

**MANAGEMENT DISCUSSION SECTION**

Operator: Good day, ladies and gentlemen, and thank you for standing by and welcome to the Q1 2010 Brocade Communication Systems Earnings and Question-and-Answer Session Conference Call. [Operator Instructions]. As a reminder, this conference may be recorded.

And now I would like to turn the program to our star speaker, Peter Ausnit, Senior Director of Investor Relations with Brocade. Sir, please go ahead.

**Peter Ausnit, Investor Relations**

Thanks, Healy. Good afternoon, and welcome to Brocade's Q1 earnings question-and-answer conference call. By now you should have seen our press release and prepared comments, which are available on [www.brcd.com](http://www.brcd.com). The press release was also distributed by First Call and Business Wire and furnished to the SEC.

Before we take questions, investors should note our comments today may include forward-looking statements, regarding Brocade's financial results, cash and debt positions, plans and business outlook, which are only predictions and involve risks and uncertainties, such that actual results may vary significantly. These and other risks are set forth in more detail in our Form 10-K for the fiscal year ended October 31, 2009. These forward-looking statements reflect beliefs, assumptions, outlook estimates and predictions as of today, and Brocade expressly assumes no obligation to update any such forward-looking statements.

In addition, our comments may include various third-party estimates regarding total available market and other measures, which do not necessarily reflect the view of Brocade. Further, Brocade does not guarantee the accuracy or reliability of any such information or forecast. Our comments may also include various non-GAAP financial measures. The most directly comparable GAAP information and a reconciliation between the non-GAAP and GAAP figures are provided in our Q1 press release, which has been furnished to the SEC on Form 8-K, and in the slide presentation on [www.brcd.com](http://www.brcd.com).

Here to take your questions are Mike Klayko, our CEO; Richard Deranleau, CFO; Marc Randall, our Senior Vice President of Products and Offerings; Dave Stevens our CTO; and Ian Whiting, our Senior Vice President of Sales and Marketing.

Now I'll turn the call over to CEO Mike Klayko. Mike?

**Michael Klayko, Chief Executive Officer**

Thanks, Peter. First, thank you for joining us. Second, I hope you've had the opportunity to read the prepared remarks and review the corresponding slide deck. We're trying to provide as much information as possible in written communications so that you can read and review at your convenience and use the information as a reference document. Before we go to live Q&A, I'd like to make a few more comments.

At a summary level, we had another good quarter, year-over-year revenue growth, exceeding our long-term operating margin target in a challenging business environment, a record EBITDA, a very successful restructuring of our capital structure and even increasing our storage area networking market share. However, as a management team, we are all very aware that we did not make our

internal plans for our business that provides tremendous growth opportunity for us and that's our Ethernet business.

We have many reasons and can cite this or that, but the fact remains that we made some planning assumptions that were wrong. And that's on us to fix and on us to own up to. Not just fix for next quarter or this year, but to make sure that we have the structure in place for the long term. We don't need to do a research project on what happened and why. We know what to do and we've taken immediate action to get our Ethernet business back on track.

Now it is interesting to note that customers have told us that Brocade being in the Ethernet business has actually had a positive impact on them increasing their spend with us for SAN products. They weren't sure when they would deploy a converged infrastructure environment, but now that we have a complete product portfolio, that has removed any concerns about continued investment in current storage offerings.

Getting our go-to-market model right for the long-term success of our Ethernet business and our company may cause greater-than-normal seasonal declines in our SAN business over the next few quarters and we've modeled that into our planning assumptions. Although we believe 2010 is still a robust growth year, it's more muted than we had previously planned for. Experience is a valuable teacher and we've learned a valuable lesson here.

We've also learned from our last conference call that the pre-release written prepared remarks were very welcomed, since many of you could more comprehensively review the results and the discussion points. However, the prepared Q&A was not so welcomed. So we'll keep the good, which is the pre-release prepared remarks and we're going to change the bad and use the entire conference call for live Q&A.

Now, we'll answer the questions on this call that were presubmitted if time allows. However, our IR group will answer all the presubmitted questions if they were not covered during the live Q&A.

With that, I'm going to turn it back over to Peter to begin the Q&A session.

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**Peter Ausnit, Investor Relations**

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Healy, do you have the first caller?

## QUESTION AND ANSWER SECTION

Operator: Yes, sir. I do have the first caller. Our first caller in queue comes from Brian Marshall with Broadpoint AmTech. Please go ahead.

**<Q – Brian Marshall>**: Great. Thanks, guys. A question with regards to page 10 of the slide deck, it talks about basically prioritizing OEM sales and trying to drive that demand for the OEM partners directly. I was wondering how that jives with the additional comments that you're going to start to invest more back into the direct sales approach?

**<A – Michael Klayko>**: Okay. One of the things that we learned – Brian, this is Mike and I'll have Ian add on a little bit – is we learned that we have to create some of our own demand in these new areas. Some of our OEM partners have been out of this area for a while and for us, what we did is we need to go ahead and create this demand by creating these new accounts ourselves and that's what we were talking about, moving some of the assets and the people around that we had previously on – moved to some of our partners are going to now be into the marketplace and generating our own OEM – our own account that we can then partner on a go-forward basis with our OEM partners.

**<A – Ian Whiting>**: Yeah. Let me just add to that, if I may. This is Ian. So certainly last year, we did invest significantly in helping our OEMs get up to speed on IP networking. And we knew we would have to do that. And I think the base case for OEMs being a complementary channel for our IP business is still very much intact. I will acknowledge it's taking longer than we had expected. And one of the learnings, as Mike was alluding to there, is that we really need to focus more on creating the pull or the demand in the market to help those OEMs overcome some of the internal challenges around organization and priorities to get focused on IP. We're starting to see the fruits of that. And as Mike's alluded to, we will be continuing to invest more of our resources on the end user demand generation and pulling the OEM opportunity with us as we go.

**<Q – Brian Marshall>**: Okay. Thanks. And a quick question with regards to the federal decline. It sounds like the majority of that was directly related to a delay on the budget side. Can you talk about the opportunity for that to be – for there to be a catch-up payment, if you will, or kind of a ramp up over the next quarter or two as that budget comes back? Or do you think that that's something that is kind of not in the cards at this point? Thanks.

**<A – Ian Whiting>**: Yeah, this is Ian again. We certainly felt the impact of a delay in the signing of the Appropriations Bill in December for our federal business, where we do have a somewhat higher concentration of our federal business in the areas of DoD and Intel in particular. So that did create somewhat of a stall in the federal business, which was reflected in our IP numbers. We do believe that there is a catch-up. It's going to take Q2 and Q3, possibly into Q4 for a lot of that money to flow into the budgets and deals to be closed. But we are confident that we'll be picking up the opportunities through Q2 and through Q3 especially.

**<Q – Brian Marshall>**: Great. Thanks. I'll get back in the queue.

**<A – Peter Ausnit>**: Thanks. Healy, can we have the next caller please?

Operator: Yes, sir. Our next caller in queue is Mark Moskowitz with JPMorgan. Please go ahead.

**<Q – Mark Moskowitz>**: Yes. Good afternoon. Thank you. Two questions, first on the 750 new accounts to-date for the Ethernet business, could you guys talk a little more about what percentage are revenue producing accounts now versus still demo, lab type of work before installation? And then maybe you could talk a little more about why has the crossover to revenue producing taken longer than expected?

<A – Michael Klayko>: I'll let Ian start.

<A – Ian Whiting>: So, this is Ian. So all of those 700 accounts, by definition, are revenue-producing. I think the nuance here is that in most of the new footprints that we've been winning, they are for smaller deployments where we're being tested and tried out in what is traditionally our competitors' install base. And I think it's fair to say that some of the – those new footprints are smaller than we'd anticipated. Typically it's a try before you buy big time and I think we're running at around 15 to 20% lower initial buy than we had originally forecasted.

Having said that, the strategy of landing an opportunity in one of our traditional large SAN accounts is still very much part of the strategy and it's working. The time to turn that into a larger footprint is where we're learning as we go. And it's taking a little bit longer than we'd anticipated, but it all starts with getting the footprint and we're well on track with meeting that particular metric that we've been driving to internally.

<Q – Mark Moskowitz>: Thanks, Ian. The second question revolves more around just the challenges that you had discussed earlier, Mike, in terms of assessing the end market demand. I want to get a sense – can you comment a little in terms of, is this a function maybe of just Brocade's expanding product set and some of the challenges of having to manage all these SKUs and all these different channel programs, OEM programs, direct partners, indirect partners, what have you? Has there been any sort of go-to-market or even product-placement issues, I guess is the question?

<A – Michael Klayko>: Mark, I think it's a combination of a lot of things you discussed there. It's just getting the right go-to-market mix correct is an area that we've had to focus on and so I can't point to one area. I'd like to – we'd like to say it's just one thing, but we've learned along the way that it's a combination of a few things.

We did a rapid integration as you know last year of our sales forces and we moved some people around, which was very positive SKU from the customer standpoint. As you can see we've even increased our SAN footprint in our market share in our SAN business, but I hate to say it, some of it was at the expense of our Ethernet business, which is not the thing we had anticipated on doing. And so we got to get that balance a little bit better.

I actually do believe that and as I mentioned before we need- we have, the demand is there. We're going to be hiring some more sales people to cover some of those areas that we did vacate, where we moved people around and we're going to make some pretty tough decisions that we're going to begin deploying right away to get that balance back.

<Q – Mark Moskowitz>: Thank you.

<A – Michael Klayko>: You're welcome.

<A – Peter Ausnit>: Okay. Healy, can we have the next questioner please?

Operator: Yes, sir. Our next question in queue comes from Min Park with Goldman Sachs. Your question, please.

<Q – Min Park>: Great. Thank you. Just on the federal side. I know you noted a delay in the Appropriations Bill impacting your January quarter revenues and as well as your mix within the government. But why do you think you saw a greater impact than most of your other competitors in that vertical?

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**<A – Ian Whiting>**: This is Ian. I think the reality is that we have a higher concentration in certain parts of the federal government than our competitors, who in those same segments all – based on what we were hearing – had the same challenge as we did. But that base in federal government is broader, because they've been in it a lot longer. So I think it's a combination of those factors. It's a stall. It's those deals are still – all of the projects and programs that we're involved in are still very solid. It's in store that we expect to catch up, as I said, over the next two-plus quarters. And the reason it impacted us more than potentially others have claimed is that concentration within those particular agencies.

**<Q – Min Park>**: Thank you. And then as far as your go-to-market strategy, are you seeing any unusual sales turnover, given that the Foundry acquisition has now been anniversaried a full year?

**<A – Ian Whiting>**: No, quite the opposite actually. I mean we're still happy to talk to the fact that we have over 95% retention from the Foundry selling organization. And where we have had turnover, it's basically an upgrade where we're taking people from our competition to complement those resources. So retention turnover is really not an issue for us. We are looking to, as Mike said, add resources and adding resources from our primary competitors in the IP space.

**<A – Michael Klayko>**: In fact, Min, let me add to one more comment to that. Ian spoke at it from the sales perspective, but from a company perspective, we just got through participating in this Fortune 100 Best Places to Work, where we have a nice position of not even being mentioned in the past to being number 61. And when we took a look and we dissected on how the people and the company – from the make-up of that survey, the people who had come from Foundry had as equal or better feeling of being part of Brocade as just a classic Brocadian. So it's a good mix. Our retention rate is very high across all the areas of the organization, not just the sales organization.

**<Q – Min Park>**: Okay. And then just lastly, I was just wondering if you can just address some of the things that you guys have put in place. Mike, you mentioned that there's a lot of things that you're expecting right way and they're already being worked on. What is it that you're doing? Is it adding more sales people or that you're putting them in different locations? Could you help us with that, please?

**<A – Michael Klayko>**: Yeah. Min, I think you answered it. We're doing both. We're going to be adding sales teams. We've really taken a look at how do we go to market around service providers, enterprise and data centers. Where are some of the areas we have gaps in terms of gaps to the opportunity, where have we deployed resources where we're not getting the return back on those resources and some of the planning assumptions we've made in the past. Those are the immediate fixes that we're going to put in place. So we can redeploy those people, put them on revenue-producing opportunities and then go back and have a more robust coverage problem, because we've identified where the gaps are right now, Min.

**<Q – Min Park>**: Great. Thank you very much.

**<A – Michael Klayko>**: Thanks, Min.

**<A – Peter Ausnit>**: Thank you. Healy, can we have the next caller?

Operator: Yes, sir. Our next caller in queue comes from Mark Sue with RBC Capital. Please go ahead.

**<Q – Mark Sue>**: Thank you. I'm just trying to get to the root cause of the dissynergies between Brocade and Foundry. And do you feel the bad economy masked the internal problems, which implies that things can actually get worse within the Ethernet side when the economy gets better?

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**<A – Michael Klayko>**: I'll give you my – Mark, we don't think that's the case at all. We actually did move quite a few people around and we moved in some of our larger SAN accounts and you can see our SAN business went up, but it went up at the expense of our Ethernet business. And we just needed to do a better job. I'm not going to blame the economy or anybody else on this. This is just – we just need to do a better job of making sure that we put the right resources on a balance of our portfolio, not just the storage business, but a balance of the portfolio. So I don't think it's masking anything. I just think we made a couple of assumptions along the way that didn't – just didn't pan out for us.

**<Q – Mark Sue>**: Mike, when you say you're adding sales teams, does that mean you're upgrading and replacing or the sort of net number stays the same?

**<A – Michael Klayko>**: No, I think we need to – the net number should go up, Min- or I mean, Mark.

**<Q – Mark Sue>**: Okay, got it. Should IP products be up sequentially in the April quarter?

**<A – Michael Klayko>**: Well, it depends on how well we execute. So if you – if we've identified the issues -

**<Q – Mark Sue>**: And you think you have?

**<A – Michael Klayko>**: Then we would hope that would be the case. Yeah. And, so you – we would hope that would be the case. That's why we're making the changes as I mentioned before.

**<Q – Mark Sue>**: So you don't think it's a one-quarter problem, it's just pretty quick ?

**<A – Richard Deranleau>**: So, Mark, this is Richard. In terms of color for the quarter, first of all, let me say that I think we feel comfortable with the range we gave for the year of eight to 12%. And that's based on a lot of the learnings that Ian and Mike have talked about. That's based on taking those learnings and really understanding our pipeline and really scrubbing it from the skeptical eye of what we learned from Q1, also with some more focus on federal. When we have said in prepared remarks that we expected greater than normal seasonal declines, if you recall, Q2 typical seasonality is down four to 6%. We really don't see any scenarios where a seasonal decline in Q2 would be more than 10%. We're not seeing that based on our analysis.

But the drivers here really – and Mike and Ian have alluded to them – is how fast the Ethernet business recovers, how much of that federal comes back, in which quarter and Ian did talk about Q2, Q3, Q4. And really the other driver on this is going to be the strength in the storage TAM in the mid-part of the year. Will it retain the strength coming out of the recession from last year or will it be more backend loaded? Those would be the drivers.

**<Q – Mark Sue>**: Okay. Thank you.

**<A – Richard Deranleau>**: Thanks, Mark.

**<A – Peter Ausnit>**: Thank you. Healy, can we have the next question?

Operator: Yes, sir. Our next question in queue comes from Katy Huberty with Morgan Stanley. Your question please.

**<Q – Katy Huberty>**: Yes, thanks. Good afternoon. It sounds like a big part of the fix in the Ethernet business comes with hiring and investing in the channels and partners. And yet in the quarter, you brought OpEx down pretty significantly and it doesn't look like you are lowering your

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operating margin assumptions for the full year versus prior guidance. So I guess the question is what's the risk that this costs you more money than what you're working in the guidance? And if it turns out that you need to invest more, are you willing to do that and give up the operating margin target if it comes to that?

<A – Richard Deranleau>: Yeah. Katie, this is Richard. So if you look at the guidance I gave for the full year, given our pretty strong performance in off-margin in Q1, it does show you that we are in an investment mode. We are going to be in model for the full year from an operating margin perspective. But if you look at the guidance we gave you, it implies from a raw dollar perspective, we have the resources, the dollars to invest in our sales and go-to-market as well as our engineering that will allow us to make those investments and still be a very profitable and cash flow positive company. I would – and I think that's a good thing.

The other thing I don't want people to mess is what Ian and Mike have talked about, is identification of resources that currently are being deployed in areas that are non – basically non-producing, revenue and his ability – Ian's ability to redeploy those resources to create that customer intimacy. So it's really two things, redeployment of expenses that are already in our P&L and the ability to invest and still be within our long-term operating margin model.

<Q – Katy Huberty>: Okay. So is the right way to think about it the next quarter or two, you might be a little bit below model on operating margins, but as you execute through the year, you'll get back into model by the last quarter or two?

<A – Richard Deranleau>: I think that's a fair way to look at it. And again from our perspective, we've always been able to manage the bottom line.

<Q – Katy Huberty>: Yeah.

<A – Richard Deranleau>: Operating profit hasn't been an area that we haven't been very good at. So right now, what we plan to do is again – and some of these drivers I mentioned around the speed of the recovery in Ethernet, the strength in storage market, but we are going to make sure we drive that customer intimacy with additional resources.

<Q – Katy Huberty>: Okay. Thanks so much.

<A – Richard Deranleau>: Thanks, Kathy.

<A – Peter Ausnit>: Thank you. Healy, can we get the next question?

Operator: Yes sir. Our next question in queue comes from Nikos Theodosopoulos with UBS. Please go ahead.

<Q – Nikos Theodosopoulos>: Yes. Thanks. I had a couple of questions, the first one on the gross margin and tax rate guidance for the year. Those – I think the tax rate has come down and the gross margin came down a point. Can you kind of just give an update us to why you made those changes?

<A – Michael Klayko>: Richard?

<A – Richard Deranleau>: Sure. This is Richard. The gross margin perspective, the drivers are lower volume on the lower revenue. That's kind of an obvious one. Also we're provisioning for Ethernet pricing, a more aggressive approach on the Ethernet side from an ASP perspective. Also as I was just talking to Katy, we will be making investments in sales and support, as well as on the sales, some of that sales and support shows up in COGS. So that's the drivers. Obviously, if –

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there's upside if we execute on a gross margin perspective and I think that's where you could see improvement in the op margin – from an op margin point of view.

Turning for a moment to the tax rate, so the drivers in the tax rate, there were some discreet events that gave us a benefit in – from a non-GAAP perspective in Q1. So that's why we had a very low tax rate and those are basically changes in the law that allow us to take carry-backs further. And secondarily, we've been resolving some of our back years with the IRS and those settlements. Typical stuff, but they've been favorable to us. So when you look at that, that helped us in the quarter. That also obviously impacts the full-year rate and those are the drivers on the tax side.

**<Q – Nikos Theodosopoulos>**: Okay. And just back on the direct sales force effort. Did I hear earlier that 90% of the original foundry sales force is still at the company? And then if so, I'm trying to understand why there was a diminished direct effort by the company?

**<A – Ian Whiting>**: Yeah. This is Ian. That's correct. It's actually north of 90% of the original Foundry sales organization that came across is still with the company. I think it goes back to some of the comments we made earlier on. I mean we took a decision based on the assumptions and how we saw the market almost a year ago now to deploy some of the Foundry resources into areas such as the data center and into driving the enablement of our OEMs. And those investments have as yet not turned into revenue.

So the decision that's been made is obviously we have to make sure we have sufficient resources to still see through the OEM opportunities, which -- the base case for which is still there. But what we need to do now is acknowledge the fact that the Ethernet business is predominantly a direct and channels-oriented business. So by redeploying, if you like, those Foundry classic sales resources and systems engineered onto end users and channels, that's how we expect to return to the kind of growth in Ethernet that we expect.

**<Q – Nikos Theodosopoulos>**: Okay. Thank you.

**<A – Michael Klayko>**: Thanks, Nicolas.

**<A – Peter Ausnit>**: Thank you. Healy, can we take the next caller?

Operator: Yes, sir. Our next question in queue comes from Keith Bachman with the Bank of Montreal. Please go ahead.

**<Q – Keith Bachman>**: Hi. Thank you. First question, Richard, for you is it looks like the cash flow assumptions for the year are lower than previously indicated. Could you just walk through there? Is it on the margin line that flows to the cash flow or is there some other assumption on the days or the working capital cycle?

**<A – Richard Deranleau>**: It is principally being driven by the lower revenues and the lower gross margin. Those are really the major driver. There's nothing else really going on from a cash flow perspective or from a capital investment perspective than what we talked about before.

**<Q – Keith Bachman>**: Okay. Great. And then you also indicated that there were some redeployments and from – it sounded like other areas, even within R&D if I was reading that correctly. And I was just wondering what was getting de-focused, if you will, or was that purely a sales comment?

**<A – Richard Deranleau>**: No. This is Richard. I would say – and Ian can jump in. But I'd say that what we're trying to communicate is that we are redeploying resources on a go-forward basis. Think about the beginning of this quarter when we were redeploying. We haven't made any

significant changes from an R&D perspective. It's really a forward-looking comment about how we're going to gain that customer intimacy that Ian had talked about.

**<Q – Keith Bachman>**: In other words – so to be clear, there's no change in how you're thinking about the HPAs or the SANs or any of those areas? It's a sales approach that you're considering?

**<A – Richard Deranleau>**: Yeah. That's correct, Keith.

**<Q – Keith Bachman>**: Okay. And then the final one from me if I could is – per the previous comment, you indicated less orientation around the partners, which – HP, IBM and Dell. Is that something you see as more of a permanent situation or you're trying to do that to generate demand for those OEMs? Because doesn't – if the latter is the case, doesn't that create some channel conflict about trying to work with the OEMs and generate demand yet serving their own interests as well?

**<A – Ian Whiting>**: Well, just a couple of comments on the OEMs. So I think obviously things changed a little bit with HP last year with the decision that they took. So that avenue is no longer one which we're exploring. I think the base case at the other OEMs that you mentioned is still very much intact and we're very confident that today we are garnering the lion's share of the business, the branded IP networking business in those particular partners. And I do think that, as I've stated at our Tech Day back in September, that it was going to take some time and it would be the back end of this year when we would start to see traction in the form of more people deployed by those OEMs on networking, clearer metrics around quotes for assignment and so forth being in place, all of which needs to happen to really accelerate through a traditional OEM model.

All that being said, the lesson that I think we've learned and that Mike has alluded to and I've commented on a couple of times, is that we need to take full control of our own destiny on the Ethernet side, which means taking a far more direct approach in creating demand. And then working with those partners, be they independent channel partners or OEMs, to go to market together, where our combined resources are obviously a lot more effective, particularly in larger accounts where there's obviously a very strong competitor. But the basic principle of OEMs being a complementary channel to us on IP is still intact. The timing has moved out and we're obviously now remixing, if you like the sales resources to ensure that we have success irrespective of how those OEM partnerships play out.

**<Q – Keith Bachman>**: Okay. Thank you.

**<A – Peter Ausnit>**: Thank you. Healy, can we have the next caller?

Operator: Yes, sir. Next question in queue comes from Jeff Evenson with Sanford Bernstein. Please go ahead.

**<Q – Jeff Evenson>**: Hi and thanks. Wondering if you could give us some color on what the non-performing initiatives you were taking are that you're reallocating resources on? And then second, what is giving you confidence that this is not a product portfolio issue?

**<A – Ian Whiting>**: So in terms of the non-performing regions, it's really – it's the OEM model, which I think as I've said, we are – we believe that we've done enough to enable our OEMs. Now we need to start driving demand, which is why the resources moved to more an end user focus and a joint selling motion versus the traditional enablement activities of training and joint marketing and so forth, which is what – where we've been spending a lot of resources.

As a salesperson you always want more products and better products, but we don't believe it's a product issued today. We have what we need to sell and be successful in the Ethernet

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marketplace, given our goals. I think what this is pointing towards is refocusing the resources on the right targets with the right amount of energy and I think that will give us what we need in terms of success. Certainly, the road map and everything else we've got going forward is very compelling. And in the data center customers, that's playing out extremely well.

One of the reasons why we've had such a lot of success in SAN in Q1 and throughout the last year is that message in the data center around our connective approach to building virtual data centers is resonating and people are continuing to buy a lot of SAN gear as a result of that, with a view to migrating to more of a conversion network infrastructure in the future. So we have what we need, it's just a question of focus and execution.

**<Q – Jeff Evenson>**: Have you communicated your decision to pull resources from the OEM partners to the OEM partners and if so how did they react?

**<A – Ian Whiting>**: Yeah. I mean the OEMs are actually very appreciative of the fact that we're focusing now on demand. They have now put in place in most cases infrastructure, people, expertise that we have been helping them to build. So it's logical for them and for us that we focus our resources and this is not a complete shift left. This is a high percentage of the people now moving into more of a demand creation mode. We still have teams of IP and other professionals managing those OEM relationships, making sure that they have what they need from us to be successful. And the only real way to prove that out is as I've we are very confident that we are driving the vast majority of the revenue for OEM branded IP product at the OEMs where we are participating.

