

WESTERN DIGITAL CORP
Form 10-Q
November 04, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended October 3, 2014

Or

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 (I.R.S. Employer
incorporation or organization) Identification No.)

3355 Michelson Drive, Suite 100 92612
Irvine, California (Address of principal executive offices) (Zip Code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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

As of the close of business on October 30, 2014, 232,201,114 shares of common stock, par value \$.01 per share, were outstanding.

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Our fiscal year ends on the Friday nearest to June 30 and typically consists of 52 weeks. Approximately every six years, we report a 53-week fiscal year to align our fiscal year with the foregoing policy. Our fiscal first quarters ended October 3, 2014 and September 27, 2013 consisted of 14 weeks and 13 weeks, respectively. Fiscal year 2014 was comprised of 52 weeks and ended on June 27, 2014. Fiscal year 2015 will be comprised of 53 weeks and will end on July 3, 2015. Fiscal year 2016 will be comprised of 52 weeks and will end on July 1, 2016. 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,” “our,” the “Company,” “WDC” and “Western Digital” refer to Western Digital Corporation and its subsidiaries, unless we state, or the context indicates, otherwise.

WDC, a Delaware corporation, is the parent company of our storage business, which operates under two independent subsidiaries – HGST and WD. Our principal executive offices are located at 3355 Michelson Drive, Suite 100, Irvine, California 92612. Our telephone number is (949) 672-7000 and our Web site is www.westerndigital.com. The information on our Web site is not incorporated in this Quarterly Report on Form 10-Q.

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

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PART I. FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

WESTERN DIGITAL CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(in millions, except par values; unaudited)

	October 3, 2014	June 27, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	\$5,159	\$4,804
Short-term investments	222	284
Accounts receivable, net	1,915	1,989
Inventories	1,272	1,226
Other current assets	422	417
Total current assets	8,990	8,720
Property, plant and equipment, net	3,202	3,293
Goodwill	2,559	2,559
Other intangible assets, net	406	454
Other non-current assets	495	473
Total assets	\$15,652	\$15,499
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$2,016	\$1,971
Accrued arbitration award	772	758
Accrued expenses	433	412
Accrued compensation	438	460
Accrued warranty	134	119
Current portion of long-term debt	125	125
Total current liabilities	3,918	3,845
Long-term debt	2,281	2,313
Other liabilities	490	499
Total liabilities	6,689	6,657
Commitments and contingencies (Notes 4 and 5)		
Shareholders' equity:		
Preferred stock, \$.01 par value; authorized — 5 shares; issued and outstanding — none	—	—
Common stock, \$.01 par value; authorized — 450 shares; issued — 261 shares; outstanding — 234 shares	3	3
Additional paid-in capital	2,285	2,331
Accumulated other comprehensive income (loss)	(14	) 12
Retained earnings	8,394	8,066
Treasury stock — common shares at cost; 27 shares	(1,705	) (1,570
Total shareholders' equity	8,963	8,842
Total liabilities and shareholders' equity	\$15,652	\$15,499

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	
	October 3, 2014	September 27, 2013
Revenue, net	\$3,943	\$3,804
Cost of revenue	2,794	2,705
Gross profit	1,149	1,099
Operating expenses:		
Research and development	437	401
Selling, general and administrative	220	132
Charges related to arbitration award	14	13
Employee termination, asset impairment and other charges	9	11
Total operating expenses	680	557
Operating income	469	542
Other income (expense):		
Interest income	4	3
Interest and other expense	(13	) (13
Total other expense, net	(9	) (10
Income before income taxes	460	532
Income tax provision	37	37
Net income	\$423	\$495
Income per common share:		
Basic	\$1.81	\$2.10
Diluted	\$1.76	\$2.05
Weighted average shares outstanding:		
Basic	234	236
Diluted	240	242

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

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WESTERN DIGITAL CORPORATION
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
 (in millions; unaudited)

	Three Months Ended	
	October 3, 2014	September 27, 2013
Net income	\$423	\$495
Other comprehensive income (loss), net of tax:		
Net unrealized gain (loss) on foreign exchange contracts	(26	) 16
Other comprehensive income (loss)	(26	) 16
Total comprehensive income	\$397	\$511

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	
	October 3, 2014	September 27, 2013
Cash flows from operating activities		
Net income	\$423	\$495
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	289	312
Stock-based compensation	39	42
Deferred income taxes	10	(10)
Gain from insurance recovery	—	(65)
Loss on disposal of assets	4	—
Non-cash portion of employee termination, asset impairment and other charges	1	7
Changes in:		
Accounts receivable, net	74	25
Inventories	(46)	(21)
Accounts payable	49	22
Accrued arbitration award	14	13
Accrued expenses	16	(52)
Accrued compensation	(22)	(65)
Other assets and liabilities	(24)	(23)
Net cash provided by operating activities	827	680
Cash flows from investing activities		
Purchases of property, plant and equipment	(160)	(136)
Proceeds from sales and maturities of investments	166	—
Purchases of investments	(120)	—
Acquisitions, net of cash acquired	—	(263)
Other investing activities, net	(12)	39
Net cash used in investing activities	(126)	(360)
Cash flows from financing activities		
Issuance of stock under employee stock plans	39	22
Taxes paid on vested stock awards under employee stock plans	(57)	(22)
Excess tax benefits from employee stock plans	20	7
Repurchases of common stock	(223)	(150)
Dividends paid to shareholders	(94)	(59)
Proceeds from debt, net of issuance costs	—	500
Repayment of debt	(31)	(58)
Net cash provided by (used in) financing activities	(346)	240
Net increase in cash and cash equivalents	355	560
Cash and cash equivalents, beginning of period	4,804	4,309
Cash and cash equivalents, end of period	\$5,159	\$4,869
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	\$10	\$63
Cash paid for interest	\$12	\$11
Supplemental disclosure of non-cash financing activities:		
Accrual of cash dividend declared	\$94	\$59

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 Part II, Item 8, Note 1 of the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended June 27, 2014. 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 ("U.S. GAAP") have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended June 27, 2014. The results of operations for interim periods are not necessarily indicative of results to be expected for the full year. The Company's fiscal year ends on the Friday nearest to June 30 and typically consists of 52 weeks. Approximately every six years, the Company reports a 53-week fiscal year to align its fiscal year with the foregoing policy. The Company's fiscal first quarters ended October 3, 2014 and September 27, 2013 consisted of 14 weeks and 13 weeks, respectively. Fiscal year 2015 will be comprised of 53 weeks and will end on July 3, 2015.

The Company acquired Virident Systems, Inc. ("Virident") on October 17, 2013, sTec, Inc. ("sTec") on September 12, 2013, and VeloBit, Inc. ("VeloBit") on July 9, 2013. These acquisitions are further described in Note 11 below. In connection with the acquisitions, Virident, sTec and VeloBit became indirect wholly-owned subsidiaries of the Company. Virident, sTec and VeloBit's results of operations since their respective dates of acquisition are included in the condensed consolidated financial statements.

Company management has made estimates and assumptions relating to the reporting of certain assets and liabilities in conformity with U.S. GAAP. These estimates and assumptions have been applied using methodologies that are consistent throughout the periods presented. However, actual results could differ materially from these estimates.

2. Supplemental Financial Statement Data

Inventories; Property, Plant and Equipment; and Other Intangible Assets

	October 3, 2014	June 27, 2014
	(in millions)	
Inventories:		
Raw materials and component parts	\$ 178	\$ 168
Work-in-process	509	493
Finished goods	585	565
Total inventories	\$ 1,272	\$ 1,226
Property, plant and equipment:		
Property, plant and equipment	\$ 8,244	\$ 8,123
Accumulated depreciation	(5,042)	(4,830)
Property, plant and equipment, net	\$ 3,202	\$ 3,293
Other intangible assets:		
Other intangible assets	\$ 980	\$ 984
Accumulated amortization	(574)	(530)
Other intangible assets, net	\$ 406	\$ 454

Warranty

The Company records an accrual for estimated warranty costs when revenue is recognized. The Company generally warrants its products for a period of one to five years. The warranty provision considers estimated product failure rates

and trends, estimated replacement costs, estimated repair costs which include scrap costs, and estimated costs for customer compensatory claims related to product quality issues, if any. A statistical warranty tracking model is used to help prepare estimates and assist the Company in exercising judgment in determining the underlying estimates. The statistical tracking model captures specific detail on hard drive reliability, such as factory test data, historical field return rates, and costs to repair by product type. Management's judgment is subject to a greater degree of subjectivity with respect to newly introduced products because of limited field experience with those products upon which to base warranty estimates. Management reviews the warranty accrual

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quarterly for products shipped in prior periods and which are still under warranty. Any changes in the estimates underlying the accrual may result in adjustments that impact current period gross profit and income. Such changes are generally a result of differences between forecasted and actual return rate experience and costs to repair. If actual product return trends, costs to repair returned products or costs of customer compensatory claims differ significantly from estimates, future results of operations could be materially affected. Changes in the warranty accrual were as follows (in millions):

	Three Months Ended	
	October 3, 2014	September 27, 2013
Warranty accrual, beginning of period	\$ 182	\$ 187
Warranty liability assumed as a result of acquisition	—	3
Charges to operations	49	40
Utilization	(49	) (49
Changes in estimate related to pre-existing warranties	19	14
Warranty accrual, end of period	\$ 201	\$ 195

The long-term portion of the warranty accrual classified in other liabilities was \$67 million at October 3, 2014 and \$63 million at June 27, 2014.

Investments

The following table summarizes, by major type, the fair value and cost basis of the Company's investments as of October 3, 2014 (in millions):

	Cost Basis	Unrealized Gains (Losses)	Fair Value
Available-for-sale securities:			
U.S. Treasury securities	\$ 203	\$—	\$ 203
U.S. Government agency securities	79	—	79
Commercial paper	119	—	119
Certificates of deposit	53	—	53
Total	\$ 454	\$—	\$ 454
Short-term investments			\$ 222
Included in other non-current assets			232
Total			\$ 454

The fair value of the Company's investments classified as available-for-sale securities at October 3, 2014, by remaining contractual maturity, were as follows (in millions):

	Cost Basis	Fair Value
Due in less than one year:	\$ 222	\$ 222
Due in one to five years:	232	232
Total	\$ 454	\$ 454

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The following table summarizes, by major type, the fair value and cost basis of the Company's investments as of June 27, 2014 (in millions):

	Cost Basis	Unrealized Gains (Losses)	Fair Value
Available-for-sale securities:			
U.S. Treasury securities	\$180	\$—	\$180
U.S. Government agency securities	88	—	88
Commercial paper	165	—	165
Certificates of deposit	66	—	66
Total	\$499	\$—	\$499
Short-term investments			
Included in other non-current assets			215
Total			\$499

The fair value of the Company's investments classified as available-for-sale securities at June 27, 2014, by remaining contractual maturity, were as follows (in millions):

	Cost Basis	Fair Value
Due in less than one year:	\$284	\$284
Due in one to five years:	215	215
Total	\$499	\$499

The Company determined no available-for-sale securities were other-than-temporarily impaired in the three months ended October 3, 2014. For more information on the Company's available-for-sale securities, see Note 7 below.

In addition, the Company enters into certain strategic investments for the promotion of business and strategic objectives. These strategic investments are recorded at cost within other non-current assets in the consolidated balance sheets and were not material to the condensed consolidated financial statements as of October 3, 2014 and June 27, 2014.

Other Comprehensive Income (Loss)

Other comprehensive income (loss) refers to revenue, expenses, gains and losses that are recorded as an element of shareholders' equity but are excluded from net income. The Company's other comprehensive income (loss) is comprised of unrealized gains and losses on foreign exchange contracts. There were no unrealized gains or losses on the Company's available-for-sale securities or actuarial gains and losses related to pensions in the three months ended October 3, 2014. In addition, the income tax impact on components of other comprehensive income (loss) is immaterial for all periods presented.

The following table illustrates the changes in the balances of each component of accumulated other comprehensive income (loss) for the three months ended October 3, 2014 (in millions):

	Actuarial Pension Gain	Unrealized Gain (Loss) on Foreign Exchange Contracts	Accumulated Other Comprehensive Income (Loss)
Balance at June 27, 2014	\$7	\$5	\$12
Other comprehensive income (loss) before reclassifications	—	(22)	(22)
Amounts reclassified from accumulated other comprehensive income (loss)	—	(4)	(4)
Net current-period other comprehensive income (loss)	—	(26)	(26)
Balance at October 3, 2014	\$7	\$(21)	\$(14)

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The following table illustrates the changes in the balances of each component of accumulated other comprehensive income (loss) for the three months ended September 27, 2013 (in millions):

	Actuarial Pension Gain	Unrealized Gain (Loss) on Foreign Exchange Contracts	Accumulated Other Comprehensive Income (Loss)
Balance at June 28, 2013	\$11	\$(46)	\$(35)
Other comprehensive income (loss) before reclassifications	—	(11)	(11)
Amounts reclassified from accumulated other comprehensive income (loss)	—	27	27
Net current-period other comprehensive income	—	16	16
Balance at September 27, 2013	\$11	\$(30)	\$(19)

3. Income per Common Share

The Company computes basic income per common share using net income and the weighted average number of common shares outstanding during the period. Diluted income per common share is computed using net income and the weighted average number of common shares and potentially dilutive common shares outstanding during the period. Potentially dilutive common shares include certain dilutive outstanding employee stock options, rights to purchase shares of common stock under the Company's Employee Stock Purchase Plan ("ESPP") and restricted stock unit awards ("RSUs").

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

	Three Months Ended	
	October 3, 2014	September 27, 2013
Net income	\$423	\$495
Weighted average shares outstanding:		
Basic	234	236
Employee stock options and other	6	6
Diluted	240	242
Income per common share:		
Basic	\$1.81	\$2.10
Diluted	\$1.76	\$2.05
Anti-dilutive potential common shares excluded*	—	1

* For purposes of computing diluted income per common share, certain potentially dilutive securities have been excluded from the calculation because their effect would have been anti-dilutive.

4. Debt

On January 9, 2014, Western Digital Ireland, Ltd. ("WDI") used existing cash to repay the outstanding term loan balance of \$1.8 billion, and the Company, Western Digital Technologies, Inc. ("WDT") and WDI entered into a new credit agreement with JPMorgan Chase Bank, N.A., as administrative agent, and the lenders party thereto (the "Credit Agreement"). The Credit Agreement provides for \$4.0 billion of unsecured loan facilities consisting of a \$2.5 billion term loan facility to WDT and a \$1.5 billion revolving credit facility to WDT and WDI (the "Borrowers"). The revolving credit facility includes a \$100 million sublimit for letters of credit and a \$50 million sublimit for swing line loans. Subject to certain conditions, a Borrower may elect to expand the credit facilities by, or obtain incremental term loans of, up to \$1.0 billion if existing or new lenders provide additional term or revolving commitments. The loans under the Credit Agreement have a five-year term. The obligations of the Borrowers under the Credit Agreement are guaranteed by the Company and its material domestic subsidiaries, and the obligations of WDI under the Credit Agreement are also guaranteed by WDT.

As of October 3, 2014, no amounts were outstanding under the revolving credit facility and the term loan facility had an outstanding balance of \$2.4 billion and a variable interest rate of 1.66%. The Company is required to make quarterly principal

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payments on the term loan facility totaling \$94 million for the remainder of fiscal 2015, \$156 million in fiscal 2016, \$219 million in fiscal 2017, \$250 million in fiscal 2018 and the remaining balance of \$1.7 billion in fiscal 2019. The Credit Agreement requires the Company to comply with a leverage ratio and an interest coverage ratio calculated on a consolidated basis for the Company and its subsidiaries. In addition, the Credit Agreement contains customary covenants, including covenants that limit or restrict the Company's and its subsidiaries' ability to incur liens, incur indebtedness, make certain restricted payments, merge or consolidate and enter into certain speculative hedging arrangements, and customary events of default. As of October 3, 2014, the Company was in compliance with all covenants.

