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Prepared Remarks on Second Fiscal Quarter 2015 Results

July 22, 2015

JAY IYER, INVESTOR RELATIONS

Thank you and good afternoon everyone. With me on the call are Sanjay Mehrotra, President and CEO and Judy Bruner, Executive Vice President of Administration and CFO. In a moment, we will hear remarks from both of them, followed by Q&A.

Before we begin, please note that any non-GAAP financial measures discussed during this call, as defined by the SEC in Regulation G, will be reconciled to the most directly comparable GAAP financial measure. The reconciliation of our financial results is available in the press release issued this afternoon. A presentation containing supplemental information and non-GAAP to GAAP reconciliation tables, including for all applicable guidance, will be posted on our investor relations website at www.sandisk.com/IR after the prepared remarks. This guidance is exclusive of any one-time transactions and does not reflect the effect of any acquisitions, divestitures or similar transactions that may be completed after July 22, 2015.

During our call today, we will make forward-looking statements that refer to expectations, projections, beliefs or other future events. Please refer to today's press release, the presentation that will be posted on our investor relations website and our SEC filings, including the most recent 10-Q, for more information on the "Risk Factors" that could cause actual results to differ materially from those expressed in the forward-looking statements. SanDisk assumes no obligation to update these forward-looking statements, which speak as of today.

With that, I will turn the call over to Sanjay.

SANJAY MEHROTRA, PRESIDENT & CHIEF EXECUTIVE OFFICER

Thank you Jay and good afternoon everyone. Our second quarter results benefited from more favorable performance than expected in enterprise and retail. We are also making good progress in strengthening our product roadmap and customer engagements. For the second half of 2015, we expect the industry environment to remain stable and look forward to delivering sequential revenue and profit growth as we continue to make progress in enhancing our execution.

In our April conference call, we discussed the pending re-qualification of a new embedded component for a customer's use in their client SSD application. We have completed the SanDisk internal validation of this new product and the qualification work on the customer side is progressing well. We expect to complete the full customer re-qualification process in the third quarter and begin revenue shipments soon thereafter.

In enterprise SSDs, our Fusion-io revenue grew sequentially in Q2. We also announced our next generation Fusion ioMemory™ PCIe application accelerators based on our 1Y NAND technology, enabling a significantly lower price point for our customers. We believe that the more competitive pricing enabled by our captive memory-based PCIe products will open up new workloads for this product category. We are currently shipping these captive NAND based PCIe solutions through distribution channels and customer qualifications at several OEMs are expected to be completed in the second half of this year.

Another factor that we believe will stimulate the future expansion of the enterprise PCIe market is the expected broadening deployment of NVMe infrastructure and availability of NVMe PCIe solutions in 2016 and 2017. In addition, PCIe flash solutions offer higher performance than SATA SSDs, due to the lower latency and higher bandwidth of PCIe. We plan to begin addressing the NVMe PCIe market opportunity with a new offering available for qualification in mid-2016.

To increase SanDisk's penetration in the enterprise SATA market, I am pleased to report that we introduced the CloudSpeed Eco™ Gen. II, a highly competitive 15 nanometer (nm) based 2 terabyte (TB) SATA SSD in the second quarter. The solution is now in qualification at multiple hyperscale customers with revenue contribution expected to begin later this year.

Our enterprise SAS SSDs sales performed well during the quarter driven by better than expected demand for several of our products. Our 4 terabyte (TB) Optimus Max™ SAS SSD was the first of its kind in the market and is making a compelling case for the replacement of 15K and 10K RPM enterprise HDDs. The Optimus Max SSD has become an important high capacity solution for one of our OEM customer's All Flash Array offerings. Several other OEM and hyperscale customers are now qualifying our 4 TB enterprise SAS SSD because they see the value of reducing their total cost of acquisition and ownership by utilizing this highest capacity solution. We are developing our next generation 15 nanometer-based 12 Gb/s SAS SSD with higher capacity and performance, and expect to introduce that solution to market in 2016 with revenue contribution starting in late 2016.

