

— MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the NetApp second quarter fiscal year 2011 earnings conference call. My name is Katy and I will be your coordinator for today. [Operator Instructions].

I would like to now hand the call over to Ms. Tara Dhillon. Ms. Dhillon, over to you please.

Tara Dhillon, Senior Director, Investor Relations

Thank you. Before we begin, I would like to acknowledge that at approximately 3:00 PM Eastern Time today it appears that someone improperly accessed a restricted website, a link to our financial tables without the accompanying press release and supplemental commentary was then disseminated by someone approximately one hour prior to the planned release. We are investigating how it happened and we will do our best to ensure that it does not happen again. With that, let me begin our prepared remarks.

Good afternoon everyone. Thank you for joining us. With me on today's call are our CEO, Tom Georgens; and our CFO, Steve Gomo. This call is being webcast live and will be available for replay on our website at NetApp.com, along with the earnings release, the supplemental commentary, our financial tables, and the Non-GAAP to GAAP reconciliation. Concurrent with today's press release, the supplemental commentary we published contains many of the metrics and analysis we've previously provided during our live call in order to provide additional time for review of the data prior to the call and allow us to focus on more strategic commentary and perspective from our CEO and CFO.

As a reminder, during today's call we will make forward-looking-statements and projections, including our financial outlook for Q3, our expectations regarding our future market share and our expectations regarding the benefits of our new product introductions, all of which involve risk and uncertainty. Actual results may differ materially from our statements or projections.

Factors that could cause actual results to differ from our projections are detailed in our accompanying press release which we have filed on Form 8-K with the SEC as well as our 10-K and 10-Q reports also on file with SEC and available on our website all of which are incorporated by reference into today's discussion. These factors include among others, customer demand for our products and services including our recently announced new product introductions, our ability to compete effectively and general economic and market conditions.

All numbers mentioned today are GAAP unless stated otherwise. To see the reconciling items between non-GAAP and GAAP, please refer to the table in our press release, on our supplemental commentary and on our website.

I'll now turn the call over to Steve for his thoughts. Steve?

Steve Gomo, Executive Vice President and Chief Financial Officer

Thanks, Tara. Good afternoon, everyone.

The Net App team delivered another quarter of outstanding financial performance in Q2. By offering customers a more flexible and efficient alternative to traditional storage, NetApp grew total revenue by 33% and product revenue by 49% year-over-year.

Our total gross margins are near their high-water mark and Non-GAAP operating margins were their highest in over a decade at 19.8%. Non-GAAP net income jumped 56% over Q2 last year. Our cash balance increased over \$460 million sequentially to \$4.4 billion with free-cash-flow contributing \$321 million.

Non-GAAP product gross margins were also at near record high levels this quarter improving by 4.5 percentage points from Q1 levels. Several favorable forces drove this improvement. First, a timing gap between some material cost reductions and the associated price reductions added about two percentage points to the sequential product margin increase. Second, the mix of richly configured systems was high, contributing about 1 percentage point to the sequential product margin increase. Finally, volume and all other factors drove the remaining improvement during the quarter.

Non-GAAP operating expenses increased 10% sequentially from Q1. The primary drivers of this increase were the full quarter impact of the net 640 people we added in the first quarter, annual merit increases which went into effect in August, and higher than expected variable and incentive compensation, associated with our strong financial performance. We added 370 new people in Q2 and expect to continue hiring primarily sales and engineering resources at similar levels next quarter.

As I mentioned earlier, our cash balance increased by over \$460 million in Q2. Some of the big contributors to our cash balance increase were our high level of net profit, an increase in deferred revenue, and a high level of stock option exercises which added about \$96 million of U.S. cash to the balance sheet. Free cash flow was \$321 million in Q2 or a very strong 27% of revenue, well above our annual target of 17 to 22%.

Before turning to our projections for Q3, there's an important phenomena I would like to point out to you about our share count this quarter. As you know, NetApp issued convertible notes in June of 2008 at a conversion price of \$31.85 when our stock price was \$23.59. At the time of the issue, we also purchased note hedges and sold warrants with the goal of reducing future economic dilution associated with the conversion of the notes.

While the notes are outstanding, our dilutive share count will be increased to extent the average closing price of our stock for any quarter is above \$31.85. Since our stock's average closing price in Q2 was \$46.28, there are approximately 12.4 million additional shares reflected in the dilutive share count to account for the impact of the notes. That number was approximately 6.4 million shares in Q1 because our average closing price was \$37.99.

Now, here's the key point. Because the note hedges which were purchased to offset dilution are considered anti-dilutive under GAAP accounting rules, they cannot be commensurately reflected in the dilutive share count. That said, we effectively lost 20% of these hedges after Lehman Brothers filed bankruptcy.

Therefore, if the notes are ultimately converted, the overall impact of the hedge transaction would be to cover 80% of the shares the company must deliver to the note holders. This equates to what would be an offset of approximately 10 million of the 12.4 million shares in Q2.

Finally, the warrants we sold will also impact the dilutive share count to the extent the average price of our stock for any quarter is above their strike price of \$41.28. With the \$46.28 average closing price of our stock in Q2, there are roughly 4.3 million shares reflected in the dilutive share count to account for the impact of the warrants.

To summarize, the structure of the convertible notes creates two potentially dilutive effects, one from the notes and one from the warrants. We expect the dilutive effect from the notes will ultimately be 80% hedged, though that hedge will not be realized until the notes are converted. The

dilutive effects of the warrants is not hedged. So until the notes are converted or mature, we will have to present the impact of the notes and the warrants without the offsetting impact of the hedge in our dilutive share count whenever the average closing price of our stock is above \$31.85 in any quarter. Please keep this in mind going forward. We have included a table in our supplemental commentary which also outlines what I have just described.

