

# FINAL TRANSCRIPT

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## STEC - Q3 2011 STEC Inc Earnings Conference Call

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## CORPORATE PARTICIPANTS

**Mitch Gellman**

*STEC Inc. - VP, IR*

**Manouch Moshayedi**

*STEC Inc. - Chairman & CEO*

**Raymond Cook**

*STEC Inc. - CFO*

## CONFERENCE CALL PARTICIPANTS

**Rich Kugele**

*Needham & Company - Analyst*

**James Schneider**

*Goldman Sachs - Analyst*

**Kaushik Roy**

*Merriman Capital - Analyst*

**Gary Mobley**

*Benchmark - Analyst*

**Sherri Scribner**

*Deutsche Bank - Analyst*

**Aaron Rakers**

*Stifel Nicolaus - Analyst*

**Nehal Chokshi**

*Technology Insights - Analyst*

**Rajesh Ghai**

*ThinkEquity - Analyst*

**Marshall Levine**

*Knott Partners - Analyst*

## PRESENTATION

**Operator**

Good day, ladies and gentlemen, and welcome to the STEC Q3 2011 earnings conference call. (Operator Instructions). As a reminder, this conference call is being recorded.

I would now like to turn the conference over to your host, Mr. Mitch Gellman. You may begin.

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**Mitch Gellman** - *STEC Inc. - VP, IR*

Thank you. Welcome, everyone. Thanks for joining us for today's Q3 2011 earnings conference call. We hope that you had an opportunity to read this afternoon's earnings release containing our results for the third quarter of 2011. For those of you who joined us on October 4 -- I'm sorry August 4 in New York City for our 2011 Analyst Day, we appreciated your positive feedback on the variety of the presentations and also on the four new product demos -- ZeusIOPS, MACH16, our PCIe solid-state accelerator card, and our EnhanceIO data caching software. As well, attendance for our Analyst Day 2011 was the highest for any similar event in our Company history. So thank you.



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I would also like to update you on our participation at one recently held investor conference, as well as one that we are presenting at this week. Scott Stetzer, our Vice President of Technical Marketing, gave a technology presentation at last week's Needham HDD & Memory Investor Day that was in Boston. And tomorrow Scott will deliver a similar presentation at Wells Fargo Securities Tech, Media and Telecom Conference in New York City.

Joining me for today's discussion of our results, our business outlook and Q&A session are Manouch Moshayedi, our Chairman and CEO, and Raymond Cook, our Chief Financial Officer.

But before we begin, I would like to remind everyone that our prepared remarks and answers to questions will include forward-looking statements within the meaning of the US Private Securities Litigation Reform Act of 1995 and are based on management's current expectations. These forward-looking statements include, but are not limited to, statements concerning growing acceptance, adoption and qualification of SSDs within the enterprise storage and server markets; expected benefits and cost advantages of STEC's product lines; the qualification of STEC's fourth generation ZeusIOPS SSD product, MACH16 SSD, PCIe solid-state accelerator card, EnhanceIO data caching software and other developing technologies; the qualification of STEC's products and solutions into emerging OEM customers; STEC's key product line initiatives and development; the transition from one product generation to the next; the capabilities and performance of STEC's products and solutions.

The rapidly evolving enterprise storage and server markets and expected fourth-quarter 2011 revenue and earnings per share entail various significant risks and uncertainties that could cause our actual results to differ materially from those expressed in such forward-looking statements. These risks and uncertainties are detailed in periodic filings with the Securities and Exchange Commission. Special attention is directed to the portions of those documents entitled Risk Factors and Management's Discussion and Analysis of Financial Condition and Results of Operations. Listeners are cautioned not to place undue reliance on these forward-looking statements, which represent our views only as of today.

While we may elect to update forward-looking statements at some point in the future, we specifically disclaim any obligation to do so, even if the estimates change, and therefore, you should not rely on the forward-looking statements as representing our views as of any date subsequent to today.

Additionally, as we discuss our financial performance, we will be referring to certain non-GAAP financial measures. Please see the reconciliations of our GAAP to non-GAAP measures included in today's earnings release. Thanks, again, for joining us everyone, and now I would like to turn our call over to our CEO, Manouch Moshayedi. Manouch?

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**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

Thank you, Mitch, and good afternoon. I would like to begin today's call with a commentary on the state of our business. Raymond Cook will follow with our usual discussions of operating results.

Despite the challenging environment, we were able to beat our guidance in Q3 and continue to build on major opportunities for our Company in the growing data storage industry. We are very excited that the potential of the SSD market is coming into full view. Even though the enterprise adoption of SSDs has been slower than originally anticipated, we have seen numerous signs during the quarter that the market we started more than five years ago is growing and that then continued adoption would be robust.

Not only have we witnessed several emerging system developer companies entering the market with all SSD systems, but we have also seen large players announce similar products. This is very encouraging as it signals a new era for storage in which system developers have recognized that indications of current systems that integrate mechanical hard drives. The new storage systems are being designed to take full advantage of SSDs that feature exponentially higher performance, enhanced reliability and endurance. This innovative thinking that one can build systems without the use of traditional HDDs has created an exciting

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new wave of opportunities, not only for enterprise markets as a whole but for STEC in particular, especially since we offer one of the broadest arrays of SSD products to the enterprise.