5. Legal Proceedings

When the Company becomes aware of a claim or potential claim, the Company assesses the likelihood of any loss or exposure. The Company discloses information regarding each material claim where the likelihood of a loss contingency is probable or reasonably possible. If a loss contingency is probable and the amount of the loss can be reasonably estimated, the Company records an accrual for the loss. In such cases, there may be an exposure to potential loss in excess of the amount accrued. Where a loss is not probable but is reasonably possible or where a loss in excess of the amount accrued is reasonably possible, the Company discloses an estimate of the amount of the loss or range of possible losses for the claim if a reasonable estimate can be made, unless the amount of such reasonably possible losses is not material to the Company's financial position, results of operations or cash flows. Unless otherwise stated below, for each of the matters described below, the Company has either recorded an accrual for losses that are probable and reasonably estimable or has determined that, while a loss is reasonably possible (including potential losses in excess of the amounts accrued by the Company), a reasonable estimate of the amount of loss or range of possible losses with respect to the claim or in excess of amounts already accrued by the Company cannot be made. The ability to predict the ultimate outcome of such matters involves judgments, estimates and inherent uncertainties. The actual outcome of such matters could differ materially from management's estimates.

Solely for purposes of this footnote, "WD" refers to Western Digital Corporation or one or more of its subsidiaries excluding HGST prior to the HGST Closing Date. HGST refers to Hitachi Global Storage Technologies Holdings Pte. Ltd. or one or more of its subsidiaries as of the HGST Closing Date, and "the Company" refers to Western Digital Corporation and all of its subsidiaries on a consolidated basis including HGST.

Intellectual Property Litigation

On June 20, 2008, plaintiff Convolve, Inc. ("Convolve") filed a complaint in the Eastern District of Texas against WD, HGST, and one other company alleging infringement of U.S. Patent Nos. 6,314,473 and 4,916,635. The complaint sought unspecified monetary damages and injunctive relief. On October 10, 2008, Convolve amended its complaint to allege infringement of only the '473 patent. The '473 patent allegedly relates to interface technology to select between certain modes of a disk drive's operations relating to speed and noise. A trial in the matter began on July 18, 2011 and concluded on July 26, 2011 with a verdict against WD and HGST in an amount that is not material to the Company's financial position, results of operations or cash flows, for which the Company previously recorded an accrual. WD and HGST have filed post-trial motions challenging the verdict. On January 17, 2014, the Court denied the Company's motion for judgment as a matter of law on invalidity. On May 20, 2014, the Court ordered supplemental briefing on post-trial motions related to infringement. Convolve and the Company filed their supplemental briefs on May 30, 2014 and June 6, 2014, respectively. Additional post-trial motions are pending, and the Company will evaluate its options for appeal after the Court rules on the remaining post-trial motions. The Company intends to continue to defend itself vigorously in this matter.

On August 1, 2011, plaintiff Guzik Technical Enterprises ("Guzik") filed a complaint in the Northern District of California against WD and various of its subsidiaries alleging infringement of U.S. Patent Nos. 6,023,145 and 6,785,085, breach of contract and misappropriation of trade secrets. The complaint seeks injunctive relief and unspecified monetary damages, fees and costs. The patents asserted by Guzik allegedly relate to devices used to test hard disk drive heads and media. On November 30, 2013, WD entered into a settlement agreement for an amount that is not material to the Company's financial position, results of operations or cash flows, for which the Company recorded an accrual in the three months ended December 27, 2013. Guzik is disputing the enforceability of the

agreement and on December 27, 2013, WD filed a motion to enforce the agreement. The Court heard oral argument on WD's motion on January 23, 2014. The Court granted WD's motion to enforce the settlement agreement on March 21, 2014. On April 14, 2014, Guzik filed a Notice of Appeal to the Federal Circuit. On June 17, 2014, Guzik filed its opening appellate brief. WD filed its appellate brief on August 14, 2014. On September 11, 2014, Guzik filed its reply brief in support of its opening appellate brief. WD intends to continue to defend itself vigorously in this matter. On July 9, 2012, Siemens Aktiengesellschaft ("Siemens") filed a complaint in German court against WD, Western Digital GmbH, and Digital River International, S.a.r.l. alleging patent infringement of European patent no. EP 674769, which claims an

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artificial antiferromagnetic (AAF) (aka, synthetic antiferromagnetic) structure for magneto-resistive sensors. On March 14-15, 2013, Western Digital GmbH filed a response of non-infringement and also filed a separate nullity action. Siemens separately served WD with the complaint on July 15, 2013. The patent expired on December 16, 2013 and, on March 10, 2014, Siemens withdrew its motion for injunctive relief. On March 7, 2014, Siemens extended the complaint including WDT as a defendant. On August 25, 2014, the parties reached a settlement agreement for an amount that is not material to the Company's financial position, results of operations or cash flows, which the Company recorded in the three months ended October 3, 2014. On August 27, 2014, the Company withdrew the nullity action which was confirmed by the Federal Patent Court on August 29, 2014. On August 27, 2014 Siemens withdrew the infringement action which was confirmed by the infringement court on September 3, 2014. This matter is now closed.

On September 5, 2013, plaintiff Lake Cherokee Hard Drive Technologies, LLC ("Lake Cherokee") filed a complaint in the Eastern District of Texas against: Marvell Asia PTE, Ltd., Samsung Semiconductor, Inc., Seagate Tech. LLC, Seagate Tech. Int'l., Toshiba Corp., Toshiba Am. Elec. Components, Toshiba Am. Inf. Sys., Inc., Toshiba Am. Inf. Equip. (Philippines), Inc., and WDT alleging infringement of US Patent Nos. 5,844,738 and 5,978,162. Lake Cherokee alleges that WDT's hard disk drive products that contain Marvell read channel systems-on-a-chip (SOCs) infringe its '738 and '162 patents. The complaint seeks unspecified monetary damages, fees and costs. On April 3, 2014, Lake Cherokee and Marvell Semiconductor, Inc. ("MSI") engaged in mediation which resulted in a settlement-in-principle on April 8, 2014. On April 21, 2014, Lake Cherokee and MSI filed a motion to stay deadlines while the parties finalized a settlement agreement. In this motion, Lake Cherokee and MSI represented to the Court that the settlement between Lake Cherokee and MSI will result in a with-prejudice dismissal of Lake Cherokee's claims against each of the defendants, including WDT, with respect to their sale or use of Marvell chips. On April 23, 2014, the Court granted a stay of deadlines. The parties submitted a Joint Stipulation of Dismissal with Prejudice, and on September 5, 2014, the Court ordered that the Stipulation of Dismissal is granted and that the claims are dismissed with prejudice. This matter is now closed.

On September 25, 2013, plaintiff Lake Cherokee filed a complaint in the Eastern District of Texas against: Marvell Semiconductor, Inc., Marvell Asia PTE, Ltd., Dell Inc., and WDT alleging infringement of US Patent No. 5,583,706. Lake Cherokee alleges that WDT's hard disk drive products that contain Marvell read channel systems-on-a-chip (SOCs) infringe its '706 patent. The complaint seeks an injunction, unspecified monetary damages, fees and costs. On April 3, 2014, Lake Cherokee and MSI engaged in mediation which resulted in a settlement-in-principle on April 8, 2014. On April 21, 2014, Lake Cherokee and MSI filed a motion to stay deadlines while the parties finalized a settlement agreement. In this motion, Lake Cherokee and MSI represented to the Court that the settlement between Lake Cherokee and MSI will result in a with-prejudice dismissal of Lake Cherokee's claims against each of the defendants, including WDT, with respect to their sale or use of Marvell chips. On April 23, 2014, the Court granted a stay of deadlines. The parties submitted a Joint Stipulation of Dismissal with Prejudice, and on August 27, 2014, the Court ordered that the Stipulation of Dismissal is granted and that the claims are dismissed with prejudice. This matter is now closed.

On March 24, 2014, plaintiff Steven F. Reiber ("Reiber") filed a complaint in the Eastern District of California against the Company, alleging infringement of U.S. Patent Nos. 7,124,927 and 7,389,905. On September 16, 2014, Reiber filed an amended complaint in the Eastern District of California against the Company alleging infringement of three additional patents-U.S. Patent Nos. 6,935,548, 6,651,864, and 6,354,479. Reiber alleges that WD products (including hard disk drive heads, head gimbal assemblies, head stack assemblies and SSDs) infringe these patents based on the allegation that the manufacturing of these products involves the use of certain bonding tools (e.g., wire-bonding tips, capillary tips, and flip-chip handling tools) that have electrically "dissipative" properties, and which are used when bonding components, such as leads, wires and flip chips. The complaint seeks an injunction, unspecified monetary damages, interests, fees and costs. On September 30, 2014, the Company filed a motion to dismiss Reiber's claims for induced infringement and contributory infringement. The parties' initial case management conference is set for February 5, 2015. The Company intends to defend itself vigorously in this matter.

On October 20, 2014, plaintiff SOTA Semiconductor LLC (“SOTA”) filed a complaint in the Central District of California against the Company, Marvell Semiconductor, Inc., Belkin International, Inc., Dell Inc., Hewlett-Packard Company, Hisense USA Corp., Konica Minolta Business Solutions U.S.A., Inc., Lenovo (United States) Inc., Netgear, Inc., Samsung Electronics America, Inc., and Seagate Technology LLC, alleging infringement of U.S. Patent No. 5,991,545 (“’545 patent”). SOTA alleges that the Company’s devices that incorporate Marvell Thumb Processors, including WD’s My Cloud EX2 network attached storage devices, which include model numbers WDBVKW0080JCH, WDBVKW0060JCH, WDBVKW0040JCH and WDBVKW0000NCH, infringe the ’545 patent. The complaint seeks unspecified monetary damages, interests, fees, costs and expenses. The Company intends to defend itself vigorously in this matter.

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Seagate Matter

On October 4, 2006, plaintiff Seagate Technology LLC (“Seagate”) filed an action in the District Court of Hennepin County, Minnesota, naming as defendants WD and one of its now former employees previously employed by Seagate. The complaint in the action alleged claims based on supposed misappropriation of trade secrets and sought injunctive relief and unspecified monetary damages, interests, fees and costs. On June 19, 2007, WD’s former employee filed a demand for arbitration with the American Arbitration Association. A motion to stay the litigation as against all defendants and to compel arbitration of all Seagate’s claims was granted on September 19, 2007. On September 23, 2010, Seagate filed a motion to amend its claims and add allegations based on the supposed misappropriation of additional confidential information, and the arbitrator granted Seagate’s motion. The arbitration hearing commenced on May 23, 2011 and concluded on July 11, 2011.

On November 18, 2011, the sole arbitrator ruled in favor of WD in connection with five of the eight alleged trade secrets at issue, based on evidence that such trade secrets were known publicly at the time the former employee joined WD. Based on a determination that the employee had fabricated evidence, the arbitrator then concluded that WD had to know of the fabrications. As a sanction, the arbitrator precluded any evidence or defense by WD disputing the validity, misappropriation, or use of the three remaining alleged trade secrets by WD, and entered judgment in favor of Seagate with respect to such trade secrets. Using an unjust enrichment theory of damages, the arbitrator issued an interim award against WD in the amount of \$525 million plus pre-award interest at the Minnesota statutory rate of 10% per year. In his decision with respect to these three trade secrets, the arbitrator did not question the relevance, veracity or credibility of any of WD’s ten expert and fact witnesses (other than WD’s former employee), nor the authenticity of any other evidence WD presented. On January 23, 2012, the arbitrator issued a final award adding pre-award interest in the amount of \$105.4 million for a total final award of \$630.4 million. On January 23, 2012, WD filed a petition in the District Court of Hennepin County, Minnesota to have the final arbitration award vacated. A hearing on the petition to vacate was held on March 1, 2012.

On October 12, 2012, the District Court of Hennepin County, Minnesota vacated, in full, the \$630.4 million final arbitration award. Specifically, the Court confirmed the arbitration award with respect to each of the five trade secret claims that WD and the former employee had won at the arbitration and vacated the arbitration award with respect to the three trade secret claims that WD and the former employee had lost at the arbitration. The Court ordered that a rehearing be held concerning those three alleged trade secret claims before a new arbitrator.

On October 30, 2012, Seagate initiated an appeal of the Court’s decision with the Minnesota Court of Appeals. On July 22, 2013, the Minnesota Court of Appeals reversed the District Court’s decision and remanded for entry of an order and judgment confirming the arbitration award. On August 20, 2013, the Company filed a petition for review with the Minnesota Supreme Court and, on October 15, 2013, the Minnesota Supreme Court granted the Company’s petition. The appeal before the Minnesota Supreme Court was fully briefed, and oral argument was held on February 5, 2014. On October 8, 2014, the Minnesota Supreme Court affirmed the decision of the Minnesota Court of Appeals; the Minnesota Supreme Court’s decision is not subject to appeal. As a result, on October 14, 2014, the Company paid Seagate \$773.4 million to satisfy the full amount of the final arbitration award plus interest accrued through October 13, 2014. This amount was paid by one of the Company’s foreign subsidiaries using cash held outside of the United States.

Seagate disputes the method the Company used for calculating post-award interest. If not resolved, the interest dispute, which involves an amount that is not material to the Company's financial position, results of operations or cash flows, will be determined by the Minnesota courts.

Other Matters

On December 22, 2011 the German Central Organization for Private Copying Rights (Zentralstelle für private Überspielungsrechte), (“ZPÜ”), an organization consisting of several levy collecting societies, submitted a pleading to the Copyright Arbitration Board (“CAB”) in Munich claiming retroactive copyright levies for multimedia hard drives, external hard drives and network hard drives sold or introduced into commerce in Germany by WD from January 2008 through December 2010. The CAB was required to issue a settlement proposal within one year of the initiation of the action, failed to do so and requested the parties to consent to continue the deadline. WD declined to provide consent and, on February 1, 2013, WD filed a declaratory relief against ZPÜ in the Higher Regional Court of Munich

(the “Higher Court”), seeking an order from the court to determine the copyright levy issue. On May 21, 2013, ZPÜ filed a counter-claim against WD with the Higher Court, seeking copyright levies for multimedia hard drives, external hard drives and network hard drives sold or introduced into commerce from January 2008 through December 2010 based on tariffs published by ZPÜ on November 3, 2011. On May 22, 2014, oral argument on the pleadings occurred. A decision from the Higher Court is expected by January 15, 2015, which either party may appeal. WD intends to defend itself vigorously in this matter.

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

6. Income Taxes

The Company's income tax provision for both the three months ended October 3, 2014 and September 27, 2013 was \$37 million. The differences between the effective tax rate and the U.S. Federal statutory rate are primarily due to tax holidays in Malaysia, the Philippines, Singapore and Thailand that expire at various dates from 2015 through 2025 and the current year generation of income tax credits.

In the three months ended October 3, 2014, the Company recorded a net increase of \$7 million in its liability for unrecognized tax benefits. As of October 3, 2014, the Company's liability for unrecognized tax benefits was approximately \$307 million. Interest and penalties recognized on such amounts were not material to the condensed consolidated financial statements during the three months ended October 3, 2014.

The Internal Revenue Service ("IRS") previously completed its field examination of the Company's federal income tax returns for fiscal years 2006 and 2007, and the Company and the IRS reached agreement with respect to all matters except on the proposed adjustments to income before income taxes relating to intercompany payable balances. The proposed adjustments relating to intercompany payable balances for fiscal years 2006 and 2007 will be addressed in conjunction with the IRS's examination of the Company's fiscal years 2008 and 2009, which commenced in January 2012. In addition, in January 2012, the IRS commenced an examination of the 2007 fiscal period ended September 5, 2007 of Komag, Incorporated, which was acquired by the Company on September 5, 2007. The Company anticipates that the IRS fieldwork will be completed in the fourth quarter of fiscal year 2015. With respect to the 2008 and 2009 audit, the Company received a notice of proposed adjustment from the IRS relating to intercompany payable balances. The proposed adjustments to income before income taxes relating to intercompany payable balances for fiscal years 2006, 2007, 2008 and 2009 total approximately \$200 million. The Company disagrees with the proposed adjustments, believes that its tax position is properly supported and will vigorously contest the position taken by the IRS. The IRS examined calendar years 2010 and 2011 of HGST, which was acquired by the Company on March 8, 2012, and completed the examination with no material adjustments.

