WESTERN DIGITAL CORP
Form 10-Q
January 29, 2009

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**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**Washington, D.C. 20549**
**FORM 10-Q**

**(Mark One)**

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended December 26, 2008**

**Or**

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from to**

**Commission file number 1-8703**
**WESTERN DIGITAL CORPORATION**
**(Exact Name of Registrant as Specified in Its Charter)**

| | |
|---|---|
| **Delaware** | **33-0956711** |
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |
| **20511 Lake Forest Drive** **Lake Forest, California** | **92630** |
| (Address of principal executive offices) | (Zip Code) |

**Registrant s telephone number, including area code: (949) 672-7000**

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

| | | | |
|---|---|---|---|
| Large accelerated filer þ | Accelerated filer o | Non-accelerated filer o (Do not check if a smaller reporting company) | Smaller Reporting Company o |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

As of the close of business on January 22, 2009, 222,608,707 shares of common stock, par value $.01 per share, were outstanding.

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Typically, our fiscal year ends on the Friday nearest to June 30 and consists of 52 weeks. However, approximately every five years, we report a 53-week fiscal year to align our fiscal quarters. The quarters ended December 26, 2008 and December 28, 2007 were 13 weeks. Fiscal year 2008 was comprised of 52 weeks and ended on June 27, 2008. Fiscal year 2009 will be comprised of 53 weeks and will end on July 3, 2009. Fiscal fourth quarter 2009 will consist of 14 weeks. Unless otherwise indicated, references herein to specific years and quarters are to our fiscal years and fiscal quarters, and references to financial information are on a consolidated basis. As used herein, the terms we , us and our refer to Western Digital Corporation and its subsidiaries.

We are a Delaware corporation that operates as the parent company of our hard drive business, Western Digital Technologies, Inc., which was formed in 1970.

Our principal executive offices are located at 20511 Lake Forest Drive, Lake Forest, California 92630. Our telephone number is (949)
672-7000 and our web site is http://www.westerndigital.com. The information on our web site is not incorporated into this Quarterly Report on Form 10-Q.

Western Digital, WD, the WD logo, WD Caviar, WD VelociRaptor, WD Scorpio and GreenPower are trademarks of Western Digital Technologies, Inc. and/or its affiliates. All other trademarks mentioned are the property of their respective owners.

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## PART I. FINANCIAL INFORMATION

**Item 1.** ***FINANCIAL STATEMENTS***

**WESTERN DIGITAL CORPORATION**
**CONDENSED CONSOLIDATED BALANCE SHEETS**
**(in millions, except par values; unaudited)**

| | Dec. 26, 2008 | Jun. 27, 2008 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 1,376 | $ 1,104 |
| Accounts receivable, net | 926 | 1,010 |
| Inventories | 446 | 456 |
| Advances to suppliers | 18 | 36 |
| Other current assets | 129 | 125 |
| Total current assets | 2,895 | 2,731 |
| Property and equipment, net | 1,620 | 1,668 |
| Goodwill | 116 | 116 |
| Other intangible assets, net | 70 | 81 |
| Other non-current assets | 270 | 279 |
| Total assets | $ 4,971 | $ 4,875 |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 1,075 | $ 1,181 |
| Accrued expenses | 243 | 266 |
| Accrued warranty | 94 | 90 |
| Current portion of long-term debt | 60 | 27 |
| Total current liabilities | 1,472 | 1,564 |
| Long-term debt | 444 | 482 |
| Other liabilities | 134 | 133 |
| Total liabilities | 2,050 | 2,179 |
| Commitments and contingencies (Note 6) | | |
| Shareholders equity: | | |
| Preferred stock, $.01 par value; authorized 5 shares; outstanding None | | |
| Common stock, $.01 par value; authorized 450 shares; outstanding 225 shares | 2 | 2 |
| Additional paid-in capital | 909 | 906 |
| Accumulated comprehensive loss | (11) | (12) |
| Retained earnings | 2,047 | 1,822 |
| Treasury stock common shares at cost; 1 share | (26) | (22) |
| Total shareholders equity | 2,921 | 2,696 |

| | | |
|---|---|---|
| Total liabilities and shareholders equity | $ 4,971 | $ 4,875 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