Looking forward, our target revenue range for Q3 is \$1.240 billion to \$1.290 billion, which implies approximately 3 to 7% sequential growth and year-over-year growth of 23 to 28%. Non-GAAP gross margins are expected to moderate in Q3 because the biggest positive forces that drove the out-performance in Q2 will abate in Q3. We expect the configuration mix to return to more normal levels in Q3 and we have already passed on our cost reductions to customers via price reductions. As a result, we anticipate that non-GAAP operating margins will pull back to a range around 18.5%.

However, given the significant increase in our stock price over the past several weeks, dilutive share count will likely be significantly impacted by the accounting for convertible notes I described earlier. We expect dilutive share count to be roughly 408 million shares in Q3, which includes 16.9 million shares from the convertible debt and 9.9 million shares from the warrant. Because the favorable impact of the hedge is not included, this brings our earnings per share estimate to approximately \$0.48 to \$0.50 per share.

Since we cannot accurately predict what the average stock price will be for Q3, the dilutive share count was calculated using the \$54.97 average share price from the first ten business days of this quarter. Our tax rate is expected to remain at 16.3% without the renewal of the Federal R&D tax credit and finally, we expect our free cash flow expressed as a percent of revenue to be at or slightly above the high end of target range in Q3.

To summarize, we expect continued strength in our business, particularly in product revenue which will drive continued market share gain. And while we continue to invest in sales and R & D, we expect the combination of strong revenue growth and solid gross margins will continue to keep our operating margin higher than the long-term target, albeit lower than this quarter's near record level.

At this point, I'll turn the call over to Tom for his perspective. Tom?

Tom Georgens, President and Chief Executive Officer

Thanks, Steve, and good afternoon, everyone. I am also very proud of the NetApp team's continued strong performance. The company produced our third consecutive quarter of more than 30% total revenue growth, our third consecutive quarter of roughly 50% product revenue growth and our second consecutive quarter of over 75% growth in system units shipped. We continue to demonstrate solid execution as we invest aggressively in our future while simultaneously generating our highest non-GAAP operating margins in over a decade.

Evidence of the impact of our investment is our announcement last week of the biggest product launch in the history of the company. This quarter we are bringing the market new medium and large system families, our latest Data ONTAP 8 release, a new OnCommand system and data management suite, a new Disk Shelf, solid state disks and a new enterprise data center solution called FlexPod for VMware, a joint development between Cisco, NetApp and VMware that offers integrated modular and validated solutions.

This launch strengthens our position as a platform of choice for the next generation IT infrastructure. IT departments today face tremendous pressure to decrease costs while simultaneously increasing their enablement of business objectives. As a result, they are changing how they are thinking about their infrastructure in order to achieve greater flexibility and efficiency.

This involves moving away from application-specific hardware silos to a shared infrastructure enabled by server virtualization which can run many applications at once.

NetApp has been a clear innovation leader in virtualized environments, producing solutions that are far more efficient, flexible, automated and secure; all with far less complexity than those of our competition. The announcements we have just made extend our capabilities in each of those dimensions.

The performance and manageability of these new offerings also enhances our competitiveness in our traditional markets of database, e-mail, file services, engineering applications and collaboration. The compelling price performance and scalability of the new platforms affirms our leadership in performance-demanding verticals such as semiconductor design, software development, oil and gas exploration and media and entertainment. We are already seeing strong interest for our new platforms from these verticals.

Looking at our business from a geographic perspective, we are led by the stand-out performance of the U.S. Public Sector team. They strengthened their number 1 market share position by growing 59% year-over-year and contributing 20% of our total revenue. Overall, the Americas grew 45% year-over-year and Asia-Pac continues to demonstrate solid progress producing another strong quarter, up 25% year-over-year.

By contrast, as we indicated in our last earnings call, EMEA remained challenging in several regions, yet still produced 14% year-over-year growth. Despite the EMEA headwinds, the exceptional performance by the other geographies still enabled 33% aggregate revenue growth.

Our multi-year strategy to diversify our channels continues to pay dividends and is a significant contributor to our growth. Our Distribution business with Arrow and Avnet continues to increase rapidly, and now has grown to be one-third of our total revenue. We have seen our reseller base expand with firms like CDW becoming one of our largest resellers in less than two years. Our OEM relationship with IBM grew year-over-year and we announced an expansion of our partnership with Fujitsu.

This year our big initiative was to expand our engagements with the world's largest systems integrators and service providers and we continue to make good progress with them as they design NetApp into their products and services. Overall, we believe NetApp has the most diversified channel in the industry, and has been an essential part of our growth.

In addition to the go-to-market partnering activities, we remain actively engaged with our technology alliance relationships. We continue to integrate with Microsoft in many of their product offerings and are actively participating in their Hyper-V Cloud Fast Track program through our OEM partners. Similarly, our collaboration with Cisco and VMware produced the aforementioned FlexPod solutions.

In the last two quarters we talked about our two year compare, a metric we have been using internally to measure our progress in the market. By looking at this quarter's revenue compared to the same quarter two years ago, we can more accurately represent the company's true sustained market performance by eliminating the distortion of weak compares to post-Lehman Monday business levels.

With a two-year window now Post-Lehman Monday, we'll likely need to change this metric in future quarters. Nonetheless, once again, the organic growth rates of our major competitors are down double digits to up slightly while NetApp's growth in this period is in excess of 30%. This indicates that unlike the others, NetApp's growth rate is more than a simple tech refresh but convincing evidence that we are gaining share, especially in the build outs of the next-generation data centers, which are still in the early stages.

Looking ahead, from a macroeconomic perspective, we expect to remain in a limited-visibility environment. This remains unchanged from the past several quarters. Just as in prior quarters, our focus will be on gaining share. We have been gaining share at rates faster than any time in the last decade and we expect to continue to gain share in good markets or bad.

