's all cash or just the long term investments?

Brian Bronson - *RadiSys Corporation - CFO*

Just the long term investments. Blended average of the 59.3 now or 62.8 of face is 2.3. And again interest rate ranges. So some are higher, as you probably read about, and some are zero.

Andrew Spinola - *Needham and Company - Analyst*

Got it. Scott, in the press release you talked about the new customer where you had been put into a live network. Can you describe what you mean as a new customer? I'm assuming obviously that the OEM or whoever is using your product went through beta testing and has been developing their product for a while and yet you describe them as new. Is this a new customer or a new direct customer from you?

Scott Grout - *RadiSys Corporation - President & CEO*

It would be new customer from a meaningful revenue perspective. And this particular situation is actually a really good example of the speed to market advantage that you can get from ATCA. So in this particular case, I believe that they chose our ATCA platform in the spring of last year, March/April time frame, did a pretty significant development and actually headed up live in the network beginning of the year this year. That's a nine-month interval for something that would take 24 or 36 months. So it's probably our best example of very fast development time if you buy at the full platform level. Back to your question, definition of new customer, so they weren't a customer of ours as of March of last year and now represent new revenue customer for RadiSys.

Andrew Spinola - *Needham and Company - Analyst*

Is it an operator or an OEM?

Scott Grout - *RadiSys Corporation - President & CEO*

I'm sorry, it is an OEM.

Andrew Spinola - *Needham and Company - Analyst*

It is.

Scott Grout - *RadiSys Corporation - President & CEO*

Yes.

Andrew Spinola - *Needham and Company - Analyst*

And then on the gross margin I guess you've given us guidance for pretty much every other line on the income statement I think, what is going to determine the fluctuation in gross margin there, is it just mix?

Brian Bronson - *RadiSys Corporation - CFO*

It is mix. There are other things as well, but given the fact that we are seeing ramp in our new products, which overall are higher gross margins, that is the trend right now, but still you've got a mix of business that can fluctuate from quarter to quarter.

Andrew Spinola - *Needham and Company - Analyst*

Got it. Last question from me. Just on the '08 guidance, I think you had said that wireless would be at the same level as '07 and '08. Is it the same absolute level of revenue or same growth rate?

Scott Grout - *RadiSys Corporation - President & CEO*

Same absolute level.

Andrew Spinola - *Needham and Company - Analyst*

Okay. Thank you.

Operator

(OPERATOR INSTRUCTIONS). The next question comes from the line of Matt Petkun from D. A. Davidson & Company.

Matt Petkun - *D.A. Davidson & Company - Analyst*

I had couple of follow-ups. So the guidance implied for the full year, Scott, where you said is growth in the high single digits to low double digits, we could theoretically kind of straight line the midpoint of your guidance for next quarter and obviously there is some fluctuation to that. Can you give us a sense of what the margin profile could do over the course of the year, assuming flattish sales as a baseline? And really my question goes to really trying to see how the $80 million you are expecting in more standard space product line should transition through the year.

Scott Grout - *RadiSys Corporation - President & CEO*

My general expectation, as I mentioned, high single digit, low double digit. I expect some of the legacy products to be falling off. I expect wireless to be kind of flattish and then of course the new products with better margins profiles to be going up. So in that, I do expect upper pressure on the gross margin as we go through the year this year.

Matt Petkun - *D.A. Davidson & Company - Analyst*

And from a pricing perspective with some of your major customers in Europe, they may be seeing pricing pressure given their cost structure on the euro relative to the dollar, but have you seen any meaningful change in pricing from a past-year perspective trying to come back towards you?

Scott Grout - *RadiSys Corporation - President & CEO*

So pricing pressure has been high for the last couple of years. I mean in some of the end markets that our customers play in, the pricing pressure is pretty significant. So it's not up materially from what we saw in '07 or '06, but still it's a high number. Definitely need to be conscious of that.

Matt Petkun - *D.A. Davidson & Company - Analyst*

For Brian, finally, looking at the inventories, are these new inventory levels -- obviously some of it and much of it is associated with the purchase of MCPD, but can we see inventories regress to historic levels on a turns basis or has something changed in the nature of the types of products you are selling on a standardized basis and your desire to keep more product in inventory?