**WESTERN DIGITAL CORPORATION**
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**
**(in millions, except per share amounts; unaudited)**

| | THREE MONTHS ENDED | | SIX MONTHS ENDED | |
|---|---|---|---|---|
| | **Dec. 26, 2008** | **Dec. 28, 2007** | **Dec. 26, 2008** | **Dec. 28, 2007** |
| Revenue, net | $ 1,823 | $ 2,204 | $ 3,933 | $ 3,970 |
| Cost of revenue | 1,533 | 1,691 | 3,219 | 3,134 |
| Gross margin | 290 | 513 | 714 | 836 |
| Operating expenses: | | | | |
| Research and development | 119 | 122 | 252 | 213 |
| Selling, general and administrative | 42 | 59 | 99 | 107 |
| Acquired in-process research and development | | | | 49 |
| Restructuring | 113 | | 113 | |
| Total operating expenses | 274 | 181 | 464 | 369 |
| Operating income | 16 | 332 | 250 | 467 |
| Other income (expense): | | | | |
| Interest income | 2 | 8 | 6 | 17 |
| Interest and other expense | (11) | (24) | (19) | (30) |
| Total other expense, net | (9) | (16) | (13) | (13) |
| Income before income taxes | 7 | 316 | 237 | 454 |
| Income tax expense (benefit) | (7) | 11 | 12 | 80 |
| Net income | $ 14 | $ 305 | $ 225 | $ 374 |
| **Income per common share:** | | | | |
| Basic | $ 0.06 | $ 1.39 | $ 1.01 | $ 1.71 |
| Diluted | $ 0.06 | $ 1.35 | $ 1.00 | $ 1.66 |
| **Weighted average shares outstanding:** | | | | |
| Basic | 222 | 220 | 222 | 219 |
| Diluted | 224 | 226 | 225 | 225 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

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**WESTERN DIGITAL CORPORATION**
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(in millions; unaudited)**

| | SIX MONTHS ENDED | |
|---|---|---|
| | Dec. 26, 2008 | Dec. 28, 2007 |
| **Cash flows from operating activities** | | |
| Net income | $ 225 | $ 374 |
| Adjustments to reconcile net income to net cash provided by operations: | | |
| Depreciation and amortization | 239 | 189 |
| Stock-based compensation | 21 | 17 |
| Deferred income taxes | (7) | 62 |
| Loss on investments | 9 | 8 |
| Non-cash portion of restructuring | 80 | |
| Acquired in-process research and development | | 49 |
| Changes in: | | |
| Accounts receivable | 84 | (270) |
| Inventories | 10 | 5 |
| Advances to suppliers | 18 | 54 |
| Accounts payable | (63) | 202 |
| Accrued expenses | 11 | 39 |
| Other assets and liabilities | (26) | 9 |
| Net cash provided by operating activities | 601 | 738 |
| **Cash flows from investing activities** | | |
| Acquisitions, net of cash acquired | | (915) |
| Purchases of property and equipment | (302) | (332) |
| Purchases of investments | | (102) |
| Sales and maturities of investments | 1 | 309 |
| Net cash used in investing activities | (301) | (1,040) |
| **Cash flows from financing activities** | | |
| Issuance of common stock under employee plans | 12 | 34 |
| Taxes on issuance of common stock under employee plans | (3) | (2) |
| Tax benefit from employee stock plans | 4 | |
| Repurchases of common stock | (36) | (16) |
| Repayment of acquired convertible debentures | | (250) |
| Proceeds from debt | | 760 |
| Repayment of debt | (5) | (7) |
| Net cash (used in) provided by financing activities | (28) | 519 |

| | | |
|---|---|---|
| Net increase in cash and cash equivalents | 272 | 217 |
| Cash and cash equivalents, beginning of period | 1,104 | 700 |
| Cash and cash equivalents, end of period | $ 1,376 | $ 917 |
| **Supplemental disclosure of cash flow information:** | | |
| Cash paid for income taxes | $ 7 | $ 7 |
| Cash paid for interest | $ 4 | $ 15 |
| **Supplemental disclosure of non-cash investing and financing activities:** | | |
| Acquired convertible debentures | $ | $ 248 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

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**WESTERN DIGITAL CORPORATION**
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**
**(unaudited)**

**1. Basis of Presentation**

The accounting policies followed by Western Digital Corporation (the Company ) are set forth in Note 1 of the Notes to Consolidated Financial Statements included in the Company s Annual Report on Form 10-K for the year ended June 27, 2008. In the opinion of management, all adjustments necessary to fairly state the unaudited condensed consolidated financial statements have been made. All such adjustments are of a normal, recurring nature. Certain information and footnote disclosures normally included in the consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America ( U.S. GAAP ) have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission ( SEC ). These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company s Annual Report on Form 10-K for the year ended June 27, 2008. The results of operations for interim periods are not necessarily indicative of results to be expected for the full year.

