FINAL TRANSCRIPT

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RSYS - Q1 2010 RadiSys Corporation Earnings Conference Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by and welcome to the RadiSys first quarter earnings conference call with Scott Grout, President and CEO of RadiSys. As a reminder, today, Tuesday, April 27th, this call is being recorded. (Operator Instructions.) Mr. Grout, please go ahead.

Scott Grout - *RadiSys Corporation - President, CEO*

Thank you, Marcello.

Good afternoon and thank you very much for participating on our first quarter conference call. In this call, we will review results for the first quarter, as well as our outlook for the second 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, I'd like to turn the call 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 that 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, CEO*

Thank you, Holly.

So, I'm very pleased with our results and our progress in the first quarter. We came in at the upper end of our revenue range and exceeded our expectations on earnings. We continued to expand our next generation revenues nicely, reaching over $30 million for the quarter, our highest level yet for shipments of these products. With a solid start to 2010, we believe that we are on track to grow our next generation business by 20% to 30% this year.

We announced a number of important new products in the quarter, including several new 10/40 gig ATCA offerings, and the new media server based mobile video solution that I'll talk about later.

We also announced our acquisition of Pactolus Communications, a maker of next generation IP solutions for converged VoIP networks. The Pactolus products will further strengthen our higher-value, software-based solutions, while leveraging our existing portfolio of communication networking products.

Pactolus software is used in operated, assisted and reservationless audio conferencing, pre and post-paid long distance services, and is installed in over 45 telecommunications service provider customers worldwide.

We expect that the acquisition will be accretive to non-GAAP EPS and operating cash flow by the third quarter. This acquisition is a nice example of a smaller, high-value technology acquisition that incrementally builds on our existing product portfolio.

In the first quarter we announced our new Integrated Mobile Media Server product, or IMMS, which enhances mobile service providers' ability to expand new revenues from the growth of mobile video services. Our IMMS is expected to increase service provider revenues and reduce their cost of deployment for 3G, 4G, LTE mobile video services.

We were again named the market leader in media server for the sixth consecutive year by Infonetics Research. RadiSys' media servers captured 60% of the total fourth quarter 2009 market, and 57% for the full year of 2009. This is an 8 and 10 point percent gain, respectively, over 2008.

We also had another excellent design win quarter, with wins from many new and existing customers in a variety of compelling applications. We were awarded our first VoIP Voice Quality Enhancement, or VQE, with a major Tier 1 service provider. This was an important win for us as it expands the market for our media server products to now include Voice Quality Enhancement, or VQE. We also won new media server business in applications including announcement, interactive voice response, and conferencing.

Moving over to our ATCA business, we won new ATCA system business in LTE, in WiMAX, in femtocell, in wireless LAN, and satellite communications applications.

The LTE win was of notable size with a Tier 1 TEM in Asia, and the WiMAX win was with a new customer for an access service gateway project in India.

Our 40G ATCA platform was named 2009 Product of the Year by Technology Marketing Corporation's Internet Telephony Magazine.

We also announced three new ATCA products that offer our customers increased choice and flexibility in 10 and 40 gigabit processing power. These new products provide significant performance increases and improved energy efficiency over previous processing technology, and target applications for the communications and mil/aero markets.

We reached several significant deployment milestones with our ATCA customers in the quarter. One of our customer's femtocell deployments in North America is now planned to occur sooner than was expected. One of our Tier 1 TEM customers is in customer trial with RadiSys ATCA solutions and, in addition, a satellite communications deployment using our ATCA solution is currently scheduled for the second quarter.

For our commercial business, we introduced a new ruggedized COM Express module for deployment in harsh military/aerospace and industrial environments that require extended temperature and vibration performance.

We also released a new rack mount server platform with significant performance increase and improved energy efficiency for applications such as medical imaging and video streaming.

In the quarter we were awarded new COM Express business in medical imaging, network switch, Voice over IP, and defense applications.

Moving back to our results for the first quarter, our top five customers in the quarter, in alphabetical order, were Fujitsu, NEI, Nokia Siemens Networks, Philips Healthcare, and ZTE. Collectively, these top five customers represented 64% of our revenue in the quarter, with 34% from Nokia Siemens Networks and 15% from NEI.

As we've talked about in the past, Nokia Siemens Networks continues to be a very strategic customer for RadiSys, with revenues diversifying nicely beyond our legacy products to include meaningful new business in ATCA and in IP media servers.

NEI was over 10% of revenue in the first quarter due to strength with their end customer, Danaher.

ZTE entered our top-five customers in the quarter with strong media server business.

With that, I'd now like to turn the call over to Brian, who will talk a bit more about our first quarter results and projections for the second quarter.

Brian Bronson - *RadiSys Corporation - CFO*

Thanks, Scott, and good afternoon.

As previously mentioned, our first quarter revenue was $67.3 million, and our next-generation revenue was $30.6 million, up 21.8% year over year and up 7.6% sequentially. Our earnings were stronger than originally projected, delivering 11 pennies of non-GAAP EPS.

Our Q1 non-GAAP gross margin rate was 33%, which was 2 percentage points better than we had previously expected. The increase was due to a greater mix of higher margin, next generation revenues, improved operational costs, and about 0.5% was due to a gain on the sale of equipment associated with the closure of our manufacturing operations in Hillsboro. Our Q1 GAAP gross margin percentage was 30.2%.

We expect our Q2 non-GAAP gross margin rate to be between 32% and 33%, at the midpoint of the guidance range, as we incur the remaining manufacturing transition related costs, as well as ongoing expedite costs to help secure raw materials with our CMs in what continues to be a challenging supply chain environment.

We do expect that gross margins will improve throughout the year as next generation revenues continue to grow, as we wrap up the remaining manufacturing and outsourcing work, and as ongoing improvements are made to materials availability within our supply chain.

Non-GAAP R&D and SG&A expenses totaled $19.3 million, which was down $1.5 million or 7% from the prior year, and down $272,000 from the prior quarter. GAAP R&D and SG&A expenses totaled $20.9 million in the first quarter.

Our expenses were down year over year as a result of putting more of our operations in lower-cost geographies, as well as ongoing cost control.

We currently expect that our non-GAAP R&D and SG&A expenses will be up in the second quarter by approximate $900,000, again, at the midpoint of the guidance range, due to the addition of Pactolus, as well as increases in sales and marketing expenses.

Non-GAAP operating income was $2.9 million, or 4.3% of revenues in the first quarter. This compares to 7.7% in the fourth quarter and 6.7% in the first quarter a year ago.

Net Q4 non-operating expense -- excuse me, net Q1 non-operating expense, which includes interest income, interest expense, and other non-operating items, was $278,000 in the first quarter. We currently expect our non-operating expense to be around the same level in the second quarter.

Our non-GAAP tax rate was a negative 6.8% in the first quarter. The rate was much lower than we expected as our IRS tax audit was successfully closed during the first quarter, and we continue to see all of our taxable earnings being generated in foreign jurisdictions.

We currently expect our non-GAAP tax rate to be around 7% for the second quarter, as well as for the full year, and our GAAP tax rate to be around 40%, which looks large, seems large, but it's because we are hovering right around GAAP breakeven. As we have stated in the past, our projected tax rates can change based on jurisdictional income and other factors.

Our non-GAAP diluted weighted average shares were 28.2 million, which includes 3.8 million shares related to our converts. Our first quarter GAAP basic shares were 23.9 million. And we project our dilutive shares to be 28.4 million for non-GAAP results, and our basic shares to be 24.1 million for GAAP results in the second quarter.

As a reminder, when including the convert shares for net income over $1.8 million, you need to add back the interest income of $291,000 to net income when calculating EPS.

DSO was 55 days in the first quarter compared to 52 days in the fourth quarter, and I expect DSO to stay around these levels throughout 2010.

And in the first quarter we reduced inventory and inventory deposits by approximate $2.5 million to $15 million. Depending on how things unfold over the next couple of quarters with regard to the ongoing raw material supply shortages in the industry, we may have to make a temporary investment along with our CMs in long lead time parts to ensure that we can meet increasing customer demand. It could be upwards of a couple million dollars, but I'll keep you informed as things unfold.

Our cash flow from operations was $8.3 million in the first quarter and better than we previously expected. We ended the first quarter with $110.4 million in cash, which is up over 40% from the prior year. We currently expect operating cash flow to be positive in the second quarter.

During the first quarter $15.2 million of our auction rate securities were repaid at full value. So, our balance due from UBS, netting the line of credit, is now down to $15.8 million, which we expect will be paid back to us in July of this year. So, if you take the $110.4 million of cash at the end of Q1, add another $15.8 million due from UBS, I view our total cash and investment position to be approximately $126 million.

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

Scott Grout - *RadiSys Corporation - President, CEO*

Thanks, Brian.

So, regarding our outlook for the second quarter and for the year, 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 the second quarter revenues to grow to be between $70 million and $75 million. We expect revenues to increase from the first quarter due to increased legacy wireless revenues, up from a seasonally lower first quarter, as well as increased commercial revenues. We expect our next-generation product revenues to be up again in the second quarter over the same quarter last year.

We expect our non-GAAP EPS to be between $0.09 and $0.14 per dilutive share. We currently expect our second quarter GAAP results to be between a net loss of $0.03 per share and a net income of $0.01 per dilutive share.

As discussed on our last earnings call, we continue to project 2010 next-generation product revenues to grow between 20% and 30% over 2009. We also project that our lower margin legacy products will decline by between 20% to 30% in 2010 from 2009, as older programs continue to roll off.

In total, we expect that our next-generation products will overtake our legacy products during the year, and that they will become a higher percentage of our revenues than our legacy products by the end of 2010.

In closing, our higher-margin next generation revenues are growing very nicely and we expect that they will overtake legacy revenues by the end of the year. We had another strong design win quarter that we expect will continue to fuel our next generation revenue growth moving forward.

Our market-leading ATCA products are effectively winning new business in 3G, 4G, LTE, wireless voice, data, video, femtocell, and secure defense communication applications.

We hold over 60% of the media server market share and continue to win new business in VoIP, video over IP communications, conferencing, and VQE applications. And with the addition -- with the acquisition of Pactolus we've broadened the scope of our media server offerings even more.

With that, I'd like to turn the call over to those of you who are participating for questions and then we will wrap the call up. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions.) Our first question comes from the line of George Notter with Jefferies. Please go ahead with your question, sir.

Rajiv Jenveja - *Jefferies & Company - Analyst*

Thanks, guys. This is Rajiv Jenveja for George.

Scott Grout - *RadiSys Corporation - President, CEO*

Hey, Rajiv.

Rajiv Jenveja - *Jefferies & Company - Analyst*

Hey. So, I guess two questions here. One, I wanted to ask about the commercial business and how you're thinking about revenues for the back half of the year there? In the past we kind of assumed or we thought that it was going to be a flat business year over year, and you grew the revenues this quarter relative to Q1 of '09. The guidance suggests that you're probably going to grow it next quarter relative to Q2 of '09. So, I'm wondering what's going to happen in the back half of 2010. Are we going to see a drop off or can you keep this going and actually grow it year over year?

Brian Bronson - *RadiSys Corporation - CFO*

Yes. I think that Q2 we do expect to be up sequentially, to your point, so that read was right. But I do think we have some timing that is driving Q2 being stronger than what I would still consider a business that's sort of $60 million, plus or minus. We are seeing some growth in the areas that we're investing in, but there's still some softness as well. So, it's a $15 million, $16 million quarter sort of run rate until proven differently I think is the answer.

Rajiv Jenveja - *Jefferies & Company - Analyst*

Okay. Okay. And then on the margin guidance, is there any way you can quantify what the impact, the negative impact is from the manufacturing transition? And this materials issue as well. What kind of headwind is that creating and how long do you expect that to kind of remain a negative variable?

Brian Bronson - *RadiSys Corporation - CFO*

Yes. So, gross margin guidance, 32% to 33%. I think when you add in the expedite and related costs, as well as call it redundant overhead in resolving the remaining outsourcing piece, it's a point to a point and a half related to this quarter. So, everything being held constant, the mix that we're describing, the $70 million to $75 million revenue range, that would be 34 points, plus or minus, had we not had those things to deal with.

Rajiv Jenveja - *Jefferies & Company - Analyst*

Okay. Okay, great. That was it for me.

Scott Grout - *RadiSys Corporation - President, CEO*

Thanks, Rajiv.

Rajiv Jenveja - *Jefferies & Company - Analyst*

Thank you.

Operator

(Operator Instructions.) Our next question is from the line of Aalok Shah with D.A. Davidson. Please go ahead with your question.

Aalok Shah - *D.A. Davidson & Co. - Analyst*

Hi, guys. A couple of quick questions.

Scott Grout - *RadiSys Corporation - President, CEO*

Sure.

Aalok Shah - *D.A. Davidson & Co. - Analyst*

Still new to the story a little bit. But in terms of the mix this quarter and the margin impact, I mean, I know, Brian, that it looks like you're at least $2 million above kind of where the Street was looking for. Was all of that next-gen revenue and is that really the reason why the EPS came in at better than it really should have? Or -- and maybe you can explain the expedited products. Was that all next-gen products? And maybe you can give us a sense of maybe where you think those are going from an end-market perspective.

Brian Bronson - *RadiSys Corporation - CFO*

Yes, we did see the strength in the next-gen piece of the business, and we also -- we have mix even inside of our next-gen business. And so, I think the mix was better than we originally planned. So, a couple million better, to your question, and the mix was right even inside of next-gen.

We had also planned -- Q4 we really started to feel in a meaningful way the supply impact, or lack thereof, in the market and industry. So, we had planned on a pretty heavy expedite and related set of costs to be incurred in Q1. We didn't spend as much as we had planned. It turns out that we're spending some of that now in Q2 to continue to recover, but that was favorable relative to our plans.

Aalok Shah - *D.A. Davidson & Co. - Analyst*

And when you look out to, like, the next couple of quarters, I mean, do you -- I mean, was the order linearity on the next-gen products pretty strong all the way throughout the quarter, or did you see a big bump? And it sounds like you saw a big bump towards the end of the quarter. And why do you think that won't really necessarily continue into this quarter?

Brian Bronson - *RadiSys Corporation - CFO*

Well, some of it is -- so, we were seeing signs of strength in demand all the way through the quarter. It was really more the tussle on the supply side, what was just simply doable inside the quarter. So, business in general pockets are picking up, as Scott referenced in the release and in the call, in various sectors. But some of it simply has to do with what we're able to ultimately deliver to our customer on the supply side.

Aalok Shah - *D.A. Davidson & Co. - Analyst*

So, I know you don't give a book-to-bill or backlog number, necessarily, but would it be fair to assume that you took down some of the backlog in Q1?

Brian Bronson - *RadiSys Corporation - CFO*

Yes, but then it turned around and filled back up again with ongoing tussle with supply. So, I would say we're still right in the middle of it and fighting through the daily battle, for lack of better words, and just trying to do the best we can in getting product to customer. So, we did dip down a little bit, but then built it back up again towards the end of the quarter.

Aalok Shah - *D.A. Davidson & Co. - Analyst*

Okay. And what kind of lead times do you get from your suppliers at this point? I mean, have they -- and I'm sure they're stretched a little bit, but what kind of lead times are you seeing right now?

Scott Grout - *RadiSys Corporation - President, CEO*

So, as you can imagine, it varies. Some lead times haven't extended that much. There are some situations where lead times get as long as 30 weeks plus.

Scott Grout - *RadiSys Corporation - President, CEO*

And so, we've been focusing a lot of attention on forecasting out two, three, four quarters and making sure our suppliers are well loaded. In addition to that, as Brian had mentioned, we'll probably put in place some strategic inventory to help with that long lead time.

Aalok Shah - *D.A. Davidson & Co. - Analyst*

Okay. And last question from me on that same subject. I mean, you've burned down some inventory in the quarter. Are you concerned that maybe you might not have enough inventory right now on hand to possibly meet some expedited orders if they come through again this quarter?

Scott Grout - *RadiSys Corporation - President, CEO*

So, I think it gets better each quarter. And again, I would expect as we go into Q3 and Q4 for us to be in a pretty good material position from an inventory perspective to support upticks.

Brian Bronson - *RadiSys Corporation - CFO*

Yes. And I was going to say, too, that it's -- some of this is just the change in our model. So, now we're -- the inventory onus in general is on our partners, on our contract manufacturers. So, the inventory reduction was back to our sort of July of last year conversation, a one-time benefit for us. And now, really, it's all about working with a CM to get the right signal into them to be able to procure the material that ultimately they hold to transform product.

Aalok Shah - *D.A. Davidson & Co. - Analyst*

So, should we expect the inventory levels on a days basis to kind of hover around this level now, especially since you've moved to that new model?

Brian Bronson - *RadiSys Corporation - CFO*

In general, yes. What's going to be left for us, Aalok, is service inventory, last-time buy inventory that we buy for customers that's sort of outside of our contractual relationship with our CMs. But in general, we get back to a normal environment, our CMs hold the inventory. We don't.

Aalok Shah - *D.A. Davidson & Co. - Analyst*

Okay. Great. And one more quick one. In terms of this quarter, the March quarter, could you have shipped more if you had more inventory on hand?

Brian Bronson - *RadiSys Corporation - CFO*

Yes. Yes.

Aalok Shah - *D.A. Davidson & Co. - Analyst*

Okay.

Brian Bronson - *RadiSys Corporation - CFO*

Yes. But I hesitated because, again, you could -- you'll be able to -- could have said that about Q4 and you'll say that about Q2 as well. So, it's really about making progress as we go through the year.

Aalok Shah - *D.A. Davidson & Co. - Analyst*

Okay, great. Thank you very much.

Scott Grout - *RadiSys Corporation - President, CEO*

Thanks, Aalok.

Operator

(Operator Instructions.) And gentlemen and ladies, it does appear that there are no questions at this time. Mr. Grout, do you have any final comments you'd like to make?

Scott Grout - *RadiSys Corporation - President, CEO*

Thank you, Marcello. Once again, thank you, everybody, for participating on the call and look forward to seeing most of you as we go through the quarter. Thank you very much. Bye-bye.

Operator

And ladies and gentlemen, this does conclude today's conference call. We would like to thank you for your participation. You may now disconnect.