We are excited about the progress we are making with our next generation converged platform for enterprise products, which brings the best technologies and IP together from our various acquisitions. This converged platform will be heavily leveraged across multiple product families in the enterprise segment, and allow us to offer market-leading products integrated with our next generation 3D NAND memories. Given the long engineering development cycle typically associated with such major programs, we expect to start sampling products based on this new architecture in 2017. While we expect to continue to grow our enterprise revenue over the next couple of years, we aim to rapidly increase our market momentum once this converged architecture is introduced into volume production.

Turning to our enterprise system and software solution offerings, since our announcement of our breakthrough InfiniFlash™ platform in March this year, we have been building up a strong pipeline of potential customers, many of whom have started proof-of-concept (POC) engagements with us. Customers are excited to see the potential of this InfiniFlash platform, as it enables them to rethink how flash can structurally improve their data center capabilities when deployed at petabyte scale. Our InfiniFlash platform allows customers to replace hard-disk drive-based solutions with our all-flash solution. InfiniFlash features excellent performance and the industry's highest density of flash at a breakthrough price point, where it competes with HDD-based solutions in both total cost of ownership as well as upfront acquisition cost, while solving a lot of challenges customers are facing today with scale-out deployments. As the mega-trends towards cloud computing, open source software and data analytics gather momentum, InfiniFlash is the solution at the intersection of these important trends, and we are excited about its potential to accelerate flash adoption in data centers over the next several years.

Switching to client SSDs, traction for our solutions increased with PC OEMs and in the channel. We announced and started shipping our 15 nanometer X2 client SSDs to the channel and began qualification of these drives with our OEM customers to whom we expect to begin revenue shipments in the second half of 2015. From a market perspective, although the overall PC environment is weak, we believe OEM customers are rapidly increasing their use of SSDs due to the many benefits we have outlined in the past. For example, in the corporate market served by OEMs, CIOs have embraced the benefits of SSDs, resulting in an SSD attach rate to corporate notebooks that is expected to approach 40% by the end of 2015. Decline in unit prices of 128 gigabyte and 256 gigabyte SSDs continues to reduce the gap when compared to HDD unit prices, with the 128 gigabyte drive approaching cost parity with low-capacity HDDs. This inflection point is expected to further cause the consumer notebook segment, which today has a low SSD attach rate of less than 15%, to accelerate adoption of SSDs. We are well positioned to benefit from this trend with our new product offerings such as the SanDisk Z400S based on 15 nanometer X2 technology and our 1Y X3 based SSDs, which offer a compelling value proposition for PC OEMs. We are excited to address this growth opportunity ahead of us, as we expect SSDs will rapidly replace HDDs in laptops and desktops.

Moving on to our mobile embedded product portfolio, we completed the qualification and began shipments of our 15 nm X3 customized solution as planned. We have also been working on another new custom embedded 15 nm X3 solution that is in the late stages of customer qualification, and expect to be shipping this new product in significant volume in the third quarter.

Within the iNAND® product family, we are expanding the adoption of our solutions. Our 1Y X3 based iNAND products, which are designed to meet the requirements of high performance mobile platforms with our innovative Smart SLC technology, are expected to ship to multiple mobile OEMs in the third quarter. Additionally, just last week at Mobile World Congress in Shanghai, we introduced an iNAND product built on 15 nanometer X3 that increases embedded capacity to 128 gigabytes, providing greater performance and cost benefits to mobile OEMs. We expect to qualify and ship these iNAND products to key mobile customers in the second half of 2015.

We are also gaining traction in newer flash markets, including connected home, automotive storage, industrial and the Internet of Things (IoT). In connected home, cable operators are beginning to use our flash storage solutions in set top boxes to improve delivery of high-demand content across their networks. Automakers continue to add computational power to their cars as a means of providing infotainment differentiation and advanced driver assistance capabilities. As the automotive industry marches towards a future that will include autonomous driving, storage requirements will grow immensely and we expect to be a leading provider of innovative solutions to this industry. The IoT market is still in its early stages of development; however, we are excited to have been selected by some leading solution suppliers for inclusion in their IoT reference designs, which we believe will lead to expanding opportunities for flash.

In retail, we have made progress recovering from our temporary share loss experienced in Q4'14 and Q1'15 which was due to the supply constraints we discussed in earlier calls. Overall, retail had a good second quarter driven by demand for imaging cards and SSDs. In June, we introduced a new SanDisk product category with the SanDisk Extreme® 900 and SanDisk Extreme 500 external SSDs at 1.92 terabytes and 480 gigabytes of capacities respectively. With no moving parts and significantly faster speeds than portable HDDs, these rugged external SSDs are the perfect solution for photographers and videographers on the go.

To summarize my comments on products, we have made considerable progress towards addressing our roadmap. Many of our new products are now at various stages of qualification, and we expect our portfolio to continue to strengthen in 2015 and throughout 2016 as well.

From a fab manufacturing perspective, our 15 nanometer technology continued ramping through the quarter with bit output exceeding 1Y volume for Q2. The mix of X3 remained at more than 50% of total bits sold. We also completed the planned 5% wafer capacity expansion for 2015 during the second quarter, and we believe the inventory challenges we discussed on the last two calls are now behind us.

In 3D NAND, we have begun our equipment purchases to support the commencement of pilot production of our 48-layer architecture in the second half of 2015. We are on track to begin using the pilot line output for product samples in 2015, and we continue to expect 3D NAND product sales to begin in 2016. The 48-layer technology provides an excellent combination of increased density, higher performance and lower power compared to 2D NAND. We plan to implement our 3D NAND first in high-capacity removable products, then client SSDs and embedded solutions, followed by enterprise SSD solutions, which have longer design and qualification periods.

From a supply bit growth rate standpoint, for 2015 we expect the industry's year-over-year supply bit growth to be somewhat above our previous estimate of approximately 40%, and we expect our captive bit growth to be in-line with the industry. For 2016, our latest estimate is that both the industry and SanDisk supply bit growth rates will be lower than in 2015.

Some of you may be wondering about the Toshiba announcements from yesterday - while there is some change to the management structure of Toshiba's semiconductor business, we continue to believe that this will not impact the strategy, investments and execution of the joint venture and that NAND remains a high priority for Toshiba.

To conclude, we are making progress in strengthening our product portfolio and improving our execution, and we are driving vigorously to regain our overall business momentum. We look forward to delivering improved results in the second half of 2015.

I will now turn the call to Judy for the financial discussion.

JUDY BRUNER, EXECUTIVE VICE PRESIDENT ADMINISTRATION & CFO

Thank you, Sanjay. Before I begin, I would like to add to Sanjay's comments on Toshiba and mention that while we are still evaluating the findings of the investigation, we do not expect Toshiba's announcement yesterday to have any impact to our financial results.

I will now review our Q2 results and then discuss our outlook, which remains within the range of expectations we outlined in April.

Our second quarter revenue of $1.24 billion was down 7% sequentially and down 24% year-over-year. Our client SSD revenue declined as expected due to the end of life during Q1 of a program with a major customer, while our client SSD revenue with other OEM customers increased nicely from Q1 to Q2. Our enterprise revenue also declined sequentially, for the reasons we discussed on our April call. Embedded revenue was down sequentially in Q2 due to the seasonality of certain embedded products, while our removable revenue increased sequentially driven by seasonality and share gains. By channel, our retail revenue increased 4% sequentially and represented 39% of our Q2 revenue mix, while commercial revenue declined 13% sequentially and represented 61% of our revenue mix. Our gigabytes sold were down sequentially by 1% and down year-over-year by 6%, with the year-over-year decline driven largely by rebuilding of our inventory levels combined with the loss of the client SSD program at a major customer as we have previously discussed. The decline in our blended ASP per gigabyte was more modest than in Q1, with a sequential decline of 6% and a year-over-year decline of 21%.

Our all-in cost per gigabyte declined 4% sequentially and declined 10% year-over-year. Sequentially, the key drivers of cost reduction were a weaker yen, a higher mix of 15 nanometer memory and lower inventory-related charges, with these factors partially offset by a higher mix of non-captive memory. On a year-over-year basis, cost reduction benefited from technology transition, a higher mix of X3, non-memory cost reductions and a weaker yen, with these benefits partially offset by higher inventory reserves, Malaysia factory startup costs and a higher mix of non-captive memory. Our non-GAAP gross margin of 42% was better than we had forecasted due primarily to product mix, with a stronger mix of retail and enterprise products and a lower mix of embedded MCP products. The yen to dollar exchange rate in our captive memory cost of sales was 117, and non-captive memory was used in 6% of our sales, compared to 2% in Q1 and 1% in Q2 of last year.