Company management has made estimates and assumptions relating to the reporting of certain assets and liabilities in conformity with U.S. GAAP. These estimates and assumptions have been applied using methodologies which are consistent throughout the periods presented. However, actual results could differ from these estimates. Certain reclassifications have been made to the prior year financial statements to conform to the current year presentation.

**2. Supplemental Financial Statement Data**

*Inventories*

| | **Dec. 26, 2008** | **Jun. 27, 2008** |
|---|---|---|
| | **(in millions)** | |
| Raw materials and component parts | **$ 124** | $ 144 |
| Work-in-process | **159** | 145 |
| Finished goods | **163** | 167 |
| Total inventories | **$ 446** | $ 456 |

*Warranty*

The Company records an accrual for estimated warranty costs when revenue is recognized. The Company generally warrants its products for a period of one to five years. The warranty provision considers estimated product failure rates and trends, estimated repair or replacement costs and estimated costs for customer compensatory claims related to product quality issues, if any. A statistical warranty tracking model is used to help with estimates and assists in exercising judgment in determining the underlying estimates. The statistical tracking model captures specific detail on hard drive reliability, such as factory test data, historical field return rates, and costs to repair by product type. If actual product return trends, costs to repair returned products or costs of customer compensatory claims differ significantly from estimates, future results of operations could be materially affected. Also, during a period of declining revenue, the percentage of warranty utilization to revenue may increase. Management s judgment is subject to a greater degree of subjectivity with respect to newly introduced products because of limited field experience with those products upon which to base warranty estimates. Management reviews the warranty accrual quarterly for products shipped in prior periods and which are still under warranty. Any changes in the estimates underlying the accrual may result in adjustments that impact current period gross margin and income. Such changes are generally a result of differences between forecasted and actual return rate experience and costs to repair. Changes in the warranty accrual for the three and six months ended December 26, 2008 and December 28, 2007 were as follows (in millions):

| | THREE MONTHS ENDED | | SIX MONTHS ENDED | |
|---|---|---|---|---|
| | **Dec. 26, 2008** | **Dec. 28, 2007** | **Dec. 26, 2008** | **Dec. 28, 2007** |
| Warranty accrual, beginning of period | **$ 119** | $ 97 | **$ 114** | $ 90 |
| Charges to operations | **30** | 25 | **61** | 50 |
| Utilization | **(26)** | (17) | **(48)** | (33) |
| Changes in estimate related to pre-existing warranties | **(2)** | (3) | **(6)** | (5) |
| Warranty accrual, end of period | **$ 121** | $ 102 | **$ 121** | $ 102 |

Accrued warranty also includes amounts classified in non-current liabilities of $27 million at December 26, 2008, $24 million at June 27, 2008, and $22 million at December 28, 2007.

**3. Income per Common Share**

The Company computes basic income per common share using net income and the weighted average number of common shares outstanding during the period. Diluted income per common share is computed using net income and the weighted average number of common shares and potentially dilutive common shares outstanding during the period. Potentially dilutive common shares include certain dilutive outstanding employee stock options, rights to purchase shares of common stock under our employee stock purchase plan and restricted stock and stock unit awards.

The following table illustrates the computation of basic and diluted income per common share (in millions, except per share data):

| | THREE MONTHS ENDED | | SIX MONTHS ENDED | |
|---|---|---|---|---|
| | **Dec. 26, 2008** | **Dec. 28, 2007** | **Dec. 26, 2008** | **Dec. 28, 2007** |
| Net income | **$ 14** | $ 305 | **$ 225** | $ 374 |
| Weighted average shares outstanding: | | | | |
| Basic | **222** | 220 | **222** | 219 |
| Employee stock options and other | **2** | 6 | **3** | 6 |
| Diluted | **224** | 226 | **225** | 225 |
| Income per common share: | | | | |
| Basic | **$ 0.06** | $ 1.39 | **$ 1.01** | $ 1.71 |
| Diluted | **$ 0.06** | $ 1.35 | **$ 1.00** | $ 1.66 |
| Anti-dilutive common share equivalents excluded* | **5** | 2 | **4** | 2 |

* For purposes of computing diluted income per common share, common share equivalents with an exercise price that exceeded the average fair market value of common stock for the period are considered anti-dilutive and have been excluded from the calculation.