As we look to expand and diversify our customer base, we are glad to report that we have been busy qualifying our products at several of these emerging companies. Our customers' products aim to reshape the storage industry by eliminating historical systems, bottlenecks and are being well-tuned for virtualization, cloud computing, big data and other technology trends appearing in the data centers across all industries. Since we have been engaged with these companies at an early stage, we are confident that our business with them will grow as their businesses flourish.

Qualification activity at our large industry leading OEM customers is also continuing. These companies are undertaking breakthrough innovations on a much larger scale, and we will continue to be their partners as they develop their next generation platforms. It is our ability to add enormous value to the systems of both large and small players in this industry that has allowed us to build a solid base of OEM customers over the years and be qualified in so many different platforms.

Even though SSD adoption is in force, we believe that we are in a period of transition where the current price of SSDs have remained a barrier to full adoption. Fortunately we saw this day coming and started to prepare for it more than three years ago.

The next versions of our products attempt to solve this issue through the replacement of FPGAs with our new ASIC and the replacement of high-price SLC flash with standard MLC flashes coupled with our proprietary endurance enhancing CellCare technology. We continue to focus on two key product transitions that are currently underway -- the release of the new version of our flagship, ZeusIOPS, now in its fourth generation, and the launch of our MACH16 product line aimed at the server market. We also have two new product lines in process for qualification -- our PCIe solid-state accelerator cards and our EnhanceIO data caching software for Windows, Linux and VMware environments. Activity on these fronts remain on track and on target.

First qualification efforts have been underway since we sent sample units to customers in Q1 of 2011, and they are now in later evaluation stages of our Gen 4 ZeusIOPS SSDs with SAS 6 Gb and Fibre Channel 4 Gb interfaces based on our new ASIC design. These next-generation SSDs feature lower-cost MLC flash media enhanced with our proprietary CellCare technology, which makes commodity MLC flash suitable for enterprise markets. We expect to move to full production in Q2 of 2012.

In addition, our MACH16 SSD, which is a SATA product line, has been in qualification with most of our major OEM storage and server customers since Q1 of 2011. This product line is already in full production mode with a few customers and is being actively moved from qualification to full production with others.

Our PCIe card is a completely new product line for us. It uses our custom-integrated ASIC that we designed for our Gen 4 ZeusIOPS. Evaluation units have been sent to some of our major OEMs customers, and we are seeing a great deal of interest in this new product at all of our OEM customers. Our PCIe solution is not only a higher performance card than those currently available in the market, but it also utilizes MLC flash with CellCare and does not drain resources the way that the incumbent competitive PCIe cards do.

We strongly believe in our go forward market strategy through major OEMs. Even though other PCIe card manufacturers have received early revenue traction selling directly to end-users by marketing our high performance, low cost and system resource efficient cards to large server and storage systems builders, we believe that we will eventually be able to capture a large portion of the PCIe market. Our focus this quarter is to continue to complete our qualifications with our customers while selling our current generations of products.

In order to bolster our competitive position, we have increased our research and development team by approximately 100 full-time engineers in recent months. Our engineering team is the foundation of our technical innovation and world-class customer support. We are also investing aggressively in our overseas R&D capabilities with plans to build a brand-new R&D center in Malaysia. This represents the second phase of our operations in Malaysia with much of the design and permit work being finalized. We are now forecasting start of construction in the first half of 2012.

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That said, the fourth quarter of 2011 is turning out to be one of the most challenging quarters that we have experienced in the past few years. We will achieve revenues between \$55 million and \$57 million with non-GAAP diluted earnings-per-share to range from a loss of \$0.02 per share to breakeven. We view the first half of 2012 as a transitional period during which we are shifting our customers to our newer generation of products.

While this transition gets traction, we are having to deal with certain competitors in the high-end enterprise storage market segment that are either offering very low aggressive pricing to displace us or lower performing, lower-cost SATA bridge alternative solutions that are being used in the place of high performance Fibre Channel or SAS solutions. We view these practices by certain competitors as unsustainable over the long term and specifically when our high performance costs reduced Gen 4 ZeusIOPS becomes qualified.

It is also important to note that the server segment of the market that is experiencing the most amount of growth and receiving a lot of attention recently have never been a big part of our business. But this changes with the introduction of MACH16 and our PCIe card. Both products should make us very competitive in this dynamic space. Once we get through this transition period, we expect to get to normal growth rates again.

In conclusion, while we are experiencing a few tough quarters, we believe that the fundamentals of our Company and our markets are strong and sound. Even though there are competing products being adopted by our customers at the high-end of the market, the competition we see is further validation that the major adoption of SSD is happening of a scale far greater than it is today and far beyond what a single source could properly supply and support., we believe the market is going to be large enough for multiple suppliers of SSD to thrive.

Because we continue to invest heavily in our R&D and have plans to introduce new products that are faster, lower priced and more efficient, we expect to have a large market share as we move forward.