Brian Bronson - *RadiSys Corporation - CFO*

You know what's -- I guess what's changed, so MCPD is known and we did procure some materials that I think is a bit of a bubble and that works itself off a bit over time. So separate from that, we are starting to go see some momentum with ATCA, which is today built here in Hillsboro and that is creating some inventory build as well. So that being said, I think we can still over time, work the inventory down a bit.

Matt Petkun - *D.A. Davidson & Company - Analyst*

Okay. Thanks so much. Nice quarter.

Brian Bronson - *RadiSys Corporation - CFO*

Thanks.

Operator

And the next question comes once again from the line of Andrew Spinola from Needham & Company. Go ahead, sir, your line is open.

Andrew Spinola - *Needham and Company - Analyst*

Thanks. I have two follow-ups. First, Brian is there anything in the second quarter operating expense guidance associated with the TSA?

Brian Bronson - *RadiSys Corporation - CFO*

No. The TSA is all gone.

Andrew Spinola - *Needham and Company - Analyst*

Okay. Very good. And then Scott, just in the macro environment, I guess obviously some consolidation still in your industry, a couple of the big waver servers manufacturers have sort of exited ATCA. Just sort of any thoughts that you can provide on the market in general and then also stepping back, I know you said the pipeline is still healthy, you're happy with where it's going but what are sort of people -- what is the reaction of your customers and end customers to sort of new applications and new products on ATCA platforms? Has that increased, decreased, the same as it was? Any sort of comments on the macro level, that would be great.

Scott Grout - *RadiSys Corporation - President & CEO*

There's a couple of players that were in ATCA business that now are not. So Intel was in ATCA business. Our own biased point of view, or my own biased point of view, they did a great job seeding the market with the belated assets to get the ball rolling. At the end of the day that is really not their core business and it's a pretty usual pattern for them to say, get the ball rolling, get the ecosystem set up with companies like RadiSys and some of our peers. Once they have confidence in that ecosystem then they'll typically sell off the asset. So Intel moving from a blade provider now back to silicon provider is normal and natural and I continue to be really grateful and really excited that we are able to pick up that business. HP, please forgive this, it will be a little bit of sour grapes here, but many discussions of yes, we want to be an ATCA player, but not a lot of actual assets and really no meaningful market position. So it's a pretty normal process. If you've got a few leaders that are doing really well attracting new customers and those that didn't do so well attracting new customers backing out of the business. So I'm not shaken at all by either of those two things, we are no longer ATCA supporters and we do have a pretty strong ecosystem out there with us and some of the other peers.

ATCA rate of adoption in general as I mentioned, I continue to be pretty happy with that. You will see the sales funnel sort of cycle up and cycle down. We are kind of on an up cycle right now, so the depth of the funnel, the number of applications, the number of customers is actually relatively pretty strong. I do expect that to continue to go up and down as projects get approved, booked and scheduled. So in general, strength of the funnel is pretty good. The benefit, the fundamental benefit of ATCA and using the model of faster time to market, less R&D dollars to get the job done, lower cost, aggregated volumes, all of those remain principal drivers for our customers and why they want to choose this model. And I think the last thing on the other side of the coin that continues to play us in the ATCA market a little bit is implementation, particularly at the software level when you move to Linux is a big undertaken. So while I had a great example of a nine- or ten-month program, other programs are taking longer. The customer continues to invest, continues to have the product deployment on their schedule and something that they are going to do, just a bit longer than they had thought and we had thought. So in summary, I'm pretty happy with how the market is developing and it's nice now to see some of the programs click into revenue mode.

Andrew Spinola - *Needham and Company - Analyst*

Sure. Thank you.

Scott Grout - *RadiSys Corporation - President & CEO*

Thanks.

Operator

At this time there are no more questions in queue.

Scott Grout - *RadiSys Corporation - President & CEO*

Great. Once again, thank you everybody for participating on our call and I look forward to seeing many of you between now and the next call. Thanks so much. Bye bye.

Operator

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