In addition, with a high rate of revenue growth, we are expecting our operating margin to be well above our historical targets, albeit with a modest decline from the record levels of this quarter. This historically-strong margin achievement is despite aggressively investing for our future success. Finally, we need to successfully deliver all the recently announced products to the market and I am confident that the team will once again demonstrate its ability to execute.

I would like to close by thanking the now 9,400 employees of NetApp as well as our ever-growing number of partners and customers. The team across the globe just executed the most comprehensive product launch in our history yet still produced 33% growth, record revenue, near-record cash flow and record profits. Despite the challenges of an uncertain economic environment, the team still maintains its focus, its intensity, its passion and its commitment.

At this point, I will open up the floor to questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions]. Your first question comes from the line of Maynard Um from UBS.

<Q – Maynard Um>: Hi. Thank you. Just a question, I guess more philosophically on how you think about your OpEx and how you manage that. And obviously at some point, you may start to see more seasonal effects on revenue. Can you talk about how you manage the OpEx relative to that revenue? How much of your OpEx is, you know, perhaps variable? And how you smooth some of that impacts out?

And then secondly, just an update on competitive landscape given the acquisition by – of Isilon by EMC? Thanks.

<A – Tara Dhillon>: I'm sorry to interrupt. We had technical difficulties on our end and lost most of that question. I apologize. Can you repeat the question for us?

<Q – Maynard Um>: Sure. The first question – the question is on OpEx and how you manage that OpEx. You know, obviously, at some point, you start to see more of a seasonal effect on revenue. I'm just curious how you think about your OpEx. Do you continue to spend to continue to drive that growth on an annualized basis? Or is there some variable amount there that can help to smooth out those effects?

And then, any commentary on the acquisition or landscape, competitive landscape given the acquisition of Isilon by EMC? Thanks.

<A>: The OpEx side, it's kind of – the conundrum that we face there is that business is good but the headlines are bad. And the question is how do we make the trade-off going forward? And the message that I've given to the team is that as long as we're winning in the market, as long as we're growing then we intent to invest accordingly. That we don't want to be in a position where three years from now, we look back and say that NetApp was exceptionally well positioned and we were cautious because we were looking at the headlines every day as opposed to the tape of the business.

So right now our stance is as long as we're winning and as long as we're growing, we are going to invest commensurately. And clearly the seasonality issues we need to work through just like we need to work through every year.

So I think the high-order bit here is that we'll continue to invest aggressively. We're hiring. We hired a thousand people in the first half of the year. So we still see opportunity ahead. We certainly see market share ahead – market share gains ahead. And that's what we're going to go after. So right now, you know, we've been investing at a high rate although that high rate of investment's been less than the growth in revenue. And we've been generating spending operating margins. And until we see material negative impact to the business, I intend to continue to invest aggressively.

Now the seasonality point, well taken. We certainly need to work through that but right now our stance is that we're winning and will continue to invest in the future.

On the question of EMC Isilon, just a couple of points on that. I think my first response is not a whole lot different than my response to the 3PAR acquisition between Dell and HP. And that is if you go back to our two year compare, basically most of the players in this industry, outside of individual acquisitions that they did, are basically flat to down. So I think in search of growth, absent an internal plan to grow is a desire to basically acquire technologies. So I think first and foremost the deal is as much about the target – as much about the acquirer than it is about the target.

And as far as Isilon as we see them in the market, they've staked out well some certain niches that in some cases we overlap with. And I think in the hands of EMC, we'll probably see them a bit more. And the message to the team is we just need to compete and win against them every day, just like we're doing today.

<A – Tara Dhillon>: Next question please.

Operator: [Operator Instructions]. Your next question comes from the line of Aaron Rakers with Stifel Nicolaus.

<Q – Aaron Rakers>: Yeah; thanks, guys. One question and one follow-up. First on the question, looks like DSO was up a little bit. I'm curious of what you guys are seeing from a month-by-month basis in the quarter. Obviously Cisco a little bit more tempered in their call a week ago. So I'm just curious on a demand perspective, can you help us understand what the monthly patterns look like through the course of the October quarter? And then one follow-up please.

<A – Steve Gomo>: Yeah. So this is Steve here. With respect to DSO, not a lot different. I think we hit kind of an unsustainable level last quarter. So if your reference point is the 30 days that we had last quarter, that's the best we've ever done. At 34 days, we're actually quite pleased. The difference between the two numbers probably has more to do with a slight shift in seasonality towards the middle month than anything else. So, we're going to take the 34 days, we're actually quite pleased with it.

<Q – Aaron Rakers>: Let me ask it differently. Can you – how would you characterize the demand environment, in particular in the month of October relative to what you guys saw in September?

<A – Tom Georgens>: I would not imply any more science to the month-to-month data than actually exists. I would say that October was not a whole lot different than September and the month before. The one dynamic that we clearly had in the middle of the quarter was the end of the federal fiscal year. And clearly that generated a flurry of activity in September. And this is clearly a strong quarter, so to the extent to try and underneath that try and glean a trend outside of Federal I think is probably overstated. So I would say that certainly there was nothing so dramatic in the number that we would recognize anything different in October that we didn't see in the prior month.

<Q – Aaron Rakers>: Okay, fair enough. And then the follow-up would be...

<A – Tom Georgens>: Okay. That's three questions.

<Q – Aaron Rakers>: Okay, guys.

Operator: Your next question comes from the line of Ittai Kidron of Oppenheimer.

<Q – Ittai Kidron>: Thanks and congrats, guys, on good numbers. Steve, I wanted to dig in a little bit into your gross margin outlook for next quarter. Just playing with the numbers I'm getting to about a three-point decline in growth margin, and looking back in history, that's pretty much the biggest drop that we've seen seasonally from – going into the January quarter. So I'm trying to understand, with the mix issues and passing along the cost reductions to the clients, why is it that you need to do that in so – in such magnitude and in such speed, especially if you claim and certainly believe that your product is so much superior than anyone else's? Why couldn't that be a much slower selected in case of specific feeds and specific needs rather than it sounds like, more of a kind of a broad cost reduction to all list pricing?