That ends my prepared comments, and I will now turn the call over to Raymond who will provide more detail on our financial results. Raymond?

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**Raymond Cook - STEC Inc. - CFO**

Thank you, Manouch, and welcome, everyone. The net revenue for our third quarter of 2011 was \$72.5 million, which surpassed our guidance of \$70 million to \$72 million for the quarter. Net revenue by major product categories was as follows. Flash-related products accounted for \$70.7 million or approximately 98% of total revenue. DRAM-related products accounted for \$1.5 million or 2% of total revenue, and service revenue was \$325,000 or less than 1% of revenue. The flash-related revenue was comprised of ZeusIOPS of \$58.4 million, MACH products of \$6.4 million, and embedded SSDs and other flash products of \$6.0 million. International sales comprise 63% of our total revenues in the third quarter of 2011.

For the third quarter of 2011, our GAAP gross profit margin was 45.8%. Our non-GAAP gross profit margin was 46% as compared to 44.9% in the second quarter of 2011. Our Q3 2011 GAAP sales and marketing expense was \$5.8 million, GAAP general and administrative spending was \$7.3 million, and our GAAP research and development spending was \$14.5 million. Total GAAP operating expenses for the third quarter of 2011 was \$27.7 million, and non-GAAP operating expenses was \$24.2 million.

Our non-GAAP results for the third quarter of 2011 excluded stock option compensation expense of \$3.7 million, net of tax impact of \$1.2 million. The non-GAAP adjustments are detailed in our third quarter of 2011 earnings release that was issued earlier today. Our provision for income taxes was booked at an effective tax rate of approximately 12.4% for the quarter ended September 30, 2011, and an effective tax rate of approximately 6.5% for the nine months ended September 30, 2011.

Our GAAP diluted earnings per share was \$0.09 for the third quarter of 2011. Our non-GAAP diluted earnings-per-share was \$0.14 for the third quarter of 2011, which surpassed our non-GAAP earnings-per-share guidance of \$0.08 to \$0.10.

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From a balance sheet perspective, the following are selected counts of interest for the third quarter of 2011. Cash and cash equivalents decreased \$52.1 million from Q2 of 2011 to \$161.2 million. This decrease was primarily related to the \$43.7 million used during the quarter to repurchase 4.466 million common shares STEC stock under our two Board of Directors' approved share repurchase programs. Accounts receivable increased \$2.0 million from the end of June 2011 to \$47.6 million. Net inventories increased \$2.2 million from Q2 of 2011 to \$82.4 million. Capital expenditures were \$3.3 million for the quarter, offset by \$3.4 million of depreciation and amortization.

Current liabilities decreased \$11 million for the quarter to \$29.3 million, due primarily to the timing of accounts payable payments to suppliers, and the Company had no long-term debt outstanding as of September 30, 2011. The net cash used in operating activities for the three months ended September 30, 2011, was \$4.1 million.

I would like to thank you for joining us today. This concludes our prepared remarks. I will now open up the call to your questions.

## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions). Rich Kugele, Needham & Co.

### Rich Kugele - Needham & Company - Analyst

Just a few questions for me. First, should we assume then that the revenue should continue to fall until the quals are complete sometime in the second quarter of 2012?

### Manouch Moshayedi - STEC Inc. - Chairman & CEO

Yes, that could be a right assumption. We are not sure yet. Obviously we don't forecast for Q1 at this time. But, as you can imagine, today we are going through a qualification of all of these different new products at our customers, and until they ramp up, we are seeing an end to the existing products that we are shipping to them. So the quantity of the current products that we are shipping are going to go down and down until the new products are adopted.

### Rich Kugele - Needham & Company - Analyst

Okay. And then in terms of new products, especially on your comments about pricing, how far do you think you are going to have to go with the next Gen in order to hit where the market is at that point for a faster adoption rate?

### Manouch Moshayedi - STEC Inc. - Chairman & CEO

I think with the new products that we are shipping out now as qualification, we are extremely competitive both on the SLC front and specifically on the MLC side with what is currently shipping in the market.

So, in terms of competitiveness, we are very competitive with ASIC-based Gen 4 and PCIe versus anything that is shipping out with FPGA, and also the MLC is getting a lot of traction from most of our customers.

### Rich Kugele - Needham & Company - Analyst

Well, how much are they pricing under you today in order to win that business?

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**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

Right now they are pricing SLC about 30% below where we are.

**Rich Kugele** - Needham & Company - Analyst

Okay. Is it similar for MLC or less?

**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

Well, MLC, we don't have a competitor in MLC yet. So, on MLC, I cannot comment if anybody is quoting anything lower than where we are. But with MLC, once our products ship out, we are very competitive with future pricing that we have already given our customers.

**Rich Kugele** - Needham & Company - Analyst

Okay. And then the last for me is on the EnhanceIO product, is there any reason why that product cannot ship sooner than some of the other solutions, or are you trying to launch them all together?

**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

No, no. The EnhanceIO still has to go through testing at multiple customers before it becomes mature enough before we can ship it. So that one is still a couple of quarters before we can ship in. I will ship it as a package. We can ship it probably during the second quarter to OEMs. However, to ship it to end-users is going to take maybe one more quarter after that.

