WESTERN DIGITAL CORP
Form 10-Q
November 24, 2006

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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 September 29, 2006

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
Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, $.01 Par Value Per Share	**New York Stock Exchange**
Rights to Purchase Series A Junior Participating Preferred Stock	**New York Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act: None

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, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer þ Accelerated filer o Non-accelerated filer 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 November 10, 2006, 221.7 million shares of common stock, par value $.01 per share, were outstanding.

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We have a 52- or 53-week fiscal year, which typically ends on the Friday nearest to June 30. However, approximately every six years, we report a 53-week fiscal year to align our fiscal quarters with calendar quarters by adding a week to our fourth fiscal quarter. The quarters ended September 29, 2006 and September 30, 2005, were 13 weeks. Fiscal year 2006 was comprised of 52 weeks and ended on June 30, 2006. 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 in this Quarterly Report on Form 10-Q.

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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)

	Sept. 29, 2006	June 30, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 603	$ 551
Short-term investments	148	148
Accounts receivable, net	614	481
Inventories	216	205
Advances to suppliers	86	80
Prepaid expenses and other	30	27
Total current assets	1,697	1,492
Property and equipment, net	598	549
Intangible and other assets	30	32
Total assets	$ 2,325	$ 2,073
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 750	$ 632
Accrued expenses	128	131
Accrued warranty	74	71
Current portion of long-term debt	30	25
Total current liabilities	982	859
Long-term debt	29	19
Other liabilities	42	38
Total liabilities	1,053	916
Commitments and contingent liabilities (Note 5)		
Shareholders equity:		
Preferred stock, $.01 par value; authorized 5.0 shares; Outstanding None		
Common stock, $.01 par value; authorized 450.0 shares; Outstanding 221.7 and 221.7 shares, respectively	2	2
Additional paid-in capital	782	775
Accumulated comprehensive income	1	1
Retained earnings	494	391
Treasury stock common shares at cost; 0.4 and 1.2 shares, respectively	(7)	(12)
Total shareholders equity	1,272	1,157
Total liabilities and shareholders equity	$ 2,325	$ 2,073

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

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

	THREE MONTHS ENDED	
	Sept. 29, 2006	**Sept. 30, 2005**
Revenue, net	$ 1,264	$ 1,010
Cost of revenue	1,046	832
Gross margin	218	178
Operating expenses:		
Research and development	75	70
Selling, general and administrative	44	40
Total operating expenses	119	110
Operating income	99	68
Non-operating income:		
Interest income	7	3
Interest and other expense		1
Total non-operating income	7	2
Income before income taxes	106	70
Income tax provision	3	1
Net income	$ 103	$ 69
Income per common share:		
Basic	$ .47	$ .32
Diluted	$ .46	$ .31
Weighted average shares outstanding:		
Basic	219	213
Diluted	225	221

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)

	THREE MONTHS ENDED	
	Sept. 29, 2006	**Sept. 30, 2005**
Cash flows from operating activities		
Net income	$ 103	$ 69
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	45	36
Stock-based compensation	9	7
Changes in:		
Accounts receivable	(132)	(67)
Inventories	(11)	(20)
Accounts payable	118	79
Accrued expenses	(1)	(40)
Advances to suppliers	(3)	(21)
Prepaid expenses and other		(3)
Net cash provided by operating activities	128	40
Cash flows from investing activities		
Capital expenditures, net	(72)	(50)
Purchases of short-term investments	(1)	(19)
Redemption of short-term investments	1	57
Net cash used in investing activities	(72)	(12)
Cash flows from financing activities		
Issuance of common stock under employee plans	2	12
Repurchase of common stock		(14)
Repayment of long-term debt	(6)	(5)
Net cash used in financing activities	(4)	(7)
Net increase in cash and cash equivalents	52	21
Cash and cash equivalents, beginning of period	551	485
Cash and cash equivalents, end of period	$ 603	$ 506
Supplemental disclosure of cash flow information:		
Cash paid during the period for income taxes	$ 2	$ 2
Cash paid during the period for interest	$ 1	$ 1

Supplemental disclosure of non-cash investing and financing activities:				
Equipment acquired under capital lease	$	21	$	6

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 as of and for the year ended June 30, 2006. 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 (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 as of and for the year ended June 30, 2006. The results of operations for interim periods are not necessarily indicative of results to be expected for the full year.