The Company believes that adequate provision has been made for any adjustments that may result from tax examinations. However, the outcome of tax audits cannot be predicted with certainty. If any issues addressed in the Company's tax audits are resolved in a manner not consistent with management's expectations, the Company could be required to adjust its provision for income taxes in the period such resolution occurs. As of October 3, 2014, it is not possible to estimate the amount of change, if any, in the unrecognized tax benefits that is reasonably possible within the next twelve months. Any significant change in the amount of the Company's liability for unrecognized tax benefits would most likely result from additional information or settlements relating to the examination of the Company's tax returns.

7. Fair Value Measurements

Financial assets and liabilities that are remeasured and reported at fair value at each reporting period are classified and disclosed in one of the following three levels:

Level 1. Quoted prices in active markets for identical assets or liabilities.

Level 2. Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3. Inputs that are unobservable for the asset or liability and that are significant to the fair value of the assets or liabilities.

The following table presents information about the Company's financial assets and liabilities that are measured at fair value on a recurring basis as of October 3, 2014, and indicates the fair value hierarchy of the valuation techniques utilized to determine such value (in millions):

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	Fair Value Measurements at Reporting Date Using			
	Level 1	Level 2	Level 3	Total
Assets:				
Cash equivalents:				
Money market funds	\$ 1,245	\$—	\$—	\$ 1,245
Commercial paper	—	53	—	53
Total cash equivalents	1,245	53	—	1,298
Short-term investments:				
U.S. Government agency securities	—	50	—	50
Commercial paper	—	119	—	119
Certificates of deposit	—	53	—	53
Total short-term investments	—	222	—	222
Long-term investments:				
U.S. Treasury securities	—	203	—	203
U.S. Government agency securities	—	29	—	29
Total long-term investments	—	232	—	232
Total assets at fair value	\$ 1,245	\$ 507	\$—	\$ 1,752
Liabilities:				
Foreign exchange contracts	\$—	\$ 24	\$—	\$ 24
Total liabilities at fair value	\$—	\$ 24	\$—	\$ 24

The following table presents information about the Company's financial assets and liabilities that are measured at fair value on a recurring basis as of June 27, 2014, and indicates the fair value hierarchy of the valuation techniques utilized to determine such value (in millions):

	Fair Value Measurements at Reporting Date Using			
	Level 1	Level 2	Level 3	Total
Assets:				
Cash equivalents:				
Money market funds	\$ 756	\$—	\$—	\$ 756
Bank acceptances	—	1	—	1
Total cash equivalents	756	1	—	757
Short-term investments:				
U.S. Government agency securities	—	53	—	53
Commercial paper	—	165	—	165
Certificates of deposit	—	66	—	66
Total short-term investments	—	284	—	284
Long-term investments:				
U.S. Treasury securities	—	180	—	180
U.S. Government agency securities	—	35	—	35
Total long-term investments	—	215	—	215
Foreign exchange contracts	—	7	—	7
Total assets at fair value	\$ 756	\$ 507	\$—	\$ 1,263
Liabilities:				
Foreign exchange contracts	\$—	\$ 2	\$—	\$ 2
Total liabilities at fair value	\$—	\$ 2	\$—	\$ 2

Money Market Funds. The Company's money market funds are funds that invest in U.S. Treasury and U.S. Government Agency securities and are recorded within cash and cash equivalents in the condensed consolidated balance sheets. Money market funds are valued based on quoted market prices.

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Certificates of Deposit. The Company's certificates of deposit are investments which are held in custody by a third party and recorded within short-term investments in the condensed consolidated balance sheets. Certificates of deposit are valued using fixed interest rates.

Commercial Paper. The Company's commercial paper securities are investment grade debt issued by corporations which are held in custody by a third party with original maturities of twelve months or less and are recorded within cash and cash equivalents or short-term investments in the condensed consolidated balance sheets depending on their original maturities. Commercial paper securities are valued using a market approach which is based on observable inputs including market interest rates from multiple pricing sources.

U.S. Government Agency Securities. The Company's U.S. Government agency securities are investments in fixed income securities sponsored by the U.S. Government and are held in custody by a third party and recorded within short-term investments or long term other assets in the condensed consolidated balance sheets depending on their original maturities. U.S. Government agency securities are valued using a market approach which is based on observable inputs including market interest rates from multiple pricing sources.

U.S. Treasury Securities. The Company's U.S. Treasury securities are direct obligations of the U.S. federal government, are held in custody by a third party and are recorded within long-term other assets in the condensed consolidated balance sheets. U.S. Treasury securities are valued using a market approach which is based on observable inputs including market interest rates from multiple pricing sources.

Bank Acceptances. The Company's bank acceptances are held in custody by a third party and recorded within cash and cash equivalents in the condensed consolidated balance sheets. Bank acceptances are valued using a market approach which is based on observable inputs including market interest rates from multiple pricing sources.

Foreign Exchange Contracts. The Company's foreign exchange contracts are short-term contracts to hedge the Company's foreign currency risk. Foreign exchange contracts are classified within other current assets and liabilities in the condensed consolidated balance sheets. For contracts that have a right of offset by its individual counterparties under master netting arrangements, the Company presents its foreign exchange contracts on a net basis by counterparty in the condensed consolidated balance sheets. For more information on the Company's foreign exchange contracts, see Note 8. Foreign exchange contracts are valued using an income approach that is based on a present value of future cash flows model. The market-based observable inputs for the model include forward rates and credit default swap rates.

The carrying amounts of cash, accounts receivable, accounts payable and accrued expenses approximate fair value for all periods presented because of the short-term maturity of these assets and liabilities. The carrying amount of debt approximates fair value because of its variable interest rate.

8. Foreign Exchange Contracts

Although the majority of the Company's transactions are in U.S. dollars, some transactions are based in various foreign currencies. The Company purchases short-term, foreign exchange contracts to hedge the impact of foreign currency exchange fluctuations on certain underlying assets, liabilities and commitments for operating expenses and product costs denominated in foreign currencies. The purpose of entering into these hedging transactions is to minimize the impact of foreign currency fluctuations on the Company's results of operations. These contract maturity dates do not exceed 12 months. All foreign exchange contracts are for risk management purposes only. The Company does not purchase foreign exchange contracts for trading purposes. As of October 3, 2014, the Company had outstanding foreign exchange contracts with commercial banks for British Pound Sterling, Euro, Japanese Yen, Malaysian Ringgit, Philippine Peso, Singapore Dollar and Thai Baht, which were designated as either cash flow or fair value hedges.

If the derivative is designated as a cash flow hedge, the effective portion of the change in fair value of the derivative is initially deferred in other comprehensive income (loss), net of tax. These amounts are subsequently recognized into earnings when the underlying cash flow being hedged is recognized into earnings. Recognized gains and losses on foreign exchange contracts entered into for manufacturing-related activities are reported in cost of revenue and presented within cash flow from operations. Hedge effectiveness is measured by comparing the hedging instrument's cumulative change in fair value from inception to maturity to the underlying exposure's terminal value. The Company determined the ineffectiveness associated with its cash flow hedges to be immaterial to the condensed consolidated

financial statements for the three months ended October 3, 2014 and September 27, 2013.

A change in the fair value of fair value hedges is recognized in earnings in the period incurred and is reported as a component of operating expenses. All fair value hedges were determined to be effective. The fair value and the changes in fair value on these contracts were immaterial to the condensed consolidated financial statements during the three months ended October 3, 2014 and September 27, 2013.

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As of October 3, 2014, the net amount of unrealized losses with respect to the Company's foreign exchange contracts that is expected to be reclassified into earnings within the next 12 months was \$21 million. In addition, as of October 3, 2014, the Company did not have any foreign exchange contracts with credit-risk-related contingent features. The Company opened \$1.0 billion and \$1.0 billion, and closed \$1.0 billion and \$1.4 billion, in foreign exchange contracts in the three months ended October 3, 2014 and September 27, 2013, respectively. The fair value and balance sheet location of the Company's foreign exchange contracts as of October 3, 2014 and June 27, 2014 were as follows (in millions):

	Asset Derivatives		Liability Derivatives		Fair Value
	October 3, 2014	June 27, 2014	October 3, 2014	June 27, 2014	
Derivatives Designated as Hedging Instruments	Balance Sheet Location	Fair Value	Fair Value	Fair Value	Fair Value
Foreign exchange contracts	Other current assets	\$—	Accrued expenses	\$24	\$2

The following table presents the gross amounts of the Company's derivative instruments, amounts offset due to master netting arrangements with the Company's various counterparties, and the net amounts recognized in the condensed consolidated balance sheet as of October 3, 2014 (in millions):

Derivatives Designated as Hedging Instruments	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in the Balance Sheet	Net Amounts of Assets (Liabilities) Presented in the Balance Sheet
Foreign exchange contracts			
Financial assets	\$2	\$(2)	\$—
Financial liabilities	(26)	2	(24)
Total derivative instruments	\$(24)	\$—	\$(24)

The following table presents the gross amounts of the Company's derivative instruments, amounts offset due to master netting arrangements with the Company's various counterparties, and the net amounts recognized in the condensed consolidated balance sheet as of June 27, 2014 (in millions):

Derivatives Designated as Hedging Instruments	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in the Balance Sheet	Net Amounts of Assets (Liabilities) Presented in the Balance Sheet
Foreign exchange contracts			
Financial assets	\$9	\$(2)	\$7
Financial liabilities	(4)	2	(2)
Total derivative instruments	\$5	\$—	\$5

The impact on the condensed consolidated financial statements was as follows (in millions):

	Amount of Loss Recognized in Accumulated OCI on Derivatives	Location of (Gain) Loss Reclassified from Accumulated OCI into Income	Amount of (Gain) Loss Reclassified From Accumulated OCI into Income
Derivatives in Cash Flow Hedging Relationships	Three Months Ended October 3, 2014	Three Months Ended September 27, 2013	Three Months Ended September 27, 2013
Foreign exchange contracts	\$(22)	Cost of revenue	\$(4)
	) \$(11)		) \$27

The total net realized transaction and foreign exchange contract currency gains and losses were not material to the condensed consolidated financial statements during the three months ended October 3, 2014 and September 27, 2013.

9. Stock-Based Compensation

Stock-based Compensation Expense

During the three months ended October 3, 2014, the Company recognized in expense \$19 million for stock-based compensation related to the vesting of options issued under the Company's stock plans and the ESPP, as compared to \$21 million in the prior-year period. The tax benefit realized as a result of the aforementioned stock-based compensation expense was \$5 million in both the three months ended October 3, 2014 and September 27, 2013. As of October 3, 2014, total compensation cost

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related to unvested stock options and ESPP rights issued to employees but not yet recognized was \$145 million and will be amortized on a straight-line basis over a weighted average service period of approximately 2.3 years. During the three months ended October 3, 2014, the Company recognized in expense \$20 million for stock-based compensation related to the vesting of awards of RSUs issued under the Company's stock plans, as compared to \$21 million in the prior-year period. The tax benefit realized as a result of the aforementioned stock-based compensation expense was \$5 million in the three months ended October 3, 2014, as compared to \$4 million in the prior-year period. As of October 3, 2014, the aggregate unamortized fair value of all unvested RSUs was \$179 million, which will be recognized on a straight-line basis over a weighted average vesting period of approximately 1.9 years. RSUs include performance stock unit awards ("PSUs"). The effect of PSUs was immaterial to the condensed consolidated financial statements during the three months ended October 3, 2014 and September 27, 2013.

During both the three months ended October 3, 2014 and September 27, 2013, the Company recognized in expense \$4 million related to adjustments to market value as well as the vesting of stock appreciation rights ("SARs"). The tax benefit realized as a result of the aforementioned SARs expense was \$1 million in both the three months ended October 3, 2014 and September 27, 2013. The SARs will be settled in cash upon exercise. As a result, the Company had a total liability of \$58 million and \$61 million related to SARs included in accrued expenses in the condensed consolidated balance sheets, as of October 3, 2014 and June 27, 2014, respectively. As of October 3, 2014, total compensation cost related to unvested SARs issued to employees but not yet recognized was not material to the Company's consolidated statement of income.

Stock Option Activity

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

	Number of Shares	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Options outstanding at June 27, 2014	10.1	\$37.03		
Granted	1.2	100.06		
Exercised	(1.3	) 31.04		
Options outstanding at October 3, 2014	10.0	\$45.16	4.7	\$514
Exercisable at October 3, 2014	4.5	\$32.19	3.3	\$290
Vested and expected to vest after October 3, 2014	9.8	\$44.56	4.7	\$509

If an option has an exercise price that is less than the quoted price of the Company's common stock at the particular time, the aggregate intrinsic value of that option at that time is calculated based on the difference between the exercise price of the underlying options and the quoted price of the Company's common stock at that time. As of October 3, 2014, the Company had options outstanding to purchase an aggregate of 8.7 million shares with an exercise price below the quoted price of the Company's stock on that date resulting in an aggregate intrinsic value of \$514 million at that date. During the three months ended October 3, 2014, the aggregate intrinsic value of options exercised under the Company's stock option plans was \$86 million, determined as of the date of exercise, as compared to \$27 million in the prior-year period.

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RSU Activity

The following table summarizes RSU activity under the Company's stock plans (in millions, except weighted average grant date fair value):

	Number of Shares	Weighted Average Grant-Date Fair Value
RSUs outstanding at June 27, 2014	3.7	\$49.77
Granted	1.1	100.07
Vested	(1.5	) 40.57
RSUs outstanding at October 3, 2014	3.3	70.88
Expected to vest after October 3, 2014	3.1	\$70.38

The fair value of each RSU is the market price of the Company's stock at the date of grant. RSUs are generally payable in an equal number of shares of the Company's common stock at the time of vesting of the units. The grant-date fair value of the shares underlying the RSU awards at the date of grant was \$113 million in the three months ended October 3, 2014. These amounts are being recognized to expense over the corresponding vesting periods. The Company has assumed a forfeiture rate of 4.4% for the three months ended October 3, 2014, based on a historical analysis indicating forfeitures for these types of awards.

SARs Activity

The share-based compensation liability for SARs is recognized for the portion of fair value for which service has been rendered at the reporting date. The share-based liability is remeasured at each reporting date, using a binomial option-pricing model, through the requisite service period. As of October 3, 2014, 0.7 million SARs were outstanding with a weighted average exercise price of \$8.06. There were no SARs granted and all other SARs activity was immaterial to the condensed consolidated financial statements for the three months ended October 3, 2014 and September 27, 2013.

Fair Value Disclosure — Binomial Model

The fair value of stock options granted is estimated using a binomial option-pricing model. The binomial model requires the input of highly subjective assumptions. The Company uses historical data to estimate exercise, employee termination, 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 was estimated using the following weighted average assumptions:

	Three Months Ended October 3, 2014	September 27, 2013
Suboptimal exercise factor	2.51	2.06
Range of risk-free interest rates	0.11% to 2.16%	0.10% to 2.02%
Range of expected stock price volatility	0.24 to 0.47	0.31 to 0.50
Weighted average expected volatility	0.36	0.43
Post-vesting termination rate	1.25%	3.09%
Dividend yield	1.68%	1.58%
Fair value	\$32.29	\$24.00

The weighted average expected term of the Company's stock options granted during the three months ended October 3, 2014 was 5.8 years, as compared to 5.0 years in the prior-year period.

Fair Value Disclosure — Black-Scholes-Merton Model

The fair value of ESPP purchase rights issued is estimated at the date of grant of the purchase rights using the Black-Scholes-Merton option-pricing model. 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. Purchase rights under the current ESPP are granted on either June 1st or December 1st of each year. ESPP activity was immaterial to the condensed consolidated financial statements for the three months ended October 3,

2014 and September 27, 2013.

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Stock Repurchase Program

Since May 18, 2012, the Company's Board of Directors has authorized \$3.0 billion for the repurchase of its common stock and approved the extension of its stock repurchase program to September 13, 2017. The Company repurchased 2.2 million shares for a total cost of \$223 million during the three months ended October 3, 2014. The remaining amount available to be purchased under the Company's stock repurchase program as of October 3, 2014 was \$931 million. The Company may continue to repurchase its stock as it deems appropriate and market conditions allow. Repurchases under the stock repurchase program may be made in the open market or in privately negotiated transactions and may be made under a Rule 10b5-1 plan. The Company expects stock repurchases to be funded principally by operating cash flows and borrowings under the Company's Credit Agreement.

Dividends to Shareholders

On September 13, 2012, the Company announced that its Board of Directors had authorized the adoption of a quarterly cash dividend policy. Under the cash dividend policy, holders of the Company's common stock receive dividends when and as declared by the Company's Board of Directors. In the three months ended October 3, 2014, the Company declared a cash dividend of \$0.40 per share of the Company's common stock to shareholders of record as of October 3, 2014, totaling \$94 million, which was paid on October 15, 2014. The Company may modify, suspend or cancel its cash dividend policy in any manner and at any time.

10. Pensions and Other Post-retirement Benefit Plans

The Company's principal pension and other post-retirement benefit plans are in Japan. All pension and other post-retirement benefit plans outside of the Company's Japanese plans were immaterial to the Company's condensed consolidated financial statements for the three months ended October 3, 2014 and September 27, 2013. The expected long-term rate of return on the Japanese plan assets is 3.5%.

The following table presents the unfunded status of the benefit obligations and Japanese plan assets (in millions):

	October 3, 2014	June 27, 2014
Benefit obligation	\$240	\$255
Fair value of plan assets	(182	) (191
Unfunded status	\$58	\$64

The following table presents the unfunded amounts as recognized on the Company's condensed consolidated balance sheets (in millions):

	October 3, 2014	June 27, 2014
Current liabilities	\$1	\$1
Non-current liabilities	57	63
Net amount recognized	\$58	\$64

The net periodic benefit cost of the Company's pension plans was not material to the condensed consolidated financial statements for the three months ended October 3, 2014 and September 27, 2013. The Company's expected employer contribution for its Japanese defined benefit pension plans is \$12 million in fiscal 2015.

11. Acquisitions

Acquisition of Virident

On October 17, 2013, the Company acquired Virident, a provider of server-side flash storage solutions for virtualization, database, cloud computing and webscale applications. As a result of the acquisition, Virident has been fully integrated into the Company's HGST subsidiary and become a wholly owned indirect subsidiary of the Company. The purchase price of the acquisition was approximately \$613 million, consisting of \$598 million which was funded with available cash, and \$15 million related to the fair value of stock options assumed. The acquisition furthered HGST's strategy to address the rapidly changing needs of enterprise customers by delivering intelligent storage solutions that maximize application performance by leveraging the tightly coupled server, storage and network resources of today's converged datacenter infrastructures.

The Company identified and recorded the assets acquired and liabilities assumed at their estimated fair values at the date of acquisition, and allocated the remaining value of \$506 million to goodwill. The values assigned to the acquired assets and

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liabilities were finalized during the three months ended June 27, 2014. The individual tangible and intangible assets acquired as well as the liabilities assumed in the acquisition were immaterial to the Company's condensed consolidated financial statements.

The final purchase price allocation for Virident was as follows (in millions):

Tangible assets acquired and liabilities assumed	\$58
Intangible assets	49
Goodwill	506
Total	\$613

The \$506 million of goodwill recognized is primarily attributable to the benefits the Company expects to derive from an ability to create server-side flash storage solutions leveraging the core technology acquired and is not expected to be deductible for tax purposes.

Acquisition of sTec

On September 12, 2013, the Company completed its acquisition of sTec, a provider of enterprise solid-state drives. As a result of the acquisition, sTec has been fully integrated into the Company's HGST subsidiary and become a wholly owned indirect subsidiary of the Company. The purchase price of the acquisition was approximately \$336 million, consisting of \$325 million which was funded with available cash, and \$11 million related to the fair value of stock options and RSUs assumed. The acquisition augmented HGST's existing solid-state storage capabilities.

The Company identified and recorded the assets acquired and liabilities assumed at their estimated fair values at the date of acquisition, and allocated the remaining value of \$89 million to goodwill. The values assigned to the acquired assets and liabilities were finalized during the three months ended October 3, 2014. The individual tangible and intangible assets acquired as well as the liabilities assumed in the acquisition were immaterial to the Company's condensed consolidated financial statements.

The final purchase price allocation for sTec was as follows (in millions):

Tangible assets acquired and liabilities assumed	\$189
Intangible assets	58
Goodwill	89
Total	\$336

The \$89 million of goodwill recognized is primarily attributable to the benefits the Company expects to derive from augmenting HGST's existing solid-state storage capabilities and accelerating its ability to expand its participation in the growing area of enterprise solid-state drives and is not expected to be deductible for tax purposes.

Acquisition of VeloBit

On July 9, 2013, the Company acquired VeloBit, a privately held provider of high-performance storage I/O optimization software. As a result of the acquisition, VeloBit was fully integrated into the Company's HGST subsidiary and became a wholly owned indirect subsidiary of the Company. The acquisition is intended to build on HGST's strategy to enhance the overall value of datacenter storage by integrating HGST SSDs with software. The acquisition was not material to the Company's condensed consolidated financial statements.

12. Employee Termination, Asset Impairment and Other Charges

During the three months ended October 3, 2014, the Company recorded employee termination, asset impairment and other charges of \$9 million in order to realign its operations with anticipated market demand, as compared to \$11 million in the prior-year period. These charges were classified as operating expenses and included in Employee termination, asset impairment and other charges on the condensed consolidated statements of income.

13. Recent Accounting Pronouncements

In July 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2013-11, "Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists" ("ASU 2013-11"). The new standard requires the presentation of certain unrecognized tax benefits as reductions to deferred tax assets rather than as liabilities in the

consolidated balance sheets when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. The new standard is effective for fiscal years and interim periods

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within those fiscal years, beginning after December 15, 2013, which for the Company was the first quarter of fiscal 2015. The Company adopted this pronouncement in the first quarter of fiscal 2015. The adoption of this pronouncement did not have a material effect on the Company's condensed consolidated financial statements. In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers" ("ASU 2014-09"), which amends the guidance in former Accounting Standards Codification Topic 605, "Revenue Recognition", to provide a single, comprehensive revenue recognition model for all contracts with customers. The new standard requires an entity to recognize revenue in a manner that depicts the transfer of promised goods or services to customers in amounts that reflect the consideration to which an entity expects to be entitled in exchange for those goods or services. The new standard also requires entities to enhance disclosures about the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The new standard allows for either a full retrospective or a modified retrospective transition method and is effective for fiscal years beginning after December 15, 2016, which for the Company is the first quarter of fiscal 2018. The Company has not yet selected a transition method and is currently evaluating the impact ASU 2014-09 will have on its consolidated financial statements and related disclosures.

14. Subsequent Event

In relation to the Company's litigation matter with Seagate, on October 8, 2014, the Minnesota Supreme Court affirmed the decision of the Minnesota Court of Appeals, and as a result, on October 14, 2014, the Company paid Seagate \$773.4 million to satisfy the full amount of the final arbitration award plus interest accrued through October 13, 2014. For additional information, refer to Part I, Item 1, Note 5 of the Notes to Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q.

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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 Part II, Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, contained in our Annual Report on Form 10-K for the year ended June 27, 2014.

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," "our," and the "Company" 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," "would," "project," "believe," "anticipate," "expect," "estimate," "continue," "potential," "plan," "forecast," 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:

- expectations regarding industry demand and pricing in the December quarter and the ability of the industry to support this demand;
- expectations concerning the anticipated benefits of our acquisitions;
- demand for our products in the various markets and factors contributing to such demand;
- our position in the industry;
- our belief regarding our ability to capitalize on the expansion in, and our expectations regarding the growth and demand of, digital data;
- our plans to continue to develop new products and expand into new storage markets and into emerging economic markets;
- emergence of new storage markets for our products;
- emergence of competing storage technologies;
- our quarterly cash dividend policy;
 - our share repurchase plans;
- our stock price volatility;
- our belief regarding our compliance with environmental laws and regulations;
- expectations regarding our external and internal supply base;
- our belief regarding component availability;
- expectations regarding the outcome of legal proceedings in which we are involved;
- our beliefs regarding tax benefits and the timing of future payments, if any, relating to the unrecognized tax benefits, and the adequacy of our tax provisions;
- contributions to our pension plans in fiscal 2015; and
- our beliefs regarding the sufficiency of our cash and cash equivalents to meet our working capital, capital expenditure and other cash needs.

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 I, Item 1A of this Quarterly Report on Form 10-Q, and any of those made in our other reports filed with the Securities and Exchange Commission (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.

Our Company

We are a leading developer, manufacturer and provider of data storage solutions that enable consumers, businesses, governments and other organizations to create, manage, experience and preserve digital content. Our product portfolio includes

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hard disk drives (“HDDs”) and solid-state drives (“SSDs”), direct attached storage solutions, personal cloud network attached storage solutions, and public and private cloud data center storage solutions. HDDs are our principal products and are today’s primary storage medium for digital content, with the use of solid-state storage products growing rapidly. Our products are marketed under the HGST, WD and G-Technology brand names. We currently operate our global business through two independent subsidiaries due to regulatory requirements - HGST and WD.

First Quarter Overview

In accordance with accounting principles generally accepted in the United States (“U.S. GAAP”), operating results for Virident, which was acquired on October 17, 2013, sTec, which was acquired on September 12, 2013, and VeloBit, which was acquired on July 9, 2013, are included in our operating results only after the respective dates of acquisition. Our fiscal year ends on the Friday nearest to June 30 and typically consists of 52 weeks. Approximately every six years, we report a 53-week fiscal year to align our fiscal year with the foregoing policy. Our fiscal first quarters ended October 3, 2014 and September 27, 2013 consisted of 14 weeks and 13 weeks, respectively. Fiscal year 2015 will be comprised of 53 weeks and will end on July 3, 2015.

For the quarter ended October 3, 2014, we believe that overall hard drive industry shipments totaled approximately 147 million units, up 5% from the prior-year period and up 7% from the June quarter.

The following table sets forth, for the periods presented, selected summary information from our condensed consolidated statements of income by dollars and percentage of net revenue (in millions, except percentages):

	Three Months Ended				
	October 3, 2014		September 27, 2013		
Net revenue	\$3,943	100.0	% \$3,804	100.0	%
Gross profit	1,149	29.1	1,099	28.9	
Total operating expenses	680	17.2	557	14.6	
Operating income	469	11.9	542	14.2	
Net income	423	10.7	495	13.0	

The following is a summary of our financial performance for the first quarter of fiscal 2015:

• Consolidated net revenue totaled \$3.9 billion.

• 55% of our net revenue was derived from non-PC (personal computer) markets, which include enterprise applications, branded products and CE (consumer electronics) products, as compared to 53% in the prior-year period.

• Net revenue derived from enterprise SSDs was \$156 million as compared to \$106 million in the prior-year period.

• Hard drive unit shipments increased 3% from the prior-year period to 64.7 million units.

• Gross margin increased to 29.1%, compared to 28.9% for the prior-year period.

• Operating income was \$469 million, a decrease of \$73 million from the prior-year period.

• We generated \$827 million in cash flow from operations and we ended the quarter with \$5.2 billion in cash and cash equivalents.

For the quarter ending January 2, 2015, we expect overall hard drive industry shipments and our revenue to decrease moderately as a result of a 13-week December quarter as compared to the 14-week September quarter.

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Results of Operations

Net Revenue

(in millions, except percentages and average selling price)	Three Months Ended		Percentage Change	
	October 3, 2014	September 27, 2013		
Net revenue	\$3,943	\$3,804	4	%
Average selling price (per unit)*	\$58	\$58	—	%
Revenues by Geography (%)				
Americas	27	% 26	%	
Europe, Middle East and Africa	21	20		
Asia	52	54		
Revenues by Channel (%)				
OEM	63	% 64	%	
Distributors	24	24		
Retailers	13	12		
Unit Shipments*				
PC	39.7	40.2		
Non-PC	25.0	22.4		
Total units shipped	64.7	62.6	3	%

* Based on sales of hard drive units only.

For the quarter ended October 3, 2014, net revenue was \$3.9 billion, an increase of 4% from the prior-year period. This increase in revenue was primarily due to an increase in total hard drive shipments and an additional week of revenue due to a 14-week quarter. Total hard drive shipments increased to 64.7 million units for the quarter ended October 3, 2014 as compared to 62.6 million units in the prior-year period. For the quarter ended October 3, 2014, average selling price ("ASP") remained flat with the prior-year period at \$58.

Changes in revenue by geography and channel generally reflect normal fluctuations in market demand and competitive dynamics. For the three months ended October 3, 2014, and September 27, 2013, Hewlett-Packard Company accounted for approximately 11% and 13% of our net revenue, respectively.

Consistent with standard industry practice, we have sales incentive and marketing programs that provide customers with price protection and other incentives or reimbursements that are recorded as a reduction to gross revenue.

Generally, total sales incentive and marketing programs range from 7% to 11% of gross revenues per quarter. For the three months ended October 3, 2014, these programs represented 9% of gross revenues, as compared to 7% in the prior-year period. These amounts generally vary according to several factors, including industry conditions, seasonal demand, competitor actions, channel mix and overall availability of product. Changes in future customer demand and market conditions may require us to adjust our incentive programs as a percentage of gross revenue from the current range. Adjustments to revenues due to changes in accruals for these programs related to revenues reported in prior periods have averaged 0.7% of quarterly gross revenue since the first quarter of fiscal 2013.

Gross Margin

(in millions, except percentages)	Three Months Ended		Percentage Change	
	October 3, 2014	September 27, 2013		
Net revenue	\$3,943	\$3,804	4	%
Gross profit	1,149	1,099	5	%
Gross margin	29.1	% 28.9	%	

For the three months ended October 3, 2014, gross margin as a percentage of revenue increased to 29.1% as compared to 28.9% for the prior-year period. This increase was primarily due to a stronger, seasonal product mix and strength in

our capacity enterprise business.

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Operating Expenses

(in millions, except percentages)	Three Months Ended		Percentage Change	
	October 3, 2014	September 27, 2013		
R&D expense	\$437	\$401	9	%
SG&A expense	220	132	67	%
Charges related to arbitration award	14	13	8	%
Employee termination, asset impairment and other charges	9	11	(18))%
Total operating expenses	\$680	\$557		

Research and development (“R&D”) expense was \$437 million for the three months ended October 3, 2014, an increase of \$36 million from the prior-year period. This increase was primarily due to the inclusion of Virident and sTec's R&D expenses and an additional week of operating expenses due to a 14-week quarter. As a percentage of net revenue, R&D expense increased to 11.1% in the three months ended October 3, 2014, as compared to 10.5% in the prior-year period.

Selling, general and administrative (“SG&A”) expense was \$220 million for the three months ended October 3, 2014, an increase of \$88 million from the prior-year period. This increase was primarily due to the inclusion of Virident and sTec's SG&A expenses, an additional week of operating expenses due to a 14-week quarter and a \$65 million flood-related insurance recovery in the prior-year period. SG&A expense as a percentage of net revenue increased to 5.6% in the three months ended October 3, 2014, as compared to 3.5% in the prior-year period.

During the three months ended October 3, 2014, we recorded \$14 million of interest charges related to an arbitration award for claims brought against us and a now former employee of ours by Seagate Technology LLC ("Seagate") as compared to \$13 million in the prior-year period. For additional information, refer to Part I, Item 1, Note 5 of the Notes to Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q.

During the three months ended October 3, 2014, we recorded employee termination, asset impairment and other charges of \$9 million in order to realign our operations with anticipated market demand as compared to \$11 million in the prior-year period.

Other Income (Expense)

Interest income for the three months ended October 3, 2014 increased \$1 million as compared to the prior-year period primarily due to a higher average daily invested cash balance for the period. Interest and other expense for the three months ended October 3, 2014 remained flat at \$13 million when compared to the prior-year period.

Income Tax Provision

Our income tax provision for both the three months ended October 3, 2014 and September 27, 2013 was \$37 million. The differences between the effective tax rate and the U.S. Federal statutory rate are primarily due to tax holidays in Malaysia, the Philippines, Singapore and Thailand that expire at various dates from 2015 through 2025 and the current year generation of income tax credits. For additional information, see Part I, Item 1, Note 6 of the Notes to Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q.

Arbitration Award

In relation to our litigation matter with Seagate, on October 8, 2014, the Minnesota Supreme Court affirmed the decision of the Minnesota Court of Appeals, and as a result, on October 14, 2014, we paid Seagate \$773.4 million to satisfy the full amount of the final arbitration award plus interest accrued through October 13, 2014. For additional information, refer to Part I, Item 1, Note 5 of the Notes to Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q.