**Rich Kugele** - Needham & Company - Analyst

And that will work on anyone's SSDs, right?

**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

That would work on anybody's SSD. That is true.

**Operator**

James Schneider, Goldman Sachs.

**James Schneider** - Goldman Sachs - Analyst

Following up on the earlier question, if revenues from your existing products are going to continue to ramp down for the next couple of quarters as customers stop taking them, is it also true that once your new products start to ramp it will also take several quarters for those to ramp up? In other words, even once we hit Q2, are we going to see several quarters before those new products ramp up?

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**Manouch Moshayedi** - *STEC Inc. - Chairman & CEO*

Well, that is a tough question to answer because we don't know which one of the customers are going to fully qualify at the end of Q1 or middle of Q2. So depending on when they qualify the product, I think the ramp will start almost immediately. Because we already have a slot in those new products that are going to be using the new generation of SSDs. So we know the ramp is going to come pretty fast once the qualification is completed.

So I don't think it is going to take -- of course, as we move forward and adoption of SSDs continues to grow, we will see the revenue models from all of those new products also increase through the quarters. But, as an immediate ramp to production, I think we will get up pretty fast.

**James Schneider** - *Goldman Sachs - Analyst*

I understand. But just to understand, regardless of when exactly they start to ramp, it would be a multi-quarter event at each customer. Is that right?

**Manouch Moshayedi** - *STEC Inc. - Chairman & CEO*

Well, it is always a multi-quarter event until the design of the system that they are building in becomes end of life, and then they have to go to a new system. But what we are qualifying in is a primary source in a new product that is going to be shipped out with our Gen 4 products or MACH16 products or PCIe products. So the ramp will happen almost immediately. And then, of course, as the adoption continues to grow, the ramp continues to grow with it.

So it is not like we are going to ship it only in 5% of the systems when they go into production. They are going to ship it to as many systems as they can sell right from the first quarter.

**James Schneider** - *Goldman Sachs - Analyst*

Okay. I understand. And then in terms of the competitive environment, I believe you have cited HGST and Samsung as being two of the competitors that are being aggressive in the marketplace. Can you talk about which one of those or both of those are being incrementally more aggressive than you are seeing in the market right now?

**Manouch Moshayedi** - *STEC Inc. - Chairman & CEO*

Well, we are seeing obviously Samsung is trying to buy this business with low SLC pricing on SATA drives, and some customers understand that they have to still use a bridge. It is a little more difficult, and it does not perform as well as a native SAS or Fibre Channel drive. So they have to discount it bigger than -- basically for the bigger discount than anybody else.

On the HGST front, they are selling a SAS and Fibre Channel product, and they are basically buying that business today at very low price of SLC, which I don't think that is sustainable because they are trying to leverage a hard drive business with SSDs, which is I don't think on a long-term basis is a sustainable business practice.

**James Schneider** - *Goldman Sachs - Analyst*

I understand. And then last one for me, can you talk about the percentage of your top customers in the quarter and whether you expect all those customers to decline in Q4?

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**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

Well, the biggest decline in Q4 comes from one customer in particular that has got both Samsung, SATA drives qualified and has qualified HGST at a lower price SLC. Most other customers are pretty stable with what they were in Q3.

**James Schneider** - Goldman Sachs - Analyst

Any percentages?

**Raymond Cook** - STEC Inc. - CFO

We have three customers during the quarter that were greater than 10%. They are detailed in our 10-Q under Note 2 - Sales Concentration.

**Operator**

Kaushik Roy, Merriman Capital.

**Kaushik Roy** - Merriman Capital - Analyst

I question your OEM only sales model. I'm looking at some of your competitors such as OCZ; they are selling well in the channel. I'm looking at Fusion-io. They are going direct to the customer. You have a good PCIe product, but you are not selling it. You are waiting nine months for OEM qual. So why don't you have a direct to customer and build a sales channel -- I mean, a channel distribution channel?

**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

First of all, building a distribution channel is not something that can be done overnight. It takes months if not years to build a proper channel out there. But, at the end of the day, this is a product that has to get integrated into an OEM system. So a PCIe card by itself you cannot use it. It has to go into a server or a storage system. That server or storage OEM would have to qualify this PCIe card as well.

Now, on a go forward basis, when we look into 2012/2013 and beyond, if you are a Facebook or an Apple or whoever you are that you are building a server system, you have to -- you are going to call up a Dell, you are going to call up a HP, you are going to call up IBM and say, I want 10,000 servers, and I want PCIe cards in them. Well, they are going to turn around and tell you that they have their own PCIe card qualified, and there's three versions of them qualified. You can just choose whichever one you want and go with it.

So I don't think that the end user, the way that they have been dictating up to this point to OEMs how and what brand of a PCIe card should be integrated into a server is going to be able to dictate that anymore a year down the road. Because every one of the OEMs that they buy from will have a PCIe card if not two or three PCIe cards qualified across all of their server platforms.