Company management makes estimates and assumptions relating to the reporting of certain assets and liabilities in conformity with U.S. GAAP. These estimates and assumptions are applied using methodologies that are consistent throughout the periods presented. However, actual results can differ from these estimates. The Company makes adjustments to these estimates and assumptions in subsequent reporting periods as more current information becomes available. Given the time involved in completing the independent investigation into its stock option accounting, the Company did not file its Annual Report on Form 10-K for its fiscal year ended June 30, 2006 until November 2006. Accordingly, information not normally available regarding these estimates and assumptions as of June 30, 2006 became available during the process of preparing the financial statements for the quarter ended September 29, 2006. The Company evaluated this additional information and its resultant impact on the estimates and assumptions as of June 30, 2006 and determined that they were not material to its financial statements. As a result, the financial impact of these changes in estimates and assumptions has been reflected in the financial statements as adjustments for the three-months ended September 29, 2006 (see Note 2).

2. Supplemental Financial Statement Data

Inventories

	Sept. 29, 2006	June 30, 2006
	(in millions)	
Inventories:		
Raw materials and component parts	**$ 33**	$ 23
Work in process	**81**	62
Finished goods	**102**	120
Total inventories	**$ 216**	$ 205

Warranty

The Company records an accrual for estimated warranty costs when revenue is recognized. Warranty covers costs of repair or replacement of the hard drive over the warranty period, which generally ranges from one to five years. This accrual is based on estimated future returns within the warranty period and costs to repair, using factory test data, historical field returns and current repair costs by product type. Return rate and repair cost estimates are reviewed quarterly and updated to reflect the impact of current results on prior expectations. If actual product return trends or costs to repair returned products demonstrate significant differences from expectations, a change in the warranty accrual is made. Changes in the warranty accrual for the three months ended September 29, 2006 and September 30, 2005 were as follows (in millions):

	THREE MONTHS ENDED	
	Sept. 29, 2006	**Sept. 30, 2005**
Warranty accrual, beginning of period	**$ 89**	$ 92
Charges to operations	**19**	21
Utilization	**(12)**	(10)
Change to prior period accruals	**(5)**	(7)
Warranty accrual, end of period	**$ 91**	$ 96

Accrued warranty also includes amounts classified in non-current liabilities of $17 million at September 29, 2006, $18 million at June 30, 2006, and $17 million at September 30, 2005.

The $5.5 million favorable adjustment to the prior period warranty accrual noted in the table above in the quarter ended September 29, 2006 represents a change in estimate and assumptions relating to the warranty accrual as of June 30, 2006. Similar adjustments in estimates and assumptions relating to other assets and liabilities as of June 30, 2006 were made for approximately $4.3 million, favorably impacting the Company s operating results for the three months ended September 29, 2006. For additional information, see Note 1.

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3. Income per Share

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

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

	THREE MONTHS ENDED	
	Sept. 29, 2006	**Sept. 30, 2005**
Net income	**$ 103**	$ 69
Weighted average shares outstanding:		
Basic	**219**	213
Employee stock options and other	**6**	8
Diluted	**225**	221
Income per share:		
Basic	**$ .47**	$ .32
Diluted	**$ .46**	$ .31
Antidilutive common share equivalents excluded	**2**	6

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

4. Stock-Based Compensation

Stock Incentive Plans

As of September 29, 2006, options to purchase 12 million shares of the Company s common stock remain outstanding, of which 8.2 million shares were exercisable, and 3 million shares of restricted stock remain unvested. The maximum number of shares of the Company s common stock that are authorized for award grants under the 2004 Performance Incentive Plan is 23 million shares. For further discussion and description of the Company s Stock Incentive Plans and Employee Stock Purchase Plan (ESPP), see Part II, Item 8, Note 7 in the Company s Annual Report on Form 10-K as of and for the year ended June 30, 2006.

Stock-Based Compensation Expense

Effective July 2, 2005, the Company adopted Statement of Financial Accounting Standards No. 123 (Revised 2004), Share Based Payment (SFAS 123-R) using the modified prospective method. SFAS 123-R establishes the financial accounting and reporting standards for stock-based compensation plans. As required by SFAS 123-R, the Company recognized the cost resulting from all share-based payment transactions including shares issued under the Company s stock option plans and ESPP in the financial statements. During the three months ended September 29, 2006, the Company charged to expense $4 million for stock-based compensation related to options issued under stock option and ESPP plans. At September 29, 2006, total compensation cost related to unvested stock options and ESPP issued to employees but not yet recognized was $27 million, which will be amortized on a straight-line basis over a weighted average vesting period of approximately 1.9 years.