**<A – Richard Deranleau>**: And Jeff, this is Richard. I just want to make sure I'm – everyone understands what Ian is saying. When we go out and say we're investing in end user sales, just like we do in the storage business, we drive the sales. But how we fulfill that is totally up to us, whether we send it to an OEM, a channel or direct. That's always the option that we have. So there's really dichotomy between investing in end users and the long-term help of the OEM model. Again today, we drive a lot of end user demand on the storage or networking side and nearly 100% of that goes through the OEM channel.

**<Q – Jeff Evenson>**: Thanks.

**<A – Peter Ausnit>**: Okay. Healy, can we have the next caller please?

Operator: Yes, sir. Our next caller in queue is Aaron Rakers with Stifel Nicolaus. Please go ahead.

**<Q – Aaron Rakers>**: I had a couple as well. I guess first of all, I want to go back to the cash flow guidance, or I guess more importantly, free cash flow guidance that you gave now for the year. Correct me if I'm wrong, I think last quarter, you had said that you were basically two thirds of the way through your campus expenditures, which I think at that point was 183 million, which would imply about 280 million. And that would imply basically 94 million left in that CapEx guide. Today in the guidance, now you're saying that you're going to do 120 to 145 million. So I guess my question is, doesn't that imply that that campus related CapEx is going up and just trying to wonder how – why that might be?

**<A – Michael Klayko>**: Yeah. As of right now the – if you look – the 120, 125, that's an annualized number. So that leaves us about \$90 million left on the campus from now until completion. That's an all-in number and we – at this point in time, we're pretty comfortable that that's the right number.

**<Q – Aaron Rakers>**: But correct me, if I'm wrong, that has been increased relative to what you've said?

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<A – Michael Klayko>: There's been some increase as we've looked at additional things. For example, we have decided to invest in a, I'll call it a solar farm, in order of which has decent payback. That's just one example of some incremental things that we've looked at.

<Q – Aaron Rakers>: Yeah. Okay. And then -

<A – Michael Klayko>: The other thing I'd point out, Aaron I don't know, I didn't – if it was buried in the prepared remarks, but one thing is, from an EPS perspective the building, the new campus is going to be slightly positive to neutral overall. But from a cash perspective, as in the prepared remarks, by the end of this year, as we exit the residual leases from our current campuses, we'll be generating nearly \$4 million in additional incremental cash per quarter. So we're generating quite a bit of cash going forward from this is campus.

<Q – Aaron Rakers>: Okay. Fair. And then the follow-up question would be, obviously, I think the key question on a lot of people's mind is Dell and IBM. I think you guys have said that that's ramped slower than anticipated. I guess first of all, can you tell us how you're strategically positioned within IBM relative to the ramp that Juniper's now talking about? And then also I think Juniper had talked about a kind of an initial ramp beginning in the second calendar quarter. I think it'd be helpful, given what's going on kind of to layout your framework of when you yourself anticipate those opportunities to begin to ramp?

<A – Ian Whiting>: Yeah, without going through all the complexes of how some of our OEMs are organized, if you look at the part of IBM that is branding the IP products from us and our competitors, we have without question the lion's share of that marketplace. There is obviously within IBM another very substantial part of the company in the services area that has many very long-standing relationships with a number of the players. And I think that's where – that's my assumption of where those comments come from around our competitors' traction.

As far as Dell's concerned, this is just really the first quarter where we're starting out in terms of building the internal OEM branded product line, the go-to-market models and putting in place all the things that you need to be successful for any of our OEMs to be successful in the IP marketplace. So every one of these OEMs is slightly different in how they're organized, but when it comes to the OEM branded IP products, that's where we are confident we have traction and that's where we think the growth will come from in the second half of the year.

<Q – Aaron Rakers>: Is there the potential to escalate your position within IBM going forward? And that's my final question.

<A – Ian Whiting>: I didn't catch that. Could you repeat the question please?

<Q – Aaron Rakers>: Well, I guess relative to your comments about the IBM positioning, is there the opportunity to further extend your positioning within IBM at some point here over the next couple of quarters?

<A – Ian Whiting>: Certainly, I think in the second half of this year – which is consistent with some of the comments I made back in September at Tech Day – that's when we expect to start seeing many of the internal systems processes, measurement and metrics kick in and that's when I would expect to start seeing the results of our investments in IBM.

<Q – Aaron Rakers>: Okay. Thanks.

<A – Peter Ausnit>: Thank you. Healy, can we have the next question?

Operator: Yes, sir. Our next question in queue comes from a Kaushik Roy with Wedbush Security. Please go ahead.

**<Q – Kaushik Roy>**: Thanks. Can you give us some color on the April quarter? If federal is coming back and on the Foundry side and storage is doing well, what are your expectations for the April quarter? It seems like the Street is at 549 million, which is up 2% sequentially. So are you comfortable with that – or any kind of color will be helpful?

**<A – Richard Deranleau>**: Sure. Kaushik, this is Richard. I think I gave quite a bit of color on it, as much as we can give you. I'll just repeat for you. Comfortable for the growth range for the full year of eight to 12%, we expect greater than normal seasonal declines, which as you know in Q2 would be four to 6%. We don't see any scenarios at this – we're not seeing scenarios where seasonal decline would be – in Q2 would be more than 10%. So that gives you some ranges on what our thoughts are. The drivers are the how fast Ethernet business recovers and the strength of the storage TAM in Q2 and Q3, given that we have a very strong position within the TAM.

**<Q – Kaushik Roy>**: Can you comment on the linearity? How was January and how has February been so far? Thank you.

**<A – Richard Deranleau>**: No. I – we wouldn't comment other than to say it's – there's nothing atypical about linearity that we've seen to date.

**<Q – Kaushik Roy>**: Okay. Thanks.

**<A – Peter Ausnit>**: Thanks you, Kaushik. Healy, Can we have the next caller please?

Operator: Yes, sir. Our next question in queue comes from Erik Suppiger with Signal Hill. Please go ahead.

**<Q – Erik Suppiger>**: Good afternoon.

**<A – Michael Klayko>**: Good afternoon.

**<Q – Erik Suppiger>**: Two questions for you. On the IBM front, a big part of the initial expectation for IBM was that they would be diverting some of the traditional business, the Cisco business, to Brocade and obviously Foundry had been competing with Cisco for years. Now it sounds as though you're going to be driving a lot of the incremental sale, or the demand, as it relates to IBM and the OEM partners. So what makes you think that you'll be able to drive market share demand if Foundry wasn't able to do it before?

**<A – Ian Whiting>**: Just to clarify couple of things, it's not just creating demand for IBM. It's creating demand for Brocade Ethernet and obviously, there are a number of accounts where that is served by jointly selling and marketing to customers with IBM or indeed other OEM partners. So it's a demand generation statement in general. I mean, loads of selling is being done in conjunction with the sales teams of our OEMs.

In terms of our ability to compete and differentiate ourselves, I think we shouldn't overlook the fact that there is still a tremendous amount of concern in the market and within the OEMs around the other companies' posture and competitive positioning, which continues to create opportunities for us to position ourselves as the alternative, either at the end user or in the minds of the sales people at our OEMs. So that issue hasn't gone away. It's definitely if anything increased recently and that is driving continued interest in what Brocade has to offer, not only in terms of technology, but in our go-to-market model, which is non-threatening to them and is very collaborative in its approach. So I think it's an opportunity for us to continue to pursue.

<A – Michael Klayko>: Erik, and in addition, when we talk to customers, they do like the fact that -- in the past there had been silos, Foundry just sold Ethernet to a certain segment and Brocade had just been primarily focusing on the data center with storage products. Our customers today like to have the choice to build these networks, whether they be -- there are some customers that want to build independent storage networks and then Ethernet. There's others that want to go a head and add converged. There's others who want to go ahead and migrate over time.

So I think therein lies a difference, is the fact if you take a look where our history has been from a standpoint, we come from different starting points. One is from the data center and then the other one's from the data center out. Therein lies the difference right now is, as customers begin these build-outs, they're trying to answer questions they don't even know to how to ask the questions of yet on what the new data center should look like. And we have a lot of networking expertise to give them options and so I think that's what gives us confidence that we can do this going forward.

<A – Ian Whiting>: Yeah. I think the way I'd summarize it is that the game plan with regards to our OEMs is the same now as it was last year. The timeline has changed and the way we are going to exploit the opportunity has changed. But we're still very confident that the OEM model will present opportunities for us to grow. But as I've said, I think the important thing for Brocade to learn from recent experience is that we focus on the customer and enable the partner.

<Q – Erik Suppiger>: Okay. Then second question is Foundry was largely direct. I'm not sure how much of Foundry's sales have migrated to indirect, but how much of the shortfall on the Ethernet side was simply giving margin to channel partners as you migrated revenues to an indirect model?

<A – Richard Deranleau>: Yeah, this is Richard. The -- and if you look at the prepared rem and press release, it's really a federal issue. And if you look at growth in what we'd call enterprise for Foundry, it was actually up sequentially. This is really a federal issue on -- had first and foremost, after the federal issue then you can look at our actual experience versus what we talked about in our plan in terms of the timing at the OEM and I think Ian has talked about that. And then a little bit of -- a little bit of it was some underperformance in Asia-Pac, Japan. That's the way I would characterize it. It's not a -- there was no meaningful or significant impact from shifting over from one channel to another.

<Q – Erik Suppiger>: At this point, are most all of the Foundry sales indirect?

<A – Ian Whiting>: I think in international markets they are and they always were, because all of the Foundry classic IP business outside of North America was indirect. In North America, there has been no material change between direct and indirect. So it's pretty consistent with the situation in the former Foundry revenue mix.

<Q – Erik Suppiger>: Okay. Very good. Thank you very much.

<A – Peter Ausnit>: Thank you, Eric. Healy, can we have the next caller please?

Operator: Yes sir. Our next caller in queue comes from Brent Bracelin with Pacific Crest. Please go ahead.

<Q – Brent Bracelin>: Thank you. I apologize up front, but I will ask a follow-up question on the Ethernet business. Two quick questions, one, based on the action plan you have in place now, how long do you think it would take before your Ethernet business could start to grow in line with the industry recovery? Is it going to be a six-month process, nine-month process, 12 month's process based on what you've done so far? And then the second part of the question is, as you think about

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your ability to build a sales or channel presence, taking share in the Ethernet market, even if the OEMs ramp, is it possible or does this model only work and only scale if the OEMs ramp?

**<A – Michael Klayko>**: It's pretty good question. I'd try to answer it in – with brevity. We're going to make changes now. If we make changes now, I hope to see affect in the second half of the year. This is not some kind of science project. We really do understand I think after analyzing all the information what we need to do and we're in the process of literally making the changes as we speak. And if you do that, how that transcends if you just look at our history, that means it would be a second half affect.

**<Q – Brent Bracelin>**: And then relative to does the model work if the OEM channel does not ramp?

**<A – Michael Klayko>**: Well, I think what we're – it becomes a hedge. And not even – more so than the hedge, the OEM model actually if it works well, actually builds on top of that, that we're planning on driving and controlling our own destiny and this becomes an add-on on top of it on the OEM model as it begins to ramp.

**<A – Richard Deranleau>**: And Brent, this is Richard. I guess the only thing I would say is for you to think about none of the issues that were brought up by in the ecosystem by people deciding to go into other people's spaces, none of that has changed. And until and unless those things change, you have the same issues that the big OEMs face from a competitive point of view. Some OEMs have chosen to address that in one way. The other one – other OEMs are continuing to look at their options. So I'm – although, we have execution timing issues, I don't think we're abandoning the OEM as a valid opportunity at all.

**<Q – Brent Bracelin>**: Okay. Thank you.

**<A – Peter Ausnit>**: Thank you. Healy, can we take the next caller please?

Operator: Yes, sir. Next question in queue comes from Jason Ader with William Blair. Please go ahead.

**<Q – Jason Ader>**: Yes, thank you. My question first is on the gross margin breakdown going forward. Would you expect the data storage gross margins to remain in the kind of low 60s for the next few quarters, which would imply that the IP products gross margins are going to be closer to 50%. Is that the right way to think about the annual guidance?

**<A – Richard Deranleau>**: From a – Jason, this Richard. From a data storage perspective, not a lot going on there. We're still keeping our expectations around the price declines in the mid single-digits, that – so kind of same old story on the data storage. That leaves you a combination of what happens to us from a, what we call global services, or service and support perspective, as well as our expectation to penetrate the Ethernet market and the implied pricing that would bring.

