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SanDisk Corporation First Quarter 2008 Analyst Teleconference Prepared Remarks
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Lori Barker, Senior Director of Investor Relations

Thank you. Good afternoon and welcome to SanDisk Corporation's financial teleconference for the first quarter of 2008. I'm Lori Barker, SanDisk's Senior Director of Investor Relations. Joining me is Dr. Eli Harari, Chairman and CEO of SanDisk, Sanjay Mehrotra, President and COO, and Judy Bruner, Executive Vice President of Administration and CFO.

The agenda for today's teleconference is as follows: Eli will start with an update on the industry and SanDisk's overall strategy, Sanjay will follow with operational and business updates and Judy will end with our first quarter financial results and future guidance. We will conclude the teleconference with your questions for Eli, Sanjay and Judy.

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. That reconciliation is now available along with supplemental schedules on our web site at sandisk.com. After the completion of this call, an audio replay of this conference, a copy of today's prepared comments and quarterly metrics will be made available on SanDisk's Investor Relations Web Site at sandisk.com.

During our call today we will be making forward-looking statements. Any statement that refers to expectations, projections or other characterizations of future events including financial projections and future market conditions, is a forward looking statement. Actual results may differ materially from those expressed in these forward-looking statements. Certain factors that may cause actual results to differ are detailed under the caption "Risk Factors" and elsewhere in the documents we file from time to time with the SEC, including our Annual Report on Form 10-K for fiscal 2007 and our quarterly reports on Form 10-Q. We undertake no obligation to update these forward-looking statements, which speak only as of the date hereof.

Now I'd like to turn the call over to our CEO, Eli Harari.

Eli Harari, Chairman and Chief Executive Officer

Thank you Lori.

Market conditions throughout the first quarter were similar to last year's first quarter, characterized by excess supply, seasonally soft demand and aggressive pricing. Demand for our products was good in all regions particularly in International retail. However, the sharp decline in market pricing exceeded our cost reductions and resulted in unsatisfactory product gross margins. We believe that some of the large NAND Flash suppliers liquidated substantial amounts of excess inventory in late Q4 and throughout Q1 at prices that were at, or below their cost, thus precipitating the depressed industry-wide margins.

We believe that conditions should improve gradually as the low-priced inventory is sold through the channels and as the U.S. government's stimulus package gets consumers back into the stores for Mothers' Day, Fathers' Day and school graduations. NAND Flash component pricing has been inching up in the most recent weeks, and the anticipated 3G Apple iPhone and competitors' new models are expected to fuel renewed demand for NAND Flash in the second half of this year.

Additionally, we believe the NAND Flash industry is self-correcting: NAND Flash component pricing has outstripped the competitiveness of 200-millimeter (mm) NAND Flash production lines and is accelerating their decommissioning in 2008 and several competitors have announced plans to delay new 300mm fabs. These actions should help to establish better balance between demand and supply in the second half of 2008 and into 2009.

As for SanDisk, our current phase of the Fab 4 production ramp is slightly ahead of schedule, and we believe that our technology lead with 43-nanometer (nm) and 3-bits per cell, coupled with the scale of our Toshiba ventures, gives us significant cost advantages. At the February analyst conference we discussed the capex investments required over the next 3 years and we believe that we have the strong balance sheet to support the cash flow requirements for these projected investments. At the same time, as much as possible, we want to grow capacity in sync with growth in market demand, and to that end, we periodically review with our manufacturing partner the appropriate timing for new capacity additions. The current phase of Fab 4 expansion is in place through the end of this year and we've not made a decision yet on the timing and the extent of the ramp of the next phase, which currently is not due to start until the first quarter of 2009, at the earliest.

In these difficult times for our industry, I believe that SanDisk's unique vertical integration model offers us greater flexibility than is available to other NAND Flash suppliers, who generally depend on a small number of large OEM NAND Flash customers for the majority of their business. They lack our very strong global retail sales channel which enables us to be one of the largest consumers of NAND Flash as we generate our own demand. We are also executing on a strategy to de-commoditize as much of our business as quickly as possible. For example, our Ultra, Extreme and Ducati card lines carry premium margins and have been adopted by high-end consumers worldwide. Our Sansa® line of MP3 players is holding steady ASPs per Megabyte despite the drop in NAND Flash pricing. And, you may have noticed in the past few months a flurry of announcements from our enterprise business that specializes in selling highly secure storage products to large corporations, banks and government agencies at very respectable margins. We see similar opportunities in the mobile space working closely with mobile network operators on developing MegaSIM™ and TrustedFlash™-supported services.

