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**MANAGEMENT DISCUSSION SECTION**

Operator: Welcome to the NetApp third quarter fiscal year 2011 conference call. My name is Monica, and I will be your operator for today's call. At this time, all participants are in a listen-only mode. Later, we conduct a question-and-answer session. Please note that this conference is being recorded.

I will now turn the call over to Tara Dhillon, Vice President, Investor Relations. Ms. Dhillon, you may begin.

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**Tara Dhillon, Vice President, Investor Relations**

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Good afternoon, everyone. Thank you for joining us today. 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.

As a reminder, during today's call we will make forward-looking statements and projections, including our financial outlook for Q4, our expectations regarding our future market share and the benefits of our recent product introductions, as well as our expectations regarding future hiring, all of which involve risk and uncertainty. Actual results may differ materially from our statements and projections. Factors that could cause actual results to differ from our projections are detailed in our accompanying press release, which we have filed on an 8-K with the SEC, as well as our 10-K and 10-Q reports also on file with the 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, refer to the table in our press release, our supplemental commentary, and on our website.

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

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**Steve Gomo, Executive Vice President and Chief Financial Officer**

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Thanks, Tara. Good afternoon, everyone. Continuing the trend of recent quarters, NetApp generated very strong business results in Q3, driven primarily by our successful new product launch in November. Total revenue grew by 25%, and product revenue grew by 32% year over year. Our total non-GAAP gross margins remained quite strong at 65.5%, demonstrating the competitive strength of our products. And non-GAAP operating margins continued near record highs. Non-GAAP net income grew 46% year over year and made a large contribution to free cash flow, which registered a robust 23% of revenue.

This quarter, we experienced the fastest uptake of a new product line in our history. Customers converted over to the new FAS3200 platform at a far faster rate than we had projected, significantly exceeding our expectations for the mix between the new and the previous FAS3000 product line. As a result, we are experiencing some material constraints, which we believe delayed the shipment of approximately \$10 million to \$15 million of revenue. We have increased our forecast with suppliers several times over the past few months, and we are managing the situation closely. Given the steep ramp in demand, certain materials may remain supply constrained in Q4. Despite this operational challenge, product revenue growth was still above 30%.

We are very pleased with our overall gross margins, which ended up slightly stronger than expected. Non-GAAP product gross margins behaved as we had anticipated, finishing just slightly above 60%. The timing of cost reductions and price reductions that we discussed last quarter is now back in balance. Non-GAAP service gross margins finished about one percentage point stronger than anticipated, as support renewals were a bit higher than expected.

Non-GAAP operating expenses increased 3% sequentially from Q2, as lower marketing and administrative expenses partially offset the salaries associated with increased head count and the increased variable compensation. We added 415 net new people in Q3, and expect to continue hiring, primarily sales and engineering resources, at slightly higher levels this next quarter.

Cash generation was another highlight this quarter. Despite a slight increase in accounts receivable DSOs, our strong net profit combined with a large uptick in the growth of deferred revenue on the balance sheet yielded \$364 million in cash from operations and \$297 million in free cash flow. As I mentioned earlier, free cash flow finished at a very solid 23% of revenue. This was the primary contributor to the \$374 million sequential increase in our cash and investments balance. Cash and investments now stand at \$4.8 billion.

Our diluted share count increased 14.5 million shares sequentially to 406 million shares, roughly in line with what we had projected on last quarter's earnings call. The increase was driven primarily by the impact of a higher average quarterly stock price and the accounting for our convertible notes and warrants.

With an average closing price of \$54.77 in Q3, approximately 4.5 million additional shares are included in the diluted share count to account for the impact of the notes. And another 5.5 million additional shares were added to account for the warrants sold as part of the original transaction. You may recall that 80% of the convertible notes are hedged, while the warrants were not hedged. If we were to adjust the share count to reflect the bond hedge, then the non-GAAP EPS would have been \$0.02 higher. You will find a table on our website which shows the impact on diluted share count for a range of stock prices.

Looking forward, our target revenue range for Q4 is \$1.38 billion plus or minus 2%, which implies approximately 7% to 11% sequential growth and 15% to 20% year-over-year growth. The current uncertainty regarding our materials constraints has been reflected in this guidance.

Non-GAAP gross margins are expected to moderate in Q4 to a range around 65%. We anticipate that non-GAAP operating margins will be in the range of around 18.2%. Diluted share count will likely continue to be significantly impacted by the accounting for convertible notes and warrants. We expect the diluted share count to be roughly 414 million shares in Q4, which includes 18 million shares from the convertible debt and 12 million shares from the warrants.

Recall that the favorable impact of the note hedges is not included as an offset, bringing our earnings per share estimates to approximately \$0.49 to \$0.53 per share. Since we cannot accurately predict what the average stock price will be for the full quarter, the diluted share count was calculated using the \$58.22 average share price from the first ten business days of this quarter. If we were to adjust the share count for the convertible bond hedge, that would add \$0.02 to the EPS guidance.

Despite the renewal of the federal R&D tax credit, our non-GAAP tax rate is expected to remain at 16.3% in Q4, primarily due to a greater concentration of profits in our U.S. geography.

While on this topic of future guidance, I wanted to make sure that you're aware that, consistent with our SEC disclosures, NetApp is required to adopt a new additional accounting standard for revenue recognition for FY '12. We will adopt in either Q4 FY '11 or Q1 FY '12, depending upon the timing of

our implementation of systems, tools, and processes. Irrespective of the timing, we do not expect any fundamental changes to our business model as a result of this adoption.