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Liquidity and Capital Resources

We ended the first quarter of fiscal 2015 with total cash and cash equivalents of \$5.2 billion. The following table summarizes our statements of cash flows (in millions):

	Three months ended	
	October 3, 2014	September 27, 2013
Net cash flow provided by (used in):		
Operating activities	\$827	\$680
Investing activities	(126	) (360
Financing activities	(346	) 240
Net increase in cash and cash equivalents	\$355	\$560

Our investment policy is to manage our investment portfolio to preserve principal and liquidity while maximizing return through the full investment of available funds. On January 9, 2014, Western Digital Ireland, Ltd. ("WDI") used existing cash to repay the outstanding term loan balance of \$1.8 billion, and we, along with Western Digital Technologies, Inc. ("WDT") and WDI entered into a new credit agreement with JPMorgan Chase Bank, N.A., as administrative agent, and the lenders party thereto (the "Credit Agreement"). The Credit Agreement provides for \$4.0 billion of unsecured loan facilities consisting of a \$2.5 billion term loan facility to WDT, and a \$1.5 billion revolving credit facility to WDT and WDI (the "Borrowers"). Subject to certain conditions, a Borrower may also elect to expand the credit facilities by, or obtain incremental term loans of, up to \$1.0 billion if existing or new lenders provide additional term or revolving commitments. For additional information, refer to Part I, Item 1, Note 4 of the Notes to Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q. We believe our current cash, cash equivalents and cash generated from operations as well as our available credit facilities will be sufficient to meet our working capital, debt, dividend, stock repurchase and capital expenditure needs for at least the next twelve months. Our ability to sustain our working capital position is subject to a number of risks that we discuss in Part II, Item 1A of this Quarterly Report on Form 10-Q.

A total of \$4.0 billion and \$3.5 billion of our cash and cash equivalents was held outside of the United States at October 3, 2014 and June 27, 2014, respectively. Substantially all of the amounts held outside of the United States are intended to be indefinitely reinvested in foreign operations. As described in the section "Arbitration Award" above, the amount of \$773.4 million was paid on October 14, 2014 from one of our foreign subsidiaries using cash held outside the United States. On September 13, 2012, our Board of Directors approved a capital allocation plan which includes repurchases of our common stock and the adoption of a quarterly cash dividend policy. Our current plans do not anticipate that we will need funds generated from foreign operations to fund our domestic operations or capital allocation plan. In the event funds from foreign operations are needed in the United States, any repatriation could result in the accrual and payment of additional U.S. income tax.

Operating Activities

Net cash provided by operating activities was \$827 million during the three months ended October 3, 2014. Cash flow from operating activities consists of net income, adjusted for non-cash charges, plus or minus working capital changes. This represents our principal source of cash. Net cash provided by working capital changes was \$61 million for the three months ended October 3, 2014 as compared to \$101 million used by working capital changes in the prior-year period.

Our working capital requirements primarily depend on the effective management of our cash conversion cycle, which measures how quickly we can convert our products into cash through sales. The cash conversion cycles were as follows:

	Three Months Ended	
	October 3, 2014	September 27, 2013
Days sales outstanding	48	43
Days in inventory	45	42
Days payables outstanding	(71) (69

Cash conversion cycle*

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* Cash conversion cycle for the first quarter of 2015 was calculated using 98 days as a result of a 14-week quarter. For the three months ended October 3, 2014, our average days sales outstanding (“DSOs”) increased by 5 days, days in inventory (“DIOs”) increased by 3 days, and days payable outstanding (“DPOs”) increased by 2 days compared to the prior year period. Changes in average DSOs and DIOs are generally related to linearity of shipments and the timing of inventory builds,

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respectively. Changes in DPOs are generally related to production volume and the timing of purchases during the period. From time to time, we modify the timing of payments to our vendors. We make modifications primarily to manage our vendor relationships and to manage our cash flows, including our cash balances. Generally, we make the payment modifications through negotiations with our vendors or by granting to, or receiving from, our vendors' payment term accommodations.

Investing Activities

Cash used in investing activities for the three months ended October 3, 2014 was \$126 million and consisted primarily of \$160 million of capital expenditures, \$120 million related to the purchase of investments and \$12 million of other investing activities, offset by \$166 million of proceeds from sales and maturities of investments. Cash used in investing activities for the three months ended September 27, 2013 was \$360 million and consisted primarily of \$263 million related to acquisitions, net of cash acquired and \$136 million of capital expenditures, offset by a net \$39 million for other investing activities, consisting of a flood-related insurance recovery and a strategic investment. For additional information on our cash equivalents and investments, refer to Part I, Item 1, Note 2 and 7 of the Notes to the Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q.

Financing Activities

Net cash used in financing activities for the three months ended October 3, 2014 was \$346 million as compared to \$240 million provided by financing activities in the prior-year period. Net cash used in financing activities for the three months ended October 3, 2014 consisted of \$223 million used to repurchase shares of our common stock, \$31 million used to make principal payments on the Credit Agreement and \$94 million used to pay dividends on our common stock, offset by a net \$2 million provided by employee stock plans. Net cash provided by financing activities for the three months ended September 27, 2013 consisted of \$500 million of debt proceeds under the revolving credit facility and a net \$7 million provided by employee stock plans, offset by \$150 million used to repurchase shares of our common stock, \$59 million used to pay dividends on our common stock and \$58 million used to repay long-term debt.

Off-Balance Sheet Arrangements

Other than facility lease commitments incurred in the normal course of business and certain indemnification provisions (see "Contractual Obligations and Commitments" below), we do not have any off-balance sheet financing arrangements or liabilities, guarantee contracts, retained or contingent interests in transferred assets, or any obligation arising out of a material variable interest in an unconsolidated entity. We do not have any majority-owned subsidiaries that are not included in our condensed consolidated financial statements. Additionally, we do not have an interest in, or relationships with, any special-purpose entities.

Contractual Obligations and Commitments

Long-Term Debt — On January 9, 2014, Western Digital Ireland, Ltd. ("WDI") used existing cash to repay the outstanding term loan balance of \$1.8 billion, and we, in our capacity as the parent entity and guarantor, and the Borrowers, entered into the new Credit Agreement.

As of October 3, 2014, no amounts were outstanding under the revolving credit facility of the Credit Agreement and the term loan facility had an outstanding balance of \$2.4 billion with a variable interest rate of 1.66%. We are required to make quarterly principal payments on the term loan facility totaling \$94 million for the remainder of fiscal 2015, \$156 million in fiscal 2016, \$219 million in fiscal 2017, \$250 million in fiscal 2018 and the remaining balance of \$1.7 billion in fiscal 2019. For additional information, refer to Part I, Item 1, Note 4 of the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q.

Purchase Orders — In the normal course of business, we enter into purchase orders with suppliers for the purchase of components used to manufacture our products. These purchase orders generally cover forecasted component supplies needed for production during the next quarter, are recorded as a liability upon receipt of the components, and generally may be changed or canceled at any time prior to shipment of the components. We also enter into purchase orders with suppliers for capital equipment that are recorded as a liability upon receipt of the equipment. Our ability to change or cancel a capital equipment purchase order without penalty depends on the nature of the equipment being ordered. In some cases, we may be obligated to pay for certain costs related to changes to, or cancellation of, a purchase order, such as costs incurred for raw materials or work in process of components or capital equipment.

We have entered into long-term purchase agreements with various component suppliers, containing minimum quantity requirements. However, the dollar amount of the purchases may depend on the specific products ordered, achievement of pre-defined quantity or quality specifications or future price negotiations. We have also entered into long-term purchase agreements

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with various component suppliers that carry fixed volumes and pricing which obligate us to make certain future purchases, contingent on certain conditions of performance, quality and technology of the vendor's components. We enter into, from time to time, other long-term purchase agreements for components with certain vendors. Generally, future purchases under these agreements are not fixed and determinable as they depend on our overall unit volume requirements and are contingent upon the prices, technology and quality of the supplier's products remaining competitive.

See Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations — Contractual Obligations and Commitments" in our Annual Report on Form 10-K for the year ended June 27, 2014, for further discussion of our purchase orders and purchase agreements and the associated dollar amounts. See Part II, Item 1A of this Quarterly Report on Form 10-Q for a discussion of the risks associated with these commitments.

Foreign Exchange Contracts — We purchase short-term, foreign exchange contracts to hedge the impact of foreign currency fluctuations on certain underlying assets, liabilities and commitments for operating expenses and product costs denominated in foreign currencies. See Part I, Item 3, of this Quarterly Report on Form 10-Q under the heading "Disclosure About Foreign Currency Risk," for a description of our current foreign exchange contract commitments and Part I, Item 1, Note 8 of the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q.

Indemnifications — In the ordinary course of business, we may provide indemnifications of varying scope and terms to customers, vendors, lessors, business partners and other parties with respect to certain matters, including, but not limited to, losses arising out of our breach of agreements, products or services to be provided by us, or from intellectual property infringement claims made by third parties. In addition, we have entered into indemnification agreements with our directors and certain of our officers that will require us, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors or officers. We maintain director and officer insurance, which may cover certain liabilities arising from our obligation to indemnify our directors and officers in certain circumstances.

It is not possible to determine the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Such indemnification agreements may not be subject to maximum loss clauses. Historically, we have not incurred material costs as a result of obligations under these agreements.

Unrecognized Tax Benefits — As of October 3, 2014, the cash portion of our total recorded liability for unrecognized tax benefits was \$252 million. We estimate the timing of the future payments of these liabilities to be within the next one to eight years. For additional information, refer to Part I, Item 1, Note 6 of the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q.

Stock Repurchase Program — We repurchased 2.2 million shares of our common stock for a total cost of \$223 million during the three months ended October 3, 2014. Subsequent to October 3, 2014 and through November 4, 2014, we repurchased an additional 1.9 million shares of our common stock for a total cost of \$175 million. For additional information, refer to Part I, Item 1, Note 9 of the Notes to Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q.

Cash Dividend Policy — During the three months ended October 3, 2014, we declared a cash dividend of \$0.40 per share of our common stock to our shareholders of record as of October 3, 2014, totaling \$94 million, which we paid on October 15, 2014. For additional information, refer to Part I, Item 1, Note 9 of the Notes to Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q.

Critical Accounting Policies and Estimates

We have prepared the unaudited condensed consolidated financial statements in accordance with U.S. GAAP. The preparation of the financial statements requires the use of judgments and estimates that affect the reported amounts of revenues, expenses, assets, liabilities and shareholders' equity. We have adopted accounting policies and practices that are generally accepted in the industry in which we operate. We believe the following are our most critical accounting policies that affect significant areas and involve judgment and estimates made by us. If these estimates differ significantly from actual results, the impact to the condensed consolidated financial statements may be material. There have been no material changes in our critical accounting policies and estimates from those disclosed in our Annual

Report on Form 10-K for the year ended June 27, 2014. Please refer to “Management’s Discussion and Analysis of Financial Condition and Results of Operations” contained in Part II, Item 7 of our Annual Report on Form 10-K for the fiscal year ended June 27, 2014 for a discussion of our critical accounting policies and estimates.

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Recent Accounting Pronouncements

For a description of recently issued and adopted accounting pronouncements, including the respective dates of adoption and expected effects on our results of operations and financial condition, refer to Part I, Item 1, Note 13 of the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Disclosure About Foreign Currency Risk

Although the majority of our transactions are in U.S. dollars, some transactions are based in various foreign currencies. We purchase short-term, foreign exchange contracts to hedge the impact of foreign currency exchange fluctuations on certain underlying assets, liabilities and commitments for operating expenses and product costs denominated in foreign currencies. The purpose of entering into these hedge transactions is to minimize the impact of foreign currency fluctuations on our results of operations. The contract maturity dates do not exceed 12 months. We do not purchase foreign exchange contracts for trading purposes. See Part I, Item 1, Note 8 of the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q.

As of October 3, 2014, we had outstanding the following purchased foreign exchange contracts (in millions, except weighted average contract rate):

	Contract Amount	Weighted Average Contract Rate*	Unrealized Losses
Foreign exchange contracts:			
Cash flow hedges:			
Japanese Yen	\$211	\$ 101.78	\$(13)
Malaysian Ringgit	\$259	\$ 3.27	\$(2)
Philippine Peso	\$43	\$ 44.17	\$(1)
Singapore Dollar	\$49	\$ 1.25	\$(1)
Thai Baht	\$648	\$ 32.64	\$(4)
Fair value hedges:			
British Pound Sterling	\$6	\$ 0.62	\$—
Euro	\$20	\$ 0.79	\$—
Japanese Yen	\$118	\$ 109.23	\$—
Philippine Peso	\$27	\$ 44.75	\$—
Thai Baht	\$86	\$ 32.51	\$—

* Expressed in units of foreign currency per U.S. dollar.

During the three months ended October 3, 2014, total net realized transaction and foreign exchange contract currency gains and losses were not material to the condensed consolidated financial statements.

Disclosure About Other Market Risks

Variable Interest Rate Risk

Borrowings under the Credit Agreement bear interest at a rate equal to, at the option of the applicable Borrower, either (a) a customary London interbank offered rate (a "Eurodollar Rate") or (b) a customary base rate (a "Base Rate"), in each case plus an applicable margin. The applicable margins range from 1.25% to 2.00% with respect to Eurodollar Rate borrowings and 0.25% to 1.00% with respect to Base Rate borrowings. The Borrowers are also required to pay a commitment fee for the unused portion of the revolving credit facility, which ranges from 0.175% to 0.300% per annum. The applicable margins for borrowings and the commitment fee ranges are determined based upon a leverage ratio of us and our subsidiaries calculated on a consolidated basis. A one percent increase in the variable rate of interest on the term loan and revolving credit facility would increase interest expense by approximately \$24 million annually. For additional information on the Credit Agreement, see Part I, Item 1, Note 4 of the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q.

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Item 4. CONTROLS AND PROCEDURES

As required by SEC Rule 13a-15(b) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rule 13a-15(e) under the Exchange Act) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this Quarterly Report on Form 10-Q, our disclosure controls and procedures were effective.

There has been no change in our internal control over financial reporting during the first fiscal quarter ended October 3, 2014 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

For a description of our legal proceedings, refer to Part I, Item 1, Note 5 of the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q, which is incorporated by reference in response to this item.

Item 1A. RISK FACTORS

The business, financial condition and operating results of the Company can be affected by a number of factors, whether currently known or unknown, including but not limited to those described below, any one or more of which could, directly or indirectly, cause the Company’s actual results of operations and financial condition to vary materially from past, or from anticipated future, results of operations and financial condition. Any of these factors, in whole or in part, could materially and adversely affect the Company’s business, financial condition, results of operations or the market price of its common stock.

If we fail to realize the anticipated benefits from our acquisition of HGST on a timely basis, or at all, our business and financial condition may be adversely affected.

In connection with obtaining the regulatory approvals required to complete the acquisition of HGST, we agreed to certain conditions required by the Ministry of Commerce of the People’s Republic of China (“MOFCOM”), including adopting measures to keep HGST as an independent competitor until MOFCOM agrees otherwise (with the minimum period being two years from the March 8, 2012 closing date of the acquisition). We worked closely with MOFCOM to finalize an operations plan that outlines in more detail the conditions of the competitive requirement. Compliance with these measures has affected, and may continue to affect, our business and financial conditions in the following ways:

- limits our ability to integrate the businesses of our HGST and WD subsidiaries (and we do not expect to achieve significant operating expense synergies while the hold separate condition continues to exist);
- has caused, and could cause further, difficulties in retaining key employees and delays or uncertainties in making decisions about the combined business;
- has resulted in, and could result in additional, significant costs (including higher capital expenditures relative to our competitors as a result of maintaining separate functions in several areas); and
- has required, and could require additional, changes in business practices.

In March 2014, we submitted an application to MOFCOM requesting that the regulatory restrictions be lifted. However, we cannot predict whether or when these restrictions will be wholly or partially lifted or whether we will be able to realize the anticipated benefits of our acquisition of HGST even if the restrictions are wholly or partially lifted. Adverse global economic conditions and credit market uncertainty could harm our business, results of operations and financial condition.