One new market that we believe will provide opportunities to differentiate ourselves is the emerging Solid State Drive (SSD) market where we have deep expertise and strong IP. This market appears to be developing into two significant segments: a large commodity segment in the notebook space where price per

megabyte will be key, and the enterprise space where premiums could be significant. Recently, there has been growing interest in embracing SSDs in the enterprise space to augment HDD storage arrays with high I/O bandwidth and low power Flash memory. Intel is strongly promoting SSD adoption in computing platforms, and Sun and others are reporting dramatic performance and power gains achieved through incorporating SSDs in new enterprise server storage architectures. These systems are sold on cost per I/O and cost of ownership rather than cost per megabyte. For this market segment, the higher price of Flash SSDs is not an impediment, and we expect accelerated deployment of Flash SSDs in enterprise storage in 2009 and beyond.

To summarize, this downturn is unusual for us in that we see demand for our products continuing to grow at a good pace, yet we have little to show for it in the near-term, because the depressed market pricing has outpaced our aggressive cost reductions. However, like all downturns we believe this one too shall come to an end and the next upturn should bring substantial long-term benefits, principally in accelerating the creation of major new markets for Flash storage to bring demand and supply into balance. Our markets are young and vibrant and we believe that few companies in our space have SanDisk's proprietary technology, IP, vertical integration business model, balance sheet and management experience. We are optimistic we will improve our gross margin and operating margin as pricing

conditions moderate, so that we can deliver strong results to our shareholders in the years ahead.

I will turn it over to Sanjay

Sanjay Mehrotra, President and Chief Operating Officer

Thank you, Eli. Good afternoon everyone.

The first quarter reflected solid demand with good sell-through in most of our served geographies. Unit sales were generally consistent with seasonal patterns and our global growth in the retail business was particularly strong in Japan, APAC, and Europe.

Our mobile business remained a key driver of overall revenue growth. Unit sales and average capacities of our microSD™ cards more than doubled year-over-year, not only because this was a fast growing market, but also due to the price decline for these cards that was more aggressive than the overall average during Q1. We added more than 15,000 mobile store fronts world wide, and our global total increased to 107,000. Our focused marketing and sales strategy continued to

succeed as our retail attach rate of mobile cards to phones increased further to a high-20% rate. In addition, there is continuing momentum driven by the mobile network operators to make mobile cards a significant part of the handset sale. In many of the emerging markets such as India, Brazil, Mexico, Ukraine, Poland and others, mobile products represent more than 50% of our product sales.

Our audio-video business performed well as growing sales of our Sansa™ Clip, among other products, continued to gain traction within the high-growth sub-$100 segment of the MP3 market. Our unit share in the overall U.S. retail MP3 market has remained stable in the mid-teens, while our share within the sub-$100 market segment is more than two times higher and it is approximately 30%, according to NPD data. Most importantly, the MP3 product line experienced the least year-over-year price decline among all of our product lines, and we view this as indicative of the growing success of our de-commoditization strategy.

On the operations side, Fab 4 continued to ramp slightly ahead of plans, and we expect to achieve a capacity of 110,000 wafers per month in the back half of the year. The faster ramp of Fab 4 has contributed to higher inventory levels, but we are comfortable with the planned ramp as we believe that its output will be needed to meet our anticipated demand in the seasonally strong second half of the year. During the quarter, we began ramping the industry's first 3 bits per cell technology

and we are on schedule to begin shipping end products that incorporate 3 bits per cell, starting with USB drives, later this month. Ramp of our 43-nm 2 bits/cell technology remains on track as well, and we expect to begin product shipments during this quarter as previously planned.

In the near term, while our industry is traversing difficult times, we are utilizing this period as an opportunity to streamline our operations, reallocate internal resources to the most productive businesses, control our expenses, accelerate product cost reductions, and focus on improving our margins. In summary, we were pleased with our Q1 demand trends and we remain optimistic about our business for 2008.

With that, I will turn the call to Judy.

Judy Bruner, Executive Vice President, Administration and CFO

Thank you Sanjay and Eli and good afternoon everyone.

Overall our first quarter revenue performance of $850 million was in line with our expectations, reflecting a seasonal decline of 32% from the Q4 holiday period, the same seasonal decline we experienced in Q1 2007. Megabytes sold declined sequentially by 9%, much less than the 22% decline experienced in the first quarter of 2007, however sequential price decline was steep at 29%. Even with this pricing, our product revenue grew by 5% on a year-over-year basis, and remember that Q1 of 2007 included $53 million of revenue from the consolidation of the Twinsys joint venture which we have since exited. Excluding Twinsys, our product revenue grew by 14% year-over-year with megabyte growth of 189% and price decline of 61%.

Overall, our Q1 retail revenue was $418 million or 58% of our product revenue. Q1 retail revenue grew 22% on a year-over-year basis, with 12% growth in North America and 36% growth internationally.

Our Q1 OEM revenue of $306 million was down 14% year-over-year, but if you pull out the Twinsys joint venture from last year, then OEM revenue was flat year-

over-year. OEM sales in megabytes grew a very strong 237% year-over-year, however ASP per megabyte was down 70%. The price decline in the OEM business primarily reflects competitive pricing in the Mobile OEM space, as well as a shift to higher capacity mobile cards. Our OEM average capacity grew 154% year-over-year.