To summarize, we are pleased with the strong demand for our products. We continue to demonstrate compelling differentiation in the market. And our competitive position is as strong as it has ever been, evidenced by the continued strength in our gross margins. We will continue to prudently invest in growing our business while at the same time generating strong free cash flow.

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

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**Tom Georgens, President and Chief Executive Officer**

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Thanks, Steve, and good afternoon, everyone. I remain pleased with our financial results and our continued momentum in the marketplace. As data centers move toward a shared virtualized infrastructure, NetApp's innovation leadership is enabling compelling business outcomes for our customers and is propelling our growth. Our recent product announcements further enhance our competitive position and led to the fastest uptake of new platforms in our company's history. Unfortunately, after solid execution by marketing, sales, and engineering, we significantly exceeded our forecast and sold out of the new products. While disappointing in the near term, we remain optimistic as demand is very strong, our margins are evidence of our competitive strength, and we continue to generate significant amounts of cash while simultaneously investing aggressively.

For the last year, we have been using a two-year compare metric to measure our progress both internally and externally. It is a comparison to the same quarter two years ago to reduce the overstatement of growth due to weak quarterly compares post-Lehman Monday. We believe it gives a more accurate depiction of true momentum in the market. While likely the last time we will use this metric, the gap between our growth rate and that of the storage business of our nearest of the four largest competitors is nearly 30%, the greatest separation we have seen since we have started doing this analysis. This is also inclusive of all of their acquisitions in the intervening periods. The result is that NetApp has gained more market share in this interval than at any time in our history.

Last month, NetApp was honored to be named number five on Fortune Magazine's 2011 list of the 100 Best Companies to Work For. We improved two positions from last year, and it was our third consecutive year in the top ten. It is a tribute to the NetApp culture and the commitment of the total NetApp team.

While the recognition is satisfying, our objective is very pragmatic. NetApp has always stressed that our culture is a long-term strategic advantage, and this process enables to measure ourselves against the very best and identify opportunities for improvement. Our belief is that if the employees are happy, they will demonstrate maximum commitment. And if our employees are happy, our customers can tell. Few comments are more rewarding than when a customer says it simply feels different doing business with NetApp.

Our recent product launch further strengthens our position as the platform of choice for the next generation IT infrastructure. IT departments today face tremendous pressure to decrease costs, while at the same time increasing their enablement of business objectives. As a result, they are changing how they are architecting their infrastructure in order to achieve greater flexibility and efficiency. This means 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 and a smaller footprint than those of the competition. The announcements we recently made extend our

capabilities in each of these dimensions. And we see nothing from our competition today that comes close to providing the storage efficiency and cost savings that we bring to IT infrastructures of the future.

In addition to products, the diversification of our channels has been a key driver to our growth and an essential part of our strategy. At this point, our channel diversification and channel relationships are the best they have ever been and among the best of any IT company. Revenue from our distribution partners, Arrow and Avnet, was up 34% year over year. And our OEM partners, Fujitsu and IBM, are both expanding, with IBM growing double digits year over year to a new record. Our newer channel initiatives around service providers and systems integrators continue to broaden our reach, as evidenced by the Accenture announcement we made this week.

An additional element of our strategy has been to deepen our technology integration and our go-to-market activities with other best-of-breed innovators in the industry. We certainly see the major server vendors offering turnkey solutions, including services, their proprietary hardware stacks, and support. Our approach is to partner with other industry leaders to create more highly integrated, technologically superior offerings with a common support infrastructure and enabled by systems integrators and channel partners.

Publicly announced solutions include our secure multi-tenancy and FlexPod offerings in partnership with Cisco and VMware. We are also a top-tier provider in the Microsoft Private Cloud program, and we have numerous solution offerings with our OEM partners. Our recent announcement with Accenture will further enable those offerings.

Looking at our business from a geographical breakdown, the results of EMEA and U.S. public sector are notable. U.S. public sector grew 8% after nearly 60% growth last quarter, and EMEA grew 35% after only growing about 15% last quarter. In the case of EMEA, despite macro headwinds in certain countries, our own execution in Q2 could have been better, and we made good progress this quarter. Nonetheless, the big variation in quarterly performance of these geos is overstated due to timing of certain launch shipments rather than any sudden major shift in positive or negative momentum. Averaging the last two quarters would be more indicative of our performance. APAC and the Americas excluding U.S. public sector were both solid.

As NetApp went through the economic downturn, we made many hard decisions to reprioritize our product lines, ceasing some activities and investing more heavily in others. And those hard choices have yielded the outcomes you are seeing today. We have continued to invest heavily over the past nine to twelve months while making similar prioritization choices, and those investments position us well for the future. Despite any number of intermediate term macroeconomic concerns, as long as we continue to gain share and outgrow the market, we intend to continue to spend aggressively to make the most of our opportunity. We are clearly winning in the market more broadly than we ever have in the past, and we intend to take maximum advantage of this competitive position we have created. Should our revenue growth and gross margins remain robust, operating margins will remain above our historic levels.

In closing, I would like to sincerely thank the nearly 10,000 employees of NetApp and all of our partners and customers for their dedication and support. The team executed the largest product launch in our history, and at the same time grew product revenue 32% over a strong compare last year. Our market share gains are evident, and our competitive position has never been more distinct.

We look forward to spending time with you at our product focused Analyst Day in March to help you gain a deeper understanding of our value proposition and the scope of our competitive differentiation.

At this point, I will open up the floor to questions, reminding you to please limit yourself to one so we may address as many folks as possible during our allotted time. Operator?

**QUESTION AND ANSWER SECTION**

Operator: [Operator Instructions] Our first question comes from Aaron Rakers of Stifel Nicolaus. Please go ahead.