Adverse global economic conditions and uncertain conditions in the credit market have had, and in the future could have, a significant adverse effect on our company and on the storage industry as a whole. Several factors contribute to

these conditions and this uncertainty, including, but not limited to, volatility in the financial and real estate markets, cost increases and other macroeconomic factors. Some of the risks and uncertainties we face as a result of these conditions include the following:

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Volatile Demand. Our direct and indirect customers may delay or reduce their purchases of our products and systems containing our products. In addition, many of our customers rely on credit financing to purchase our products. If negative conditions in the global credit markets prevent our customers' access to credit, product orders may decrease, which could result in lower revenue. Likewise, if our suppliers, sub-suppliers and sub-contractors (collectively referred to as "suppliers") face challenges in obtaining credit, in selling their products or otherwise in operating their businesses, they may be unable to offer the materials we use to manufacture our products. These actions could result in reductions in our revenue and increased operating costs, which could adversely affect our business, results of operations and financial condition.

Restructuring Activities. If demand for our products slows as a result of a deterioration in economic conditions, we may undertake restructuring activities to realign our cost structure with softening demand. The occurrence of restructuring activities could result in impairment charges and other expenses, which could adversely impact our results of operations or financial condition.

Credit Volatility and Loss of Receivables. We extend credit and payment terms to some of our customers. In addition to ongoing credit evaluations of our customers' financial condition, we traditionally seek to mitigate our credit risk by purchasing credit insurance on certain of our accounts receivable balances. As a result of the continued uncertainty and volatility in global economic conditions, however, we may find it increasingly difficult to be able to insure these accounts receivable. We could suffer significant losses if a customer whose accounts receivable we have not insured, or have underinsured, fails and is unable to pay us. Additionally, negative or uncertain global economic conditions increase the risk that if a customer whose accounts receivable we have insured fails, the financial condition of the insurance carrier for such customer account may have also deteriorated such that it cannot cover our loss. A significant loss of an accounts receivable that we cannot recover through credit insurance would have a negative impact on our financial results.

Impairment Charges. Negative or uncertain global economic conditions could result in circumstances, such as a sustained decline in our stock price and market capitalization or a decrease in our forecasted cash flows such that they are insufficient, indicating that the carrying value of our long-lived assets or goodwill may be impaired. If we are required to record a significant charge to earnings in our consolidated financial statements because an impairment of our long-lived assets or goodwill is determined, our results of operations will be adversely affected.

We participate in a highly competitive industry that is subject to the risk of declining ASPs, volatile gross margins and significant shifts in market share, all of which could adversely affect our operating results.

Demand for our devices, software and solutions that we offer to our customers, which we refer to in this Item 1A. as our "products", depends in large part on the demand for systems manufactured by our customers and on storage upgrades to existing systems. The demand for systems has been volatile in the past and often has had an exaggerated effect on the demand for our products in any given period. As a result, the storage market has experienced periods of excess capacity, which can lead to liquidation of excess inventories and more intense price competition. If more intense price competition occurs, we may be forced to lower prices sooner and more than expected, which could adversely impact revenue and gross margins. In addition, we compete based on our ability to offer our customers competitive solutions that provide the most current and desired product and service features. We expect that competition will continue to be intense, and there is a risk that our competitors' products may be less costly, provide better performance or include additional features when compared to our products. Our ASPs and gross margins also tend to decline when there is a shift in the mix of product sales, and sales of lower priced products increase relative to those of higher priced products. In addition, rapid technological changes often reduce the volume and profitability of sales of existing products and increase the risk of inventory obsolescence. These factors, along with others, may result in significant shifts in market share among the industry's major participants, including a substantial decrease in our market share.

Our failure to accurately forecast market and customer demand for our products, or to quickly adjust to forecast changes, could adversely affect our business and financial results or operating efficiencies.

The data storage industry faces difficulties in accurately forecasting market and customer demand for its products. The variety and volume of products we manufacture is based in part on these forecasts. Accurately forecasting demand has become increasingly difficult for us, our customers and our suppliers in light of the volatility in global economic conditions and industry consolidation, resulting in less availability of historical market data for certain product segments. In addition, because our products are designed to be largely interchangeable with competitors' products, our demand forecasts may be impacted significantly by the strategic actions of our competitors. As forecasting demand becomes more difficult, the risk that our forecasts are not in line with demand increases. If our forecasts exceed actual market demand, then we could experience periods of product

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oversupply and price decreases, which could impact our financial performance. If market demand increases significantly beyond our forecasts or beyond our ability to add manufacturing capacity, then we may not be able to satisfy customer product needs, possibly resulting in a loss of market share if our competitors are able to meet customer demands.

We experience significant sales seasonality and cyclical, which could cause our operating results to fluctuate. Sales of computer systems, storage subsystems, gaming consoles and CE tend to be seasonal and cyclical, and therefore we expect to continue to experience seasonality and cyclical in our business as we respond to variations in our customers' demand for our products. However, changes in seasonal and cyclical patterns have made it, and could continue to make it, more difficult for us to forecast demand, especially as a result of the current macroeconomic environment. Changes in the product or channel mix of our business can also impact seasonal and cyclical patterns, adding complexity in forecasting demand. Seasonality and cyclical also may lead to higher volatility in our stock price. It is difficult for us to evaluate the degree to which seasonality and cyclical may affect our stock price or business in future periods because of the rate and unpredictability of product transitions and new product introductions and macroeconomic conditions.

Our sales to the CE, cloud computing, network attached storage (NAS), surveillance and enterprise markets, representing an increasing percentage of our overall revenue, may grow at a slower rate than current estimates, which could materially adversely impact our operating results.

The secular growth of digital data is resulting in a more diversified mix of revenue from the CE, cloud computing, NAS, surveillance and enterprise markets. As sales into these markets become a more significant portion of our revenue, events or circumstances that adversely impact demand in these markets, or our inability to address that demand successfully, could materially adversely impact our operating results. For example, demand in, or our sales to, these markets may be adversely affected by the following:

- **Mobile Devices.** There has been and continues to be a rapid growth in devices that do not contain a hard drive such as tablet computers and smart phones. As tablet computers and smart phones provide many of the same capabilities as PCs, they have displaced or materially affected, and may continue to displace or materially affect, the demand for PCs. If we are not successful in adapting our product offerings to include disk drives or alternative storage solutions that address these devices, demand for our products in these markets may decrease and our financial results could be materially adversely affected.

- **Cloud Computing.** Consumers traditionally have stored their data on their PC, often supplemented with personal external storage devices. Most businesses also include similar local storage as a primary or secondary storage location. This storage is typically provided by hard disk drives. Over the last few years, cloud computing has emerged whereby applications and data are hosted, accessed and processed through a third-party provider over a broadband Internet connection, potentially reducing or eliminating the need for, among other things, significant storage inside the accessing computer. If we are not successful in manufacturing compelling products to address the cloud computing opportunity, demand for our products in these markets may decrease and our financial results could be materially adversely affected.

- **Obsolete Inventory.** In some cases, products we manufacture for these other markets are uniquely configured for a single customer's application, creating a risk of obsolete inventory if anticipated demand is not actually realized.

- **Macroeconomic Conditions.** Consumer spending has been, and may continue to be, adversely affected in many regions due to negative macroeconomic conditions and high unemployment levels. Please see the risk factor entitled "Adverse global economic conditions and credit market uncertainty could harm our business, results of operations and financial condition." for more risks and uncertainties relating to macroeconomic conditions.

In addition, demand in these other markets also could be negatively impacted by developments in the regulation and enforcement of digital rights management and the emergence of new technologies, such as data deduplication,

compression and storage virtualization. If we are not able to respond appropriately, these factors could lead to our customers' storage needs being satisfied at lower prices with lower capacity hard drives or solid-state storage products, thereby decreasing our revenue or putting us at a disadvantage to competing storage technologies. As a result, even with increasing aggregate demand for digital storage, if we fail to anticipate or timely respond to these developments in the demand for storage, our ASPs could decline, which could adversely affect our operating results. Furthermore, our ability to accurately read and respond to market trends, such as trends relating to the Internet or big data, could harm our results.

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If we fail to respond to changes in the client compute market (the “PC market”), our operating results could suffer. While sales to the other markets are becoming a more significant source of revenue, sales to the PC market remain an important part of our business. The PC market, however, has been, and may continue to be, adversely affected by the growth of tablet computers, smart phones and similar devices that perform many of the same capabilities as PCs, the lengthening of product life cycles and macroeconomic conditions. If we fail to respond to changes in the PC market, our operating results could suffer. Additionally, if demand in the PC market is worse than expected as a result of these or other conditions, demand for our products in the PC market may decrease at a faster rate and our operating results may be adversely affected.

Selling to the retail market is an important part of our business, and if we fail to maintain and grow our market share or gain market acceptance of our branded products, our operating results could suffer.

Selling branded products is an important part of our business, and as our branded products revenue increases as a portion of our overall revenue, our success in the retail market becomes increasingly important to our operating results. Our success in the retail market depends in large part on our ability to maintain our brand image and corporate reputation and to expand into and gain market acceptance of our products in multiple channels, including traditional retail, e-commerce and online channels. Adverse publicity, whether or not justified, or allegations of product or service quality issues, even if false or unfounded, could tarnish our reputation and cause our customers to choose products offered by our competitors. In addition, the proliferation of new methods of mass communication facilitated by the Internet makes it easier for false or unfounded allegations to adversely affect our brand image and reputation. If customers no longer maintain a preference for WD[®], HGST[™] or G-Technology[™] brand products, our operating results may be adversely affected.

Sales in the distribution channel are important to our business, and if we fail to respond to demand changes in distribution markets or if distribution markets for our products weaken, our operating results could suffer.

Our distribution customers typically sell to small computer manufacturers, dealers, systems integrators and other resellers. We face significant competition in this channel as a result of limited product qualification programs and a significant focus on price and availability of product. In addition, the PC market is experiencing a shift to notebook and other mobile devices and, as a result, more computing devices are being delivered to the market as complete systems, which could weaken the distribution market. If we fail to respond to changes in demand in the distribution market, our operating results could suffer. Additionally, if the distribution market weakens as a result of a slowing PC growth rate, technology transitions or a significant change in consumer buying preference, or if we experience significant price declines due to demand changes in the distribution channel, then our operating results would be adversely affected.

Loss of market share with or by a key customer, or consolidation among our customer base, could harm our operating results.

During the quarter ended October 3, 2014, 45% of our revenue came from sales to our top 10 customers. These customers have a variety of suppliers to choose from and therefore can make substantial demands on us, including demands on product pricing and on contractual terms, often resulting in the allocation of risk to us as the supplier. Our ability to maintain strong relationships with our principal customers is essential to our future performance. If we lose a key customer, if any of our key customers reduce their orders of our products or require us to reduce our prices before we are able to reduce costs, if a customer is acquired by one of our competitors or if a key customer suffers financial hardship, our operating results would likely be harmed.

Additionally, if there is consolidation among our customer base, our customers may be able to command increased leverage in negotiating prices and other terms of sale, which could adversely affect our profitability. In addition, if, as a result of increased leverage, customer pressures require us to reduce our pricing such that our gross margins are diminished, we could decide not to sell our products to a particular customer, which could result in a decrease in our revenue. Consolidation among our customer base may also lead to reduced demand for our products, replacement of our products by the combined entity with those of our competitors and cancellations of orders, each of which could harm our operating results.

Also, the storage ecosystem is constantly evolving, and our traditional customer base is changing. Fewer companies now hold greater market share for certain applications and services, such as social media, shopping and streaming media. As a result, the competitive landscape is changing, giving these companies increased leverage in negotiating prices and other terms of sale, which could adversely affect our profitability. In addition, the changes in our evolving customer base create new selling and distribution patterns to which we must adapt. To remain competitive, we must respond to these changes by ensuring we have proper scale in this evolving market, as well as offer products that meet the technological requirements of this customer base at competitive pricing points. To the extent we are not successful in adequately responding to these changes, our operating results could be harmed.

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Expansion into new markets may increase the complexity of our business, cause us to increase our research and development expenses to develop new products and technologies or cause our capital expenditures to increase, and if we are unable to successfully adapt our business processes and product offerings as required by these new markets, our ability to grow will be adversely affected.

To remain a significant supplier in the storage industry and to expand into new markets, we will need to offer a broad range of storage products to our customers. We currently offer a variety of 3.5-inch and 2.5-inch hard drives, solid state drives and other products for the PC and other storage markets. As we expand our product line to sell into new markets, the overall complexity of our business increases at an accelerated rate and we become subject to different market dynamics. These dynamics may include, among other things, different demand volume, seasonality, product requirements, sales channels, and warranty and return policies. In addition, expansion into other markets may result in increases in research and development expenses and substantial investments in manufacturing capability or technology enhancements. If we fail to successfully expand into new markets with products that we do not currently offer, we may lose business to our competitors or new entrants who offer these products.

Our vertical integration of head and magnetic media manufacturing makes us dependent on our ability to timely and cost-effectively develop heads and magnetic media with leading technology and overall quality, increasing capital expenditure costs and asset utilization risks for our business.

We develop and manufacture a substantial portion of the heads and magnetic media used in the hard drive products we produce. Consequently, we are more dependent upon our own development and execution efforts and less able to take advantage of head and magnetic media technologies developed by other manufacturers. Technology transition for head and magnetic media designs is critical to increasing our volume production of heads and magnetic media. There can be no assurance, however, that we will be successful in timely and cost-effectively developing and manufacturing heads or magnetic media for products using future technologies. We also may not effectively transition our head or magnetic media design and technology to achieve acceptable manufacturing yields using the technologies necessary to satisfy our customers' product needs, or we may encounter quality problems with the heads or magnetic media we manufacture. If we are unable to timely and cost-effectively develop heads and magnetic media with leading technology and overall quality, our ability to sell our products may be significantly diminished, which could materially and adversely affect our business and financial results.

In addition, as a result of our vertical integration of head and magnetic media manufacturing, we make more capital investments and carry a higher percentage of fixed costs than we would if we were not vertically integrated. If our overall level of production decreases for any reason, and we are unable to reduce our fixed costs to match sales, our head or magnetic media manufacturing assets may face underutilization that may impact our operating results. We are therefore subject to additional risks related to overall asset utilization, including the need to operate at high levels of utilization to drive competitive costs and the need for assured supply of components that we do not manufacture ourselves. In addition, as a result of adverse labor rates or availability, we may be required to increase investments in automation, which may cause our capital expenditures to increase. If we do not adequately address the challenges related to our head or magnetic media manufacturing operations, our ongoing operations could be disrupted, resulting in a decrease in our revenue or profit margins and negatively impacting our operating results.

We make significant investments in research and development to improve our technology and develop new technologies, and unsuccessful investments could materially adversely affect our business, financial condition and results of operations.

As a leading supplier of hard drives and a major supplier of enterprise solid state drives, we make significant investments to maintain our existing products and to lead innovation and development of new technologies. This strategy requires us to make significant investments in research and development and, in order to remain competitive, we may increase our capital expenditures and expenses above our historical run-rate model. There can be no assurance that these investments will result in viable technologies or products, or if these investments do result in viable technologies or products, that they will be profitable or accepted by the market. Significant investments in unsuccessful research and development efforts could materially adversely affect our business, financial condition and results of operations. In addition, increased investments in technology could cause our cost structure to fall out of alignment with demand for our products, which would have a negative impact on our financial results.

Current or future competitors may gain a technology advantage or develop an advantageous cost structure that we cannot match.

It may be possible for our current or future competitors to gain an advantage in product technology, manufacturing technology, or process technology, which may allow them to offer products or services that have a significant advantage over the products and services that we offer. Advantages could be in capacity, performance, reliability, serviceability, or other attributes. A competitive cost structure for our products, including critical components, labor and overhead, is also critical to the success of our

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business. We may be at a competitive disadvantage to any companies that are able to gain a technological or cost structure advantage.

Consolidation within the data storage industry could provide competitive advantages to our competitors.

The data storage industry as a whole has experienced consolidation over the past several years through acquisitions, consolidations and decisions by industry players to exit the industry. Consolidation across the industry, including by our competitors, may enhance their capacity, abilities and resources and lower their cost structure, causing us to be at a competitive disadvantage.

Some of our competitors with diversified business units outside of storage products, may over extended periods of time, sell storage products at prices that we cannot profitably match.

Some of our competitors earn a significant portion of their revenue from business units outside of storage products.