<A – Steve Gomo>: Okay. So, first, Ittai, if you look back basically to the second quarter of last year and the third quarter of last year, you'll see that the drop in the consolidated gross margin was about 3.3 percentage points. So – and typically, quarter twos are typically pretty good quarters for

us coming off strong quarter ones, particularly when we can build backlog and things like that. And I think you're going to see a similar pattern as you go back in time. That said, I think that if you look forward now from the second quarter, most – you're absolutely right, we're looking at roughly 3%. It's a little less than that, in fact it's less than it was last year, reduction in gross margin.

Most of that is due to this cost/pricing issue. So what happens is this, basically we anticipate certain costs to decline throughout the quarters, right? Most of those costs are associated with materials, and most of the material is disk drives. We typically try to match our price reduction to these cost reductions, and sometimes there's a timing difference that occurs. This was a very favorable timing difference in the sense that we had a massive drop in costs and there was a lag in the price decrease because the cost decline came a little sooner than we were expecting.

The reason why we pass this along is because our customers are very valuable to us. There's a reason why our customers value us. They want to keep us around. They continue to buy from us and we have tremendous loyalty. Because they know we are passing these costs along to them. We don't want to make money off of disk drives. Okay, so that's the idea, we try to provide value through our software and all the other costs we try to pass back to the customers.

<Q – Ittai Kidron>: Very good. And the follow-up, regarding your share count and I understand the dynamics here but within the last four, five quarters, your overall share count has increased by about 20%, which is a pretty aggressive number. Are there any thoughts here with regard to buy-back or doing something to mitigate this continuous increase in share count?

<A – Steve Gomo>: Again, as you look at the share count increase, as I indicated in my script, some of the share count that you see, in fact a very large portion of it, is actually hedged. It's just that we don't report it that way. The economics of some of that share count, i.e. the hedged portion of the convert, is that it will never see the light of day. We have a call option on it. The share count is illusory in that it's overstating the true economic effect.

With respect to the rest of it, would we consider repurchasing shares to offset that? Absolutely. We'll consider that going forward. We're making no commitments at this point with respect to any share buy-backs and any timing of that.

<Q – Ittai Kidron>: Very good. Good luck.

<A – Steve Gomo>: Thank you.

Operator: Your next question comes from the line of Keith Bachman of Bank of Montreal. Please proceed.

<Q – Keith Bachman>: Thank you. Steve, could you talk a little bit about mix in the context of guidance? Products versus the add-on software and services. The services growth – the product growth was great this quarter and services were a little bit slower than what I was thinking. So just hoping to get a little context please on the guidance?

<A – Steve Gomo>: I think, Keith, you're going to see another quarter of sequentially slower deferred element growth, the deferred elements being the software entitlements and the service contracts. I would expect that to be relatively slow, low single digits for the next couple of quarters. I think that starts to turn around, around the first quarter of next year. I think I've talked about that. Probably not going back to the growth rates that we used to see in the go-go days, back in '05, '06, '07 type of thing, but certainly a little better than it is today. That's just the nature of the game. I think most of the growth in the top line is going to come from the sale of products going forward as we recognize the revenue in the current period.

<Q – Keith Bachman>: Okay.

<A – Tom Georgens>: Yeah, Keith this would be – we effectively have to age-off the low growth quarters from a couple of years ago and replace them with higher growth quarters as we go forward.

<Q – Keith Bachman>: Yeah. Fair enough.

<A – Tom Georgens>: One of the key components of the NetApp story is we're still growing 30-something percent and roughly a third of our revenue is not growing at all. We are just overpowering it with product growth so in a lot of ways our market share performance is actually even better than our financial performance.

<A – Steve Gomo>: Yes and in the long run, just one final thought on that is everything we do here is attached to the products, so product sales are really good.

<Q – Keith Bachman>: Okay. Steve then, my follow-up if I could just on the cash flow was very strong this quarter and as you mentioned 27% free cash flow yield related to revenues. Is the longer term target still – the upper bound of that longer term target still 22 or can we think about it might be a better number as we look out over the next periods of time?

<A – Steve Gomo>: Well, you know, Keith, as I stated in our analyst day, the last analyst day we had, I provided that table and I showed you that as the net, excuse me, the operating income increases above 16% to 17%, 17 to 18 and so on type of thing. As the operating income increases, you should expect a higher level. So right now I would probably set a slightly higher target given the fact that we just guided to 18.5% type of operating income, I'd probably set the target probably somewhere around 26% at the upper end.

<Q – Keith Bachman>: Okay. Thanks very much, Steve.

<A – Steve Gomo>: Yeah.

<A – Tara Dhillon>: Folks, before we continue in the Q&A, we'd like to ask that your – if you have a follow up question that it's related, otherwise it's not fair at all to the other callers and we're not going to be able to get through everyone's questions today. Thanks.

Operator: Your next question next question comes from the line of Alex Kurtz with Merriman Capital.

<Q – Alex Kurtz>: Hi. Merriman Capital. Thanks for taking the question. Tom, can you just talk about where you're going to be putting new sales bodies in North America and Europe? What segments, what verticals do you think need the most coverage right now?

<A – Tom Georgens>: If you look at it, first of all, the first thing I probably want to do is that not all the sales bodies are direct selling people. We're actually investing in our channel. I think the diversification of our channels is one of probably the lesser understood components of NetApp's growth rate. And we're going to continue to invest in enabling our channel partners.

Now that said, we'll continue to add direct sales in certain key areas. This past year the telcos and the service providers have been a big investment area for us. We're building a vertical practice around healthcare now. So historically the company's not been very vertically focused, except when those verticals happen to be geographically centered like financials in New York or media and entertainment or oil and gas in Houston. So telco and service provider has been a big investment for us this past year. And I think we see healthcare as another one.