**<Q – Aaron Rakers>**: Yes, thanks, guys, for taking the question. If we can dive a little bit deeper into the component constraints, you guys had referenced \$10 million to \$15 million. Was that across both the midrange and the high-end products? And then also as it relates to the company's guidance, what are you assuming as far as that constraint continuing in the current quarter? Thanks.

**<A – Tom Georgens>**: For the most part, the constraints are more severe on the midsized product. And actually more particular than that is – to put it in perspective, we've introduced products before, but this one actually has four times the take-up rate of any of our previous products, so clearly the ramp was pretty steep.

And the other thing that's a little bit different about the 3000 family here is they also have this thing called an I/O Expansion Module, which allows you to put more connectivity in. And the demand for that was much higher than we forecasted as well, and in fact that ended up being the limiting factor. And probably in retrospect, the lesson learned here is that people were looking to build with the higher performance systems that we introduced. They were looking to build bigger systems. And the other thing is that those slots where the Flash cards go in, and clearly demand for our Flash cards is very, very high. In fact, the attach rate of Flash on these class of machines are actually ten points higher than they were on the previous class.

So overall in terms of constraints, it's primarily in the I/O Expansion Module, certain semiconductor components along the way. But at the end of the day, demand is really strong, so it's a bright side at the end of this. But nonetheless, it's primarily and particularly that dimension. I wouldn't call out any individual part, but the simple fact of the matter is we ended up shipping thousands of these units and we ended up at four times the demand that we expected.

As we go into the next quarter, our guidance currently reflects the fact that we've not resolved these problems yet. We're working on them. We think we have approaches that will resolve them. But it did cause us to take some consideration here with respect to whether or not we get all the parts we wanted, whatever the case. We also can't estimate the mixes correctly. We want to make sure that if there was this huge mix shift one way or the other, more modules, for instance, of IXM OM modules, we could handle that. So the bottom line here is we tended to be a little more conservative with our guidance because we have not solved all of the mix and the material stuff yet.

**<Q – Aaron Rakers>**: Okay, thank you.

Operator: Our next question comes from Maynard Um of UBS. Please go ahead.

**<Q – Maynard Um>**: Hi, thanks. Can you just clarify? Did you guide the op margins to 18.2% because if I take the midpoint of your guidance, just to get to the midpoint of your EPS implies op margins of sub-18%? So if you can just talk about the drivers there; were there any one-time compensation, next quarter, or other items that were in there?

**<A – Steve Gomo>**: Yes, the guidance at the midpoint we expect to be at about 18.2%. And if you go to the extremes of the ranges we gave you, you're going to have a range around operating margin as well. No secrets here; we showed you that gross margin is anticipated to come down slightly from the 65.5% level we just reported in Q3. And OpEx is up a little bit in the fourth quarter, as is typical in our fourth quarters, and we're reflecting that as well.

Operator: Our next question comes from Brian Marshall of Gleacher & Company. Please go ahead.

**<Q – Brian Marshall>**: Great. Thanks, guys, a question with regards to the M&A strategy. Obviously, your arrays are doing quite well, \$5 billion. But if you look, some of your competitors are expanding into big data, et cetera, and there are some other opportunities out there in security software and other ancillary markets. And so I just wanted to get an update on what the thought process is with regards to TAM expansion outside of the product categories as it stands today. Thanks.

**<A – Tom Georgens>**: Okay. I guess first to start, before we think about that is we've got to think about just where we are with our existing business. So if I look at the market share, at least the way we calculate it in the markets that we participate in, is for all of our growth and for all of our momentum, we're still 15% or so market share, and so I still think there's plenty of opportunity. So in a \$15 billion market, and if you believe IDC growing 7% or 8% per year, that's a pretty big opportunity. We're number one or number two in market share in probably 4 out of the 20 largest geos, concluding our awareness needs to be better than where it is today.

So those all sound like daunting tasks, but what it tells me first and foremost is that: A), that there's no limit to our ability to double our business just in the business we're in. And second, the fact that we gained two points in market share, as I measured it, just in the last 12 months tells me that market share is gainable in this segment. So first and foremost, I think our fundamental core business is very, very healthy and our aspirations are to double our business right in the space we're in.

When I think about acquisitions, there are really two components that I think about. Number one is there needs to be affinity; affinity meaning something that our sales force can sell or something that by virtue of having it in our portfolio we can move more of our existing products. I think if there's one thing that this industry has shown is that buying up dissimilar assets with no leverage and no affinity don't yield any shareholder value. And I think there are some pretty high profile cases in this market of very, very good assets that are not great stocks.

The other thing that I think is key to our strategy as well is that we don't want a lot of overlap. We don't want to pursue a product that may give us marginal incremental market but end up having substantial overlap with what we do, and we spend the next several years of our core team and this new product basically spending money replicating each other's features and basically building Noah's Ark, two of everything. So at the end of the day, I think the affinity and the lack of overlap are things that are key to us.

So certainly, if you think about Data Domain and our past, Data Domain was a backup product. It was targeted at that target market. It clearly had affinity and it didn't have overlap. On the other hand, I think there were some other properties that changed hands recently that had tremendous overlap with what we were doing, and therefore we weren't interested. That's how we see it. But right now, I feel no pressure to do acquisitions to generate near-term growth, nor do I believe that we're out of headroom in our current market. But that said, I do believe that there are adjacencies that are very, very attractive that I think are high growth, and I think that will be part of our acquisition strategy going forward. So I expect that we will be acquisitive, but I feel no pressure to do it in the near term. And likewise, I certainly don't want to signal any lack of conviction about our core business.

**<Q – Brian Marshall>**: That's very helpful, thanks.

Operator: Your next question comes from Scott Craig of Bank of America.

<Q – Scott Craig>: Thanks, good afternoon. I was wondering if one of you guys could go over the small systems growth. That looked like it came off a little bit this quarter. Is that from some competitive pressures with new products coming out and how you see those segments rolling out all through the guidance? Thanks.

<A – Tom Georgens>: I wouldn't say that there was anything special in that category. While I talk, I'll try and look up the exact numbers. But I wouldn't say that there was anything notable, either competitive or otherwise. Still, the business was up double digits, and the units were up more than that, so I still consider that to be an important part of our business. I know in mid-sized enterprise, I believe we've added over 1,500 new accounts this year, and a lot of it is driven in that segment. Our Arrow and Avnet business, which moves a lot of that product, has been very, very strong.

And the other big mover of the entry-level products is actually public sector. And while the public sector business shipments don't look that impressive, that business is actually quite healthy for us. And I think that we also refreshed the midrange business as well and may have drawn a little bit of demand, particularly from the larger of the smaller machines into a more modern unit. So that probably had some impact on the number as well. But fundamentally, I don't see any change in dynamics there that I have any concern about.

<Q – Scott Craig>: Okay, thank you.

Operator: Our next question comes from Shebly Seyrafi of Capstone Investments.

<Q – Shebly Seyrafi>: Yes, thank you very much. Can you talk about the current lead times for the midrange? I'm hearing things like possibly six weeks. Do you think -- that the supply constraints will be resolved at least by the fiscal Q1 quarter, and might that drive better than seasonal growth during that quarter because of this?

<A – Tom Georgens>: Yes, I'm not going to confirm the six weeks. I think that at some point in time, some of the products were on allocation and some of the customers may have gotten delivery in six weeks. Obviously, we're working like mad to try and close this gap. Frankly, from my personal perspective, it's disappointing to be having this conversation because other than that, we were putting up another very, very solid quarter. As a company, we would have been at the top of our range and over the top on EPS.

But in general here, I think the question is will the mix shift again and will it shift even more aggressively towards the new products. And I think we're certainly planning as if it is. We've never been a company that optimized ourselves around our inventory position, so I think we're willing to take material risk to cover uncertainty. But at the end of the day, there's only so much capacity downstream. So my hope and my expectation is that we'll get this cleared up this quarter. But at this point, I think that there's still ten weeks to go or more, and things can happen.

<Q – Shebly Seyrafi>: Great, thank you.

Operator: Our next question comes from Bill Shope of Goldman Sachs. Please go ahead.

<Q – Bill Shope>: Okay, great. Thanks, guys. Can you give us a little more clarification on what your comments were around the U.S. public sector? I just want to make sure I understand. So you mentioned, obviously, there was a big falloff in the growth rate this quarter versus last quarter. I think you had said there were some large deals that distorted this comparison. Should we take that to mean that there are really no incremental signs of spending constraints from your customers here? And how should we think about the steady-state trends here given those distortions you cited?

<A – Tom Georgens>: I think the 60% number last quarter was an outlier, and likewise the 8% this quarter. So what happens is we really track the business based on bookings and we see that every day, and then revenue could either lag by product availability or big shipments or revenue recognition. So a lot of big things move the needle there. So neither the euphoria of the 60% nor the despair of the 8% I think accurately represents the business.

And to answer the direct question, certainly the quarters that we've just been through, I've seen basically no change in the posture of the U.S. public sector business. And in fact, I wish all of our businesses were performing as well as that one is.

<Q – Bill Shope>: Okay, that's clear enough. Thanks a lot.

Operator: Our next question comes from Ben Reitzes of Barclays Capital.

<Q – Ben Reitzes>: Good afternoon, thanks a lot. Bigger picture, you have some things here moving around with your \$10 million to \$15 million of constraints and maybe it's even bigger. But what is your view of the market right now? You typically have said you can quote 2x to 3x the market. IDC conservatively is at 7.5%. I think that there's upside to that number. And has anything happened that would change your view of your ability to grow off that 2x to 3x, and what about your prospects as we head out the long term?

<A – Tom Georgens>: Yes, I think as far as 2.5x to 3x, even the guidance still is in that range. And the other thing about the 7.5% is that 7.5% will be an average but we'll probably never see any 7.5% years. We'll see 3s and 15s as we go forward, so it will be very lumpy.

So the way we think about the business in light of the fact that the market I expect to be lumpy is we think almost exclusively in terms of market share. Because market share, a point of share is a point of share, whether the market is up or down, and we tend to continue to gain share. But if you do the math, a point of market share on a market this size growing at this rate, a point of share alone is roughly 15% growth. And this past year, we gained two points of share. So from that perspective, I think the mathematics of us growing at the rates that you talked about I think are still very, very much achievable. Clearly, as we get bigger, it becomes more and more challenging, but certainly we've been big all year. We've still been growing probably the last trailing 12 months growth rate is probably in the vicinity of 30%. So the business is robust. It's certainly there.

If I look at the geographical landscape, we talked about U.S. public sector, and there's lots of speculation about what may happen, but there has been lots of speculation and the business is still as strong, certainly stronger than anybody else's in the storage business.

When I look at Europe, Southern Europe is still a challenging environment, but that's not really material to our business. In fact, our growth there, I tell the team with no market share, the macro doesn't matter. UK is a concern because of the government austerity, and I met with the CIOs of a number of agencies of the UK ministries when I was over there just a couple weeks ago, and clearly they're seeing constraint. But the German economy is remarkably strong and they're remarkably confident.

And Asia-Pacific hasn't been historically a strong area for us, but actually we've seen very, very good growth. I'm very pleased with the progress we're making there. And that frankly needs to be a bigger percentage of our business going forward.

And then the U.S., in the U.S., I think I feel better about our execution in that market than I do about the market at large. So all in all, I'd say what's gone on would lead me to believe that 7.5% is probably a viable estimate going forward, and I feel good about our competitive position.

<Q – Ben Reitzes>: Thank you.

Operator: Our next question comes from Amit Daryanani of RBC Capital Markets.

**<Q – Amit Daryanani>**: Thanks a lot. I just have a question going back to this \$10 million to \$15 million revenue hole from component shortages. I guess what's the risk that you think it could get bigger in the April quarter? And are these shortages more because you just can't get the components, or the components are really long lead times and we just inaccurately guess how much we needed?

**<A – Tom Georgens>**: I think a few things happened. Could it get bigger? I'm not going to alarm anybody and say otherwise; but it could, I suppose. All that is factored into our guidance in terms of what we think the various risk factors are one way or the other. But some parts are fabricated like sheet metal and cables and stuff, and some parts are off the shelf. So when you consume off the shelf in worldwide distribution, then eventually you're exposed to the manufacturers' lead times. And likewise, we've been working on this for a while, so some of that lead time has been worked down. But we're still working through – we're working through the issues.

Clearly, when you look at the grand scheme of things, new product introductions are always tricky. But we came out with really not much engineering drama, and these products came out. And like I said, we've built thousands of these. It's not like we can't build them and ship them. We just can't get enough parts to build enough of them. And I think we'll still have on some of the products, certainly some of the products are back to normal lead times, but some of them aren't, and we need to continue to work on that issue.

**<Q – Amit Daryanani>**: To the best you can see, when do you think these issues get resolved? Is it by July quarter?

**<A – Tom Georgens>**: I clearly want to get this cleared off by this fiscal year end, and I think we have a plan to close it based on various different mix scenarios. But if the mix scenario changes dramatically yet again, there could still be some unknowns. I wish I knew the answer, and in 90 days we'll all know the answer. But I think at this point, we're looking at the data we have, and we're expediting as hard as we can. We're certainly taking a fair amount of material risk, or at least near-term inventory risk. We'll ultimately burn it off, but I can't tell you with full confidence that we're going to clear this up. But I can tell you with full confidence that we're working on it night and day. And I can tell you that we've made – the bounds we put around the guidance reflect reasonable assumptions about mix and change et cetera. So we've tried to reflect everything we know in the guidance.

**<Q – Amit Daryanani>**: Got it, thanks a lot.

Operator: Our next question comes from Katy Huberty of Morgan Stanley.

**<Q – Katy Huberty>**: Thank you. Tom, I'm curious if you have any thoughts on EMC's aspirations to sell more product through your channel. And specifically, do you feel like you have to go head to head with them at that \$9,000 to \$10,000 price point, or do you just have richer software offerings and you'll let them deal with that low-end market?

**<A – Tom Georgens>**: First of all, I appreciate you calling it our channel. I think, certainly, if I was in their shoes, certainly I would go after our channel partners as a pinch point on NetApp. On the other hand, there's a lot that goes into partner relationships. And I think that we're going to participate in the segments where we currently play, and I think we've got very, very strong relationships there. And certainly, I wouldn't cede any ground functionality. But even in addition to the functionality, there are programs, there are relationships, there's longevity, there's trust. There's a whole set of factors that go into building channel loyalty.

So certainly, I expect EMC to continue to assault us on all fronts, like they've been doing for the last year, and I think it's up to us to compete. And I think we'll compete based on compatible channel strategies. I think we'll compete based on product features. We'll compete on our ability to make our channel partners more profitable. So yes, I would expect nothing less than EMC to come out very aggressively with their new products, just like they have with everything else that they've got. But I really don't see anything happening here that's going to fundamentally tilt the balance in this business.

If there was one irony in the product release is that there was a heavy dose in the press of talk about EMC closing the gap with NetApp. And on one hand, we can debate the merits of that statement, whether they're really closing the gap and whether there's a whole category features they haven't even begun to address. But I think the real key component there is that NetApp has become the innovation yardstick by which EMC is measured. And I think at least that part, we felt good about.

<Q – Katy Huberty>: Thank you.

Operator: Our next question comes from Alex Kurtz of Merriman Capital.

<Q – Alex Kurtz>: Thanks for taking the question; a lot of consolidation in the data analytics space over the last call it two quarters. I know you guys announced a partnership with ParAccel last year. Do you feel that's a space that you need to be more involved in from an acquisition perspective? Or do you feel like there's just enough core storage opportunity and share that that's more of a TAM for larger companies to go chase?

<A – Tom Georgens>: I think for us to be in the data analytics space, I think that's probably in the category of affinity. I'm not quite sure. I think that there are more attractive adjacent markets for us to pursue. And in addition, I think that doesn't mean that there's more TAM elsewhere and we're not interested in that. I think partnership opportunities in that space are still very attractive to NetApp, and at this point are going to be the way we're going to go after that business as opposed to actually being in the analytics business ourselves.

<Q – Alex Kurtz>: Okay, thank you.

Operator: Our next question comes from Lou Miscioscia of Collins Stewart.

<Q – Louis Miscioscia>: Okay, thank you. Maybe you can talk about the component environment. Dell saw some nice margin upside. I realize that there's only a minimum amount of overlap, but obviously you have DRAM and hard disk drives. And it looks like obviously your product gross margin was down a bit quarter to quarter. I guess I would have thought maybe it would have ticked up; just what you're seeing there and what you expect going forward?

<A – Steve Gomo>: Yes, so we had anticipated our product margins were going to be down. In fact, I think we guided you that way. Remember, our second quarter benefited from a timing difference between cost reductions and price reductions. We straightened all that out this quarter. We had rich configuration mix last quarter. We thought we were back to normal this quarter. So the fact that the product gross margins are down was anticipated. And in fact, I would argue that we're slightly ahead of where we expected to be, and that's why our gross margins are a little higher than what we had told you.

With respect to the component environment out there, our operations people tell me that -- generally speaking, there are not a huge amount of supply constraints, but there are key components that are under constraint. And unfortunately, we have a couple of those in our products. And when mixes shift in a manner that hits those particular components, it just gets exacerbated at the system level. So at the end of the day, I think that there are some spot

shortages out there. They're not widespread across a whole variety of different components, but there are a few that are, unfortunately, in constraint right now.

**<A – Tom Georgens>**: I think overall in terms of the pricing environment, the key commodities that are interesting to us, clearly disk drives. And I think the disk drive supply chain has got multiple suppliers, and they all appear to be relatively healthy in terms of being able to meet our needs. So I think that gives us some multiple choice options; clearly DRAM, and the other one is Flash. About a year ago, we made a very, very significant inventory commitment around Flash to guarantee supply, which we've now completely burned through well in advance of when we thought it would be. And we're going to move forward with that as well.

So all in all, I think the pure commodities are probably – we probably are seeing some ability to exert a little bit of pricing leverage, but not a lot. And the issue that we have with our product isn't suddenly some part is in short supply. What it really is, is that we suddenly have tremendous demand for a part. And we either need to find them throughout the supply chain or try and convince them to wrestle them away from somebody else, or in some cases actually have them fabricated by the original manufacturer.

**<Q – Louis Miscioscia>**: Okay. And then looking out to the April quarter, pretty much still a decent benefit, or is it moderating?

**<A – Tom Georgens>**: That's hard to tell. Particularly with these commodity parts, Flash and DRAMs and disk drives, pricing changes on a weekly basis, so we need to stay on top of that. But I would say that our takedowns in those areas have been good, probably a little bit better than we forecasted. But I should also add that some of those commodities are also – our competitors see them too, so we basically use that to pass that along to our customers.

**<Q – Louis Miscioscia>**: Okay, thank you.

Operator: Our next question comes from Jason Maynard of Wells Fargo.

**<Q – Jason Maynard>**: Hi, guys. I had a question for you on FlexPod. I know there's obviously a lot of talk about EMC going after you, but I'm curious what you can talk about in terms of the FlexPod launch and how you think that's going to play out from a competitive dynamic over the next year.

**<A – Tom Georgens>**: As far as FlexPod is concerned, it's just as significant relative to the full server vendors as it is specifically around EMC. I think FlexPod and Vblock are basically strategies by EMC and ourselves to really go after the value proposition of what the server vendors offer. So the server vendors offer a stack of proprietary technologies with front-end services and back-end support, and they come as effectively a one-stop shop. So the appeal of that is basically the one point of contact. But the down side of it is that none of the technology is best in class or state of the art. So ultimately, what you're getting is you're trading off in favor of integration, but you're trading off best of breed, and you're trading off the ability to drive lower cost and greater efficiencies in your company.

So recognizing that there is a power of integration that I think the players in the industry are looking to integrate with other best-of-breed providers to basically create integrated solutions that approximate the integration of those at the server vendors, and then have professional services and common support on the back end. So I think that effectively, this is a way to effectively compete and nullify the one advantage of the server vendors, yet at the same time offer best-of-breed technology.

Now as far as EMC, I think clearly we've taken – we've clearly taken different approaches. I think we've really designed for more flexibility as opposed to fixed configurations. I think we're a bit more

channel friendly. And frankly, it's generating a tremendous amount of momentum in the market. I'm sure you guys check and see that. But first of all, the engagement between VMware has always been strong. The engagement between us and Cisco is accelerating, and FlexPod is the culmination of a number of those activities; so all in all, good.

<Q – Jason Maynard>: Thank you.

Operator: Our next question comes from Chris Whitmore of Deutsche Bank. Please go ahead.

<Q – Chris Whitmore>: Hi, thanks very much. I wanted to ask about the Oracle relationship. Can you give us an update of where that stands? And what threat, if any, do products like Exadata create for NetApp going forward? Thanks.

<A – Tom Georgens>: So the Oracle relationship from a go-to-market perspective as a technology partner and our engagement with customers is probably largely unchanged. Clearly, we're involved in accounts. We do projects together, so I think that continues. One of the things that stood in the way of doing some joint technology development, obviously, was the lawsuit that they inherited from Sun. And the resolution of that has allowed us to do more collaboration from a technical perspective, while that had been a roadblock there for a few months. So with that out of way, we can work on more constructive things going forward.

As far as Exadata, it's an interesting scenario. And that is the idea of a totally integrated stack from software all the way down to storage in some ways is orthogonal to the idea of building a shared virtual infrastructure that can run multiple different types of apps at the same time. And I have a lot of conversations with the customers about where do you draw the line. Do you basically carve off – because there's no doubt that the vast majority of the applications are going to pursue the virtualization path because of the flexibility and the efficiency and the economics involved. And the question is do they carve off one or two applications that are so important they're going to build a dedicated stack.

So I think that Exadata is not a broad market product. It's really tied to the Oracle, and it's really tied to only really a certain class of Oracle applications. And where the customers ultimately draw the line, does Exadata support all the Oracle apps in an enterprise or just one or two? I think time will tell. But at the end of the day, I think our strategy with Oracle is to basically engage them around Exadata rather than competing directly with it. Clearly, the space where Exadata is competing today is clearly occupied a lot more by our competitors than it is with us. So I think it gives us more of an opportunity to work collaboratively with them around the rest of the infrastructure rather than just the online transaction processing database or the data warehouse.

<Q – Chris Whitmore>: Thanks.

Operator: Our next question comes from Jason Ader of William Blair.

<Q – Jason Ader>: Yes, thanks. Guys, the last two quarters, even if we include the \$10 million to \$15 million miss from the demand situation this quarter, it just seems like last two quarters, it has gotten tougher for you to beat the top end of the guidance, whereas the prior three quarters you were blowing away the top end of the guidance. I'm just wondering. Are we just coming to a more normal environment, and the previous three quarters before the last two quarters were just pent-up demand and you under-forecast significantly? I'm just trying to get a sense of anything – has anything changed in either the demand or the competitive environment which is causing the actual results to be more top-end to guidance versus above that?

<A – Steve Gomo>: There has been no change in our approach to guidance. We gave it our best shot with respect to what we think we're going to do. We give you a range and we point you toward the midpoint, and that's the point that we're focused on. If things develop during the quarter that

allow us to take it to the high end, we do. If it goes the other way, so be it. But we haven't changed the way we're giving guidance. And I think the numbers speak for themselves in terms of the growth rates, and particularly the product in the space, which is the one I would focus on.

**<A – Tom Georgens>**: Yes, I think it's pointless for us to game the system if we basically gave you guidance that we intend to come in over the top of, then effectively you'd ignore the guidance that we're giving, so there's no gaming that's going on. We're giving guidance and that is the guidance, and there are no winks and nods here. We're giving a range and this is where we think we're going to be given everything we know.

**<Q – Jason Ader>**: Thank you.

Operator: Our next question comes from Richard Gardner of Citigroup. Please go ahead.

**<Q – Richard Gardner>**: Great, thanks. Tom, as a follow-up to Katy's earlier question, you said you'd be willing to engage in a discussion around features on VNX and where you think their product continues to be deficient, and I'd just love to get your thoughts there.

**<A – Tom Georgens>**: I think first of all from a maturity point of view, we certainly have an eight-year head start on them. And then I think more generally, I think the breadth of our software features, the breadth of our integration, the efficiency technology, particularly in that segment of the market, the ability to drive economics because mostly at the very, very low end we talked about people with relatively small IT budgets. So to be tightly integrated with the applications they run, to be able to run it far more efficiently with our deduplication technology and the maturity and proven technology as time goes on, I think are all factors that come into play.

The other thing is I think that we've enabled our channel partners with our professional services strategy that our channel partners I think are far more capable of helping small customers adopt and put our technology to use than the generic channel partners. So the professional services strategy of not doing it ourselves in this segment of the market has basically raised the confidence level of our channel partners, and I think that's a factor here as well. So I think from an economic perspective, from an ease of use perspective, from an integration perspective, and from a risk of deployment perspective, I still think we have a superior offering.

Operator: Our next question comes from Mark Moskowitz of JPMorgan. Please go ahead.

**<Q – Mark Moskowitz>**: Yes, thanks. Good afternoon. Steve, I wanted to get a sense from you in terms of the guidance if we should take anything from the 18.2% operating margin midpoint. Does that imply any change in your indirect channel exposure because I do know you get a little better operating margin boost there to offset some of the gross margin detriment from being in the indirect channel? And you did have a pretty big indirect channel number this past quarter. So I just want to see if you can talk about that a little more.

**<A – Steve Gomo>**: Sure. At the operating margin level, the channel mix almost has absolutely no effect. It can almost swing 100% one way or the other, and you're going to get the same operating margin. This just reflects the fact that we expect to see some abatement in the level of gross margin, which would be typical in our fourth quarter. Most of that would be in the product margin area. And then typically, we tend to invest for next year. We're putting resources in place in both the field and engineering as we get ready to ramp up for next year. And those are the kind of investments that create the growth we have seen. So there's nothing more to it than that.

Operator: Our next question comes from Jayson Noland of Robert Baird. Please go ahead.

**<Q – Jayson Noland>**: Thank you. And just to clarify, the material constraint mostly results in delayed business, not lost orders. And my question is on the high end. I think there were a couple

hundred beta sites. If you guys could talk about conversion and what you're seeing at the high end and if you thought there was some pent-up demand coming out of that November refresh, thank you.

**<A – Tom Georgens>**: I think as far as the high end is concerned, the high-end customers fall into various different categories. There are some that are on the extreme end of the performance, and they're going to basically adopt the new technology as soon as it's available. So clearly, there is probably some pent-up demand there. But there are other customers that are running the high-end systems or the large systems in mission critical applications. And for them, they'll go through a phase of certification and testing and performance modeling and all of that. So I wouldn't say that there's a general rule that applies to all of the large systems. I think it depends on the customer set that's actually using them.

Clearly, one thing that we also see is the connect rate of our Flash technology on the high-end systems is extremely high, not quite in every unit item, but very, very high. So I think people are using that technology very, very effectively. And I think the high-end systems help us with that as well, particularly – and also the latest release of the software allows us to use the cache with all of our other features and large drives and things like that. So a lot of the compatibility issues we have with cache are now gone, and so it allows the deployment a little bit more broadly. So I'd say that that's really what's driving it there. Like I said, people buy large systems for high performance. They buy them for high capacity, and they also buy them for large scale mission critical applications. And I'd say that all three of them have a different adoption schedule.

Operator: Our next question comes from Keith Bachman of Bank of Montreal. Please go ahead.

**<Q – Keith Bachman>**: Hi, thank you. I had a related question to the past one. And that is, Steve, if you look longer term, if you think about product mix, I want to try to understand if there's impact to gross margins. What I mean by that is you mentioned the 3200 has a lot of I/O and customers are scaling out. Does that eventually have some implication for product mix from people moving from high to low, and/or does the inclusion of more Flash longer term have an impact on gross margin?

And related to that, Steve, is there anything on the mix side that would impact services margins from where they are now? Thanks very much.

**<A – Steve Gomo>**: If you look out long term, we're not anticipating any major shift in the mix of cost of goods sold or in the mix of gross margin because of some of these new technologies that we're adding. We'll be pricing accordingly, and we'll be pricing to be remaining competitive in the marketplace. So I think that our goal is to try and keep the product margins at or around 60%. I've always said give us a point or so for normal fluctuations, but that's pretty much where we're going to be. I think these new features allow us to grow as fast as much as they do to give us some competitive margins.

**<Q – Keith Bachman>**: Okay.

**<A – Tom Georgens>**: And some of our software is capacity based in terms of its pricing. So to the extent that we sell larger capacities, from a software perspective, that's still going to scale largely linearly. And that too varies if you're talking about the high-end products. Some of the high-end products that are extremely capacity intensive tend to not have the rich software set. But certainly, the ones that are in the mission critical data processing or transaction processing environments, they tend to be very, very software heavy.

**<Q – Keith Bachman>**: Okay. Okay, and then, Steve, anything on the services side?

<A – Steve Gomo>: Nothing at this point, Keith; we talked about the new accounting convention that we're going to be adopting. That could have a minor influence, but very minor. I'm not anticipating anything major long term because I think we'll adjust our business model accordingly.

<Q – Keith Bachman>: Okay, fair enough. Thanks, Steve.

<A – Steve Gomo>: Yes.

Operator: Our next question comes from Bill Fearnley of Janney Capital Markets.

<Q – Bill Fearnley>: Yes, good afternoon. Thanks for taking the question. When you look at the vertical markets, any additional color, either domestically or in EMEA, that you wanted to call out for the quarter; any particular verticals that were stronger than you had expected?

And then one other question on the backlog; is there any additional color on who got left waiting? Was there any geo effect on that as well?

<A – Tom Georgens>: Okay. So from a geo perspective just looking at the mix, probably a little bit more strength in financial services, which probably should be good news for all you guys. But other than that, most of the other ones stayed relatively constant.

As far as who got shipped what, that's a function of a lot of things. We've got revenue recognition relative to other items that are on the PO and what gets deferred and what doesn't get deferred or what other pieces were short. Obviously, some customers in terms of their size and their history and the urgency is a factor as well. So I would say that there's probably no overt geo color. But if you look at the growth rates of the geos, clearly the shipments were not evenly distributed. And we talked about U.S. PS [Public Sector] being at 8% and that being grossly understated relative to their business. To be fair and honest, the EMEA number at 35% is probably overstating the activity level there. And I'm sure how these got prioritized probably had some impact on those numbers as well.

<Q – Bill Fearnley>: Thanks.

Operator: Our next question comes from Kaushik Roy of Wedbush. Please go ahead.

<Q – Kaushik Roy>: Thanks. So you're definitely continuing to gain market share, but are you having to discount more than in the past? The reason I ask is because I'm looking at gross margins. And I understand for January it came down, but April is seasonally a stronger quarter, and your gross margins expand in April. It appears because of volume. If you could give some color, that would be helpful.

<A – Steve Gomo>: Sure. Kaushik, even if you look back to last year, our product margins actually declined slightly from the third quarter to the fourth quarter. We're not projecting a particularly significant decline. It's on the order of 0.5 percentage point, probably within our ability to call. But we're expecting that we'll see the normal aggressive sales behavior that we do. There will probably be some extra discounting that we typically see in the fourth quarter, nothing unusual and nothing that's going to have a significant impact on product gross margins.

<A – Tom Georgens>: If I look at the numbers, I think it's 0.2 percentage point versus 0.6 percentage point, so I don't think it's that much different. And as Steve indicated, I think that pressure in the fourth quarter is clearly – it's obviously peak commission time. And obviously the amount of whining and crying on our shoes that we get about doing discounts around specific accounts becomes particularly acute this time of year, as you can well imagine.

<Q – Kaushik Roy>: Okay, thank you.

Operator: Our last question comes from Eric Martinuzzi of Craig-Hallum. Please go ahead.

<Q – Eric Martinuzzi>: You had a particularly strong cash flow generation quarter a year ago in your Q4 2010. Could you give some color on your expectations for free cash flow for Q4 '11?

<A – Steve Gomo>: Yes, I think it's going to be on the order of the same type of percent of revenue that we just saw. Some of it's going to depend on that DSO number maybe coming down a little bit from where it was in the third quarter. If that were to happen, you'll see a number that's a little bit north of the 23% we just posted. But I think modeling in the 23% – 24% range is probably reasonable for the fourth quarter.

<Q – Eric Martinuzzi>: Thanks.

Operator: At this time, I would like to turn the call back over to NetApp for any closing remarks.

### Tara Dhillon, Vice President, Investor Relations

Thank you, operator. We look forward to seeing you all at our Technology Forum on March 22nd in New York. Registration will open next week on February 22nd. We appreciate your time today, talk to you soon.

Operator: Thank you, ladies and gentlemen. This concludes today's conference. Thank you for participating. You may now disconnect.

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