**4. Debt**

In February 2008, Western Digital Technologies, Inc. ( WDTI ), a wholly-owned subsidiary of the Company, entered into a five-year Credit Agreement ( Credit Facility ) that provides for a $750 million unsecured loan consisting of a $500 million term loan facility and a $250 million revolving credit facility. The revolving credit facility includes borrowing capacity available for letters of credit and for short-term borrowings referred to as swingline. In addition, WDTI may elect to expand the Credit Facility by up to $250 million if existing or new lenders provide additional term or revolving commitments. The $500 million term loan had a variable interest rate of 2.75% as of December 26, 2008 and requires sixteen quarterly principal payments beginning in June 2009 of approximately $18 million, $25 million, $31 million and $50 million per quarter for each four quarter increment. As of December 26, 2008, WDTI had $250 million available for future borrowings on the revolving credit facility and was in compliance with all covenants.

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## 5. Stock-Based Compensation

*Stock-Based Compensation Expense*

During the three and six months ended December 26, 2008, the Company charged to expense $5 million and $10 million, respectively, for stock-based compensation related to options issued under stock option plans and the Employee Stock Purchase Plan ( ESPP ), compared to $4 million and $8 million in the comparative prior-year period. At December 26, 2008, total compensation cost related to unvested stock options and ESPP rights issued to employees but not yet recognized was $41 million and will be amortized on a straight-line basis over a weighted average vesting period of approximately 2.6 years.

*Fair Value Disclosures*

The fair value of stock options granted during the three and six months ended December 26, 2008 was estimated using a binomial option pricing model. The binomial model requires the input of highly subjective assumptions including the expected stock price volatility, the expected price multiple at which employees are likely to exercise stock options and the expected employee termination rate. The Company uses historical data to estimate the rate at which employee options are exercised, employee terminations, and expected stock price volatility within the binomial model. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The fair value of stock options granted during the three and six months ended December 26, 2008 and December 28, 2007 was estimated using the following weighted average assumptions:

| | **THREE MONTHS ENDED** | | **SIX MONTHS ENDED** | |
|---|---|---|---|---|
| | **Dec. 26, 2008** | **Dec. 28, 2007** | **Dec. 26, 2008** | **Dec. 28, 2007** |
| Suboptimal exercise factor | **1.73** | 1.66 | **1.73** | 1.57 |
| Range of risk-free interest rates | **0.38% to 1.80%** | 3.31% to 3.96% | **0.38% to 3.44%** | 3.31% to 4.38% |
| Range of expected stock price volatility | **0.49 to 0.71** | 0.37 to 0.63 | **0.43 to 0.71** | 0.33 to 0.67 |
| Weighted average expected volatility | **0.56** | 0.46 | **0.49** | 0.47 |
| Post-vesting termination rate | **4.15%** | 5.67% | **4.39%** | 5.38% |
| Dividend yield | | | | |
| Fair value | **$7.01** | $10.71 | **$9.62** | $8.94 |

The weighted average expected term of the Company s stock options for the three and six months ended December 26, 2008 was 4.79 years and 5.49 years, respectively, compared to 5.51 years and 5.29 years in the comparative prior-year period.

The fair value of ESPP rights issued is estimated at the date of issue using the Black-Scholes-Merton option-pricing model. The Black-Scholes-Merton option-pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. The Black-Scholes-Merton option pricing model requires the input of highly subjective assumptions such as the expected stock price volatility and the expected period until options are exercised. Shares granted under the current ESPP provisions are issued on either June 1 or December 1. ESPP activity was immaterial to the condensed consolidated financial statements for the three and six months ended December 26, 2008.