As far as geographically, I think one of the challenges that we always have is how do we balance mature market investments with emerging market investments. And that's one of the things that we're also going to need to balance. Now it's pretty safe to assume that the best return, best near term return on the incremental dollar spent will be in our mature markets. Even though we've achieved number 1 market share in places like Germany and federal, the market share numbers are still well below the majority, so the short-term gains there are obviously there to invest. But we need to invest for the future, and that's going to be our balance.

So I think it'll be a combination of the two, we need to maintain discipline of not just focus on the near term but also the long term. But in terms of vertical markets, as I said, the service providers will continue to get investment because we clearly believe that more and more customers will be looking at to provide IT as a service; and likewise we need to get an emerging market component as well.

<Q – Alex Kurtz>: On the related quick note, is the service provider vertical, is that over 10% of revenue at this point for you guys?

<A – Steve Gomo>: I'd have to look at my chart. Yeah. We kind of put that telco in service provider. I'd say probably in that vicinity, but I don't know off the top of my head actually. And probably a little bit lower than that.

<Q – Alex Kurtz>: Thank you.

Operator: Your next question comes from the line of Chris Whitmore from Deutsche Bank. Please proceed.

<Q – Chris Whitmore>: Thanks very much. I was interested to get some more color on the product announcement. Maybe more specifically, was this product announcement well anticipated by your customer base? And did you see any kind of pull back or slowdown in front of this announcement?

<A – Tom Georgens>: You know, that's always one of the complexities. And I think as a tribute to the sales team, because first of all, there are no secrets in this business. So I'm sure that certainly our biggest customers were hinted at this and certainly the ones that have access to our roadmap under NDA have seen this coming. But I think as a tribute to the discipline of the sales force and production, we were able to manage, despite having the biggest tech refresh or the biggest technology refresh of our platforms in the history of the company, we still managed not to disrupt our financial performance in the prior quarter with 33% growth. So I think we've been very disciplined and very structured about that, very clear about the deliveries and probably a big component of that that's probably understated is belief in the predictability of our ability to deliver so customers can plan accordingly.

When they don't have confidence then all sorts of odd behavior happens. They'll order in advance and things like that. So all in all, I don't believe it had an impact on last quarter's business. Clearly it is going to enhance our competitiveness. Some customers will adopt this technology right away and other customers will evaluate it over time. So I don't expect it to be a sharp knife-edge cut-over from the old products to the new products, but I think certain segments will go to the new products pretty aggressively.

Operator: Your next question comes from the line of Kevin Hunt from Hapoalim Securities. Please proceed.

<Q – Kevin Hunt>: Thank you. I just had a question about the direct/indirect. It seems like you had much stronger growth on the direct side – I'm sorry, on the indirect side. And wondering if that's – I know you've been pushing that for a while. Is that something where you are trying to push more and more through the channels? Or how should we think about that mix going forward?

<A – Tom Georgens>: Well, I think we've been steadily increasing. I probably, if I had to suggest one distinction here is that a lot of our indirect business is aided by our direct people, so particularly in U.S. public sector, our people are involved with all the customers and we fulfill indirect. So I wouldn't equate indirect business with either low touch or zero touch from that perspective.

Certainly a fair amount of our Arrow and Avnet business and a fair amount of our CDW business and other resellers are volume businesses that we don't have a lot of touch in, but the Indirect business in our big accounts, particularly in the Federal space, have a lot of NetApp involvement.

So to the relative growth rates between the two I would not equate with relatively success of large customers versus smaller customers because I don't see it playing out that way. All in all I think the Indirect business is a measure of our leverage and the more that we can help them be successful with a high touch model the more they're willing to invest and generate low touch sales for us as well.

Operator: Your next question comes from the line of Brian Marshall from Gleacher.

<Q – Brian Marshall>: Great, thanks. A question with regards to guidance, clearly enterprise storage is a secular growth market and NetApp's gaining share and that is pretty clear, but if you look back over the last ten years I think your average sequential growth for the January quarter has been about 8%. And so given the guidance of 3 to 7% sequentially, I was wondering if you can help us fill the disconnect there?

And then just if you could give a quick confirmation, if you include the hedge on the convert that you're earnings per share guidance for January would actually be 0.50 to \$0.52? Thanks.

<A – Steve Gomo>: Thanks, Brian. A couple of things, with respect to the sequential guidance again if you go back over 10 years you're absolutely right. The difference is the company was a lot smaller, the installed base was different than it is today, etcetera. The bottom line is the same answer that I gave to Keith.

Look at the size of the deferred elements in our revenue today and look at how fast they are growing. Tom made the point that they're actually an impediment to rapid growth and that is indeed the case. Sequentially they're growing in the very low single digits at the low end of the range that we gave you. So the thing that's really carrying the growth here is the products. In the period that you're comparing to, that's when the deferreds were also growing at about the same rate as the products, i.e., in the 30% year-over-year.

So I think you have to adjust for the size of the company today, how the revenue mix has changed and the way the deferreds are coming off the balance sheet.

With respect to guidance on earnings per share, you're correct. It's about \$0.02 adjustment if you look at it on an economic basis.

<A – Tom Georgens>: Yeah. And I think relative to market share and the guidance, I think Steve is right. We have a third of our revenue that flowed through the balance sheet over a 30-plus month period. So clearly we need to age-off the lousy quarters and replace them with some better quarters, and that will take some time. But nonetheless the guidance that we give going forward from a product growth perspective it's still a high 30s, 40% number year-over-year growth, and I think from a market share perspective I don't anticipate any of our competitors will be close to that.

<A – Steve Gomo>: Yeah. I would almost say if you went back over that 10-year period and you look I'll bet you products are growing faster over the past three quarters than they have over that same period of 10 years ago.

Operator: Your next question comes from the line of Richard Gardner from Citigroup.

<Q – Richard Gardner>: Thanks. I wanted to ask about Professional Services which looked like it was up a little bit less than the normal seasonal amount in the quarter. I know it's a small piece of the business, but I was just wondering if there's any story there? Is this just a situation where you continue to slough off some of the lower value added Professional Services to your partners, or was there another story there? Thanks.

<A – Tom Georgens>: Well, slough off, I mean, those are our customers we're talking about, but...

<Q – Richard Gardner>: Yeah. That's maybe not the best term. Sorry about that.

<A – Tom Georgens>: I think first and foremost, you're right. I think as a company, we built a strategy that while we firmly believe that Professional Services is an essential component of success with our products and other products like it we do not believe that it's a necessity for us to actually build that Professional Services business ourselves. We've got partners who would be more than happy to do it. In a lot of ways a lot of times that is their profit opportunity in these accounts, and for us to compete with them for their profit opportunity was problematic for us.

I still remain convinced that Professional Services are essential to customers' success and we continue to invest as a company around projects that customers insist on we do or projects that only we can do, but absent that I'm not looking to grow the business on Professional Services. We're a product company, and if we've got partners that are willing to make the investment in learning about our technology and being capable of doing this and delivering services to their customers then I would rather enable them than to build a big low margin infrastructure of our own to provide the similar services.

<Q – Richard Gardner>: Thanks, Tom.

Operator: Your next question comes from the line of Mark Moskowitz from J.P. Morgan.

<Q – Mark Moskowitz>: Yes, thank you. Good afternoon. Tom, I wanted to see if you could talk a little more about the government business just in terms of the outsized performance you saw this past quarter. How should we think about that trend line going forward? Can you still stay above the mid-teens as a percentage of revenue?

And then, Steve, if you could just really talk quickly about your OpEx profile. Can R&D kind of peel off here now that you had a big, major product launch this past week?

<A – Steve Gomo>: Okay, so it's really two questions. One of them is clearly the Federal business has a fair amount of seasonality to it. We've just come off the glamour quarter for them. And Q4 will be strong again although not quite as strong and then Q1 and Q3 are kind of the bounce back quarters.

In terms of the mid-teens aggregate for the full year, in that vicinity, maybe not as high as 15% for the full year, probably a little bit lower than that on a full-year basis. But it remains an important part of our business. I think that we as a storage provider have the number one share in that sector and we intend it to continue to be robust and continue to invest. But clearly, this is the end of the government buying season. So this is always a quarter where they've got the biggest impact on our business.

And as far as R&D is concerned, we've always got 10 more things to do than we've got money to do it with. So yeah we just did a significant product release. We got asked about DSO. I think one of the things we should mention is that despite a very, very, very large hardware release, we

actually had higher inventory turns than the prior quarter. I think the execution by the operations team is notable.

I don't necessarily see any slacking off. I mean the vast majority of our R&D investment is actually in software and not in hardware platforms and that continues at full force. So I think we are a technology company and as long as business is robust, I think we want to take the opportunity to invest and create competitive advantage for ourselves.

Operator: Your next question comes from the line of Paul Mansky from Canaccord Capital. Please proceed.

<Q – Paul Mansky>: Thank you. And I'd like to echo the solid quarter congratulations. You know, going back to the, some of the earlier comments particularly pertaining to the software E&M velocity over the next couple of quarters, if I recall, it was a year ago that you introduced the low-end refresh. And while the revenue mix might not have changed, certainly there was a lot of volume velocity there at the low end. If I also recall you gave away or you bundled in if I – maybe is a better choice of words – a lot more software with that product at effectively the same price. So the question is why shouldn't we be thinking about that E&M business accelerating as you come back in on the one-year anniversary and start hitting those installations up for that 20% maintenance renewal?

<A – Steve Gomo>: Steve here, Paul. The S&M business or the software and contract maintenance business is a long-term business, Paul. These contracts on average are three-years long. So you're actually looking back into a period on average – be careful of averages – but on average, 18 months. So a lot of things happen over this period of time.

Remember it's driven by the mix of deferred versus the mix of non-deferred. It's driven by the rate at which the business is growing. And then it's driven by the individual contracts and how the contracts shift over time with renewals which tend to be shorter length and point-of-sale contracts, which tend to be longer length. It's a very complex equation that yields a bleed off, if you will, from the balance sheet into revenue.

So basically you're not going to see – unless nothing is going to change the deferred performance on the revenue line in any short order. It is something that's more evolutionary. It takes time. And you have to make a whole bunch of assumptions going forward about the mix between deferreds and non-deferreds, the rates, et cetera, all the things I just went through.

So suffice it to say that we have a lot of information here about what the current deferred revenues look like today. From that we can model what it's going to look like pretty much going forward. As we go out further and further, we're going to be more dependent on the assumptions we make about what the forward orders look like. Nonetheless, I can tell you that for the next couple of quarters, we're not going to see a significant change in the sequential growth rate of those elements.

<Q – Paul Mansky>: Thank you for that color. And just quickly, can you touch on for us – obviously there was a press release earlier in the quarter relative to the dropped mutual suits around ZFS. And I know that terms can't be discussed, but can you kind of talk to us a bit about philosophically how we should be thinking about that action and then maybe in context of Xyratex, specifically a key partner of yours recently purchasing Lustre, which obviously has a pretty big ZFS focus?

<A – Tom Georgens>: Yeah. I think as far as the lawsuit has got a lot of factors to it. And there's a lot of things that go into the calculus of pursuing a lawsuit versus not pursuing a lawsuit. And clearly the dynamics changed when the counterparty of that deal moved from Sun to Oracle. There's a lot more – Oracle is a long term partner of ours. And at the end of the day, without getting into any

details, I think it's safe to assume that an opportunity to collaborate more effectively with them had an economic value that didn't exist as we positioned against Sun.

So I think we took another look about the behavior that we thought was potentially risky and potentially damaging to us, evaluated that against the economic opportunity associated with a better and continued strong collaboration with Oracle. And at the end of the day, we decided to do what we did. So it really has nothing to do with the trajectory of the lawsuit, it had more to do with the overall – all the factors involved in the relationship. In fact Oracle is going to be a key mover in the industry. And from our perspective, we have a long-term partnership with them. And likewise, the things that were particularly irritating about the prior arrangement with the prior owner, we felt were lower risks in this scenario.

So at the end of the day, we just decided this was the better thing to do. Basically there's no restrictions on either of us, we can go back and restate our hostile intent, but I don't anticipate that happening. In fact, I'm actually optimistic about continued collaboration.

Operator: Your next question comes from the line of Jayson Noland from Robert W. Baird. Please proceed.

<Q – Jayson Noland>: Hi, great. Thanks for the – thanks for the question. And just a couple on FlexPod. We've heard good things specifically regarding virtual desktop. Tom, how big of a deal is FlexPod and how does it compare to Vblock? Thank you.

<A – Tom Georgens>: Well, I think first and foremost, the target of this particular offering is against the integrated system vendors, the HPs, the IBMs, the people who invent solutions. And really the strength of their offering is effectively in the integration. They all come from one place and they're all integrated and tested together. The weakness of the offering is the individual components of the stack. And it's our belief as a best of breed provider that customers would prefer to see best of breed solutions in their data centers. And the imperative upon companies like us is to lower the integration barrier of them being able to deploy these.

So ourselves and VMware and Cisco created a solutions that if we can approximate the integration capability of HP and IBM, we can build solutions out of best of breed components, then that's a far better outcome for customers.

And to your question, given the other options are to fight this battle, clearly all three of us felt that there was still a sufficient opportunity in the market to warrant our investment in creating yet another option to go to market with.

I think there's some components of it that are different. Clearly this is a channel focused type of a solution set that's really aimed to enable our channel. I think it's a bit more flexible. But I think it's less about what do we have that Vblock doesn't have and it's more about how do we and Cisco together go after HP and IBM. And really what we're trying to do is undermine the one advantage they have, which is integration.

Operator: Your next question comes from the line of Jason Maynard of Wells Fargo.

<Q – Jason Maynard>: I had a question about server virtualization and just how it might impact your business going forward. VMware talks about server virtualization being 25% to 30% penetrated on existing workloads, and they're starting to penetrate more Tier I, Tier II workloads. And I was wondering, do you think this next leg in virtualization is harder or the same in terms of the processes of getting the sales made? And what impact does that have on you given that some of your growth is obviously is being driven by your position in that market?

<A – Tom Georgens>: Well, I think there's really two components to this. I think what you're saying is true. But I'd say from the NetApp perspective, we might look at it a little bit differently. When I look at virtualization, I would say the initial wave of virtualization was really simply about server utilization. And that is, I can now run multiple apps on a single server when I used to have dedicated servers and therefore I can reduce my server count or run more apps on my existing server. And it's a pretty compelling economic argument. And clearly it propelled VMware and they did quite well with it. And it's a perfectly legitimate argument.

But what really happened, which I think is just as dramatic, is that what this technology effectively did was decouple the application from the server, really for the first time. Now it allows people to think differently about their infrastructure. Instead of having servers around individual applications, now the applications are independent. They can redesign their entire server infrastructure so it can be homogenous, it can be cost efficient, it can be automated and it can be very flexible.

The implication of that is that they want the same thing for storage. They want to have a homogenous, automated, easy to manage, cost efficient infrastructure. And if you look at NetApp's unified story, we've got SAN and NAS, high and low end, we've got primary, we've got backup, we have archiving all with one set of tools and one architecture. That's pretty compelling in that model.

So the penetration of virtualization relative to physical systems is one measure, but the thing that's really driving our business is really the customers that are actually leveraging this technology to build out the next generation data center, whether you call it a private cloud or a dynamic data center or whatever brand name you want to attach to it. I would say that, that is really in the early stages.

And I would also contend that if you look at our performance over time when most of our competitors are flat over an extended period of time and NetApp is growing, I would say that NetApp's growth isn't necessarily coming from us winning incremental storage demand around legacy apps. I think NetApp has been particularly effective winning next generation data centers as people now use this opportunity, leveraged by the capabilities of virtualization, to rethink about how they build a much more flexible IT infrastructure. And I think that is where we're winning. And I think we have a disproportionate share there. And that's what I think is driving our partner relationships, particularly the big partners, is that we're really about the future designs and less about incremental demand around legacy apps.

Operator: Your next question comes from the line of Brent Bracelin from Pacific Crest. Please proceed.

<Q – Brent Bracelin>: Thank you. Steve, a question for you around the model and growth rate, clearly you have two-thirds of the business tied to product revenue that's on fire. You're clearly taking share. A third of the business tied to deferred revenue elements. You talked about the lag there, 18-month lag, pretty clearly. I guess my question is, looking out beyond the January quarter into the April timeframe where you really have the first tough compare on product revenue side that was up, what, 50% year-over-year tied partially to some unfulfilled orders that got filled that quarter. Is it reasonable to expect a more normalized product growth rate in the high-teens six-months from now, or do you think it's actually possible for the new products that you just introduced, continued share gains to kind of overpower some of the tougher compares and sustain product growth in this 30% kind of growth range?

<A – Steve Gomo>: Well, you know that's a tough question to answer because a lot of it has to do with the environment that we're selling into out six-months from now. But that said, I've got to believe that irrespective of the fact that the compare gets tougher, these new products that we launched I think are going to be – are going to help us to be even more competitive than we were yesterday type of thing. So I'm expecting that we're going to be able to maintain a fairly high level of product growth. It may not be at the 50% level. That's kind of – that's an outlier, but I do think that

we're going to be substantially better than the market we serve and I think substantially better than what we're going to see from the competition.

<A – Tom Georgens>: Yeah, I think looking out, I made the commentary about limited visibility, and it's the same as it's been for a while. And kind of the way we answer this question internally is, that's why we're so focused on market share growth. And good market or bad market, a point of market share gain is a point of market share gain. And things could always slow down but if we continue to gain share then we're going to emerge stronger than ever. So that's really our focus.

So internally, one of our top three objectives as a firm is to grow share. And that remains our top priority. And then we'll look at the overall envelope around the business, what does the macro look like, and then we'll translate that into actual dollar growth and we'll basically modulate our expenses accordingly. That's kind of how we're looking at it. But share gain is basically the point of the arrow. And as we're gaining share, then I think life is improving for us no matter what the macro's doing.

<Q – Brent Bracelin>: Thank you.

Operator: Your next question comes from the line of Kathy Huberty from Morgan Stanley.

<Q – Kathryn Huberty>: Thanks, Steve. Just a follow up on the January quarter revenue guidance. What are you expecting as it relates to U.S. growth rate versus the growth rate in international markets? And particularly, can you comment on whether you think the sequential uptick from the typical year-end enterprise commercial spending will be enough to offset the sequential decline we should see in the public sector spending in the U.S?

<A – Steve Gomo>: So we didn't give any specific guidance with respect to the geographic distribution of growth next quarter. I would expect it to look somewhat similar to what we saw this quarter particularly if you lump the U.S. and the USPS our U.S. Public Services – or Public Systems business together. I think that Europe is going to continue to be a challenge because of the economic situation over there. Asia looks to be strong and I don't see any reason why that wouldn't continue and the rest will be the U.S. So I think that's kind of going to be the distribution going forward. What was the second part of your question, Katy?

<Q – Kathryn Huberty>: That's it. You covered it.

<A – Steve Gomo>: Okay.

Operator: Your next question comes from the line of Kaushik Roy from Wedbush. Please proceed.

<Q – Kaushik Roy>: Congratulations, Tom, on the nice quarter. So your operating margins for the last three quarters have been higher than your long-term target of 17.5 to 18% level and your guiding 18.5% for January. So how should we model for next year? Are you going to cap operating margin at 18% or could it go much higher? Thanks.

<A – Tom Georgens>: Okay, well first of all, thanks to Steve too for the quarter. His feelings were hurt.

<A – Steve Gomo>: [Laughter].

<A – Tom Georgens>: Whatever it is he does.

<A – Steve Gomo>: [Laughter].

<A – Tom Georgens>: So as far as going forward, I think – you know, I think historically that number has been 16% and the thing that's been keeping us above that is, really for a sustained

period, our gross margins are much higher than they've ever been in the history of the company over time. And the overall growth rate has been very, very robust. But barring any major reversal on either of those two line items, which I don't see in the very near-term, then I would think that our gross – our operating margin will remain well above the 16% and I think we'd kind of hover around where we've been for the last few quarters.

As far as going into next year, frankly I don't want to give really any guidance there. Simply put, the macro environment is going to have a big impact, so once again my standard answer, once we get beyond the current quarters, it's all about market share and we're going to adjust the model as we get closer.

<Q – Kaushik Roy>: Okay, thanks.

Operator: Your next question comes from the line of Benjamin Reitzes with Barclays Capital.

<Q – Benjamin Reitzes>: Yeah, thanks a lot. Can we talk a little bit about the public business and I'm sorry but, U.S. public is 20% and it looks like if you add the rest of the world, it's 25 to 30. I was just wondering if you could even talk in more detail than you did already about how that business was looking in October and how the dynamics of state versus local impact you sequentially and into next year. Obviously, everybody focused on it with Cisco and whether you really are going to see the slowdown. It seems like your guidance says no, I just would like a little more detail as to why.

<A – Tom Georgens>: Yeah, I think first of all, our public sector penetration outside the U.S. is probably not as high as it was in the U.S. The public sector business tends to be more U.S. centric. We certainly do public sector business overseas but not quite to the level of proficiency we do it here.

You know, I think going forward, obviously there's been elections, a new regime. We'll see what ultimately – what happens in terms of spending and you can look at it a bunch of different ways. I've certainly seen arguments that spending will get cut back. I've seen other arguments that people will seek efficiency and IT spending will actually be a component of their ability to modernize and drive efficiency in the government.

My sense is that there's not going to be any dramatic change in the behavior of IT spending by the government. That's just my gut feel, simply because these things tend not to change quickly. Probably one other thing about the NetApp business is the U.S. Public Sector is not only our federal business but it's also our state and local business. For us we really only started to have a focus on state and local, we actually built a team around it probably a year and a half ago maybe a little more, but certainly in that timeframe. And there's been a lot of speculation that the state and local might actually be a lot worse off than the federal in terms of its ability to spend.

So for us that's been a rapidly growing part of the business, but it's actually quite small. It's our belief that the state and local opportunity is roughly is the size of the federal opportunity in total market share but the relative size of those two businesses are dramatically different. So I'm probably more inclined to believe that there will be some slowdown in state and local spending than I am in federal spending. But for us, I'd say that the mix between those two is probably a lot lower on the state and local side than our competition.

<Q – Benjamin Reitzes>: Thanks a lot for that.

Operator: Due to time constraints, I would like to now turn the call back over to management for closing remarks.

Tara Dhillon, Senior Director, Investor Relations

Thank you, operator. We'd like to remind everyone that we will be hosting our 2011 Analyst Day on March 22 in New York. Registration will open in late January. We appreciate your time. Thanks.

Operator: Ladies and gentlemen, thank you very much for your participation in today's conference call. You may now disconnect. Have a wonderful day.

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