Because they do not depend solely on sales of storage products to achieve profitability, they may sell storage products at lower prices and operate their storage business unit at a loss over an extended period of time while still remaining profitable overall. In addition, if these competitors can increase sales of non-storage products to the same customers, they may benefit from selling their storage products at lower prices. Our operating results may be adversely affected if we cannot successfully compete with the pricing by these companies.

If we fail to qualify our products with our customers, it may have a significant adverse impact on our sales and margins.

We regularly engage in new product qualification with our customers. Once a product is accepted for qualification testing, failures or delays in the qualification process can result in delayed or reduced product sales, reduced product margins caused by having to continue to offer a more costly current generation product, or lost sales to that customer until the next generation of products is introduced. The effect of missing a product qualification opportunity is magnified by the limited number of high volume OEMs, which continue to consolidate their share of the storage markets. Likewise, if product life cycles lengthen, we may have a significantly longer period to wait before we have an opportunity to qualify a new product with a customer, which could reduce our profits because we expect declining gross margins on our current generation products as a result of competitive pressures.

We are subject to risks related to product defects or the unintended use of our products, which could result in product recalls or epidemic failures and could subject us to warranty claims in excess of our warranty provisions or which are greater than anticipated.

We warrant the majority of our products for periods of one to five years. We test our products in our manufacturing facilities through a variety of means. However, there can be no assurance that our testing will reveal defects in our products, which may not become apparent until after the products have been sold into the market. In addition, our products may be used in a manner that is not intended or anticipated by us, resulting in potential liability.

Accordingly, there is a risk that product defects will occur, which could require a product recall. Product recalls can be expensive to implement and, if a product recall occurs during the product's warranty period, we may be required to replace the defective product. Moreover, there is a risk that product defects may trigger an epidemic failure clause in a customer agreement. If an epidemic failure occurs, we may be required to replace or refund the value of the defective product and to cover certain other costs associated with the consequences of the epidemic failure. In addition, a product recall or epidemic failure may damage our reputation or customer relationships, and may cause us to lose market share with our customers, including our OEM and original design manufacturers ("ODM") customers.

Our standard warranties contain limits on damages and exclusions of liability for consequential damages and for misuse, improper installation, alteration, accident or mishandling while in the possession of someone other than us.

We record an accrual for estimated warranty costs at the time revenue is recognized. We may incur additional expenses if our warranty provision do not reflect the actual cost of resolving issues related to defects in our products, whether as a result of a product recall, epidemic failure or otherwise. If these additional expenses are significant, it could adversely affect our business, financial condition and operating results.

In addition, third-party components or applications that we incorporate or use in our products may contain defects in design or manufacturing that could unexpectedly result in epidemic failures and subject us to liability.

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Because we are dependent on a limited number of qualified suppliers for components, sub-assemblies, equipment, consumables, raw materials, and logistics, a supplier's inability, unwillingness, or failure to support us in a timely manner with goods or services at a quality level and cost acceptable to us can adversely affect our margins, revenues and operating results.

We depend on an external supply base for technologies, components, equipment and materials for use in our product design and manufacturing. We also depend on service suppliers for providing technical support for our products. In addition, we use logistics partners to manage our JIT (just-in-time) hubs, distribution centers and freight from suppliers to our factories and from our factories to our customers throughout the world. Many of these components and much of this equipment must be specifically designed to be compatible for use in our products or for developing and manufacturing our future products, and are only available from a limited number of suppliers, some of whom are our sole-source suppliers. We are therefore dependent on these suppliers to be able and willing to dedicate adequate engineering resources to develop components that can be successfully integrated into our products, technology and equipment that can be used to develop and manufacture our next-generation products efficiently. However, many of the risks that affect us also affect our supply base, including, but not limited to, having single site manufacturing locations based in high risk regions of the world, macro and local economic conditions, shortages of commodity materials, proper management of technology transitions, natural disasters, geo-political risks, compliance with legal requirements, financial instability and exposure to intellectual property and other litigation, including an injunction or other action that could delay shipping. If any of these risks were to affect our suppliers, we could also be adversely affected, especially in the case of products, components or services that are single-sourced. For example, if suppliers are facing increased costs due to the above risks, they may require us to enter into long-term volume agreements to shift the burden of fixed costs to us. Further, we work closely with many of our suppliers to develop new technologies and, as a result, we may become subject to litigation from our suppliers or third parties.

Without a capable and financially stable supply base that has established appropriate relationships within the supply chain and has implemented business processes, strategies and risk management safeguards, we would be unable to develop our products, manufacture them in high volumes, and distribute them to our customers to execute our business plans effectively. As PC demand slows, competition increases from NAND and other consumer devices, the total available market for hard disk drives decreases and costs increase, these suppliers may reevaluate their business models. Our suppliers may be acquired by our competitors, consolidate, or decide to exit the industry, redirect their investments and increase costs to us, each of which may have an adverse effect on our business and operations. In addition, moving to new technologies may require us to align to, and build, a new supply base, such as NAND flash. In the case of NAND suppliers, many of which are involved in developing storage products such as SSD that, in some cases, compete with our products. Our success in these new product areas may be dependent on our ability and their willingness to develop close relationships, with preferential agreements. Where this cannot be done, our business and operations may be adversely affected.

In addition to an external supply base, we also rely on an internal supply chain of heads, media and media substrate. Please see the risk factors entitled, "A fundamental change in storage technologies could result in significant increases in our costs and could put us at a competitive disadvantage" and "If we do not properly manage technology transitions, our competitiveness and operating results may be negatively affected" for a review of some of the risks related to our internal supply.

Price volatility, shortages of critical materials or components, or use by other industries of materials and components used in the storage industry, may negatively impact our operating results.

Increases in the cost for certain critical materials and components and oil may increase our costs of manufacturing and transporting our products and key components and may result in lower operating margins if we are unable to pass these increased costs on to our customers. Shortages of critical components such as DRAM and NAND flash, or materials such as glass substrates, stainless steel, aluminum, nickel, neodymium, ruthenium, platinum or cerium, may increase our costs and may result in lower operating margins if we are unable to find ways to mitigate these increased costs. We or our suppliers acquire certain precious metals and rare earth metals like ruthenium, platinum, neodymium and cerium, which are critical to the manufacture of components in our products from a number of countries,

including the People's Republic of China. The government of China or any other nation may impose regulations, quotas or embargoes upon these metals that would restrict the worldwide supply of such metals or increase their cost, both of which could negatively impact our operating results until alternative suppliers are sourced. Furthermore, if other high volume industries increase their demand for materials or components used in our products, our costs may further increase, which could have an adverse effect on our operating margins. In addition, shortages in other components and materials used in our customers' products could result in a decrease in demand for our products, which would negatively impact our operating results.

Contractual commitments with component suppliers may result in us paying increased charges and cash advances for such components or may cause us to have inadequate or excess component inventory.

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To reduce the risk of component shortages, we attempt to provide significant lead times when buying components, which may subject us to cancellation charges if we cancel orders as a result of technology transitions or changes in our component needs. In addition, we may from time to time enter into contractual commitments with component suppliers in an effort to increase and stabilize the supply of those components and enable us to purchase such components at favorable prices. Some of these commitments may require us to buy a substantial number of components from the supplier or make significant cash advances to the supplier; however, these commitments may not result in a satisfactory increase or stabilization of the supply of such components. Furthermore, as a result of uncertain global economic conditions, our ability to forecast our requirements for these components has become increasingly difficult, therefore increasing the risk that our contractual commitments may not meet our actual supply requirements, which could cause us to have inadequate or excess component inventory and adversely affect our operating results and increase our operating costs.

Changes in product life cycles could adversely affect our financial results.

If product life cycles lengthen, we may need to develop new technologies or programs to reduce our costs on any particular product to maintain competitive pricing for that product. If product life cycles shorten, it may result in an increase in our overall expenses and a decrease in our gross margins, both of which could adversely affect our operating results. In addition, shortening of product life cycles also makes it more difficult to recover the cost of product development before the product becomes obsolete. Our failure to recover the cost of product development in the future could adversely affect our operating results.

A fundamental change in storage technologies could result in significant increases in our costs and could put us at a competitive disadvantage.

Historically, when the industry experiences a fundamental change in storage technologies, any manufacturer that fails to successfully and timely adjust its designs and processes to accommodate the new technology fails to remain competitive. There are some revolutionary technologies, such as current-perpendicular-to-plane giant magnetoresistance, shingle magnetic recording, heat-assisted magnetic recording, patterned magnetic media and advanced signal processing that if implemented by a competitor on a commercially viable basis ahead of the industry, could put us at a competitive disadvantage. As a result of these technology shifts, we could incur substantial costs in developing new technologies, such as heads, magnetic media, and tools to remain competitive. If we fail to successfully implement these new technologies, or if we are significantly slower than our competitors at implementing new technologies, we may not be able to offer products with capacities that our customers desire, which could harm our operating results.

The difficulty of introducing hard drives with higher levels of areal density and the challenges of reducing other costs may impact our ability to achieve historical levels of cost reduction.

Storage capacity of the hard drive, as manufactured by us, is determined by the number of disks and each disk's areal density. Areal density is a measure of the amount of magnetic bits that can be stored on the recording surface of the disk. Generally, the higher the areal density, the more information can be stored on a single platter. Higher areal densities require existing head and magnetic media technology to be improved or new technologies developed to accommodate more data on a single disk. Historically, we have been able to achieve a large percentage of cost reduction through increases in areal density. Increases in areal density mean that the average drive we sell has fewer heads and disks for the same capacity and, therefore, may result in a lower component cost. However, increasing areal density has become more difficult in the storage industry. If we are not able to increase areal density at the same rate as our competitors or at a rate that is expected by our customers, we may be required to include more components in our drives to meet demand without corresponding incremental revenue, which could negatively impact our operating margins and make achieving historical levels of cost reduction difficult or unlikely. Additionally, increases in areal density may require us to make further capital expenditures on items such as new test equipment needed as a result of an increased number of gigabytes per platter. Our inability to achieve cost reductions could adversely affect our operating results.

If we do not properly manage technology transitions, our competitiveness and operating results may be negatively affected.

The storage markets in which we offer our products continuously undergo technology transitions which we must anticipate and adapt our products to address in a timely manner. If we fail to implement these new technologies successfully, or if we are slower than our competitors at implementing new technologies, we may not be able to competitively offer products that our customers desire, which could harm our operating results.

If we do not properly manage new product development, our competitiveness and operating results may be negatively affected.

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As advances in computer hardware and software are made, our customers have demanded a more diversified portfolio of products with new and additional features. In some cases, this demand results in investments in new products for a particular market that do not necessarily expand overall market opportunity, which may negatively affect our operating results.

In addition, the success of our new product introductions depends on a number of other factors, including

- difficulties faced in manufacturing ramp;
- implementing at an acceptable cost product features expected by our customers;
- market acceptance/qualification;
- effective management of inventory levels in line with anticipated product demand;
- quality problems or other defects in the early stages of new product introduction and problems with compatibility between our products and those of our customers that were not anticipated in the design of those products; and
- our ability to increase our software development capability.

Our business may suffer if we fail to successfully anticipate and manage issues associated with our product development.

If we fail to develop and introduce new products that are competitive against alternative storage technologies, our business may suffer.

Our success depends in part on our ability to develop and introduce new products in a timely manner in order to keep pace with technology advancements. Newer storage technologies have successfully served mobility markets for products that cannot be serviced using traditional storage technologies. Advances in semiconductor technology have resulted in other emerging technologies that can be competitive with traditional storage technologies for high performance needs in advanced digital computing markets such as enterprise servers and storage. There can be no assurance that we will be successful in anticipating and developing new products for the PC and other storage markets in response to competing storage technologies. If our hard drive and solid state products fail to offer a superior value proposition to alternative storage products, we will be at a competitive disadvantage to companies using alternative technology and our business will suffer.

Our operations, and those of certain of our suppliers and customers, are concentrated in large, purpose-built facilities, subjecting us to substantial risk of damage or loss if operations at any of these facilities are disrupted.

As a result of our cost structure and strategy of vertical integration, we conduct our operations at large, high volume, purpose-built facilities in California and throughout Asia. The facilities of many of our customers, our suppliers and our customers' suppliers are also concentrated in certain geographic locations throughout Asia and elsewhere. A localized health risk affecting our employees at these facilities or the staff of our or our customers' other suppliers, such as the spread of a pandemic influenza, could impair the total volume of our products that we are able to manufacture or sell, which would result in substantial harm to our operating results. Similarly, a fire, flood, earthquake, tsunami or other natural disaster, condition or event such as political instability, civil unrest or a power outage that adversely affects any of these facilities, including access to or from these facilities by employees or logistics operators, would significantly affect our ability to manufacture or sell our products, which would result in a substantial loss of sales and revenue and a substantial harm to our operating results. For example, prior to the 2011 flooding in Thailand, all of WD's internal slider capacity and 60% of WD's hard drive manufacturing capacity was in Thailand. As a result of the flooding in Thailand, WD's facilities were inundated and temporarily shut down. During that period, WD's ability to manufacture hard drives was significantly constrained, adversely affecting WD's business, financial condition and results of operations. A significant event that impacts any of our manufacturing sites, or the sites of our customers or suppliers, could adversely affect our ability to manufacture or sell our products, and our

business, financial condition and results of operations could suffer.

Manufacturing and marketing our products globally subjects us to numerous risks.

We are subject to risks associated with our global manufacturing operations and global marketing efforts, as well as risks associated with our utilization of and reliance on contract manufacturers, including:

- obtaining requisite governmental permits and approvals;
- currency exchange rate fluctuations or restrictions;

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- political instability and civil unrest;
- limited transportation availability, delays, and extended time required for shipping, which risks may be compounded in periods of price declines;
- higher freight rates;
- labor challenges, including difficulties finding and retaining talent or responding to labor disputes or disruptions;
- trade restrictions or higher tariffs;
- copyright levies or similar fees or taxes imposed in European and other countries;
- exchange, currency and tax controls and reallocations;
- increasing labor and overhead costs; and
- loss or non-renewal of favorable tax treatment under agreements or treaties with foreign tax authorities.

Terrorist attacks may adversely affect our business and operating results.

The continued threat of terrorist activity and other acts of war or hostility have created uncertainty in the financial and insurance markets and have significantly increased the political, economic and social instability in some of the geographic areas in which we, our suppliers or our customers operate. Additionally, it is uncertain what impact the reactions to such acts by various governmental agencies and security regulators worldwide will have on shipping costs. Acts of terrorism, either domestically or abroad, could create further uncertainties and instability. To the extent this results in disruption or delays of our manufacturing capabilities or shipments of our products, our business, operating results and financial condition could be adversely affected.

Sudden disruptions to the availability of freight lanes could have an impact on our operations.

We generally ship our products to our customers, and receive shipments from our suppliers, via air, ocean or land freight. The sudden unavailability or disruption of cargo operations or freight lanes caused by, among other things, labor difficulties or disputes, severe weather patterns or other natural disasters, or political instability or civil unrest, could impact our operating results by impairing our ability to timely and efficiently deliver our products.

If we sustain system failures, cyber attacks to our systems or to our products or other data security breaches, we could suffer a loss of revenue and increased costs, exposure to significant liability, reputational harm and other serious negative consequences.

We are heavily dependent on our technology infrastructure to, among other functions, operate our factories, provide and sell our products and services, fulfill orders, manage inventory and bill, collect and make payments and we are subject to laws, rules and regulations in the U.S. and other countries relating to the collection, use and security of user data. Our systems are vulnerable to damage or interruption from natural disasters, power loss, telecommunication failures, cyber attacks such as computer viruses, computer denial-of-service attacks and other events. Our business is also subject to break-ins, sabotage and intentional acts of vandalism by third parties as well as intentional or unintentional acts by employees. Computer programmers, hackers and others may be able to develop and deploy viruses, worms, and other malicious software programs or otherwise attack our products, to discover or exploit any security vulnerabilities or breach or compromise the security schemes of our products. In addition, sophisticated hardware and operating system software and applications that we produce or procure from third parties may contain defects in design or manufacture, including “bugs” and other problems that could unexpectedly interfere with the operation of the system.