**<Q – Jason Ader>**: Okay. So should we expect the services gross margins to be lower than they were in Q1 for the remainder of the year?

**<A – Richard Deranleau>**: Well, it's a mix issue. It depends on the mix of services versus support. We had a one-time item in services as we cleaned up our supply chain in support – support is where we saw the issue. That goes away, but then it becomes the mix and the more successful we are at growing our professional services, that brings in pressure on the overall mix between services and support. We drive for the professional services, because we're using it strategically to sell more hardware, create additional intimacy with our customers.

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**<Q – Jason Ader>**: Okay. And then second question is why do you expect a worse-than-normal seasonal decline in the second quarter? I didn't catch that.

**<A – Richard Deranleau>**: Sure. The drivers – and Mike can jump in. The drivers are the speed at which the Ethernet business recovers and then the strength – what's the final strength of storage TAM in Q2 and Q3. That would – when we had Analyst Day, we were expecting the storage market to be pretty robust even in the first half. It was in Q1, but I think we're looking at something a little bit more in the second half for storage. Those are the two drivers on it.

**<Q – Jason Ader>**: Okay. So Ethernet's probably going to be down and storage is going to be down a lot, because of seasonal a effect. I guess what is – I mean it almost looks like you kind of pulled in revenue from the April quarter and the January quarter, because the January quarter was so strong. Is that having an impact on this Q2 guidance or the seasonal comment?

**<A – Michael Klayko>**: Well, you've said that we've – you've put words in our mouth that we haven't said regarding both Ethernet and storage. To address your question head on there, OEM inventories we don't really control them. The OEMs control their inventory. Inventories were up very slightly. As you know, we've been operating in to – well, in the height of the economic issues, inventories, last year, inventories went very, very low, down into like one-and-a-half weeks. They have been recovering as the OEMs have had more confidence in their business and their willingness to hold more inventories. And that's really a positive for us, because it's a vote of confidence on the part of our OEMs. But our field inventories at the OEMs are still below three weeks of inventory. They've been operating kind of in the mid- to two-and-a-half weeks. So hopefully that answers your question.

**<Q – Jason Ader>**: Okay. And then the last question is I know everyone's been kind of driving at this and I think the reason everyone's driving at it is because of some comments that you made at your Analyst Day. But you guys talk about your expertise as an OEM company, that you know how to work with the OEMs, you know how to drive end user demand and you made a lot of comments about redeploying your resources and originally you deployed more for OEMs and now you're going back to end user demand. It just seems like there's a bigger issue here. Is it a problem – is there a structural issue here on the OEM channel for this Ethernet market? I mean that's what it feels like. And I know you guys don't believe that and you're telling us that it's just going to take more time. But you're trying to apply some of the things that you applied on the fiber channel side onto the Ethernet side and obviously they're not working. So I guess what gives you the confidence that they will work?

**<A – Ian Whiting>**: This is Ian. Let me add a couple of comments. So I guess, first of all, I think it's very significant that certainly two of our major OEMs have decided to put – to take branded Brocade products. So they are committed to the business. And that requires them to go through – and you'd have to talk to them more about the detail of this, but there's a lot of internal changes that had to happen for them to organize and align themselves, create whole new product divisions in some cases and all that, candidly, is something that was outside of our control that is now, I think, established and in place at the OEMs where we're participating and jointly marketing together. That's what took longer, frankly. I mean, we continue to do all the things that we were asked to do and we've been told that we're doing them well in terms of enablement and training and getting baked into the various solution sets for our OEMs.

I think there were just – there was some inertia and some initial organizational challenges that had to be overcome, which we anticipated, which is why we always called out the second half of this year. But I'll reiterate what I said this – earlier on, that the base case for OEMs taking IP networking products as part of a solution set, in the context of the – their overall competitive environment with regards to winning the big IP networking company out there is still very strong. And if anything we're starting to see an increasing interest in the whole go-to-market with the OEMs, more

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collaboration, more interest in putting joint programs together and so forth. So it's a timing issue. The base plan is still intact, we're just finessing, I think a little bit, the sales model to make sure that we're creating demand at the same time, not just waiting for the OEMs to bring opportunity. So I hope that explains some of the nuances of the OEM model.

<Q – Jason Ader>: Great. Thank you.

<A – Peter Ausnit>: Thank you. Healy, can we get the next caller please?

Operator: Yes, sir. Our next caller in queue comes from Rajesh Ghai with ThinkEquity. Please go ahead.

<Q – Rajesh Ghai>: Yes, thanks. So a question for you, Michael. It's been a year since the acquisition of Foundry, just wanted to understand the end-to-end networking company strategy that you've outlined when you acquired Foundry, do you think there is a need to revisit that, given the divergence in performance of the two businesses? And do customers really care if you're an end-to-end networking company? What's your thought at this point in time a year into the acquisition?

<A – Michael Klayko>: Yeah, thanks. Said differently, did we – would I make the same decision today is what I think you're asking. The answer is, yes.

<Q – Rajesh Ghai>: Yes.

<A – Michael Klayko>: And the answer is, yes. The customers we talk to today do want to have an end-to-end solution. There is a tremendous amount of change going on in the data center right now as customers are trying to figure out how do they handle this explosive growth, not only in just data, but in networking traffic. And if you don't have the entire product portfolio, I think you're disadvantaged. And so strategically it's the right decision. Customers have told us we've made the right decision.

In fact, we do have some benefits by getting into the – our SAN business actually is growing because of our Ethernet business, because we can allow customers on their timeline to either have an independent network or a converged network as what they want to do, they are coming to us. So I think it is incredibly important and you're going to have to have an answer regardless of who you are in the marketplace as you go to this customer base or you're just going to get put into a box as a point solution long-term. Strategically, right thing to go ahead and do. We – I think we had a quarter of learning along the way but from a strategy standpoint, it doesn't really change anything.

<Q – Rajesh Ghai>: Great. And talking of this discussion around creating – generating end user demand on the LAN side and trying to execute the OEM model along those lines. But isn't that the model that was originally planned for for the LAN side also? Can I assume that's something – is that divergent from what you planned for on the OEM side over the past six months?

<A – Ian Whiting>: Well, we had originally talked about continuing to drive direct touch, direct sales and channel activity, but at the same time, leverage the opportunities that were being presented to us by our OEMs. And that required obviously some reallocation of resources from what were Foundry IP networking sales specialists into the OEM and into some of the large account opportunities. So that was always the case.

I think what we've been saying consistently today is that the lessons that we've learned recently suggest that we now need to move on to that more end user focus, reallocate the people where necessary, change people where necessary, where we have underperformance and execution issues. But make sure we're taking control of our own destiny. But just to be clear, we still have

significant teams of people that will remain focused on driving success of our OEM partnerships. But the mix of those resources is what we're talking about now, not the -

<Q – Rajesh Ghai>: One last question.

<A – Ian Whiting>: Okay?

<Q – Rajesh Ghai>: Okay. One last question, was that on the positive side, you had a pretty strong quarter on the SAN side. What was the driver of the market share gain on the SAN side and was there anything to do with the OEM realignment of Cisco entering the server market?

<A – Ian Whiting>: I think it's two things, one is exactly what you just mentioned. It's the continued reaction, I think the other major networking company out there and their posture in the marketplace, being viewed increasingly as a competitor and forcing the end user customer into proprietary solutions. So I think that's definitely one dynamic.

The other though is simply the fact that we have a very compelling product offering in the data center. And as customers are thinking about virtualization and converged networks, they're picking Brocade on the – with the current SAN infrastructure because we provide a very logical migration for them through FCoE and CEE and we're not in the server business. So we're not competing with our OEMs. We're not – we're an open standards company. We have solutions, which suit all environments. So I think it's a combination of our technology and our position in the marketplace and the continued competitive threat from the other company.

<Q – Rajesh Ghai>: All right. Thank you.

<A – Peter Ausnit>: All right. Healy, we have time for two more questions. Can we have the next question please?

Operator: Yes sir. Our next question in queue comes from Scott Craig with Banc of America. Your question please.

<Q – Scott Craig>: Hi. Thanks. Good afternoon. First on the head count, you'd provided the numbers at the end of the first quarter in your press release, but just curious what your thoughts are on potentially how many people you would add by the end of the fiscal year? And then secondly, back to the OEM business, the incentive structure there. Has that changed enough over the past, let's call it, six months to where the sales force at IBM and Dell have a better incentive structure to push your product as opposed to other networking company's products, just curious there? Thanks.

<A – Michael Klayko>: Yeah, let me take the first one. One of the things we constantly do is rebalance our head count. We have a fairly diverse force where we also bring in a lot of young people into the company. And so as you – we have a very heavy college recruitment program right now. We're going to add more than 250 college hires this year alone in all disciplines, whether it be engineering or marketing or sales and finance and so forth, so the actual head count itself. And so I think it will go up significantly.

The mix, when you look at the balance, the dollars don't go up proportionally, so it's really hard. I know if you're trying to model out how many head count we have and how that models out in terms of costs per head and so forth. It becomes more challenging just because of the mix. We do a lot of things right now in terms of our sustaining in lower-cost countries such as India and China, as well as some things we're doing in Europe. But we also have a mix change of the people we're bringing in have lower cost base. So we'll be adding hundreds of people to the company, but I don't think it's a necessary correlation to the dollars we'll be adding to that.

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**<A – Ian Whiting>**: And on the question of incentives, I mean, obviously each of our OEMs is different. But I will just say in general, there are strong incentives to sell their own brand products on their own brand product. In other words, their networking with their servers, with their storage and so forth. That's an important part of the strategy. It's part of their own end-to-end networking and infrastructure solutions. I mean, obviously we always like there to be an unfair advantage for us within the OEMs when it comes to metrics and incentives. I do however believe that many of those incentives are now in place that probably weren't there a year ago. And I feel confident that those will stimulate the right kind of behavior and encourage, if not force, the OEMs own sales organization to sell the branded solution, which as I said, is more often than not going to be Brocade.

**<Q – Scott Craig>**: Okay. Thank you.

**<A – Peter Ausnit>**: Thank you. Healy, can we have our last caller please?

Operator: Yes sir. Our final question for today comes from Jayson Noland with Robert Baird. Please go ahead.

**<Q – Jayson Noland>**: Yes. Thank you. Two questions, Richard, first, if you could talk a little bit about OpEx expectations through Fiscal '10, pace of hiring and how we should think about that from a modeling perspective?

**<A – Richard Deranleau>**: Yeah. I would tend to think linearly along the year from adding expenses. I would also remind you then when I talked – when we talked with Katie, this is all well within, in fact below our E to R modeling for our long-term model. So with the head count we're going to add again – we have increase in raw dollars, but we're still going to maintain our operating margin of 20 to 23%.

**<Q – Jayson Noland>**: Okay. Last question from me, Mike, the original expectations for your SAN business was to maintain share. You generally continue to take share in the business, up to 70% now. I guess if you could talk about what your expectations are going forward and is it fair to think of Cisco as really just having traction at a single OEM from here?

**<A – Michael Klayko>**: Jayson, it's a good point. I mean, we are – as we mentioned before, we're – the growth opportunities for us is to get this Ethernet business really growing at [inaudible]. Our focus will be there. The strength of product line we currently have in the SAN business as well as the installed base has been – it's boded very well for us. And so with that, we try. I should say we're – our market share has continued to increase in that space. But it's not – it's not the huge focus for us. Again, our focus right now is as we look at the customers that we're dealing with, these new network build-outs – and they were a combined opportunity for a variety of different networking products, from fiber channel to Ethernet, to converged. And so we're not going to have a maniacal focus on growing the SAN business. I think that is going to go and happen just based on the strength of the product line on a long-term basis. But we will have a maniacal focus on growing the Ethernet and the converged business.

**<Q – Jayson Noland>**: Thank you.

**Michael Klayko, Chief Executive Officer**

Okay. Well, I want to say thanks – this is, Mike. I want to say thanks again. That's all the time we have. We really do understand the challenges ahead of us and we're very informed of what we need to go ahead and do on a go-forward basis. We're going to keep the Q&A e-mail address line open. So please continue to send us your questions and thoughts and that way we'll try to go

ahead and answer those back. If we couldn't get your question live today, we'll try to get back to you via e-mail. With that, I'd like to say thank you for joining us today and I hope to see you at an upcoming event.

Thank you, Healy. That closes our call.

Operator: You're welcome, Sir. Thank you. Well, ladies and gentlemen, this does conclude today's program. Thank you for your participation and have a wonderful day. Attendees, you may now disconnect.

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