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NetApp, Inc. *(NTAP)*

Q3 2013 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Kris Newton

industry analysts contact, Network Appliance, Inc.

GAAP AND NON-GAAP FINANCIAL MEASURES

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

Nicholas R. Noviello

Executive Vice President, Finance and Chief Financial Officer, NetApp, Inc.

FINANCIAL HIGHLIGHTS

Q3 Results

- NetApp delivered solid financial results in fiscal Q3
- Revenue of $1.63B was slightly above the midpoint of our prior guidance
    - We achieved non-GAAP gross margins of 60.4% and operating margins of 17.1%
- Non-GAAP EPS of $0.67 exceeded the high end of our Q3 guidance range, and we generated $254mm in FCF in the quarter, just under 16% of revenue

REVENUE

- Revenue increased 6% sequentially and 4% y-over-y
- Revenue from our Americas commercial, EMEA and APAC geographies all grew both sequentially and y-over-y
- Revenue from our U.S. public sector geography was down sequentially as expected but was up 14% from Q3 a year ago
- Branded revenue of $1.43B was up both sequentially and y-over-y
- Branded revenue grew 7% from Q2 and 8% from Q3 last year while OEM revenue declined 3% sequentially and 17% from Q3 a year ago
- Product revenue was flat from last year but up 7% from Q2

GROSS MARGINS, OPERATING MARGINS, OTHER INCOME AND EXPENSES

- Non-GAAP gross margins of 60.4% were in line with prior guidance and our targeted financial model
- Product gross margins of 53.1% were down slightly from Q2 related to customer mix

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- Service gross margins of 58.7% were up just over a point from Q2 due to lower costs and a more favorable mix of revenues related to service contracts vs. professional services
- Non-GAAP operating margins of 17.1% were just inside the range of our targeted financial model and exceeded prior guidance for the quarter
- Non-GAAP operating expenses were down slightly from Q2 reflecting lower variable compensation and conservatism in spending given the overall business environment
- Non-GAAP other income net was down from prior quarters reflecting interest expense related to our senior notes offering in December

EFFECTIVE TAX RATE, R&D TAX CREDIT AND EPS

- Our Q3 effective tax rate was 13.6%, lower than prior guidance and reflected a prior-year discrete item and current-year cumulative benefit related to the R&D tax credit approved by Congress in early January
- For Q4 and the FY2013 we now expect the non-GAAP effective tax rate just below 16%
- Non-GAAP EPS exceeded the high end of our guidance range by $0.09, $0.03 of which was due to the lower effective tax rate and the remainder due to improved operating margins

BALANCE SHEET ITEMS

Cash, Investments, Inventory, FCF and Acquisition

- Our balance sheet remains strong with approximately $6.7B in cash and investments
- The increase of approximately $1.2B in cash and investments from Q2 reflects the $1B in five- and ten-year senior unsecured notes we issued in December
- Total deferred revenue increased by $106mm from Q2 and accounts receivable, DSO, decreased slightly from 36 days to 35 days
- Inventory improved to 14.9 turns with inventory levels down and normalizing to more historical levels
- Cash from operations was $365mm and FCF was $254mm
- FCF was reduced by approximately $70mm related to the buy-out of our remaining off-balance sheet synthetic leases
- Overall cash also reflects the repurchase of approximately $62mm of stock in the quarter and the completion of the acquisition of CacheIQ.
    - We expect to repurchase two to three times more shares in Q4 than we did in Q3

Diluted Share Count, Hedges and Shares Repurchasing

- Diluted share count decreased in Q3 by approximately 3mm shares
- The accounting for the shares associated with our $1.265B of convertible notes had minimal impact on diluted share count in the quarter
- The notes become fully convertible in March and will mature at the beginning of June
- At that time we will settle them with $1.265B of U.S. cash paid to note holders and to the extent the average share price is over the strike price of $31.85 shares of common stock associated with the conversion feature of the notes
    - This dilution will be partially offset by note hedges at that time
- As you may recall, 80% of our convertible notes are hedged
- Separately, our related warrants will come due beginning in September, 2013, and may also create dilution if our share price is over $41.28 at maturity

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  - We expect to repurchase shares to offset any remaining dilution associated with the maturity of our convertible notes as well as our warrants

Revenue, Gross Margins, Tax Rate, EPS and Share Count

- Our target revenue range for Q4 is $1.7B to $1.8B which at the midpoint implies just over 7% sequential growth and just under 3% y-over-y growth
- We expect the growth of branded revenue to exceed that of the total revenue and to be offset by flat to reduced OEM revenue
  - We expect consolidated non-GAAP gross margins of approximately 60% to 61% and non-GAAP operating margins of approximately 17%
  - We expect our blended consolidated non-GAAP effective tax rate to be just below 16%, bringing our non-GAAP EPS estimate to approximately $0.65 to $0.70 per share
- Diluted share count is projected to increase to about 372mm shares in Q4 based on our average stock price of $36.02 for the first ten days of the quarter
  - This will include about 5mm shares from the convertible notes
- Recall that the impact of the note hedges is not included as an offset

Thomas Georgens

President, Chief Executive Officer & Director, NetApp, Inc.

BUSINESS HIGHLIGHTS

- In what remains a challenging macro environment NetApp again performed well with revenue coming in just above the midpoint of our prior guidance and EPS above the top of our range
- The NetApp team remains focused on things that we can control: delivering innovation, expanding our partnerships and strengthening our go-to-market position
- Our ability to execute in all of these areas by delivering innovative best of breed solutions creates a compelling reason for customers to choose our technology for the foundation of their shared and dedicated storage infrastructures and enables NetApp to deliver strong financial performance

Branded Business

- Our branded business was strong again this quarter, growing at twice the rate of the total business y-over-y

DATA ONTAP AND CUSTOMERS

- Driven by the strong value proposition of Data ONTAP, the branded business grew 8% from Q3 a year ago, its strongest growth in FY2013
- Data ONTAP is the number one storage operating system and serves the needs of the shared storage infrastructure, which represents the vast majority of today's opportunity
  - We are pleased to see strong customer adoption of ONTAP 8
- Almost 50% of our installed base has moved to ONTAP 8 and half of that has moved to the rapidly expanding 8.1 release introduced less than a year ago
  - The adoption of clustered ONTAP is also seeing strong growth
  - The acceleration of clustered nodes continues with units shipped up 70% from last quarter

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    - We now have cumulatively shipped well over 2,000 clustered nodes
- While some customers are still in the learning or early adopter stage, others have made it a standard for their data center
- For example, in the course of one year a new financial services customer has grown to 38 clustered nodes and roughly 12 petabytes of storage
- In addition to the benefits of unlimited scale, performance and nondisruptive operations, customers value the reduction of complexity that clustered ONTAP brings to their environments

OFFERING FLASH SOLUTIONS

- NetApp has the most comprehensive flash portfolio in the storage industry, offering solutions for both shared infrastructure and workload specific requirements
- As with clustered ONTAP the value delivered by these solutions is generating robust customer demand
- Since the introduction of our first flash solutions three years ago we have shipped 36 petabytes of flash and more than 20,000 systems have been deployed with at least one NetApp flash solution
- By offering flash solutions at the array, controller and server level we enable our customers to get the performance they require at an optimum price
- To date NetApp customers have accelerated three exabytes of disk storage using Flash Cache

HYBRID DISK AND SSD SOLUTION

- Bookings of system with Flash Pools, our hybrid disk and SSD solution introduced in Q1, have increased 67% sequentially
- Flash Accel, which enables customers to utilize server-based flash to accelerate application performance without sacrificing any of the NetApp management capabilities will begin shipping this quarter
- On last quarter's call we talked about a highly competitive all flash array bake-off in which we competed and won using the high performance characteristics of E-Series in SSDs
- In Q3 we booked more than a hundred of these systems
- You can expect NetApp to be much more aggressive on the all flash array front
- Look for more news in the near future

FAS3000 AND FAS6000 FAMILY

- In Q3 we refreshed the FAS3000 family, the newly introduced FAS3220 and FAS3250 target enterprises and mid-size businesses that are consolidating operations onto a shared storage platform
- The new systems improve performance by up to 80% and increased storage capacity up to 100% over our existing products in this space
    - These new platforms already comprise 32% of the FAS3000 units shipped in the quarter
- Overall, the units of the 3000 family were up 16% sequentially but down 24% y-over-y as there continues to be some migration between the FAS2000 and the older lower end 3000 platforms
- The FAS2000 product line continues to grow rapidly with units up 10% from last quarter and up 55% from Q3 a year ago
- The FAS6000 family was up 19% sequentially and flat from last year
- In Q3 over 20% of our FAS6000 systems shipped in cluster deployments and 19% shipped as hybrid arrays with Flash Pools

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E-SERIES PRODUCTS

- Finally, over the course of FY2013 we have seen a marked improvement in activity and pipeline for the branded E-Series products
- In Q3 we enhanced the E-Series platform with improved performance, increased connectivity and greater data protection
- Unit shipments of the E-Series have grown 43% sequentially

Strategy

- Partnering remains key to our strategy
- Both our alliance partners and our reselling channel partners are core to our ability to globally deliver a complete innovation stack to our customers
- There is no better example than the power of this strategy than FlexPod, a converged solution based on NetApp and Cisco technology sold by our joint channel partners for shared storage infrastructures
    - This solution has strong momentum with over 2,100 customers in 35 countries and over 700 partners enabled to deliver the stack

FLEXPOD

- During the quarter we saw record new customer adoption of FlexPod
- In Q3 we expanded the Cisco partnership through deeper and broader solution integration and announced FlexPod for cloud service provides, FlexPod for branch offices and expanded application validation to include Oracle, SAP BusinessObjects, SAP HANA, Microsoft Private Cloud and Citrix Cloud platform
    - We also announced clustered ONTAP support for Citrix ShareFile, enabling customers who are storing their data on premise to leverage ONTAP software to access data, scale performance and capacity, reduce data center footprint and reduce costs

CUSTOMERS

- Customers not only have a requirement for shared storage and dedicated storage infrastructures, they are also looking for new means of IT delivery utilizing the cloud
- NetApp has long been focused on servicing the needs of the cloud service providers and customers looking for IT as a service
- In Q3 we introduced NetApp private storage for Amazon web services, an enterprise storage solution that balances internal data center resources along with AWS cloud resources to best meet customer needs
    - The volume of activity around this solution is very promising

Indirect and OEM Businesses

- Our indirect and OEM businesses represented 81% of revenue in Q3 and grew 7% from Q3 a year ago
- Arrow and Avnet were 33% of total revenue, up from 27% of revenue last year
- OEM business was 12% of revenue, down both sequentially and y-over-y
- While we have always said that the OEM business will have a different growth profile than the branded side, the 3% sequential decline was greater than we anticipated at the outset of the quarter
    - We continue to aggressively position our solutions with the OEM partners, some looking to do less business with us and others looking to grow

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CHANNEL AND ALLIANCE PARTNERS

- We are pleased that we continue to make progress on our key initiatives
- Adoption of clustered ONTAP, leadership in the flash space and leverage through our channel and alliance partners
    - While there are some pockets of optimism the global macro environment remains uncertain with renewed concerns in Europe and uncertainty in the U.S. federal spending due to looming sequestration
- In every geography we continue to see lengthening of sale cycles and large deals being drawn out
    - However, I am confident in our ability to execute and realize the payoff investments we have made in innovation and partnerships

CLOSING REMARKS

- Finally, I will like to extend my congratulations to the entire NetApp team for being ranked number six on Fortune's list for great places to work
- NetApp's culture is a competitive advantage and a key to our continued success
    - We are proud when our customers and partners say that it just plain feels different to work with NetApp
        - This recognition, our fifth year in the top ten, is evidence of our commitment to creating a model company

QUESTION AND ANSWER SECTION

Kulbinder S. Garcha
Analyst, Credit Suisse Securities (USA) LLC (Broker)

Q

For Tom, I have a question I guess. If I look at your full year – if I look to your guidance for the next quarter and even take the high end of the range. It looks like full year product revenue growth will still be down maybe as much as 2%. I'm just trying to think, how do you think about that with respect to competitive environment, market share for the full FY? How do you feel about that and then kind of linked to that your capacity growth only at 9% which is much lower than any trend level we seen historically, do you have any insight as to why it is so low Tom? Anything on that would be useful as well.

Thomas Georgens
President, Chief Executive Officer & Director, NetApp, Inc.

A

So obviously a few questions there. I think in terms of our guidance for next quarter, and clearly the factor in the macro as we see it, the factors that I talked about in the prepared text around certainly concerned about sequestration, certainly concerned about Europe, negative GDP growth last quarter, I know we need to balance that against what we see, what our customers are telling us, what we see in our own business and I mean what we see in the pipeline. That's what ultimately leads to the number. I think certainly it's a difficult environment to be aggressive in, but the guidance we gave is a combination all of those factors, probably a tough macro and perhaps a little bit more focused on our own customer base where clearly we've had some momentum in the past two quarters.

I think it's probably the product revenue. The key component there is to ultimately tease apart a couple of issues. Number one is the OEM business vs. the branded business. The OEM business is almost exclusively product

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revenue. So to the extent that there is a slowdown in that part of the business it hits product revenue pretty hard. The branded business is spread out a little bit more than that, but if I look at this particular quarter our branded business was actually up 8% y-over-y. That's the strongest performance of our branded business all year long. So if anything, that business is probably stronger now than it has been all along.

To kind of glean the market share out of all of that is, what is the product revenue growth of the branded business? Because that's the only part that counts in the market share number, and I don't think we reported that, but the growth of the branded product revenue, which would be correlated with market share, is greater than our overall y-over-y growth. So that would put it in certainly single digits but mid-single digits, and from a market share perspective there might be somebody else at that level but I don't see anybody doing better than from that. So I got to believe that this number from a market share perspective has to be an increase in our performance y-over-y.

Yeah, the broader question around the drive capacity. That's a function of a few things. Part of that is also the OEM business, is a factor in that as well. The OEM business was bigger last year. The other thing is it also had to do with product mix. We certainly saw a big push of the low end platforms, which are good upgradeable platforms and new footprints for us for the future in new customer acquisition, but they're not as capacity laden as some of the other ones. So I think at the end of the day it's not something that we're alarmed about. I think it's a function of the product mix both OEM vs. branded and likewise high-end vs. low-end.

Shebly Seyrafi
Analyst, FBN Securities, Inc.

Q

So your OEM business was actually getting worse, growth wise I think it was down 17% last quarter vs. down 9% in the prior quarter. It seems that's a big headwind and I think you said in the prepared remarks that you expect flat to reduced growth in fiscal Q4. So are you thinking about – this is it, basically it's not going to be a headwind going forward, and perhaps the product revenue growth can now accelerate to high single digits over the next year; just your thoughts on that?

Thomas Georgens
President, Chief Executive Officer & Director, NetApp, Inc.

A

What I think specifically about the OEM business is a few things. I think first and foremost the OEM business is going to be dated by the sell-through of the OEM partners, and most of the partners in that portfolio have storage businesses that are actually down y-over-y and some by a substantial amount. So I think that's case number one. The other part of it, frankly, is that it was down lower than we would have thought. So clearly there is the behavior of the OEMs themselves, and I think the OEM business will be different than our branded business in that there will be a combination – it will tend to be a little bit more volatile over time as –make buy decisions on their part to shift back and forth. Likewise we add new OEMs; that tends to be lumpy.

So I think in the long run it's absolutely our aspiration to continue to grow this business. I expect it to be a little bit lumpy and a little bit volatile certainly compared to our branded business. So certainly it's not something that we're backing off on. I don't know if I'm necessarily going to call a bottom on it yet because that's going to be a function of the performance of our OEM partners. But that said it's still an investment area, it's still an opportunity for us, and we're still looking to add new partners, which we did last quarter. And the other point that I should add on top of that is that the E-Series OEM side of it, the E-Series branded side of it is actually picking up the pace quite a bit. We actually saw some good momentum particularly around the flash products.

Andrew J. Nowinski
Analyst, Piper Jaffray, Inc.

Q

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I just wanted to touch base on the telco side. I think last quarter you called out revenue doubled from the prior year. Did you mention anything on how that vertical performed this quarter? And then could you just provide any color in terms of what's driving that demand? Thanks.

Thomas Georgens
President, Chief Executive Officer & Director, NetApp, Inc.
A

First of all, it was robust again. I don't think we put a number on it this quarter not wanting to mix bookings and revenues, but it was still very, very strong. In certain areas of the world we actually have a go-to-market channel that's around telco and service providers which isn't the entire service provider opportunity. It does include SaaS vendors and stuff like that, and that was the strongest performing sector in the U.S. by far.

So overall that business remains robust. We made a bet a couple of years ago that this was going to be a big element of growth for us and a big segment as customers think about IT as a service and they think about service providers. And if I look at where we are with the service providers, where we are with the various different cloud providers, I think that those investments are paying off, and I think we're seeing that in the growth.

Certainly other people have talked about the growth of that segment, but I think the role of the service providers, the role of IT as a service is increasing over time and necessitated a focus. But part of that business tends to look like an OEM business and that is you kind of work with them, you get design wins, you get designed into their practices and their services, and then they need to sell through. And I think we're clearly seeing that. So from a service provider perspective; although, there isn't really great number out there, but I would eventually guess that our market share there is higher than our aggregate market share in the entire industry, and I feel good about the payoff we're getting from those investments we made a couple years ago.

Brian Marshall
Analyst, International Strategy & Investment Group, Inc.
Q

If you look at my entire coverage universe you have the highest percent of your market cap in net cash, and was curious if you could give us a quick update on your thoughts with respect to M&A and pursuing innovation through external measures as opposed to internal. And then also from a capital allocation perspective, love to get an updated thought there as well. Thanks.

Nicholas R. Noviello
Executive Vice President, Finance and Chief Financial Officer, NetApp, Inc.
A

Let me start that and I'm sure if Tom has some comments he'll add on to it. If you look at the cash and investments balance at the end of the quarter here, this is reflective of the notes and the $1B of notes that we issued in December. The other thing to think about is 50% of the cash is in the U.S. So a couple of things going on; let me kind of work through the pieces here.

We have $1.265B of convertible notes coming due in June. Those are cash settled convertible notes, so that is $1.265B of U.S. cash due in June. So you have to really take that off of the 50% of cash and investment balance. Now let me kind of work the other side for a second which is what are we doing with cash?

If I look at cash from operations YTD, and I take that off the cash flow statement, 80% of that has been re-invested in the business. It's been re-invested in the business or returned to shareholders. The re-investments in the business, CapEx side, on the acquisition side, we've now got a set of technology tuck-ins that we've done. In terms of returns to shareholders we've got a set of returns, $410mm so far this year. We're going to do some additional in Q4. All of those pieces will come through this year and show up in these numbers.

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So if I roll back to what I indicated at our financial analyst day last June, it was really balance in the use of cash. Balance in the use of cash in terms of investing in the business, balance in terms of investment in M&A, balance in terms of return to shareholders. We're doing all of those things. We expect to continue to do all of those things.

We're in a period here where we've got a convertible note coming due in June, we've got senior debt that we issued in December, we've got a set of synthetic leases which were the remaining off-balance sheet synthetic leases that are now done and taken care of in Q3. All of those things are kind of coming together and are part of clearing up and making obvious the capital allocation philosophy.

Thomas Georgens
President, Chief Executive Officer & Director, NetApp, Inc.

A

I think another way to solve the cash as a percentage of market cap obviously is to make the stock price go up, and so we're working on that too. But I think in general to your question on acquisitions, I've said in the past that as far as tuck-ins go I think you should expect just as we get bigger we're looking for technologies. Probably the rate of that will increase modestly. We did one last quarter. We just announced one today. So I think you should expect that kind of cadence going forward in terms of small tuck-in type acquisitions.

In terms of the larger transactions, those are going to be asynchronous. They're going to be a function of the opportunity, the price, the execute-ability and obviously the strategic fit. So I wouldn't forecast any trend on larger deals. Those are going to be entirely opportunistic. But as far as tuck-in activity, I think you should expect to see us just as we get bigger and more focused on this area that probably our historical rate will increase a bit, and like I said, you've just seen two in the last two quarters.

Amit Daryanani
Analyst, RBC Capital Markets Equity Research

Q

Just have a question on your gross margin, especially on the product side. Could you maybe talk about despite the sequential growth you saw in January quarter and what you're expecting in April as well, it looks like gross margins overall are kind of stuck in that 60.5% range of the midpoint. Could you just talk about maybe what are the headwinds you see there that's negating maybe the better revenue growth and even the better mix you're getting from stronger branded revenue all year? Thank you.

Nicholas R. Noviello
Executive Vice President, Finance and Chief Financial Officer, NetApp, Inc.

A

So I think there's a couple of things there, Amit. Let me start. This is again Nick. Let me just start with the quarter and in Q3. And there was a set of questions going from Q to – from Q2 to Q3 guidance and really a set of questions on what's going on, on the product side of the fence because if you looked at the guidance it would suggest that gross margins on the product side would be down a little bit. What's going on the service side of the fence? So, there's some different things going on in both areas, okay? First of all, on the product side of the fence we suggested that, and I think there was a specific question last quarter, hey, our product gross margin is going to go higher. We said hold on a second. There's a couple things going on.

First of all, we've have an OEM business. We've got a little bit of CYend drag that's going to happen in product gross margins from a OEM business. As we close the quarter there's probably less of that drag than we expected. There's probably some other elements that offset that in a few other areas in product gross margin. But at end of the day, the 53 one we did was probably pretty close to what we expected. There's been noise over the last year around disk drives and the drag associated with disk drives. That's all behind us now. Q2 is generally a higher configuration mix quarter. That obviously is not going to happen in Q3.

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So all of the things, they're never going to be exactly as you'd expect, but all of those things came together and overall product gross margin kind of in the range of what we'd expect. If I look back 16 quarters, or if I look Q3 to Q4 for the last four years, product gross margin is flattish to up. That's what we're expecting in the guidance here. It's flattish to up. It's a combination of what's going on in the branded business and it's a combination of the OEM side of the fence. If OEM revenue is flat to down, there's less drag, because OEM revenue carries a lower product gross margin than the rest of the business.

On the service side of the fence we have inside Q3 a little bit better gross margin than we originally anticipated associated with mix of business. On the service side of the fence we also manage and make investments from time to time, and many times because those investments are made to service the growing installed base, you make the investments in front of the installed base growth, which means you're making them in advance of the revenue growth. So sometimes that will mean that you've got a service gross margin decline in front of the revenue that occurs. We build all of those factors together and look at those in combination from Q3 to Q4.

So in terms of the guidance range of 60% to 61%, again, I think that's based upon the bottom up roll-up that I just took you through in some respects here. It's based upon the revenue side of the fence and that flat to down on the OEM and the up on the branded side, on the product revenue side, and it is based upon the continued growth of installed base and the investments we need to make on the service side of our business from time to time.

Keith F. Bachman
Analyst, BMO Capital Markets (United States)

Q

I'd like to ask about your FCF targets. This quarter I think it came in about 16% of revenues. In the past you've talked about targets more in the 18%-plus or 18% to 20%, and yet over the past few quarters it has been tracking a little bit below that in kind of the 16% to 17%. Could you just talk a little bit about what you expect in the near-term in the April quarter? But more importantly, just talk about your longer term targets for FCF yield, please? Thank you.

Nicholas R. Noviello
Executive Vice President, Finance and Chief Financial Officer, NetApp, Inc.

A

So, Keith, one of the impacts, and we talked about this last quarter to FCF in Q3 was the buyout of those synthetic leases. Right.

Nicholas R. Noviello
Executive Vice President, Finance and Chief Financial Officer, NetApp, Inc.

A

It's up to the CapEx, that's going to drag FCF performance as a percentage of revenue. Our expectation is to be able to get back to that range. We talked about at our analyst day. You know our expectation would be for continued performance on the cash flow side of the fence in Q4. And so I think, if I take it to the overall model, the expectation is to continue to move towards the ranges we've put out there. And you see that on the gross margin side, we're inside the range on the model we've put out there, which was 60% to 62%. For Q3 we hit the low end of the range of the operating margin, 17% to 19%. And we'll continue to work on the FCF side.

Thomas Georgens
President, Chief Executive Officer & Director, NetApp, Inc.

A

I believe the impact of the synthetic lease buyout was $70mm.

Nicholas R. Noviello
Executive Vice President, Finance and Chief Financial Officer, NetApp, Inc.

A

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$70mm.

Thomas Georgens
President, Chief Executive Officer & Director, NetApp, Inc.
A

So that's a real number in the context of our overall FCF generation. If you back that number out, we're pretty much in the range.

Ananda P. Baruah
Analyst, Brean Capital LLC
Q

Just a question on OpEx if I could. All three OpEx lines are down from the October quarter, and I went back I just took a look back at the history, it's the first time with the exception of the recession going back to nearly 2000 that, that was the case. So there were some anecdotal comments in the prepared remarks about just being prudent. But could you – it seems like for Jan quarter and April quarter, there's a little bit more prudence than typical and I'm just wondering if there's any kind of conscious shift in strategy and how long we might expect that to continue? Thanks.

Thomas Georgens
President, Chief Executive Officer & Director, NetApp, Inc.
A

Certainly there's been no shift in strategy other than clearly it's a challenging environment we need to be careful, whether it be in the guidance that we give, or the targets we're giving internally, but we still have a very, very broad agenda of expanding our partnerships, ongoing innovation, the introduction of clustered ONTAP. You'll see some other announcements from us very, very shortly around some new technologies that we spent some time working on. So the investment profile is still pretty robust. So we certainly haven't backed off on the innovation agenda, but we're being careful about how we spend on other types of things and trying to keep this well within the envelope of reasonableness.

Clearly, it still is a high growth environment that we need to be very, very careful on the OpEx in order to continue to drive the operating margin improvement. And as Nick indicated, we're now in the range of our long-term model in terms of gross margin. We're in the range of our long-term model in terms of operating margin this quarter, and our guidance for next quarter would apply similarly. But clearly we need to be generating growth in this business. So we certainly aren't going to cut off R&D and preclude future growth.

Brian G. Alexander
Analyst, Raymond James & Associates, Inc.
Q

Just a follow up on E-Series. Tom, given some of the enhancements you've made to the platform, do you see E-Series competing more with some of your OEM customers branded offerings? And/or are lines blurring at all with your core FAS offerings as you add these features and if that may be contributing to the accelerated OEM declines we saw this quarter? Or do you still see this as an entirely separate use case?

Thomas Georgens
President, Chief Executive Officer & Director, NetApp, Inc.
A

I think it's substantially a separate use case. I'd say in the specific case of IBM, clearly they've got their own portfolio, and the positioning of the product within their portfolio there is unquestionably overlap and that's clearly a factor, and I think that's certainly true now and certainly true even before Engenio we had the E-Series. So I think the IBM is probably the one where there is competing factions within the portfolio. I think the other partners range from totally committed to this technology to having a clear defendable spot for this, but doesn't have as much overlap. So I think partially in your question, yes, it's certainly true of IBM.

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In terms of competing with FAS, that's a lot less likely. Clearly the price performance profile of this product is really aimed at optimizing price performance and capacity, is a segment that we've not gone after with FAS per se. And if you look at where it has been successful, the vertical markets around high performance computing, around media management, around video, around full flash arrays. Those are things where the price performance-value proposition shows through, and I don't really think that that's leading off any material FAS business. And that business, its growth plus the FAS business, has generated the 8% branded revenue growth that we saw this quarter, and they were quite pleased about that. And that's certainly the best number we've seen in a year.

Katy Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Can you just talk a little bit about linearity in the quarter? And specifically, what did you see demand-wise in the month of January after all the noise around the fiscal cliff in December?

Nicholas R. Noviello
Executive Vice President, Finance and Chief Financial Officer, NetApp, Inc.

A

For us, it was somewhat of an unusual quarter for us, because we've got the CY in the middle of our quarter. And I would say the fiscal cliff and the looming sequestration and an impact on federal spending certainly – while the Federal and U.S. public sector number growth were actually quite good, I wouldn't say that we were immune from those dynamics in any way. We certainly saw big deals being stretched out. We saw greater approval cycles necessary to make business happen. And I think the key to that is, we just need to have more things in the hopper that are going to come out the other side. So I wouldn't say that our business wasn't subject to all the dynamics that you're hearing from everybody else. I just think we're in more deals, we've got more partners engaged.

And as far as linearity in the quarter, I would say that it wasn't that much different than other quarters that we've seen. I'd say that the budget flush at the end of the year was within range, although certainly not robust. And as far as January goes, since we're trying to close the quarter when other people are starting to begin a quarter, I think our January dynamics were a little bit different than other people. So I wouldn't want to generalize on January. There's a lot of budgets that are being created, a lot of uncertainty in our customer base. So, we'll see how it plays out. But like I said, I don't think that given our guidance and given the numbers that we put up and the EPS, I wouldn't say that we were immune to the dynamics. I just think we're in more deals, we're more engaged, and we have our partners more engaged, and it's allowing us to have many irons in the fire now, and they came through for us this quarter.

Maynard J. Um
Analyst, Wells Fargo Securities LLC

Q

I'm curious if you can share your philosophy on market share vs. margin preservation. Were there deals you walked away from, or would you walk away from deals that are a low product margin structure? Or would you manage the business more to a product margin? If you can just kind of share the philosophy there, I'd appreciate it. Thanks.

Thomas Georgens
President, Chief Executive Officer & Director, NetApp, Inc.

A

Clearly as a company, we have to preserve the business model, so we're not going to chase business at any price. We have a field organization, particularly at the senior levels that are very, very heavily compensated on margin, on deals. But it's a portfolio. And, would we take a low margin business? Yeah, we do. I don't think – I'm not ashamed to say that. But it's a function of a number of factors. It's a function in the territory of what their portfolio looks like. They basically have a good mix of good solid deals that they can absorb some low-margin deals? And

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it's a function of where the opportunity leads. Sometimes breaking into some big accounts takes some sacrifice on our part, if we believe that there's big opportunity for us going forward. And those are strategic decisions we make every day.

So absolutely, we walk away from ugly deals that we believe are not leverageable in the future or are not strategic to us, or a poor fit for our technology. Clearly that happens. On the other hand, we also take some very ugly deals, as long as they fit within the broader portfolio and where we are in the quarter, and we think that there's longevity and long-term opportunity in those accounts.

Rajesh Ghai
Analyst, Craig-Hallum Capital Group LLC

Q

You've seen several announcements over the past few months, which indicate that Cisco and NetApp are coming closer. At least, that was related to FlexPod. I was wondering if you could share any data or any quantitative information as to how the Cisco leadership has benefited you for the past few quarters, either in terms of the trajectory of revenue, or for FlexPod's new customer wins. Thank you.

Thomas Georgens
President, Chief Executive Officer & Director, NetApp, Inc.

A

We certainly shared the FlexPod numbers on the call. And that number, I believe, is 2,100 new customers. In fact, we had the biggest acquisition of new customers around FlexPod this quarter. So, I don't really see any slowing down of that momentum. And I think the key, independent of any specific product component, is I think that there's good alignment between NetApp and Cisco. I think our long-term view of the market and the role of Ethernet-based storage, I think we're very aligned on that.

I think if we think about how we go to market, and very partner-centric, I think we're very much aligned on that. And I think the other component that we can't underestimate is in terms of our aspiration and opportunity in the business I think the opportunity for strategic overlap and strategic conflict is a lot less with NetApp and potential some other partners. And as a result I think we've got some good, clear momentum with a lot of runway ahead of us.

So FlexPod is certainly something that's worked out very, very well. I think, it's certainly been material to our business. I believe it's been material to Cisco as well. And some of the recent announcements that we did around some future joint development is actually expanding that not only in FlexPod domain but around other use cases as well. So, I think we're very, very pleased with the Cisco relationship. I think there's great alignment between the two companies and I think that there's a clear runway of not a lot of strategic overlap and not a lot of conflict and I think frankly that has helped us as well.

Ben Alexander Reitzes
Analyst, Barclays Capital, Inc.

Q

I wanted to go back to the OEM business. Without the decline y-over-y in the high teens would've been quite a product quarter if that could have been a lot flatter. I guess, the question is, looking into next couple of quarters, Tom, how do you manage that decline? Should it – do you feel it's possible to say that, that can actually maybe flatten out at some point or is it just something that we should model declining and a drag on the business like it was in the last quarter?

Thomas Georgens
President, Chief Executive Officer & Director, NetApp, Inc.

A

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I think to answer that question you'd have to predict the business trajectory of our partners which in many cases look like the overall market. And I think that's probably a good first pass approximation about where this is going. I think for us in terms of the E-Series OEM and the NetApp FAS OEM is in there as well – clearly this isn't something that we're anywhere close to surrendering on. In fact, I see growth opportunity there. We're certainly pursuing other OEM partners. But I think that we need to be careful on the OEM business that we also bear in mind that within the OEM context and that technology set is also coming E-Series branded which is becoming more and more important to our business and we're seeing good bookings growth there. So E-Series in the aggregate last quarter – last year at OEM business well ahead of our forecast and a little bit of slow ramp on the branded side. This year we're seeing the OEM business coming down a bit and certainly disappointing relative to that. But we are seeing the pickup on the other side. So in the aggregate the E-Series is probably moving closer to where we originally anticipated this business to be but we need some more branded pickup to really get there.

But as far as the OEM business clearly it's something that we want to see. It's very, very prone to the dynamics of the OEMs themselves – their own make buy decisions and that's a business that will be volatile because those make by decisions can change and when they do change they can go one way or the other. But we're being looking to add more partners. We have added more partners and we clearly want to see growth out of that. But if we could see growth out of that business and continue the acceleration of the E-Series, I think there's a big amount of impending growth in that category that we've not yet realized and not really seen on our P&L yet.

Steven M. Milunovich
Analyst, UBS Securities LLC

Q

Could you dig a little bit into deeper in your government exposure which as you pointed out was very strong – up 14% y-over-y yet you indicated some caution going forward. Maybe talk about some of the components of that and do you still expect maybe single digit growth going forward or could it be worse?

Thomas Georgens
President, Chief Executive Officer & Director, NetApp, Inc.

A

I think as we put together the guidance we look at a number of factors and then weight those. So, I mean, clearly we could all make our bet on how sequestration is going to play out. It is going to play out as currently stated? Is it going to kick the can down the road? Is there going to be some type of compromise? And those are the things that we factor in. The other thing about the sequestration is it's not the entire federal business and there are other areas of that, that we've actually had a pretty good quarter in and as you know we've been trying to diversify our federal business over the last couple years and we've done that. And the other component of our public sector business is actually state and local and that's actually has been a very, very high growth business for us and now it's not a trivial part of our business anymore.

Two years ago when we started that it was relatively small and that's continuing to grow. The healthcare segment part of that is also healthy. So in terms of the U.S. public sector I think it would be hard for us to claim that sequestration will be good for our business. But I think we're a bit more diversified than we used to be but nonetheless I think we need to be careful and that's factored into the guidance we gave.

Peter J. Misek
Analyst, Jefferies & Co., Inc.

Q

I just wanted to get some color on penetration and pipeline for ONTAP upgrades and how it's looking for the rest of the year. Can you give us any data on how many people have upgraded or what kind of upgrade activity you have, trials, projects, et cetera, and how the pipeline looks for the rest of the year? Thanks.

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Thomas Georgens
President, Chief Executive Officer & Director, NetApp, Inc.

A

I think first and foremost the sequential growth now has been very, very strong sequential growth, three quarters in a row, and the actual number of systems out there is over 2,000, so it's not a trivial number anymore. When we look at the 6000 family, which is our larger systems, over 20% of those are being shipped with clustered ONTAP now. Now in general most of the clustered ONTAP nodes are coming with new equipment as opposed to being upgrading old equipment in the field, so that's a general trend. So, for us it appears to be the momentum is very, very high. We did our training sessions at the end of last year for our technical people and our partner technical people. We did that if Europe, United States and Asia, and it was very, very well received.

So this is clearly a technology that we're pushing with very, very high energy, and I think that right now the ramp is probably steeper than we anticipated. And if I had to summarize, I'd say that we're probably a little bit slower starting, but the ramp is actually steeper than we thought. So I think that with the latest releases of the software, perhaps the last hesitancy both on the part of our sales force and on the part of customers, may have been cleared away, and certainly post 8.1 the acceleration has been quite severe.

Jayson Noland
Analyst, Robert W. Baird & Co. Equity Capital Markets

Q

I wanted to ask about Amazon. Any more color you can offer on the partnership? What does economics look like to NetApp? And I guess how do you think about cannibalization here longer term?

Thomas Georgens
President, Chief Executive Officer & Director, NetApp, Inc.

A

In some ways I kind of consider this similar to the questions that we got four or five years ago around de-duplication, and the question is, is that good for our business or bad for our business? And if we had 99% market share then it might be a concern, but as far as Amazon, I think the simple fact of the matter is, that they are spending billions of dollars building an infrastructure. There are certain use cases that are going to be interesting to, customers, and customers have to manage the hybrid nature of it, that they'll have some data on-prem and some data off-prem, and it's an opportunity for ONTAP to basically manage that for them.

So we can look at Amazon as purely a competitor, or we can look at somebody we can sell product to. But I think that there's a lot of value in us thinking about Amazon as an alliance partner that's going to build an infrastructure that will be integral to the environment, and how do we enable customers to use that and use that effectively?

It's a way for us to partner with Amazon. It's a way for us to help solve a problem for end users. And the way I see it is, data will be in a lot of places. It'll be on prem, it'll be in service providers, it'll be on flash arrays, it'll be on FAS arrays, it'll be in hyper scale plot providers like Amazon, and as far as we're concerned that what we want to do is we want to be in a position to manage all of that data no matter where it lives. And the other thing about the offering that we provide is an opportunity to have access to – the customer to use the server forms that Amazon has. They could use the storage as well or they can use NetApp storage all at the same time, and I think that's what's unique about it.

So for us what's innovative and what's really interesting is the customer response to this. We just got briefed on this yesterday, and very, very strong customer response that's interested in this technology. And maybe in a simple way of putting this, we don't make disk drives but we do software to manage them, and I think we want to bring the AWS environment into our management domain. So I think there's an opportunity to innovate here, there's an opportunity to create value, and yeah will some storage go in that direction? Absolutely. I'm not in

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denial about that, but if we can manage that process and use data ONTAP as the central control point then I think it's a big opportunity for us because customers clearly want to go that way with a certain set of their workloads.

Louis R. Miscioscia
Analyst, Credit Agricole Securities (USA), Inc.
Q

A question pretty much in line with that one that was just asked. When you look at some of the startups like Nirvanix and Cleversafe, they're not exactly like AWS, even though some of the technology under the covers is the same thing. But obviously they're looking to manage the data themselves. Has that taken away any of your business I guess either in the last CY or looking forward? And maybe if you could talk about your own product mix base storage grid and it's sort of been buried within NetApp. Is it starting to emerge at some point?

Thomas Georgens
President, Chief Executive Officer & Director, NetApp, Inc.
A

I think the whole cloud space is, you know, we could probably spend the whole call on that, and has a bunch of definitions that we want to go through. But first of all, on premise computing, really driving the private cloud, enabled by virtualization, that's a big opportunity. It's an area we've been successful, and something that I see still as a huge opportunity for NetApp, particularly around clustered ONTAP and that will continue to grow.

Out of that, some of that customers are looking at SaaS models or IT as a service. And in the process of doing that, that's been a big part of our service provider for us is understand that our customers what to move in that direction, it creates a concentrated set of customers, but ones who have massive scale and massive performance requirements and non-disruptive operation and multi tendency. And once again, that's a good match for clustered ONTAP. So some of that business will move to other types of cloud providers and clearly that's a target for us. It's something that we've invested in and actually one of the areas of our business that's growing the fastest.

And then there's this broader category of the hyperscalers. And that's what we're talking about here. I think that there are a set of workloads where those are not appropriate, and there's a set of workloads where those are, which means that end users are going to have some amount of their data on premise, some data in service providers and some data at these hyperscalers. And I think somebody to broker all of that I think is really important. I think a single point solution around any one of those is going to be an island of storage, and I think it's NetApp's opportunity to integrate those. So rather than viewing Google or Azure or Amazon as purely a competitor, the question is what about them as an alliance partner as part of the overall hierarchy of storage and the infrastructure of a data center. And that's our play. And it's really interesting to see what the response has been to this, this announcement that we did with Amazon.

Louis R. Miscioscia
Analyst, Credit Agricole Securities (USA), Inc.
Q

And your storage grid?

Thomas Georgens
President, Chief Executive Officer & Director, NetApp, Inc.
A

Well storage grid is clearly a different type of opportunity. What Amazon and some of these other technologies are driving is really object-based storage at scale. And whether people want to build that capability in-house or we want to enable people to build a capability that can compete with Amazon, particularly around vertical markets like healthcare. Clearly we see storage grid in that particular domain. So there's no doubt that the roll of object-based storage is becoming a bigger and bigger talking point with customers, and that's where we see storage grid playing.

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Glenn Hanus
Analyst, Needham & Co. LLC

Q

Could you contrast – you made a lot of comments about big deals, sale cycles, deferrals; could you sort of contrast where you see all of that stuff today vs. three months ago?

Thomas Georgens
President, Chief Executive Officer & Director, NetApp, Inc.

A

Three months is kind of a narrow point of view.

Glenn Hanus
Analyst, Needham & Co. LLC

Q

However you want to characterize it, just trying to get kind of more color about the trend of that. Is it kind of getting better? Worse? How do you see that now going forward as you look at your pipelines and stuff?

Thomas Georgens
President, Chief Executive Officer & Director, NetApp, Inc.

A

It's clearly anecdotal. It's company-by-company. It's industry-by-industry. Financial Services is still an area where we see elongated cycles and obviously concern economically. On the other hand there are certain geographies that are very, very robust for us. Japan has been remarkably strong. China remains strong. But it's very, very mixed, and it's very, very case-by-case specific. Certainly there are overhangs. I think sequestration, the impact on DoD I think is pretty clear, and I don't think we've escaped that. Overall GDP growth being negative in the U.S. But some industries like financial services are struggling. Other ones, oil and gas or consumer have actually been a little bit stronger on the IT side. So I think it's very, very mixed. I don't think there's one geography that's successful across the board, and even within the more active vertical markets, it's really a story around successful players and less successful players. If I had to generalize, I would say certainly no improvement, despite the best I could say at this point.

Mark A. Moskowitz
Analyst, JPMorgan Securities LLC

Q

The question is really around consistency. Clearly you put together now a string of quarters where your operating metrics have been more consistent. There still seems to be though, if we look at it from a stock perspective, since we're all stock analysts here on the call, there seems to be skepticism sill. Your stock is still below where it was trading a year ago despite your revenue and operating model now getting back to similar levels. You seem to be projecting a little more optimism around your book of business, and also you've got new products coming and more new products coming down the pipe. Can you talk just kind of talk more about what has changed to allow NetApp to get back to this point of consistency? And how we should think about the next step function up? Is it really just driven by the new products? Or have you done anything internally around either your sales force infrastructure or global support to be a little more directed in line of sight in terms of working with your customers better?

Thomas Georgens
President, Chief Executive Officer & Director, NetApp, Inc.

A

I think that, as far as the stock price, that's going to be derived from our performance. And so, our focus is executing on the performance and delivering the results every day. The other message, to the extent that there's a dramatic message to the team, is that the macro is the macro, it's everybody's problem, and there's nothing we're going to do about that. We need to focus on the things that we can control. We need to focus on innovation, we need to focus on expanding our partnerships and our alliances. And if I look at the hard work that we've done

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around that, it's great to see the clustered ONTAP adoption that's the biggest innovation in our history. It's great to see the momentum around that, because it's a big differentiator. And when that's fully deployed and people really see the value of it, and now that we've gotten a substantial amount of functionality there that people have derived tremendous value on that today, we like that.

And likewise, we've got other things on the way. You'll see a flash announcement from us very, very soon. The use of E-Series as an all flash array, and shipped 100 units last quarter, pending growth of branded E-Series. So if I look at where we are today, I think there's a lot of amazing growth opportunities. Clearly, we need to ultimately execute, but I'd say that clustered ONTAP is in the early days of impacting NetApp's business. E-Series is in the early days of impacting NetApp business. We're going to ship Flash Accel this quarter, we're going to make a flash announcement in the near future. So I think there's some pending growth things.

So for us, focus on that innovation piece. You've seen publicly what we've done around alliances, around recent announcements with Cisco, around Citrix, around SAP, really broadening the appeal of our products, integrating tightly with other solutions. And then internally, when we talked about the OpEx story, is that, how do we be very, very, very focused on execution across every aspect of the business?

So it's a time for focus, it's a time for intensity. It's not a time when there's a big investment envelope, and just focus on the things that we can control. And the messages to the team is, is that independent of the macro, if we execute on things that we can do on all of these fronts, that NetApp can drive consistency, do what we say we're going to do, and drive outperformance in this industry, whether the macro rebounds or not. And that's really our focus

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