The foregoing security problems could result in, among other consequences, loss or theft of our, our customers' or our business partners' intellectual property, proprietary business information or personally identifiable information. The costs to us to eliminate or address the foregoing security problems and security vulnerabilities before or after a cyber incident could be significant. Our remediation efforts may not be successful and could result in interruptions, delays or cessation of service and loss of existing or potential customers that may impede our sales, manufacturing, distribution, or other critical functions. We could lose existing or potential customers in connection with any actual or perceived security vulnerabilities in our products. In addition, breaches of our security measures and the unapproved dissemination of proprietary information or sensitive or confidential data or personal data or information about us, our customers or other third parties, could expose us, our customers, or other affected third parties to a risk of loss or misuse of this information, result in litigation, damage our brand and reputation, or

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otherwise harm our business, operating results and financial condition. Further, we rely on third-party data management providers whose possible security problems and security vulnerabilities may have similar effects on us. If we fail to identify, manage, complete and integrate acquisitions, investment opportunities or other significant transactions, it may adversely affect our future results.

As part of our growth strategy, we have completed, and we may continue to pursue, acquisitions of, investment opportunities in, or other significant transactions with companies that are complementary to our business. For example, we completed the acquisitions of VeloBit on July 9, 2013, sTec on September 12, 2013, and Virident on October 17, 2013. In order to pursue this part of our growth strategy successfully, we must continue to identify attractive acquisition or investment opportunities, successfully complete the transactions, some of which may be large and complex, and manage post-closing issues such as integration of the acquired company or employees. We may not be able to continue to identify or complete appealing acquisition or investment opportunities given the intense competition for these transactions. Even if we identify and complete suitable corporate transactions, we may not be able to successfully address any integration challenges in a timely manner, or at all. Failing to successfully integrate or realign our business to take advantage of efficiencies or reduce redundancies of an acquisition may result in not realizing all or any of the anticipated benefits of the acquisition. In addition, failing to achieve the financial model projections for an acquisition may result in the incurrence of impairment charges and other expenses, both of which could adversely impact our results of operations or financial condition. Furthermore, we may agree to provide continuing service obligations or enter into other agreements in order to obtain certain regulatory approvals of our corporate transactions, and failure to satisfy these additional obligations could result in our failing to obtain regulatory approvals or the imposition of additional obligations on us, any of which could adversely affect our business, financial condition and results of operations.

Please also see the risk factors above for specific risks and uncertainties regarding our acquisition of HGST.

Our strategic relationships subject us to risks that could adversely affect our business, financial condition and results of operations.

We have entered into strategic relationships with various partners to reduce the risk associated with relying on external suppliers for technologies, components, equipment and materials for use in our product design and manufacturing. (Please see the risk factor entitled “Because we are dependent on a limited number of qualified suppliers for components, sub-assemblies, equipment, consumables, raw materials, and logistics, a supplier’s inability, unwillingness, or failure to support us in a timely manner with goods or services at a quality level and cost acceptable to us can adversely affect our margins, revenues and operating results” for a further description of the risks associated with our reliance on external suppliers.) These strategic relationships are subject to various risks that could adversely affect the value of our investments and our results of operations. These risks include the following:

- our interests could diverge from our partners’ interests or we may not be able to agree with partners on ongoing activities, or on the amount, timing or nature of further investments in our partnership
- we may experience difficulties and delays in ramping production at, and transferring technology to, such partnerships;
- our control over the operations of our partnerships is limited;
- due to financial constraints, our partners may be unable to meet their commitments to us or may pose credit risks for our transactions with them;
- due to differing business models or long-term business goals, our partners may decide not to join us in funding capital investment by our partnerships, which may result in higher levels of cash expenditures by us;
- we may experience difficulties or delays in collecting amounts due to us from our partners;

- the terms of our partnering arrangements may turn out to be unfavorable; and
- changes in tax, legal or regulatory requirements may necessitate changes in the agreements with our partners.

If our strategic relationships are unsuccessful, our business, results of operations or financial condition may be adversely affected.

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The loss of our key executive management, staff and skilled employees, the inability to hire and integrate new employees or decisions to realign our business could negatively impact our business prospects.

Our success depends upon the continued contributions of our key management, staff and skilled employees, many of whom would be extremely difficult to replace. Global competition for skilled employees in the data storage industry is intense and, as we attempt to move to a position of technology leadership in the storage industry, our business success becomes increasingly dependent on our ability to retain our key staff and skilled employees, to attract, integrate and retain new skilled employees and to make decisions to realign our business to take advantage of efficiencies or reduce redundancies. Volatility or lack of positive performance in our stock price and the overall markets may adversely affect our ability to retain key staff or skilled employees who have received equity compensation. Additionally, because a substantial portion of our key employees' compensation is placed "at risk" and linked to the performance of our business, when our operating results are negatively impacted, we are at a competitive disadvantage for retaining and hiring key management, staff and skilled employees versus other companies that pay a relatively higher fixed salary. If we lose our existing key management, staff or skilled employees, or are unable to hire and integrate new key management, staff or skilled employees, or if we fail to implement succession plans for our key management or staff, our operating results would likely be harmed. Furthermore, if we do not realize the anticipated benefits of our intended realignment after we make decisions regarding our personnel and implement our realignment plans, our operating results could be adversely affected.

The nature of our industry and its reliance on intellectual property and other proprietary information subjects us and our suppliers and customers to the risk of significant litigation.

The data storage industry has been characterized by significant litigation. This includes litigation relating to patent and other intellectual property rights, product liability claims and other types of litigation. Litigation can be expensive, lengthy and disruptive to normal business operations. Moreover, the results of litigation are inherently uncertain and may result in adverse rulings or decisions. We may enter into settlements or be subject to judgments that may, individually or in the aggregate, have a material adverse effect on our business, financial condition or operating results. As disclosed in Part I, Item 1, Note 5 in the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q, in relation to our litigation matter with Seagate, on October 8, 2014, the Minnesota Supreme Court affirmed the decision of the Minnesota Court of Appeals, and as a result on October 14, 2014, we paid Seagate \$773.4 million to satisfy the full amount of the final arbitration award plus interest accrued through October 13, 2014.

We evaluate notices of alleged patent infringement and notices of patents from patent holders that we receive from time to time. If claims or actions are asserted against us, we may be required to obtain a license or cross-license, modify our existing technology or design a new non-infringing technology. Such licenses or design modifications can be extremely costly. In addition, we may decide to settle a claim or action against us, which settlement could be costly. We may also be liable for any past infringement. If there is an adverse ruling against us in an infringement lawsuit, an injunction could be issued barring production or sale of any infringing product. It could also result in a damage award equal to a reasonable royalty or lost profits or, if there is a finding of willful infringement, treble damages. Any of these results would increase our costs and harm our operating results. In addition, our suppliers and customers are subject to similar risks of litigation, and a material, adverse ruling against a supplier or customer could negatively impact our business.

Our reliance on intellectual property and other proprietary information subjects us to the risk that these key ingredients of our business could be copied by competitors.

Our success depends, in significant part, on the proprietary nature of our technology, including non-patentable intellectual property such as our process technology. If a competitor is able to reproduce or otherwise capitalize on our technology despite the safeguards we have in place, it may be difficult, expensive or impossible for us to obtain necessary legal protection. Also, the laws of some foreign countries may not protect our intellectual property to the same extent as do U.S. laws. In addition to patent protection of intellectual property rights, we consider elements of our product designs and processes to be proprietary and confidential. We rely upon employee, consultant and vendor non-disclosure agreements and contractual provisions and a system of internal safeguards to protect our proprietary

information. However, any of our registered or unregistered intellectual property rights may be challenged or exploited by others in the industry, which could harm our operating results.

The costs of compliance with state, federal and international legal and regulatory requirements, such as environmental, labor, trade, health, safety, anti-corruption and tax regulations, customers' standards of corporate citizenship, and industry and coalition standards, such as those established by the Electronics Industry Citizenship Coalition, could cause an increase in our operating costs.

We are subject to, and may become subject to additional, state, federal and international laws and regulations governing our environmental, labor, trade, health, safety, anti-corruption and tax practices. These laws and regulations, particularly those

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applicable to our international operations, are or may be complex, extensive and subject to change. We will need to ensure that we and our suppliers and partners timely comply with such laws and regulations, which may result in an increase in our operating costs. Legislation has been, and may in the future be, enacted in locations where we manufacture or sell our products. In addition, climate change and financial reform legislation is a significant topic of discussion and has generated and may continue to generate federal, international or other regulatory responses in the near future. If we or our suppliers or partners fail to timely comply with applicable legislation, our customers may refuse to purchase our products or we may face increased operating costs as a result of taxes, fines or penalties, or legal liability and reputational damage, which would have a materially adverse effect on our business, financial condition and operating results.

In connection with our compliance with environmental laws and regulations, as well as our compliance with industry environmental initiatives, the standards of business conduct required by some of our customers, and our commitment to sound corporate citizenship in all aspects of our business, we could incur substantial compliance and operating costs and be subject to disruptions to our operations and logistics. In addition, if we were found to be in violation of these laws or noncompliant with these initiatives or standards of conduct, we could be subject to governmental fines, liability to our customers and damage to our reputation and corporate brand which could cause our financial condition or operating results to suffer.

Conflict minerals regulations may cause us to incur additional expenses and could limit the supply and increase the cost of certain components and metals contained in our products.

In August 2012, the SEC adopted new rules establishing diligence and disclosure requirements regarding the use and source of gold, tantalum, tin and tungsten, commonly referred to as 3TG or conflict minerals, that are necessary to the functionality or production of products manufactured or contracted to be manufactured by public companies. These rules require us to determine and report annually whether such 3TG originated from the Democratic Republic of the Congo or an adjoining country, the first such report was due on June 2, 2014. These rules could affect our ability to source components that contain 3TG, or 3TG generally, at acceptable prices and could impact the availability of such components or 3TG, since there may be only a limited number of suppliers of “conflict free” 3TG. Our customers, including our OEM customers, may require that our products contain only conflict free 3TG, and our revenues and margins may be harmed if we are unable to meet this requirement at a reasonable price, or at all, or are unable to pass through any increased costs associated with meeting this requirement. Additionally, we may suffer reputational harm with our customers and other stakeholders if our products are not conflict free or if we are unable to sufficiently verify the origins of the 3TG contained in our products through the due diligence procedures that we implement. We could incur significant costs to the extent that we are required to make changes to products, processes, or sources of supply due to the foregoing requirements or pressures. To the extent that proposed conflict minerals legislation is adopted by the European Commission or Canada, these risks could increase.

Violation of applicable laws, including labor or environmental laws, and certain other practices by our suppliers or customers could harm our business.

We expect our suppliers and customers to operate in compliance with applicable laws and regulations, including labor and environmental laws, and to otherwise meet our required standards of conduct. While our internal operating guidelines promote ethical business practices, we do not control our suppliers or customers or their labor or environmental practices. The violation of labor, environmental or other laws by any of our suppliers or customers, or divergence of a supplier’s or customer’s business practices from those generally accepted as ethical, could harm our business by:

- interrupting or otherwise disrupting the shipment of our product components;
- damaging our reputation;
- forcing us to find alternate component sources;
- reducing demand for our products (for example, through a consumer boycott); or

- exposing us to potential liability for our suppliers' or customers' wrongdoings.

Any decisions to reduce or discontinue paying cash dividends to our shareholders or repurchase shares of our common stock pursuant to our previously announced stock repurchase program could cause the market price for our common stock to decline.

Our payment of quarterly cash dividends and repurchase shares of our common stock pursuant to our stock purchase program will be subject to, among other things, our financial position and results of operations, available cash and cash flow, capital requirements, and other factors. Any reduction or discontinuance by us of the payment of quarterly cash dividends or

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repurchases of our common stock pursuant to our stock repurchase program could cause the market price of our common stock to decline. Moreover, in the event our payment of quarterly cash dividends or repurchases of shares of our common stock are reduced or discontinued, our failure or inability to resume paying cash dividends or repurchasing shares of our common stock at historical levels could result in a lower market valuation of our common stock.

Fluctuations in currency exchange rates as a result of our international operations may negatively affect our operating results.

Because we manufacture and sell our products abroad, our revenue, margins, operating costs and cash flows are impacted by fluctuations in foreign currency exchange rates. If the U.S. dollar exhibits sustained weakness against most foreign currencies, the U.S. dollar equivalents of unhedged manufacturing costs could increase because a significant portion of our production costs are foreign-currency denominated. Conversely, there would not be an offsetting impact to revenues since revenues are substantially U.S. dollar denominated. Additionally, we negotiate and procure some of our component requirements in U.S. dollars from non-U.S. based vendors. If the U.S. dollar weakens against other foreign currencies, some of our component suppliers may increase the price they charge for their components in order to maintain an equivalent profit margin. If this occurs, it would have a negative impact on our operating results.

Prices for our products are substantially U.S. dollar denominated even when sold to customers that are located outside the United States. Therefore, as a substantial portion of our sales are from countries outside the United States, fluctuations in currency exchanges rates, most notably the strengthening of the U.S. dollar against other foreign currencies, contribute to variations in sales of products in impacted jurisdictions and could adversely impact demand and revenue growth. In addition, currency variations can adversely affect margins on sales of our products in countries outside the United States.

We have attempted to manage the impact of foreign currency exchange rate changes by, among other things, entering into short-term, foreign exchange contracts. However, these contracts do not cover our full exposure and can be canceled by the counterparty if currency controls are put in place.

Increases in our customers' credit risk could result in credit losses and term extensions under existing contracts with customers with credit losses could result in an increase in our operating costs.

Some of our OEM customers have adopted a subcontractor model that requires us to contract directly with companies, such as ODMs, that provide manufacturing and fulfillment services to our OEM customers. Because these subcontractors are generally not as well capitalized as our direct OEM customers, this subcontractor model exposes us to increased credit risks. Our agreements with our OEM customers may not permit us to increase our product prices to alleviate this increased credit risk. Additionally, as we attempt to expand our OEM and distribution channel sales into emerging economies such as Brazil, Russia, India and China, the customers with the most success in these regions may have relatively short operating histories, making it more difficult for us to accurately assess the associated credit risks. Our acquisition of HGST has also resulted in an increase to our customer credit risk given that we service many of the same customers. Any credit losses we may suffer as a result of these increased risks, or as a result of credit losses from any significant customer, especially in situations where there are term extensions under existing contracts with such customers, would increase our operating costs, which may negatively impact our operating results.

Our operating results fluctuate, sometimes significantly, from period to period due to many factors, which may result in a significant decline in our stock price.

Our quarterly operating results may be subject to significant fluctuations as a result of a number of other factors including:

- the timing of orders from and shipment of products to major customers;
- our product mix;
- changes in the prices of our products;
- manufacturing delays or interruptions;

- acceptance by customers of competing products in lieu of our products;
- variations in the cost of and lead times for components for our products;
- limited availability of components that we obtain from a single or a limited number of suppliers;

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- seasonal and other fluctuations in demand for systems that use storage devices often due to technological advances; and
- availability and rates of transportation.

We often ship a high percentage of our total quarterly sales in the third month of the quarter, which makes it difficult for us to forecast our financial results before the end of the quarter. As a result of the above or other factors, our forecast of operating results for the quarter may differ materially from our actual financial results. If our results of operations fail to meet the expectations of analysts or investors, it could cause an immediate and significant decline in our stock price.

We have made and continue to make a number of estimates and assumptions relating to our consolidated financial reporting, and actual results may differ significantly from our estimates and assumptions.

We have made and continue to make a number of estimates and assumptions relating to our consolidated financial reporting. The highly technical nature of our products and the rapidly changing market conditions with which we deal means that actual results may differ significantly from our estimates and assumptions. These changes have impacted our financial results in the past and may continue to do so in the future. Key estimates and assumptions for us include:

- price protection adjustments and other sales promotions and allowances on products sold to retailers, resellers and distributors;
- inventory adjustments for write-down of inventories to lower of cost or market value (net realizable value);
- testing of goodwill and other long-lived assets for impairment;
- reserves for doubtful accounts;
- accruals for product returns;
- accruals for warranty costs related to product defects;
- accruals for litigation and other contingencies;
- liabilities for unrecognized tax benefits; and
- expensing of stock-based compensation.

The market price of our common stock is volatile.

The market price of our common stock has been, and may continue to be, volatile. Factors that may significantly affect the market price of our common stock include the following:

- actual or anticipated fluctuations in our operating results, including those resulting from the seasonality of our business;
- announcements of technological innovations by us or our competitors, which m