So that product -- that type of a sales model that you are talking about, it is very good if you are selling a system, a fully enclosed system, that you go sell it to an end-user, and they just plug it in and it all works. But if you have to sell a component that goes into another system, another OEM system, then it is pretty tough. It is good on a temporary basis, but not a long-term strategy.

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**Kaushik Roy** - Merriman Capital - Analyst

And can you give some color on your gross margin assumptions for December? Is it going to be up or down sequentially?

**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

Well, you have to think that some of our production costs are fixed, so that is not going away. And if you spread that production cost over a smaller revenue base, it is going to have some negative impact on the gross margins. (multiple speakers) All-in-all when you look at our product sales, we are selling the product at the same price as before, and there is no degradation of price of the product.

**Kaushik Roy** - Merriman Capital - Analyst

So let me be clear, so you are assuming because of the volume impact, it is going to be down sequentially, correct?

**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

Yes.

**Kaushik Roy** - Merriman Capital - Analyst

Last question, pricing. Hard disk drives -- SAS hard disk drive prices have gone up anywhere between 50% to 100% in the distribution. I guess my question is, what about SSDs? Do you see -- are you getting any pricing power there or not really?

**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

Well, again, you have to think about the markets that we sell into. We sell into OEMs, and the OEM customer base is either able to sell systems because they have enough hard drives or they cannot sell systems because they don't have the hard drives. Most of our SSDs are a very small percentage of a bigger system. So there is no way for them to be able to come and say, okay, instead of 24 SSDs in a system, I'm going to use 500 SSDs in a system because I cannot find hard drives or the hard drive prices have gone up. That does not really work in the systems that we sell into. It might work in the server. It might work in an individual end-user type of basis. It might work on a laptop. But it does not work in a system where the 2000 hard drives that ship out with 20 or 30 SSDs. You have to be able to source the hard drives first before you get the SSDs.

I would doubt that there is much impact in terms of pricing to our customers. Our customers are very large OEMs, and at the end of the day, I think they are getting the same type of (unintelligible) price that they were getting in the past.

**Operator**

Gary Mobley, Benchmark.

**Gary Mobley** - Benchmark - Analyst

I just had a couple of questions. I know you talked about constructing a new R&D facility in Malaysia. But I was wondering if you guys are still running full steam ahead with your additional capacity? I think last time you quoted maybe a doubling of capacity. And then as well, what sort of steps are you taking on a cost-cutting front for the next few quarters in light of the revenue outlook?

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**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

Okay. So there is really no cost-cutting that -- as you know, we are going at a pretty low cost, and somewhere around \$60 million of revenue for us is a breakeven area. In terms of the facility that we are building in Malaysia, we will have R&D and production basic facility built in. So it is going to be a 210,000, 220,000 square feet facility. 50,000 or 60,000 square feet of it will be R&D. The rest will be functions that would support production.

Now, of course, the bigger and more expensive part of the whole thing is outfitting the facility with the actual machinery to be able to build or ramp up production. And we will not order those until we see clear signs of SSDs really gaining traction and our sales going up.

**Operator**

Sherri Scribner, Deutsche Bank.

**Sherri Scribner** - Deutsche Bank - Analyst

I was curious about your revenue this quarter and next quarter, trying to think about the percentage of your business that is your Gen 3 products now. Is there any Gen 2 in the revenue numbers for this quarter and next quarter?

And then also trying to understand how much of the revenue is for Gen 4 products knowing that OEMs tend to buy some products for testing? I just wanted to get a sense of what the mix is.

**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

This quarter we have not had any Gen 2 products, I think, for a couple of quarters already. So all of it comes from Gen 3 type of products that we are selling this quarter. And at this point in the numbers that we are forecasting for this quarter, we don't have any sort of qualification samples, big build type of things calculated in that number.

If those come this quarter, they will be additional to the current numbers that we have already forecasted. But we are thinking that whatever we do for qualification units will be either at the very end of this quarter or the beginning of next quarter.

**Sherri Scribner** - Deutsche Bank - Analyst

Okay. So, in terms of buying the drives for testing, you are not seeing any revenue for Gen 4 from that testing?

**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

No, we are still in small quantity testing periods. We have not yet gotten to a larger I would say better testing at our customers.

**Sherri Scribner** - Deutsche Bank - Analyst

Okay. And then thinking about the PCIe products, I think that came out a little bit later. Would you expect to see that product qualified in the second quarter also, or is that a little bit later in 2012?

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**Manouch Moshayedi** - *STEC Inc. - Chairman & CEO*

It is on the same timeline as the rest of the products. We are going at full qualification today with major OEM customers, and we are still expecting it to happen by the end of Q1.

**Operator**

Aaron Rakers, Stifel Nicolaus.

**Aaron Rakers** - *Stifel Nicolaus - Analyst*

A couple of questions, moreso follow-ups than anything. First, back on the guidance going into this quarter, just to be clear, Manouch, I think you said that it reflects significantly a falloff at one of your key customers. Are you assuming that revenue at this key customer -- basically does it go to zero? Are you assuming -- I'm just trying to gauge how significant we should be looking at that one customer falling off. In the same context of that, where does it stand for other customers having competitive solutions that could also be a challenge for you upon this transitional period?

**Manouch Moshayedi** - *STEC Inc. - Chairman & CEO*

Right. So a couple of differences between this one customer and the rest of the customers is that we were only selling into the highest performing systems that the customer was selling, and the amount of adoption that was happening and the increase in volume was not really going on at this one customer. So any impact in terms of competitive pressures at this customer would immediately take away from our total sales into this customer.

The growth of this customer has not happened in the past couple of years, has maintained within 5000 to 7000 units on a quarterly basis in this one very high-level platform that they sell. The difference between this customer and other customers is that while we were doing business with other customers at the very high end of the markets, the high-end markets were growing also. So, even with competition coming into those markets, we are still seeing and at least we are getting similar type of quantities of orders as we did in the past.

So that is a big difference between this one customer and the rest of the customers.

**Aaron Rakers** - *Stifel Nicolaus - Analyst*

Great. And two other questions if I can. Just back on the gross margin, assuming that you have a decent amount of fixed costs in your OpEx structure, I guess where I'm falling out is, are you telling us that your gross margin is going to be in that 40% or even high 30% range this next quarter and possibly over the next couple of quarters? And on that same basis, how do we think about the gross margin structure as we transition to MLC and some of the other products going forward? And then I will have one other follow-up. I apologize.

**Raymond Cook** - *STEC Inc. - CFO*

So we have given our long-term model on our operations, you know, at the 40% gross margin level, and that is still what we are shooting for. I think with the guidance that we gave today from both a top line and a bottom line and hearing Manouch's comments about the fact that we're not doing cost-cutting measures, you can pretty much back into the operating expense and then back into the gross margin number that we were utilizing in the calculation, and I think you will see that that is in the 40% plus range.

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**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

Yes, so the cost of manufacturing in Malaysia is pretty small compared to what we used to have in California. We have about a \$4.5 million, \$5 million fixed cost on a quarterly basis in Malaysia that would basically apply -- today it is applying to \$72 million for third quarter is going to apply to \$55 million in the fourth quarter.

**Aaron Rakers** - Stifel Nicolaus - Analyst

And then final question for me would be, how do we think about cash balance or cash burn or however you want to phrase it here over the next couple of quarters again going through this transition, and have you set aside any cash for the ongoing legal issue that you guys are working through?

**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

Okay. So number one we think that we are going to still build cash over the next couple of quarters as we move through the inventory of Gen 3 and legacy products that we already have in our inventory. So I would look for the inventory to come down over the next couple of quarters and cash to go up.

In terms of legal issues, for now basically everything that we are spending is based on the D&O insurance that we have.

**Operator**

Nehal Chokshi, Technology Insights.

**Nehal Chokshi** - Technology Insights - Analyst

Clearly with the share repurchase executed this quarter that increased R&D spending, you guys clearly think this is a temporal issue. What is it exactly that you are seeing from your customers or maybe lack of competitive offerings from Samsung, SMOD and Pliant Technology that STEC storage SSDs will stimulate demand, the Gen 4 will stimulate the incremental demand that you have been talking about?

**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

Yes, so a couple of points. Number one, I think the lower-cost Gen 4 will definitely stimulate demand. We are seeing that already. We are seeing the application of SSDs grow at all of our customers. But also the MACH16 is gaining a lot of traction in terms of qualification at server customers. But we should not discount the PCIe. I think the PCIe is going to be one of those bigger pieces of our business on a go forward basis. The amount of attention to PCIe and the amount of interest that we are gaining in PCIe is something that is unprecedented from our customers, and everyone is now looking at PCIe as something that in the future they will integrate into their systems, and they look at our PCIe as the most interesting solution that is out there.

So obviously on the outlook of the Company, we are very, very positive on SSDs as a whole. As I mentioned in my prepared remarks, also we are seeing multiple customers, newer customers, coming to the market with all SSD systems, systems that have got huge amount of IOPS, a huge amount of performance and throughput, and that has caught the attention of our larger customers, and we are seeing that they are also looking at building systems similar to the ones from the smaller guys.

So all-in-all what I am seeing is very positive for SSDs. We are seeing a new thought process at our customer base, and we are seeing that we can do without HDDs on the long run in order to be able to satisfy the data storage demand, and that is exactly

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the type of thing that we were looking for five years ago, and I think that we are finally very much on to that sort of thought process at our customers.

So I think having taken the FPGA out of the system and only going with ASIC and having MLC that works in enterprise markets will definitely add to the adoption that is happening right now.

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**Nehal Chokshi** - *Technology Insights - Analyst*

So based on the feedback that you are getting from both the server and storage OEMs, what is your feeling as far as what will be the bigger contributor to your second half of 2012 revenue? Will it be PCI Express SSDs, or will it be storage array SSDs?

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**Manouch Moshayedi** - *STEC Inc. - Chairman & CEO*

Well, it is very tough to say. I think Gen 4 would be extremely successful, but at the same time with the amount of interest I am seeing in PCIe, I think PCIe could be a very, very successful product for us also.