Fair Value Disclosures

The fair value of stock options granted during the three months ended September 29, 2006 and September 30, 2005 was estimated using a binomial option pricing model. The binomial model requires the input of highly

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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 months ended September 29, 2006 and September 30, 2005 was estimated using the following weighted average assumptions:

	THREE MONTHS ENDED	
	Sept. 29, 2006	**Sept. 30, 2005**
Suboptimal exercise factor	**1.64**	1.58
Range of risk-free interest rates	**4.59% to 4.91%**	4.01% to 4.34%
Range of expected stock price volatility	**0.42 to 0.77**	0.38 to 0.82
Weighted average expected volatility	**0.63**	0.68
Post-vesting termination rate	**5.25%**	15.36%
Dividend yield		
Fair value	**$7.65**	$5.82

The fair value of ESPP shares issued are 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, except for the initial offering period, which began on December 15, 2005. Accordingly, there were no shares issued under the Company s ESPP for the quarters ended September 29, 2006 and September 30, 2005.

Stock Options

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

	Number of Shares	Weighted Average Exercise Price Per Share	Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Options outstanding at June 30, 2006	12.4	$ 10.65		
Granted	0.1	17.26		
Exercised	(0.2)	9.47		
Canceled or expired	(0.1)	11.62		
Options outstanding at September 29, 2006	12.2	$ 10.73	5.9	$ 102
Exercisable at September 29, 2006	8.2	$ 9.84	4.8	$ 78

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 for those awards that have an exercise price currently below the quoted price. As of September 29, 2006, the Company had options outstanding to purchase an aggregate of 7 million shares with an exercise price below the quoted price of the Company s stock resulting in an aggregate intrinsic value of $102 million. During the three months ended September 29, 2006 and September 30, 2005, the aggregate intrinsic value of options exercised under the Company s stock option plans was $2 million and $5 million, respectively, determined as of the date of exercise.

Deferred Stock Compensation

The Company granted five thousand shares of restricted stock during the three months ended September 29, 2006. The aggregate market value of these awards was $0.1 million. As of September 29, 2006, the aggregate unamortized fair value of all unvested restricted stock awards was $22 million and will be amortized on a straight-line basis over a weighted average vesting period of approximately 1.1 years. For the three months ended September 29, 2006, the Company charged to expense $5 million related to restricted stock awards that were vested during the period. Of these amounts, $2 million represented the incremental cost from modification of pre-existing awards in the beginning of fiscal 2006.

5. 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 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, beyond that provided at September 29, 2006, would not be material to the Company s financial condition. 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.

Since the Company s announcement on July 27, 2006 that it was conducting a company-initiated, voluntary review of its historical stock option grants, several purported derivative actions were filed nominally on behalf of the Company against certain current and former directors and officers of the Company in the United States District Court for the Central District of California and the Superior Court of the State of California for the County of Orange. These complaints assert claims for violations of Sections 14(a) and 20(a) of the Securities Exchange Act, accounting, breach of fiduciary duty and/or aiding and abetting, constructive fraud, waste of corporate assets, unjust enrichment, rescission, breach of contract, violation of the California Corporations Code, abuse of control, gross mismanagement, and constructive trust in connection with the Company s option granting practices. The complaints seek unspecified monetary damages and other relief against the individual defendants and certain governance reforms affecting the Company. The Company is named solely as a nominal defendant in each action. The Company has joined or intends to join the other defendants in filing motions to dismiss each action.

6. New Accounting Standards

In July 2006, the FASB issued FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes. FIN No. 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN No. 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. The interpretation applies to all tax positions related to income taxes subject to SFAS No. 109. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. Differences between the amounts recognized in the statements of financial position prior to the adoption of FIN No. 48 and the amounts reported after adoption should be accounted for as a cumulative-effect adjustment recorded to the beginning balance of retained earnings. The Company is currently evaluating the impact the adoption of FIN No. 48 could have on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in U.S. GAAP, and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the impact the adoption of SFAS No. 157 could have on its consolidated financial statements.