License and royalty revenue for the first quarter of $126 million increased 30% year-over-year. This strong growth rate reflects the addition of new licenses that did not exist in the year ago quarter as well as growth in variable NAND component based royalty and card royalties.

First quarter non-GAAP product gross margin of 20.9% was lower than we had forecasted in January as we made more price moves than originally planned for the quarter, reflecting the competitive industry environment, and we also recorded higher inventory reserves than originally forecasted related to the growth in our inventory balances. Our first quarter cost of sales included zero Fab 4 start-up costs and very little non-captive memory.

Non-GAAP operating expenses of $230 million were down 3% sequentially and up 30% year-over-year. Our expenses came in above our previous Q1 forecast of

$215 to $220 million primarily because of legal expenses and increases to our bad debt reserves.

Non-GAAP operating income for the first quarter was $47 million or 5.6% of revenue, essentially the same dollar level and same percent of sales as last Q1. Other Income of $26 million is down year-over-year due to lower cash and interest rates and up sequentially because Q4 included a 200mm Fab impairment charge. Non-GAAP EPS for Q1 is $0.21 compared to $0.19 in Q1 of last year, with the increase primarily due to a reduction in our fully diluted shares and a reduction in the tax rate.

On the balance sheet, cash and short and long-term investments increased from Q4 by $128 million to $3.0 billion. Q1 cash flow from operations was a positive $219 million, primarily reflecting the impact of our bi-annual receipt of certain royalties. Accounts receivable declined reflecting Q1 seasonality and the impact of price protection and promotions. Inventory on our balance sheet grew to $695 million, more than 90 days' worth, reflecting the ramp in Fab 4 and the seasonally lower Q1 sales. Channel inventory ended Q1 at approximately 7 weeks, a healthy level. Related to capital investments in the Flash Ventures, we invested $37 million of cash during Q1, and we guaranteed additional operating leases of $426 million.

Turning to our outlook, we currently expect a more moderate pricing environment in the second quarter and sequential growth in megabytes sold driven by seasonality and continued expansion in average capacity. We are forecasting second quarter total revenue, including both product revenue and license and royalty revenue, to be between $875 million and $950 million. Within this total revenue, we expect our Q2 license & royalty revenue to be between $115 million and $125 million.

We continue to forecast 2008 growth in megabytes sold of 150% to 170%, and while we believe that pricing will moderate over the course of the year, the aggressive start to pricing in Q1 could result in annual price decline being at the high end of our forecasted range of 50-55%.

We expect the second quarter to be the low point in our gross margin for the year as we have now recognized most of the benefit from the transition to 56nm wafers, and the P&L benefit from 43nm wafers will begin in the second half of the year. Compounding this, the dollar has recently depreciated significantly versus the yen, making our yen-based wafers more expensive. Based on these factors, we expect second quarter non-GAAP product gross margin to be between 14% and 18%. While we expect an increase in gross margins in the second half, the stronger yen may result in us being unable to achieve our previous annual forecast of 24% to

28% non-GAAP product gross margin. The dollar has depreciated about 6% relative to the yen since the end of February and about 10% since the end of 2007. A 10% depreciation of the dollar relative to the yen impacts our product gross margins by approximately 4 percentage points.

We have implemented significant expense controls across the company and are working to reduce investment in certain programs and projects and streamline business operations. We expect Q2 non-GAAP operating expenses to remain approximately flat to the Q1 level, with a decrease in G&A expenses, an increase in Sales & Marketing expenses related to seasonal retail programs, certain one-time costs related to the expense reduction actions we are taking, and also an increase in expenses resulting from the weaker US dollar. In addition to the non-GAAP guidance I have provided, our Q2 GAAP results will include share-based compensation and amortization of intangibles. Forecasts for these expenses in COGS and operating expenses are included in the non-GAAP to GAAP reconciliation tables that are currently posted on our website. We expect Other Income for Q2 to be between $20 and $22 million.

On the balance sheet, we expect inventory dollars to increase, and we expect to make Q2 investments in the Flash Ventures of approximately $100 million. We

also expect to guarantee additional operating leases of approximately $300 million for Fab equipment purchases by the Flash Ventures.

Looking beyond Q2, we are optimistic that margins will improve in the second half due to favorable technology transitions and our continued expectation of more moderate price declines. As we make key business decisions such as pricing, product prioritization, and capacity growth, improving profitability is a top focus for our management team.

We will now open the call for your questions.

Conclusion: Eli Harari, Chairman and Chief Executive Officer

Undoubtedly we are in a challenging environment, however, conditions should improve gradually. We have a seasoned management team and we are approaching this downturn as an opportunity to grow our market share while prioritizing our profitability. Thanks for listening.

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