*Stock Options*

The following table summarizes activity under the Company s stock option plans (in millions, except per share and remaining contractual life amounts):

| | Number of Shares | Weighted Average Exercise Price Per Share | Remaining Contractual Life (in years) | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Options outstanding at June 27, 2008 | 8.0 | $ 14.92 | | |
| Granted | 1.7 | 23.82 | | |
| Exercised | (0.1) | 9.34 | | |
| Canceled or expired | | | | |
| Options outstanding at September 26, 2008 | 9.6 | $ 16.47 | | |
| Granted | 0.2 | 15.17 | | |
| Exercised | (0.1) | 8.33 | | |
| Canceled or expired | | | | |
| Options outstanding at December 26, 2008 | 9.7 | $ 16.48 | 5.5 | $ 15 |
| Exercisable at December 26, 2008 | 5.2 | $ 10.93 | 4.7 | $ 15 |

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted price of the Company s common stock on December 26, 2008 for those awards that have an exercise price currently below the quoted price. As of December 26, 2008, the Company had options outstanding to purchase an aggregate of 2.9 million shares with an exercise price below the quoted price of the Company s stock resulting in an aggregate intrinsic value of $15 million. During the three and six months ended December 26, 2008, the aggregate intrinsic value of options exercised under the Company s stock option plans was $0.3 million and $1.6 million, respectively, determined as of the date of exercise. The aggregate intrinsic value of options exercised under the Company s stock option plans during the three and six months ended December 28, 2007 was $26 million and $40 million respectively.

*Deferred Stock Compensation*

The Company granted approximately 0.7 million restricted stock units during the six months ended December 26, 2008, which are payable in an equal number of shares of the Company s common stock at the time of vesting of the units. The aggregate market value of these awards was $16 million at the date of grant. As of December 26, 2008, the aggregate unamortized fair value of all unvested restricted stock and restricted stock unit awards was $46 million and will be amortized on a straight-line basis over a weighted average vesting period of approximately 2.1 years. For the three and six months ended December 26, 2008, the Company charged to expense approximately $6 million and $11 million, respectively, related to restricted stock and restricted stock unit awards that were vested during the period, compared to $5 million and $9 million in the comparative prior-year period.

**6. Legal Proceedings**

In the normal course of business, the Company is subject to legal proceedings, lawsuits and other claims. Although the ultimate aggregate amount of probable monetary liability or financial impact with respect to these matters is subject to many uncertainties and is therefore not predictable with assurance, management believes that any monetary liability or financial impact to the Company from these matters or the specified matters below, individually and in the aggregate, would not be material to the Company s financial condition, results of operations or cash flows. However, there can be no assurance with respect to such result, and monetary liability or financial impact to the Company from these legal proceedings, lawsuits and other claims could differ materially from those projected.

On June 20, 2008, Convolve, Inc. ( Convolve ) filed a complaint against the Company and two other companies for patent infringement in the Eastern District of Texas alleging infringement of U.S. Patent Nos. 6,314,473 and 4,916,635. Plaintiff is seeking unspecified monetary damages and injunctive relief. On October 10, 2008, Convolve amended its complaint to allege infringement of only the 473 patent. The 473 patent allegedly relates to interface technology to select between certain modes of a disk drive s operations relating to speed and noise. The Company intends to defend itself vigorously in this matter.

On December 8, 2008, MagSil Corporation and the Massachusetts Institute of Technology filed a complaint in the District of Delaware against the Company and seven other companies in the disk drive industry alleging infringement of U.S. Patent Nos. 5,629,922 and 5,835,314. Plaintiffs are seeking unspecified monetary damages and injunctive relief. The asserted patents allegedly relate to tunneling magnetoresistive technology. The Company intends to defend itself vigorously in this matter.

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**7. Income Taxes**

The Company s income tax benefit for the three months ended December 26, 2008 was a net $7 million which consists of a tax provision of $6 million, offset by a $6 million tax benefit related to the extension of the research and development tax credit, which was enacted into law in October 2008, and a $7 million favorable adjustment to previously recorded tax accruals to reflect a change in the Company s outlook of future income before taxes. The Company s income tax expense for the six months ended December 26, 2008 was $12 million. The differences between the effective tax rate and the U.S. Federal statutory rate are primarily due to tax holidays in Malaysia and Thailand that expire at various dates through 2022 and the current year generation of income tax credits.

In the quarter ended December 26, 2008, the Company recognized a $2 million increase in the liability for unrecognized tax benefits. As of December 26, 2008, the Company had approximately $115 million of unrecognized tax benefits. Interest and penalties recognized on such amounts were not mat