In September 2006, the SEC staff published Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 addresses quantifying the financial statement effects of misstatements, specifically, how the effects of prior year uncorrected errors must be considered in quantifying misstatements in the current year financial statements. This statement is effective for fiscal years ending after November 15, 2006. The Company is currently evaluating the impact the adoption of SAB 108 could have on its consolidated financial statements.

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Item 2. ***MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS***

This information should be read in conjunction with the unaudited condensed consolidated financial statements and the notes thereto included in this Quarterly Report on Form 10-Q, and the audited consolidated financial statements and notes thereto and Management s Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K as of and for the year ended June 30, 2006.

Unless otherwise indicated, references herein to specific years and quarters are to our fiscal years and fiscal quarters. As used herein, the terms we , us and our refer to Western Digital Corporation and its subsidiaries.

Forward-Looking Statements

This document contains forward-looking statements within the meaning of the federal securities laws. Any statements that do not relate to historical or current facts or matters are forward-looking statements. You can identify some of the forward-looking statements by the use of forward-looking words, such as may, will, could, project, believe, anticipate, expect, estimate, continue, potential, plan, forecasts, and the like, or the use of future tense. Statements concerning current conditions may also be forward-looking if they imply a continuation of current conditions. Examples of forward-looking statements include, but are not limited to, statements concerning:

- *growth in demand for hard drives in the desktop, mobile, enterprise and consumer electronics markets and factors contributing to such growth;*
- *our expansion into new hard drive markets, such as consumer electronics, retail, and enterprise, and into emerging geographic markets;*
- *increase in our sales of notebook hard drives and our on-going volume ramp of our Scorpio™ 2.5-inch hard drives;*
- *our planned use of new recording technologies;*
- *expectations regarding traditional seasonal demand trends and price declines for the hard drive industry;*
- *beliefs regarding the sufficiency of our cash, cash equivalents and short-term investments to meet our working capital needs; and*
- *beliefs regarding our operating performance and general industry conditions and their impacts on the realization of our deferred tax assets and the need to reduce all or a portion of our valuation allowance.*

Forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those expressed in the forward-looking statements. You are urged to carefully review the disclosures we make concerning risks and other factors that may affect our business and operating results, including those made in Part II, Item 1A of this Quarterly Report on Form 10-Q, and any of those made in our other reports filed with the SEC. You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this document. We do not intend, and undertake no obligation, to publish revised forward-looking statements to reflect events or circumstances after the date of this document or to reflect the occurrence of unanticipated events.

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Our Company

We design, develop, manufacture and sell hard drives. A hard drive is a device that uses one or more rotating magnetic disks to store and allow fast access to data. Hard drives are key components of computers, data storage subsystems and many consumer electronic devices.

We sell our products worldwide to original equipment manufacturers (OEMs) for use in computer systems, subsystems and consumer electronics (CE) devices, and to distributors, resellers and retailers. Our hard drives are used in desktop computers, notebook computers, and enterprise applications such as servers, workstations, network attached storage and storage area networks. Additionally, our hard drives are used in CE applications such as digital video recorders (DVRs), satellite and cable set-top boxes, MP3 players, and USB thumb drives. We also sell our hard drives as stand-alone storage products and integrate them into our own WD-branded external storage products for purposes such as personal data backup and portable or expanded storage of digital music, photography, video, and other data.

Hard drives provide non-volatile data storage, which means that the data remains present when power is no longer applied to the device. Our hard drives currently include 3.5-inch, 2.5-inch and 1.0-inch form factor drives. The 3.5-inch form factor drives have capacities ranging from 36 gigabytes (GB) to 500 GB, nominal rotation speeds of 7,200 and 10,000 revolutions per minute (RPM), and offer interfaces including both Enhanced Integrated Drive Electronics (EIDE) and Serial Advanced Technology Attachment (SATA). The 2.5-inch form factor drives have capacities ranging from 40 GB to 160 GB, nominal rotation speed of 5,400 RPM, and offer both the EIDE and SATA interfaces. Our 1.0-inch form factor, with 4 GB and 6 GB capacities, have a nominal rotation speed of 3,600 RPM and use the CompactFlash® 130 interface.

We assemble hard drives in Malaysia and Thailand. We also design and manufacture a substantial portion of our required magnetic heads, head gimbal assemblies and head stack assemblies in Fremont, California and Bang Pa-In, Thailand. For geographical financial data, see Part II, Item 8, Note 10 in the Notes to Consolidated Financial Statements, included in our Annual Report on Form 10-K as of and for the year ended June 30, 2006.