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**Nehal Chokshi** - *Technology Insights - Analyst*

Okay. And I understand that you are not putting together a direct sales force, but I do believe that at your Analyst Day you talked about the ability to go through the few very, very large Web scale customers and at least get the product in front of them. Is that correct, and if so, have you had success in actually getting in front of these very large Web scale customers with the initial sampling?

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**Manouch Moshayedi** - *STEC Inc. - Chairman & CEO*

Yes. In fact, most of the Web companies have been already contacted. We have shown samples of our EnhanceIO product line and also PCIe cards, how they perform. So basically if you look at -- the few top Web 2.0 customers have already been contacted, and samples have been shown to them. But, as I mentioned, our big push is to sell through the OEM channel. This part of the market is not as fully serviced as the rest of the market by our customers, so it is something that needs a little push still.

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**Nehal Chokshi** - *Technology Insights - Analyst*

Right, okay. And two more questions, please. You guys saw actual GM strength in this quarter. It was actually up q-over-q despite revenue being down q-over-q, and ZeusIOPS was also down q-over-q. So could you help us -- step us through what is actually going on there with the impressive GM here?

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**Manouch Moshayedi** - *STEC Inc. - Chairman & CEO*

Well, I think it is the result of more ZeusIOPS being sold than MACH8 being sold. That pushed -- MACH8 was something that we were selling at a lower margin than our regular margins to some server customers, but all different types of different telecom customers and so on. And the result that you saw from Q3 shows just higher sales volume of the ZeusIOPS in comparison to MACH8 and other types of products that we have been selling traditionally.

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**Raymond Cook** - *STEC Inc. - CFO*

Yes, our DRAM also halved q-over-q.

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**Nehal Chokshi** - *Technology Insights - Analyst*

Got it. Okay. And my final question is that with the additional R&D engineers that you have brought on, the new Pune, India R&D development center, it looks like you guys are trying to develop a lot more comprehensive set of software-based data management capabilities. Can you just talk about what is the intent for this position and time-to-market for developing a full suite of data management software technologies?

**Manouch Moshayedi** - *STEC Inc. - Chairman & CEO*

We have to obviously walk before we run, but our initial product will be hopefully shipping out in the second half of 2012. And based on the amount of traction that that gets, obviously we will move on and then get bigger and bigger data management type of software out there in the hands of customers. We are putting a lot of effort behind this product line, and we are very hopeful that it will take off. There is a definite need in the market for this type of product.

**Nehal Chokshi** - *Technology Insights - Analyst*

And this is a to be announced product, correct? It is not something that -- you are not talking about the EnhanceIO product, right?

**Manouch Moshayedi** - *STEC Inc. - Chairman & CEO*

For now I'm talking about the EnhanceIO product, and then going forward obviously a couple of quarters from now we will see what happens with EnhanceIO. Once that starts getting traction and gets sold into some customers, obviously we will have more information about the needs of the customers, and we will be able to come out with newer product lines.

**Operator**

Rajesh Ghai, ThinkEquity.

**Rajesh Ghai** - *ThinkEquity - Analyst*

A question on the length of the transition period. You mentioned that you were very likely to see the ramp happen in the second half of 2012. I am just wondering are we going to see the bottom end of your revenue decline in Q2 of next year? I think you start to see some ramp in Q2, and Q1 would really be the bottom where you would kind of see the minimum revenue in this transition period.

**Manouch Moshayedi** - *STEC Inc. - Chairman & CEO*

At this point we are forecasting Q1 to be the bottom of our revenue model. Going into Q2 we should be growing already.

**Rajesh Ghai** - *ThinkEquity - Analyst*

Okay. ZeusOPS revenue actually did not decline as much. It is only down about \$3.7 million sequentially. Was that as part of your expectations given that you lost share at one OEM to HGST I guess, and what is your estimation at this point in time as to what your share is at that OEM after your share loss this quarter? Do you expect to lose more shares at that OEM next quarter? And if your competitor is 30% lower, why do you still have business at that OEM?

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**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

Okay. So I actually answered a similar question a few minutes ago. We think as we go forward into obviously out of Gen 3 and Gen 4 we will gain the share from the competitor, but all of our customers have a dual-sourced strategy. So, even if they have to pay a little bit more, they will pay a little bit more in order to keep a vendor around, at least even at a minimal level. That is one of the reasons why we are still there.

But, as I mentioned, this one particular OEM, their business in terms of number of units over the past two or three years has not changed. The numbers are exactly the same. You have 5000 to 7000 or 8000 units on a quarterly basis.

So when you -- and when that does not grow over the years and you bring new competitors in there and they take part of that share, obviously your revenues go down. In the rest of the customer base that we have, even though they have got in new vendors as a competitor to us, their markets have grown also and their usage of SSDs as a whole in those systems have gone up. So, even though we are sharing what we traditionally had all by ourselves with other vendors, still our markets are growing and still are being stabilized rather than just on a net basis go down.

**Rajesh Ghai** - ThinkEquity - Analyst

In terms of strategy going forward, given that most of your IP is in your SSD controller, would you kind of in the long-term consider licensing out a controller to other players in the market for them to make the SSDs, something along the lines of what LSI is probably going to do with SandForce going forward?

**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

I cannot really speculate on we are going to do in the future years with our business.

**Rajesh Ghai** - ThinkEquity - Analyst

Okay. And as far as your MLC Gen 4 qualifications are concerned, have you found anyone else that was trying to qualify MLC-based products along the same timeline as you. Is there anyone out there who is qualifying at the same time, or do you think right now they are still product development players?

**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

So on MLC, I must say that there is a huge amount of misdirection and miscommunication from our competitors. People who don't have the full CellCare technology, just because they are using eMLC flash that has got 30,000 write cycles, they go to the customer base and still guarantee 5 times per day -- 10 times per day for five years at the customer base. From our point of view, that is complete false. It cannot happen because if you have to have 10 times a day for five years, you need about 50,000 plus number of writes in order to be able to sustain that.

So, to some of these mis-marketing and trying to pull the wool over the customer base, they have been able to successfully gain traction at customers with eMLC type of a chip. That is not what we market. We market a MLC chip that has got full CellCare on it, that gets up to 50,000, 60,000 writes, and is fully able to sustain 10 times per day for five years.

So answering your question is tough. Anyone with a CellCare type of technology coming to market and marketing, we have not seen. Lots of people out there marketing saying that they can do 10 times per day for five years, absolutely.

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**Rajesh Ghai** - *ThinkEquity - Analyst*

A last question for me. All SSD or all flash storage arrays, you talked about that. Do you get a sense that those players would likely go for SSDs using your Gen 4 kind of solution, or do you think they could essentially buy raw flash and build their own controllers that manage the flash? What kind of solution do you think they are going to lean towards at this point in time? What do you think?

**Manouch Moshayedi** - *STEC Inc. - Chairman & CEO*

I think at the end of the day most of the customers will lean towards buying third-party fully based SSDs rather than taking on not only building a software for the system, but also building their own SSD controller and doing all of those type of things by themselves.

So what you have seen up to this point is that they would buy a Gen 4 type of a product line for the front end -- (technical difficulty) MLC type of SSD for the backend. So systems that would have, let's say, 10 TB or 20 TB of SSDs onboard, a few percentage of it would be a high-end ZeusIOPS, and the rest will be a MACH16 type of product with regular consumer MLC.

**Operator**

Marshall Levine, Knott Partners.

**Marshall Levine** - *Knott Partners - Analyst*

I'm wondering if you can discuss a little bit the average selling price of the ZeusIOPS products that were sold this current quarter?

**Manouch Moshayedi** - *STEC Inc. - Chairman & CEO*

Do we have (inaudible)?

**Raymond Cook** - *STEC Inc. - CFO*

Yes, we don't.

**Marshall Levine** - *Knott Partners - Analyst*

You cannot disclose that?

**Raymond Cook** - *STEC Inc. - CFO*

That is correct. We don't disclose our average selling price.

**Marshall Levine** - *Knott Partners - Analyst*

Okay. And then one other question on the transition to MLC. Are you competing directly against other MLC providers or eMLC? I think there is a little confusion in the market about the distinction between the two.

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**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

That is true, and that is what I just described. What we are seeing from competitors at our customers is that they are going out there and marketing an eMLC chip from a supplier, whoever is the supplier of the eMLC component itself, which usually comes with about 30,000 write cycles, and they are marketing that product as if it will have the endurance to withstand enterprise type of applications. We don't believe that it does. That is why we have come out with the CellCare technology that takes care of MLC components, and we don't think that 30,000 writes are good enough for five years, if you like, 10 times a day into the system. So that is what we are competing with today.

**Marshall Levine** - Knott Partners - Analyst

Okay and one other quick one. I just noticed your share count does not seem to have changed a lot. Was the buyback compensating merely for options and RSUs, that sort of thing?

**Raymond Cook** - STEC Inc. - CFO

The share buyback that we did was primarily in the last couple of weeks of September. Therefore, since it is a weighted average, you will see more of the effects in Q4.

**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

(multiple speakers) Before the buyback, we had what, 51.5 million, 52 million shares completely fully diluted?

**Raymond Cook** - STEC Inc. - CFO

Basic, correct.

**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

Right. And then we bought back 5.5 million, 5.6 million shares --

**Raymond Cook** - STEC Inc. - CFO

Over the two quarters.

**Manouch Moshayedi** - STEC Inc. - Chairman & CEO

Over the two quarters, so that should reduce by that much.

**Marshall Levine** - Knott Partners - Analyst

Okay. Thank you for your help.

**Operator**

Thank you. I'm showing no further questions in the queue at this time. I will hand the call back to you.

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**Mitch Gellman** - STEC Inc. - VP, IR

Okay. Thank you. I would just like to thank everybody for joining us. If you are attending the conference tomorrow where Scott is going to be giving a technology presentation, please make it a point to attend, and thanks for following with us. Please keep track of us during the next few quarters, especially as we work to get our key products and product lines and new generation products qualified.

We will look forward to talking with you next time. Thanks very much.

**Operator**

Thank you. Ladies and gentlemen, this concludes the conference for today. You may all disconnect, and have a wonderful day.

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