Our Q2 non-GAAP operating expenses of $327 million were sequentially lower by $48 million, with the reduction stemming from 1) lower charges for 'restructuring and other', 2) a reduction-in-force, which was largely completed in the second quarter, and 3) some engineering project expenses which shifted from the second quarter to the second half.

Our Q2 non-GAAP operating margin, inclusive of the restructuring and other charges, was 15%, consistent with the Q1 non-GAAP operating margin. In Q2, our non-GAAP other income of $10 million included $7 million of one-time gains related to foreign exchange and venture investments. Our Q2 non-GAAP tax rate remained at 32%, while our Q2 GAAP tax rate was 11% due to a discrete benefit from a tax audit settlement. The reduction in our non-GAAP diluted share count was driven by a full quarter weighting of our Q1 share repurchases, a partial weighting of the 3.7 million shares repurchased in Q2, and elimination of dilution from the 2017 warrants related to our convertible debt, as the warrants were not in-the-money for Q2.

Turning to cash flow and the balance sheet, our share of flash venture fab investments during Q2 was $233 million, and non-fab capital investments were $96 million. For these total gross capital investments of $329 million, we utilized cash of $80 million, with the difference funded by new joint venture equipment leases of $97 million and joint venture working capital. Our off-balance sheet joint venture equipment lease guarantees stood at $636 million at the end of Q2.

Our inventory increased sequentially by $68 million, and on a petabyte basis, the inventory reflects approximately 12 weeks of forward supply. We expect to continue holding inventory at approximately this level of weeks in order to provide adequate supply for our diverse products and customers. For Q2, cash flow from operations was $29 million, compared to $309 million in Q1 and $241 million in Q2 of 2014. The primary drivers of the sequential decline in cash flow from operations were the seasonality of our accounts receivable, which is typically a source of cash in Q1 and a use of cash in Q2, coupled with the planned increase in our inventory levels. On a year-over-year basis, the decline in cash flow from operations was driven primarily by the decline in net income and the growth in inventory. Free cash flow for Q2 was a negative ($52) million, and we spent $250 million on share repurchases and $63 million on the quarterly dividend. Our cash ended the quarter at $4.0 billion on a gross basis and $1.5 billion, net of debt. We expect our cash flow from operations to be at a significantly stronger run rate in the second half compared to Q2, and we currently plan to continue share repurchases in the second half of 2015.

Now I'll turn to our outlook. Our current estimate for 2015 revenue remains within the range of $5.4 to $5.7 billion that we provided in April.   We expect the majority of our sequential second half revenue growth to come from mobile embedded products, with a significant portion of this revenue forecasted on the cusp between Q3 and Q4. The ramp timing of several mobile embedded products, along with the market success of our customers' mobile products, are key variables in where we land in our forecasted 2015 revenue range. For the third quarter, we estimate our revenue to be in the range of $1.35 billion to $1.45 billion.

We continue to expect non-GAAP gross margin for the second half of the year to be in the range of 40% to 43%. Compared to Q2, we expect the key factors impacting second half gross margin to be an increased mix of mobile embedded sales, which will have a negative impact on gross margin, and a slightly weaker yen to dollar rate coupled with higher sales volume, which will have a positive impact. For Q3, we expect the yen to dollar rate in cost of sales to be approximately 120.

We expect non-GAAP operating expenses in Q3 to be between $335 million and $345 million, and continue to expect full year 2015 non-GAAP operating expenses to be approximately or slightly below $1.4 billion. For the second half, we expect our non-GAAP other income & expense to be approximately break-even and our non-GAAP tax rate to remain at approximately 32%.

Our 2015 fab and non-fab capital investment forecast remains at $1.4 billion, with $709 million purchased in the first half, and our 2015 forecasted cash usage for capital investments remains at approximately $500 million, with $190 million used in the first half.

To conclude my remarks, we look forward to delivering sequential growth in revenue and earnings in the second half of the year as we continue to focus on improving our execution and strengthening our product portfolio.

We'll now open the call for your questions.

JAY IYER, INVESTOR RELATIONS

We want to thank everyone for joining our call today. A webcast replay of today's call should be available on our investor relations website shortly. Thank you again and have a good evening.