Market Overview

For calendar year 2005, we believe that the total market for hard drives was more than 380 million units, or almost $28 billion in sales. Over half of these unit shipments were to the desktop market. Total hard drive unit growth depends greatly on developments in the personal computer (PC) market. We believe that the demand for hard drives in the PC market has grown in part due to:

- the overall growth of PC sales;
- the increasing needs of businesses and individuals for increased storage capacity on their PCs;
- the continuing development of software applications to manage multimedia content; and
- the increasing use of broadband Internet, including content downloaded from the Internet onto PC hard drives.

We believe several other factors affect the rate of PC unit growth, including maturing PC markets in North America and Western Europe, an increase in first-time buyers of PCs in Asia, Eastern Europe and Latin America, and the lengthening of PC replacement cycles.

We entered the mobile computing part of the PC market in the first quarter of 2005, commencing volume production of our WD Scorpio family of 2.5-inch hard drives for notebook computers. We expect the mobile market, which is primarily notebook computers, to continue to grow faster than the desktop or enterprise markets in the next three years. We believe that the demand for mobile drives has grown from approximately 16% of the overall hard drive market in 2003 to 21% of the overall hard drive market in 2005. As the mobile market evolves to a higher volume market, we believe customers are placing increased emphasis on attributes such as quality, reliability, execution, flexibility, and competitive cost structures on their hard drive suppliers. These are the same attributes that have mattered for many years to customers in the high-volume desktop market.

The enterprise market for hard drives focuses on customers that make workstations, servers, network attached storage devices, storage area networks, and other computing systems or subsystems. We serve this market with hard drives using the SATA interface, which is similar in performance in some applications to the Small Computer Systems Interface (SCSI), but more cost effective than SCSI. We believe that the enterprise market has two distinct sectors: a marketplace for high-performance enterprise hard drives and a marketplace for high capacity enterprise hard drives. We believe that acceptance of SATA in both of these enterprise market sectors is growing. Additionally, we offer high-capacity, high reliability Parallel Advanced Technology Attachment (PATA) enterprise products to service video surveillance and similar PATA-based systems. Expansion of our involvement in the enterprise market may require us to make additional investments.

The use of hard drives in CE products has been a major growth area in recent years. Today s three largest segments of this market are: (1) digital television content in applications such as DVRs; (2) audio content in applications such as consumer handheld devices, such as MP3 players; and (3) hard drives in game consoles. Since 1999, DVRs have been available for use in home entertainment systems and they offer enhanced capabilities such as pausing live television, simplifying the process of recording, cataloging recorded television programs and quickly forwarding or returning to any section of a recorded television program. The market for DVR products favors large capacity hard drives, such as the 3.5-inch form factor, and continues to grow in Japan, North America, and Europe. We believe growth in this market will continue to build demand for higher capacity hard drives. Hard drives with 1.8-inch or 1.0-inch form factors primarily address the consumer handheld device and portable external storage markets. The majority of hard drives used in portable media players that play both digital audio and video content are 1.8-inch form factors. Game consoles that include hard drives primarily use the 2.5-inch form factors.

The branded products market for hard drives features storage products that we sell directly to end customers through retail store fronts and online stores. Our branded products include external hard drives, which are internal drives embedded into WD branded PC peripheral-style enclosures, which have FireWire , USB 2.0 and Ethernet network connections; and internal hard drives that are packaged as an installation kit with the WD brand for retail store sales. We believe the worldwide demand for external hard drives is growing, spurred by consumers and businesses expanding use of digital content in the form of photographs, video and music all of which consume large amounts of storage.

First Quarter Overview

The following table sets forth, for the periods indicated, selected summary information from our condensed consolidated statements of income (dollars in millions):

	THREE MONTHS ENDED			
	Sept. 29, 2006		**Sept. 30, 2005**	
Net revenue	**$ 1,264**	**100.0%**	$ 1,010	100.0%
Gross margin	**218**	**17.3**	178	17.7
Total operating expenses	**119**	**9.3**	110	10.9
Operating income	**99**	**7.9**	68	6.7
Net income	**103**	**8.2**	69	6.8

The following is a summary of our financial performance for the first quarter of 2007: