

## — MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the NetApp Q3 Fiscal Year 2010 Earnings Conference Call. My name is Derek, and I'll be your operator for today. [Operator Instructions] We will be conducting a question-and-answer session towards the end of this conference. [Operator Instructions]

I would like to turn the call over to your host for today, Tara Dhillon, Senior Director of Investor Relations. Please proceed, ma'am.

### **Tara Dhillon, Senior Director, Investor Relations**

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Good afternoon, everyone. Thank you for joining us. With me on today's call are Tom Georgens, our CEO 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 earning release, the supplemental commentary, our financial tables and a non-GAAP to GAAP reconciliation.

As we indicated on our February 4 press release, this quarter, we implemented a new format for our quarterly results announcement. Concurrent with the press release, we are now publishing and distributing supplemental commentary, which contains the metrics and some of the analysis we have previously provided on our live call. Our goal is to provide the investment community with additional time to review and analyze all of our results, allowing for a more thoughtful, interactive dialogue during the Q&A. This live call will focus on strategic commentary and outlook from our CEO and CFO and allow for a little longer a Q&A period. We'll be interested in hearing your feedback on this new approach.

As a reminder, during today's call, we will make forward-looking statements and projections, including our financial outlook, 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, that our quarterly operating results may fluctuate for a number of reasons, some of which are beyond our control.

All numbers mentioned today are GAAP, unless stated otherwise. To see the reconciling items between non-GAAP and GAAP, refer to the table available in our press release, our supplemental commentary and on our website. I'll now turn the call over to Steve for his thoughts.

Steve?

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

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Thanks, Tara. Good afternoon, everyone.

Now that you've had a chance to read our written commentary, I'd like to take a few minutes to discuss our perspective on these results. We are extremely pleased with the breadth of our success this quarter, and all of the records set across the various geos, products, revenue and earnings. While Tom will delve further into these, I'll talk about the impact of our performance as it relates to our business model and the implications for the future.

NetApp significantly outpaced both the market and the competition, and we are forecasting Q4 sequential growth at about six to 9%. These sequential growth numbers translate into about 22 to

25% year-over-year organic growth in revenue, a figure that our competitors are nowhere near achieving in their storage businesses. On top of that, this implies our year-over-year product revenue growth will be greater than 30%, a growth number that is remarkable in any environment, especially for a company of scale. While we significantly outpaced our revenue forecast, our non-GAAP growth margin, expressed as a percent of revenue, was almost exactly where we expected it to be.

Moreover, we passed along some cost savings to our customers in order to stimulate growth and share gains, just as we said we would. It's worth noting that our 64%-plus gross margins were achieved in a quarter where we had a significant jump in the mix of low-end units. A robust low-end does not materially impact our gross margin. In fact, because it carries far less disk, the low end actually has very similar margins to our high-end system, which typically pull more software but also have far more disk. The key point is with a unified architecture and a single operating system across all of our product lines, we are relatively indifferent to the changes in the mix of our platforms.

With the mix of deferred revenue and the P&L remaining strong, non-GAAP gross margins should continue at a similarly healthy level next quarter. Our non-GAAP operating expenses were above plans, although it was due to greater than expected variable compensation related to our expense and operating income performance. While you should expect us to continue to drive toward a 16% annual income target, Q4 is likely to be higher than that, as it takes time to ramp investments targeted at additional share capture.

I would like to call your attention to this quarter's 10% year-over-year growth in deferred revenue on the balance sheet. It is not surprising that this occurred in the quarter when products started to show year-over-year growth again.

Deferred elements result mostly from attachment to product sales, with some additional contribution from renewals by the installed base. Over the long haul, product revenue growth drives the deferred revenue liability. I'd also like to reiterate that we expect our free cash flow as a percent of revenue to return to our targeted range of 17 to 22% next quarter as accounts receivable level off. It is worth noting that the average for Q2 and Q3 combined is 20.3%, right in the middle of our targeted range, with the quarterly variation due to fluctuation in accounts receivable.

The bottom line is that our business model is thriving and should be relatively stable going forward. We are excited about the market opportunities unfolding in front of us and proud of the team for capitalizing on them so effectively. At this point, I'll turn the call over to Tom.

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

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Thank you, Steve. The NetApp team demonstrated remarkable execution this quarter. We produced record revenues, record numbers of systems shipped, record profits, record EPS, as well as producing double-digit year-on-year growth and guiding to over 20% revenue growth for next quarter. All of this in an improving, but hardly robust, IT spending environment. I'm especially pleased with the breadth of our progress. We saw year-over-year bookings growth in every major geography, momentum in both our channel and our direct businesses, tremendous performance from our operations team in the face of persistent supply constraints and our 17% year-over-year product revenue growth is far better than any of the other major storage vendors. NetApp clearly gained significant share this quarter.

Delivering storage efficiency to key business applications is the primary driver of this demand. The NetApp value proposition offers customers the ability to accomplish their objectives with lower cost and improving their business performance at the same time. With NetApp, customers can deploy

their next-generation, virtualized, shared-infrastructure architectures with greater confidence, reduced implementation time and lower CapEx and administrative costs than our competitors.

The transition from siloed application-specific infrastructures toward a broad homogeneous infrastructure shared by multiple applications, generally referred to as an internal cloud, offers compelling advantages in terms of cost, rapid application deployment and administrative efficiency. It is rare that I meet with an IT executive where we do not discuss this at length. In addition, the age of their existing infrastructure, prolonged by reduced investment during the downturn, is creating a sense of urgency to deploy their next-generation data center and will likely represent a significant portion of IT hardware spending in the intermediate term.

In fact, many of these projects have moved beyond the talking stage and into implementation, and are contributing to the results we announced today. NetApp technology is particularly well-positioned for this new architecture, as evidenced by our recent success, and as many customers move in this direction over the next couple of years, it represents a major opportunity to gain share and outgrow the market.

As we highlighted at our analyst day in October, diversifying our pathways to market has been a top priority for the company, and this quarter, we are beginning to see demonstrable results from these investments. Our new customer acquisition across all segments was very strong. In fact, this was the second highest quarter ever of new customer additions. Of particular note was the performance in the mid-size enterprise or MSE space.

We simplified our order process, repositioned our low-end products, created solution bundles targeted at this space, and we made it even easier for our channel partners to do business with us. As a result, we saw remarkable growth in our channel business. Our distribution partners, Arrow and Avnet, together combined for a record 28% of revenue, which grew over tremendous increase in shipments of our low-end systems.

Along with the strength at the low-end, our high-end units were up significantly and contributed the highest percentage of our revenue in over a year. A number of factors drove this, including a return to spending from some of our larger customers, infrastructure build-outs by certain cloud service providers and our newly-created performance bundles. These bundles tightly integrate Flash memory next to the CPU in the form of a performance acceleration module or PAM, enabling significant improvement in performance.

In addition, this performance boost frequently eliminates the need for fiber channel drive in favor of lower-cost, denser, serial ATA drives, thereby simultaneously improving performance, increasing density, reducing power requirements, and lowering cost. The PAM card is a big part of our strategy to seamlessly deploy Flash technology in our offerings more pervasively than our major competitors. In just their second quarter of availability, the PAM is already attached to 10% of supported systems shipped.

It has been a long time since I discussed operations on this call, but this was a remarkable quarter for that team. On the last earnings call, we indicated that supply constraints were a definite challenge, but they were not a threat to our guidance. The problems remained all quarter, yet the operations team still managed to achieve more than 50% sequential increase in systems shipped while maintaining inventory turns at near record levels.

Going forward, we do expect some supply constraints to persist in Q4, particularly in semiconductors, but we do not expect them to be as acute as last quarter and we have once again factored them into our guidance.

Our partner relationships continue to deepen and produce results. Quarterly revenue from our IBM OEM relationship was at a record high. Early in Q3, we announced the expansion of our producer

relationship and then we recently announced the Cisco, VMware, NetApp collaboration. The jointly-developed product from this collaboration is a unique solution to one of the most compelling needs in virtualized infrastructures, the need for secure multi-tenancy. This provides the industry's first end-to-end solution to enable customers to run multiple applications on a shared infrastructure with predictable performance and data security.

Our newly-expanded strategic alliance with Microsoft deepens our product collaboration and technical integration and will extend joint sales and marketing activities to customers worldwide. We are beginning to see a greater proliferation of Hyper-V installations in the market and our strong relationship with Microsoft will further our traction in virtualized environments of all types.

While virtualization and its enablement of a shared infrastructure is a key component of our growth strategy, the impact of our storage efficiency and the industry's most mature unified storage offerings also resonate in environments running general business applications, engineering applications and traditional file services. In the past quarter, we saw success on all of these fronts in customers both large and small.

There is no doubt we are seeing momentum in the business, and we have resumed investing in key areas to drive growth. In prior quarters, I indicated that, outside of variable compensation, we are holding controllable spending flat until we return to our 16% operating income target. That return came sooner than expected last quarter and resumed this quarter.

Now that we are back on the model and with the undeniable opportunity ahead, we are choosing to reinvest in the business and do not anticipate generating leverage much beyond 16% annually in the intermediate term. This has been the strategy that has served NetApp well throughout its history and it is even more appropriate today as we endeavor to be a growth company of scale.

To summarize, while we have need for improvement in several areas, the company is still executing very well on many fronts. Our product portfolio has never been more reliable or more relevant to the major trends underway in IT, our channel breadth has never been greater across multiple geographies, Storage 5000 and MSE, direct and indirect and systems integrators and cloud service providers. Our industry alliance activity is creating meaningful solutions for customers through our recent announcements with Cisco, Fujitsu, Microsoft and VMware. We are more committed than ever to the strategy we described at our Analyst Day in terms of the emergence of the virtualized data center and the leverage of various types of channel and technology partners.

The intervening period also confirms our belief that an aging infrastructure is creating time urgency for customers to act. Intercepting the technology refresh of legacy products that cannot match our value proposition in the new data center reality represents an immediate market opportunity of which we are just beginning to see the results.

At this point, I will open up the floor to questions. Although we have more time for Q&A with our new call format, given the number of people in the queue, we still ask you to limit yourself to one question so that we may address everyone during our allotted time. Thank you. Operator?

**QUESTION AND ANSWER SECTION**

Operator: [Operator Instructions] I have the first question coming from the line of Brian Marshall with Broadpoint AmTech. Please proceed, sir.

**<Q – Brian Marshall>**: Great. Thanks, guys. Well done. Question with regards to OpEx as a percent of total revenues, can you talk about if you can get to 45% of OpEx as a percent of total revenues and what the timeframe is to get to that point? Thanks.

**<A – Tom Georgens>**: Sure. The first thing I think we'd like to do before we answer any questions, Brian, is acknowledge HP, that was gracious enough to start their call a half hour early to allow us to go ahead today on the same day as they did. So – and also allowed most of you to join the call and most of the investors listening as well, so we really appreciate it, and thank you to HP.

Okay, Brian, with respect to the 45% question, yeah, we can get to 45% of expenses expressed as a percent of revenue very quickly, if we wanted to. But in doing so, the question one would have to ask is, if we're foregoing opportunities to invest, would it increase our growth going forward? And therein lies the tradeoff that we have to make and we have to make all the time.

So I think that our goal remains to achieve a 16% operating margin over the long haul, and we'll manage between operating expenses and gross margin along the way. They'll be periods of time when we're a little higher, and there will be periods of time when we're a little lower, but over the long haul, our goal remains 16%.

**<Q – Brian Marshall>**: Okay. So suffice to say that pretty soon here in the near term you're going to see OpEx grow faster than revenues on a sequential basis?

**<A – Tom Georgens>**: We'll see. We haven't drawn that conclusion yet.

**<Q – Brian Marshall>**: Okay. Thanks, guys.

Operator: Your next question comes from the line of David Bailey with Goldman Sachs. Please proceed, sir.

**<Q – David Bailey>**: Great. Thank you very much. Headcount was up almost 70 people this quarter. How should we think about that trend as we move through the year?

**<A – Steve Gomo>**: Well David, we're not forecasting out beyond next quarter. I do think we're going to see on the order of 150 to 200 people joining us next quarter. Now some of that is going to be from some new college hires, the early grads that are coming out. Some of it's going to be from engineering and a few sales people. As I think Tom noted in his portion this morning or earlier conference call today, we are starting to invest in the business and that certainly engineering and sales remains I think two of the focal areas.

**<Q – David Bailey>**: Great. Thank you.

**<A – Steve Gomo>**: Yes.

Operator: The next question comes from the line of Wamsi Mohan with Bank of America Merrill Lynch. Please proceed.

**<Q – Wamsi Mohan>**: Thank you. There was significant revenue outside in the quarter relative to your guidance. Can you help us with which areas you saw particular strength relative to your original expectations? And you also commented that there were product availability issues throughout the quarter, how much revenue do you think was left on the table because of that?

**<A – Tom Georgens>**: So in general I'd say strength was pretty strong across the board. I think what was particularly notable was the dramatic rise in the entry level systems. And I think a lot of the programs that we've put in place in the channel, I think we've extended our reach, and I think we've moved deeper into that particular sector. It's been something we've been working on for a while. It's actually something that we've been having progress on, but we've – in the last two quarters, we've seen quite a bit of a run-up.

So I'd say that the strength of the MSE has really been an important part of this as well. Interesting thing is as you see the numbers, the high-end was also strong. And I think that's been a return of some of our larger customers, and we talked about a little bit about the performance acceleration modules on the prepared text. But I also see some of our big service providers key systems moving into that category as well. So what was interesting about this is that we saw significant strength on both the very low-end and the very high-end, which I think would speak to the breadth of the business.

As far as supply constraints, clearly that kept us entertained all quarter, suffice to say. In terms of leaving revenue on the dock I think we worked very, very hard in trying to understand which revenue we could ship and which revenue we couldn't ship, and expediting things. I don't know if I would really want to speculate as to how much we really left behind. Clearly there was revenue out of last quarter into this quarter. So there's a bunch of moving parts there, but I wouldn't suspect that, that was a substantial component either on the plus side or the minus side of the revenue numbers we posted.

**<Q – Wamsi Mohan>**: Okay, thank you. And just for the follow-up in the margin commentary from an earlier question...

**<A – Tom Georgens>**: Okay, I was asked to go to one question. We'll come back.

**<Q – Wamsi Mohan>**: Okay, thanks.

**<A – Tom Georgens>**: Thank you.

Operator: Your next question comes from the line of Ben Reitzes with Barclays Capital. Please proceed, sir.

**<Q – Ben Reitzes>**: With regard to margins, could you just talk a little bit about the 16%, it sounds like it's going to be higher than 16 for the fourth quarter. And then, I assume by your commentary, Tom, that by 1Q you want to go back down and then stay there for the next fiscal year. And then, I just wanted to see if that's what you meant by your commentary. And then, Steve if you could just clarify what gross margin levels go into that, that would be great. Thanks so much.

**<A – Tom Georgens>**: Yes, I think the operating margin target is more of an annual number. So I think we'll see some variability quarter to quarter as we go through it. I think, frankly, the overachievement on revenue has been – well, I'll go so far as to say is a surprise to us. But I think we certainly weren't banking that into our operating expense plans as we went along. So I think there'll be a little bit of lag until we kind of catch up to the business a little bit. And I think as a result, that will flow through in the form of increased operating margins. We certainly saw that this quarter.

But I think in the long run, our objective is to invest in the business. First of all, the momentum on many fronts is – has obviously got us excited. And I think that there's plenty of avenues for us to invest very, very proactively in order to generate some growth here. So I don't think this is a time for us to be cautious. So I think we want to invest in the business.

Obviously, we don't want to be wasteful and reckless, so we need to be careful about it. And some of those investments have a lead time. So I would be really clear is that we're not going to be perfectly 16% every quarter, I think you will see some seasonality in our results. And beyond that, with variability on the top line either above or below our expectation, you'll also see some variability on the bottom line. But right now, I think our investment stream is still catching up to the revenue growth.

**<A – Steve Gomo>**: I think that's a fair characterization. Also the margins – the gross margins that support that kind of position in the fourth quarter, then I don't see a lot of change from the third quarter's margin levels, either on a product basis or on a overall company-wide basis. I think we're going to see pretty steady margins – gross margins, in the fourth quarter.

**<A – Tara Dhillon>**: Question, please?

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

**<Q – Kaushik Roy>**: Congratulations on the nice quarter and guidance. Can you comment on the linearity in the quarter and some of the specific verticals where you saw strength?

**<A – Tom Georgens>**: Linearity of the quarter pretty much had two dimensions to it, I think. The bookings linearity was actually pretty solid and this tends to be a more linear quarter than most because of the – because of December being the end of the fiscal year for a lot of our partners and a lot of our customers and especially IBM. On the other hand, the revenue linearity, because of the supply constraints was probably a bit more back-end loaded than the bookings would indicate.

Overall, I'd say government was to – the public sector continues to be strong. And I'd say that other industries, up and down. Tech was strong. Financials, obviously we went through quite a trough there, I think they've come back to some degree. And within each of the industries there are winners and losers. So I wouldn't say that one industry is outpacing the others. I think we've got the top end companies in each of the industries appear to be reasonably active.

**<A – Steve Gomo>**: Just to add another commentary to that, the supply constraints that we talked about here tended to clear up towards the back half of January. We didn't come completely out of the constraint scenario, but a lot of the constraints were alleviated with about two or three weeks to go.

**<Q – Kaushik Roy>**: Thanks.

Operator: The next question comes from the line of Aaron Rakers with Stifel Nicolaus. Please proceed.

**<Q – Aaron Rakers>**: Yeah. Thanks, guys, and congratulations as well. One of the things that I look at in terms of your gross margin structure on the product side is I think you obviously talked about the low-end business, but one of the things I don't know that you really discussed was the continued ramp that we're seeing in the V-Series product, and that obviously has a very low disk content to it. So it might be helpful just to understand what that gross margin trend looks like, why we should maybe not think that that continues to be a positive driver. Any kind of framework of how meaningful V-Series is either as a percentage of revenue or total product revenue?

**<A – Tom Georgens>**: I think the way to think about V-Series is less as an economic engine and more as an opportunity for us to enter new accounts. So one of the things that happens with V-Series is that we'll frequently enter with a V-Series and then as time goes on and customers get familiar with it, and their existing infrastructure behind it ages, it'll get replaced with traditional FAT systems. So in some ways the V-Series business is somewhat self-cannibalizing.

So the way we see V-Series, it's a relatively small percentage of overall revenue because the disk attachment, as you indicated, is smaller, but it's [inaudible] tool for entering new accounts, because people, if they're intrigued with the net-off value proposition and they can see the value that we can break in, it allows us to basically allow customers to start using our technology without step one being replacing everything that they have. So I see the V-Series adoption as a) a measure of people's interpretation of the difference between the value proposition of the NetApp software portfolio versus that of the infrastructures that they typically have in place, primarily SAN. And more importantly it's an opportunity for us to get into new accounts, and that's primarily how we see V-Series as opposed to something that's going to fundamentally change our business model.

**<Q – Aaron Rakers>**: Is it fair to say that that carries a pretty meaningfully above product gross margin relative to your overall business? I mean is it a high 70% gross margin versus what you guys just recorded?

**<A – Tom Georgens>**: It's a high gross margin product and definitely higher than the norm. On the other hand as a percentage of total revenue, it's not a big number. So I wouldn't use that heavily in modeling our gross margin. I think it's more important of, and indicative of, our ability to penetrate new accounts.

**<Q – Aaron Rakers>**: Okay. Thanks, guys.

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

**<Q – Keith Bachman>**: Hi, guys. Thanks for taking the question. I wanted to go to product trends, if I could, and see if we could understand a little bit more about why Unified ticked up as a percent of total, and more importantly, versus just NAS alone and SAN, and more importantly, what does that suggest about mix and/or client – new client penetration, please?

**<A – Tom Georgens>**: That's kind of a tough one. I guess there's a couple of things that I would say is I think we've been making the point that as customers seek to build more of a homogeneous infrastructure that can run multiple applications, typically those applications have the need for multiple access methods, both file and block.

**<Q – Keith Bachman>**: Right.

**<A – Tom Georgens>**: As a result, as we see more of this virtualized shared infrastructure roll out, then I'd see more and more customers that are interested in products that can run both at the same time. The other thing is it gives them an option that if it's NAS today it could be SAN tomorrow or vice versa, and I think that that's a factor as well.

And the other thing that's a little bit different is I think that all along, the unified component is a little bit higher. A customer may buy NetApp because it can do both SAN and NAS, but they may actually buy certain boxes for SAN and certain boxes for NAS simply because that's the way they are segregated in their installation. However, the unified story is the reason why they bought because it gives them flexibility.

So I would expect to still see some volatility in the unified number, but I think in the long run, if customers that want to build a big homogeneous storage infrastructure to run multiple applications, the ability to be multi-protocol is going to be an essential requirement, and I think single-protocol products are going to become essentially obsolete over time.

<Q – Keith Bachman>: If I could just ask for clarification, and I hope Dan's not listening to push back, but does it suggest that if that is unified it's weighted towards a 3,000 or 6,000 line at the expense of the 2,000, so that's positive for mix? That's what I was trying to understand.

<A – Tom Georgens>: Not sure. Not sure how Dan would react. I'm not sure where Dan is.

<Q – Keith Bachman>: Well I meant on asking a follow-up question.

<A – Tom Georgens>: Okay, all right. So I think on the unified storage, it's both. So on the high-end, you might think about business applications and running Oracle and file services. But on the low-end, simply to be able to do Windows file services and Microsoft Exchange at the same time would typically generate a multi-protocol system, probably iScuzzy and CIF/SMB or even Fiber Channel with CIF. So I think from that regard, I wouldn't rule out that it's a high-end versus a low-end type of a thing. In fact, you might actually see – actually I would venture to guess that you'd see it in both cases.

<Q – Keith Bachman>: Okay. Thank you.

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

<Q – Kevin Hunt>: Thank you. Tom, I just wondered if you could clarify your comment on investing in the business. It looks like in the quarter, you had down R&D expense on a pro forma basis. Is that one area you will invest? And you did have a pretty good product margin in the quarter, is that something where you'll continue to sort of reinvest on, on a pricing front, like you had suggested last quarter?

<A – Tom Georgens>: Yes, I think we're going to invest in things that we believe are going to generate growth. And I think they'll primarily be field activities, product-development activities and service and support activities, which consist of most of the categories of our head count. Yes, I'd say what we've been doing all along is we've been relatively constrained from a spending perspective as we tried to climb back to our operating margin target. And what we have seen in terms of the actual results printed is the impact of the overachievement on operating margin and growth that's basically driving a lot of incentive compensation.

That's been a big part of our growth and remains that way this quarter. Clearly, next year we'll go back to more of a baseline and some of that will go away and the true growth of the business will be more evident in the numbers. But right now, we've had a pretty big run-up in operating expense, last quarter to this quarter, and even buried into our forecast for next quarter. But most of that is in the form of incentive compensation and not really that much of it just yet in the form of increased investment. We released some spending, a few months back we released more, and we're being more aggressive going forward. So I think you'll see some of that kick in in Q4 and then more of it in Q1, but Q1 will also see the rollback of the incentives.

<Q – Kevin Hunt>: Congrats on finally getting your billion dollar [inaudible].

<A – Tom Georgens>: Thank you.

Operator: Your next question comes from the line of Bill Shope with Credit Suisse. Please proceed.

<Q – Bill Shope>: Okay. Great. Thanks, guys. I have a question, actually sort of a follow-up on the prior V-Series question. Can you give us some color on the conversion rate you are seeing with V-Series customers right now, to full net-up systems? And have you seen a material increase in that

rate, particularly as the economy started to recover? And if you have seen an increase, are there any specific verticals where you're starting to see this conversion become more common?

**<A – Tom Georgens>**: On the vertical question, no. In fact, there was a long time where we had one particular V-Series customer that was a substantial amount of the V-Series revenue. They've actually converted over to full systems at this point. So in terms of the V-Series growth numbers, they need to overcome these things from quarter to quarter. In fact they had their biggest single customer actually go away, obviously a tremendous benefit for NetApp.

So for us, the numbers just continue to keep increasing, and the rate of new ones coming in are offsetting the ones going away. I don't have a data point on how many of them actually convert, but it's a substantial number. There are some customers, even some big customers, that have standardized on V-Series and other people's back-ends, but that is not very common. Most customers enter this model with the intention of converting over time.

**<Q – Bill Shope>**: Okay. Very helpful, thank you.

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

**<Q – Chris Whitmore>**: Thanks very much. Wanted to follow-up a question around passing cost savings on to customers, specifically, I was wondering if that translated into a higher win rate in the quarter versus competition? And to what extent are component shortages impacting your pricing strategy going forward?

**<A – Tom Georgens>**: So on the question of passing it back to customers, I'd say that we didn't just say to the sales force, go out and discount like mad. I think we did a few things. One of them was specific channel programs around certain resellers to stimulate business. And I think we saw that in the performance of our distribution partners in particular. So that was clearly using above the line our gross margin dollars to stimulate sales without changing our sales behavior at all. And then clearly there are some accounts that we felt that price elasticity would open up doors for us where they previously wouldn't have. So we went ahead – we basically approved selected deals where we went ahead aggressively and strategically.

So we worked really hard in the past three quarters to get discipline around discounting. And I think it's showing in the results. And we weren't going to give that up overnight. So for the most part, we've tried to keep that discipline in place and focused our use of our gross margin dollars really around very, very specific targeted accounts and targeted programs around resellers.

As far as parts go, I would say it's had relatively small impact on pricing. Where it will come into play, and we really haven't seen this that much just yet, at least not with most of the components, is if our downstream pricing from our suppliers now becomes problematic because of the shortages, then clearly that would create some pressure on us to hold that back from our customers. However, I think that the worst of that, at least for most of the commodities, has passed.

So I think if that was going to happen, it would have already happened. But I wouldn't try and imply that the gross margin decline we saw sequentially had to do with parts. Most of that was mixed IBM components and a strategic choice on our part that I had talked about on the last call as an effort to use that very, very high gross margin to drive growth.

**<Q – Chris Whitmore>**: Very helpful. To what extent did the component shortages cause a greater than normal backlog exiting the quarter?

**<A – Tom Georgens>**: We have to stick to one question...

<Q – Chris Whitmore>: Thanks.

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

<Q – Brent Bracelin>: Thank you. Tom, I had a question kind of on the sustainability of the rebound here, still in early stage of ONTAP 8 product cycle, second highest number in new customer adds in the quarter. Your outlook suggests you're going to return to 30% kind of product growth. I guess my question here is how much of the success that you're seeing would you attribute to share gains from new products versus share gains from new channel partners, versus really a change in the enterprise kind of spending patterns, improving budget dollars. That kind of gives you confidence in the outlook here. Not only in the quarter but also kind of as you enter next fiscal year?

<A – Tom Georgens>: Yes, I don't know if I could tease apart all of those. I think that in terms of the overall storage market as a whole, we just put up 15% numbers. HP reported down, IBM was up a little, EMC was down – and they've been all – and those are improved numbers for all of them. [inaudible], Hitachi down. So I wouldn't claim that this market is by any means robust. I think that it's clearly improved over the last six months where all of those guys were down double digits. But nonetheless I'd say that it's not like it's a roaring success. So I don't think that we're expecting a double-digit growth rate in this industry to propel our growth going forward.

So pretty much there's several things that play. I think within the context of IT spending, I think storage is going to get a disproportionate amount of the incremental spending by virtue of it being a consumable. I think that virtualization is fundamentally changing the way that people think about the data centers of the future, and I think that these data center build-outs, as their equipment ages, is becoming a top priority, and that's going to compete for IT dollars.

So I think that our growth opportunity here is basically winning, or participating in the segments of the IT that are actually going to get investment, even if the overall IT market doesn't grow. So I don't think that we need to get significant IT or storage growth for us to grow. I think we will dramatically outgrow the market. I do expect it to rebound. I think we do have some concern about if we're going to see another leg down, is this going to be a W or not.

But on the other hand, the business has momentum, and at some point, you have to believe, and I think that we don't want to look back a couple of years from now and say, you know what? We were poised, we were perfectly positioned with the products, perfectly positioned with the channel and we passed up an opportunity to invest. So I think we need to take some courage, go with the momentum of the business, make some investment choices and try and take share where we believe that things are in our favor.

<Q – Brent Bracelin>: Thank you.

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

<Q – Jayson Noland>: Yes, thank you. A question on EMEA, Tom or Steve. You were up 5% sequentially on a really tough comp. I guess, what are you seeing there, and what are your expectations going forward from here on the guidance?

<A – Steve Gomo>: Yeah. The EMEA growth was actually muted a little bit from what it could have been. The supply constraints, while it did not impact out overall business, did impact various geographies, and I think Europe was one of the two geographies that was impacted by it. And that just has to do with the mix of customers, the terms of the trade, if you will, with respect to the orders that we're shipping again, the ability to get the right parts to the right geography, and so I think that

Europe's revenue tends to be a little bit understated from what it could have been, had we not seen the supply constraints that we did.

<A – Tom Georgens>: I think going forward you're going to see a rebound revenue growth-wise in both Europe and Asia Pacific, in particular in the fourth quarter.

<Q – Jayson Noland>: Thank you.

Operator: Your next question comes from the line of Doug Ireland with JMP Securities. Please proceed, sir.

<Q – Doug Ireland>: Thank you. This is Douglas. I was just wondering if you could comment on any budget flush that happened during the quarter and how linear the quarter was?

<A – Tom Georgens>: I would say that the budget flush was not particularly evident. I would say that I don't believe that we got a dramatic headwind in this quarter that wasn't going to persist because of the budget flush, otherwise we wouldn't have guided the way we did. So I mean there's no doubt that certain parts of the government still remain strong, and I think certain commercial customers certainly had a budget flush to some degree, but I wouldn't say it was like what we've seen in the past.

Probably the biggest non-linear component of our business would be IBM, which tends to be very fourth-quarter centric. So clearly they were the biggest part of our – percentage of our revenue. They were the high point in terms of the year, which is typical. But overall linearity I'd say is more or less what we would have expected.

<Q – Doug Ireland>: Thank you.

Operator: Your next question comes from the line of Richard Gardner with Citigroup. Please proceed, sir.

<Q – Richard Gardner>: Okay. Thanks. Tom, you mentioned what you're doing with the channel in terms of product bundling. Can you give us a sense of what inning we're in there? How far along that process is? What your channel partners are telling you about that? How what you're doing compares with what your competitors are already doing in the channel? In other words how unique is this? And how we should think about the margin profile in the channel as the business scales up more? Thank you.

<A – Tom Georgens>: Okay. So this going after the channel has been a recurring theme on this call, and if I go back a year and a half, two years ago, certainly I had competitors of mine talking about strength in the commercial space, which in a lot of ways is synonymous with the channel. And we've been going after that, and if you look at the volumes of our low-end products, we went from 2,000 a quarter to 4,000 a quarter. So obviously a much bigger number this quarter.

So I guess this one side of me says we have not completely tapped that market. Certainly, we haven't seen a leveling off. If anything, it seems to me some of – either the investments we made, the channel partners we took, perhaps some of the alienation created by some of our competitors, has opened up a door. So I still think we're early on in this. There's nothing that would indicate to me that we're out of ideas or out of channels. The other thing is most of our dialogue here is about the U.S. I think that there's creativity that we could apply internationally as well in getting some more channel partner leverage over there as well.

<Q – Richard Gardner>: Thank you, Tom.

Operator: Your next question comes from the line of Mark Moskowitz with J.P. Morgan. Please proceed, sir.

**<Q – Mark Moskowitz>**: Thank you. Good afternoon. I want to come back to the mix in terms of the low-end. I hear how you're not too concerned about it in terms of the margin impact. I just want to see if you can help us understand more in terms of some of the other puts and takes with respect to the low-end. Is this a function of competitive shifts in the market that's forcing this? Or is it a function of the channel or could it be a combination also of maybe the Nehalem web server refreshes? I mean industry standard environments' driven lower in the patch to storage. Thank you.

**<A – Tom Georgens>**: I guess that could be – if we did nothing and the number suddenly materialized then I'd say perhaps there's some external impact. But what we did in the quarter is we introduced a new product and we pushed our existing low-end products further down in the market. So I think that our product positioning has changed. Now it is possible that server refresh has also taken storage refresh with it, and maybe our channel partners are connecting those two dots that we are not. That's certainly a possibility. Certainly, we've seen the server business. We also have been trying to make ourselves just plain easier to do business with.

So we've – not only have we done bundles we've reduced the amount of software skews, we've done a lot more bundling in with the base unit and fewer options, just to make this whole thing easier so that in the process of flowing through NetApp getting – we did some things that they don't have to come to us for pricing. There's a whole bunch of things that we did to try and make this easier, and in the channel I think if there's one lesson that we've learned, and perhaps the company knew it but I didn't, is that product is one component, but the process and the pricing and the positioning and the competitive behavior also matter quite a bit as well.

**<Q – Mark Moskowitz>**: Thank you.

Operator: Your next question comes from the line of Eric Martinuzzi with Craig-Hallum. Please proceed, sir.

**<Q – Eric Martinuzzi>**: The public sector's strength, it sounds like that trend persists. I was wondering if you could address that by geography? And then if those geographies, if there's a shift in your – in the geographies in your guidance?

**<A – Tom Georgens>**: Well most of the public sector is still federal for us. Although, interestingly enough, the public sector market is actually bigger than the federal market. So therefore, we're excited about that growth opportunity. And it had a big year-over-year growth, but nonetheless, our historical emphasis has been federal as opposed to state and local and higher ed. We formed a whole new division. We put that in the public sector component. And that's coming along really, really strong, but it's a smaller number.

So right now, most of our federal numbers that we're posting is really – I'm sorry most of our public sector numbers that we're posting is really federal-related. But nonetheless, state, local and higher ed has good momentum. It's a big market that we've clearly not participated very deeply in in the past. It's something that we're going to go after aggressively. So obviously, with all the components to it, the block grants for the states and some of the federal programs that have got state components and the Race to the Top, all these things are all components of participating at that level.

That's a big investment, we took one of our most senior people to run that and we put it into our Public Sector business. But right now I'd say most of the conclusions you should draw about that business should be really pertaining to federal.

**<Q – Eric Martinuzzi>**: Okay. And that persists throughout – that good momentum from Q3 continues through Q4?

**<A – Tom Georgens>**: Yes. I think on a relative year-over-year basis Q2 buying season, obviously it's a big lump in the year, and so Q2 is usually the big hitter for them and then Q3 is a big drop-off and then Q4 is a little bit bigger and then it drops off again. So I think year-over-year, the comparison's been just fine, but there's been no doubt there was a sequential drop-off as you would expect with the seasonality of their business.

**<Q – Eric Martinuzzi>**: Thank you.

Operator: Your next question comes from the line of Katy Huberty with Morgan Stanley. Please proceed, ma'am.

**<Q – Katy Huberty>**: Thank you. Nice quarter, guys. How would you characterize your visibility in general right now? And then more specifically, do you have a view yet as to whether revenues could trend better than normal in the typically slower summer months as large enterprise spending continues to come back and you're able to shift to full demand without the same component constraints?

**<A – Tom Georgens>**: I wish I could say that I had that kind of visibility. I'd say external effects, the dollar, the overall economy, are we going to see another leg down? So those types of things I can't predict, so I don't want to overlay that on my guidance. And that's why I really only guided for one quarter.

However, what I do feel strongly about, the things that I can control are my competitive position, the breadth of my channel and those I feel really good at. So as far as guidance in terms of how strong we believe that we will be able to maintain our competitive position, I feel good about that and certainly into the summer and beyond. But the overall economic environment I'm a little bit reluctant to do that. We're really only one month into 2010, and we'll see how people are going to really respond here.

But overall, I expect our close rates to be normal. Probably more important than that is that we're actually participating in more accounts, more deals than we ever have in the past. And unless the economy ticks down or we have some blow-up with exchange rates, I would expect the momentum to continue, but I'm not in a position to do macroeconomic forecasting.

**<Q – Katy Huberty>**: Okay. That makes sense. Thank you.

Operator: Your next question comes from the line of Alex Kurtz with Merriman and Company. Please proceed, sir.

**<Q – Alex Kurtz>**: Yeah, thanks for taking the question. Tom, you were talking about making an investment in field activities and obviously that's going to lead to OpEx growth, but what specifically, what vertical, what customer segment are you going to be spending your incremental dollars on growing field presence? Thanks.

**<A – Tom Georgens>**: Well, historically, our field activities have not been vertically-oriented. However, I say telco and service providers is a high priority for us, and clearly, as a lot of dollars – secular dollars are going to flow to health care, that's probably, to the extent that we're going to go after verticals, it'd probably be those two. But some of the investment is going to be geo-based as well as we expand our coverage, both in our successful geos and also a lot of geos where we're just really getting off the ground.

**<Q – Alex Kurtz>**: Okay. Thank you.

Operator: Your next question comes from the line of Glenn Hanus with Needham Company. Please proceed, sir.

**<Q – Glenn Hanus>**: Thanks and congrats. Maybe to throw in sort of a tech thing, EMC's been talking up their FAS auto-tiering, which is kind of phase one now with a more important product, I guess, later this year. Could you give us kind of your competitive view of that and what NetApp's doing in that regard?

**<A – Tom Georgens>**: Well I think it's a couple of components. Specifically to EMC, is – FAS is a collection of things, not a specific capability, right? So FAS on a Symmetrix is different than what FAS is on a Clarion which is different than what it is on a Solara, which is different than what is on a Atmos or what have you. So FAS is kind of an umbrella name for a bunch of point technologies that are different on every platform. But I think first and foremost whatever NetApp does, it's going to be consistent across all of its SAN and NAS, high-end and low-end.

Second of all, frankly I think the concept of tiering is dying. And I probably don't want to go into a long speech on that, but at the end of the day, the simple fact of the matter is tiering is a way to manage migration of data between fiber-channel based systems and serial ATA-based systems. With the advent of Flash, and we talked about our performance acceleration module, basically these systems are going to large amounts of Flash, which are going to be dynamic with serial ATA behind them, and the whole concept of HSM and tiered storage is going to go away.

**<Q – Glenn Hanus>**: Okay. Thank you.

Operator: Your next question comes from the line of Rajesh Ghai with ThinkEquity. Please proceed, sir.

**<Q – Rajesh Ghai>**: Yes. Thanks. The combination of Arrow and Avnet was up pretty significantly quarter-on-quarter, if it were mapped correctly I think it was up 35% quarter-on-quarter, and I was just curious how you expect this to trend over the next few quarters? And also on the low-end, are you gaining share over there? And who are you gaining share from? Or is it a question of customers adopting network storage for the first time and [inaudible] fresh?

**<A – Tom Georgens>**: Yes, so that would still be share, and I'll probably come back to the question on margins, because I think I skipped over that earlier.

Well, I think with a growth rate of 15% year-over-year and forecasting 20% year-over-year, we absolutely, positively have to be gaining share, particularly with product growth rate actually even higher than that, which is not true of my competitors, where their product growth rate is generally lower than their aggregate growth rate. So I think we are clearly gaining share. And at Analysts' Day, I talked about our objective to gain a point of share this year, I think we did more than that this quarter. And if next quarter plays out the way we say, I think it will do that as well.

As far as the margin position, I think Steve talked about the mix. And as far as the channel is concerned, the channel margins are not substantially different than our large-customer margin. So I think the channel mix is not a big margin play. In terms of will it trend down a little bit next quarter, it may. I think – we're not actually forecasting that as part of our margin calculation, but the number was up quite a bit. There are a number of factors for that and stuff that may have been backlogged from the prior quarter.

So I would probably expect it to come down a little bit, but I think that the strength of those two partners and the investments that we're making in them and some of their partners downstream, that's going to persist. So I would expect them to be higher than they were in the past, even if it does dip down a little bit from this quarter.

**<A – Steve Gomo>**: Now, if your question has to do with does your margin structure change, is it exposed to channel shift, shifts between MSE and enterprise markets, whatever the case there, high-end, low-end products? The answer is no. There's not going to be a material shift because of that. If customers at the high-end or the low-end choose to configure products differently, order richer configurations, obviously that could have an impact. But channel shifts in and of themselves, shifts between our high-end and low-end offerings, all other things being equal, it's not going to make a material mark on our gross margins.

**<Q – Rajesh Ghai>**: All right. Thank you.

Operator: Your next question comes from the line of Amit Daryanani with RBC Capital Markets. Please proceed.

**<Q – Amit Daryanani>**: Thanks. Just a question on your balance sheet. You have about 3.2 billion of cash on hand. Could you talk about cash usage, be that acquisitions, stock buyback or actually looking at the convert, which I think stock can get exercised at around 32 bucks for you guys.

**<A – Steve Gomo>**: Sure. So we have \$3.2 billion of cash, as you note. Right now, we have no plans for a stock repurchase. Certainly, we're not announcing anything today. I wouldn't rule one out in the future by any means. Our objective is still to offset the dilution associated with the option grants with repurchases. That said, if you look at where we are versus our history, we're in pretty good shape right now.

So as it stands right now, we're still basically planning to augment our cash balance, particularly our U.S. cash balance. Make sure we have plenty of dry powder in case there is an M&A opportunity that comes along that we choose to pursue. As far as the convert is concerned, yes, the base bond converts at \$32 and some odd cents. But remember, we had a call overlay on top of that, which takes us up effectively to a 41 or \$42 convert point. And to be fair, we lost about 20% of that call spread when Lehman went under. So – but, if the stock goes to \$42 I think everybody's going to be happy. That's our view of it right now.

**<Q – Amit Daryanani>**: All right. Thanks.

Operator: Your next question comes from the line of Paul Mansky with Canaccord Adams. Please proceed, sir.

**<A – Tara Dhillon>**: Paul?

Operator: Your next question comes from the line of Kevin Shea with MKM Partners. Please proceed, sir.

**<Q – Kevin Shea>**: Hey, there. Thanks for taking me and great quarter, guys. Just wondering as virtualized environments sort of drive more stores demand, and just curious if you can give some insight into how much of your business is driven by VMware or VMware-related. And as far as your technological competitive advantage there, has that changed all with regards to EMC or other competitors?

**<A – Tom Georgens>**: Okay, so virtualization in general, not just VMware, and also virtualization including virtual desktop, not just virtual servers, are all key areas of focus for us. And the competitive advantage that we bring to that space is first of all I think we recognize it as a trend and made the appropriate development adjustments earlier than anybody else. And I think we got to market sooner. I also think it exposed, or I should say, unveiled a lot of the other technologies that we had in a very positive way.

The NetApp is really still the only player that does primary deduplication, and our deduplication technology in the context of VMware environments is very, very effective. In fact, we run a campaign that our new accounts that we'll guarantee that we can do it at half the space. We have provisional technology called FlexCloning or FlexClon that will actually create a copy of the data without actually replicating any of the physical space.

So if you're provisioning virtual desktops, it allows your provision – we've done demos where we provision 5,000 virtual desktops, consume no additional space and did the whole thing in five minutes. So – and then we've got other technologies as well including tight integration. So I think the value proposition there is obviously economic; it's ease of management, it's reduced space, reduced power. It's all of those things.

So I think the economic story is very, very strong. So I think that's what we're going out with. Now those technologies, deduplication, and the thin provisioning and the FlexCloning, and the dual parity rate is also important in other environments as well, so I don't want to make this only about VMware. But if we look at last year, virtualization was the primary application when we won a new account.

This year, VMware, whether you want to call it an application or not or an environment, is up there with all the traditional environments; Oracle and things like that. So I don't want to give the impression that it's half our business, but clearly it's risen from nothing five years ago to now one of the dominant environments in which we sell. But it's also an area that's growing very, very rapidly for us and growing very rapidly for the industry and a key focus for customers. So it keeps our story top of mind.

The VMware world, we're not a server vendor and we don't own VMware, so if a customer chooses VMware, they need to choose NetApp to run VMware, they need a good reason. And I think our value proposition has demonstrated that, and VMware has recognized that. And our partnership with them is outstanding, particularly at the field level, where it really matters. So all in all, I think our value proposition is good there, and I think that VMware has moved less around pure server utilization and now virtualization is enabling what's ultimately coming with what we call shared infrastructure or cloud computing now that applications are de-coupled from hardware.

And that creates a whole another set of requirements that I think NetApp is particularly well-suited for and that was our announcement with VMware and Cisco with our secure multi-tenancy. And that's, if you're going to share an infrastructure, how do you guarantee performance and how do you guarantee data security? And ourselves, VMware and Cisco collaborate on the solution to go after that problem.

So all in all, this virtualization trend I consider to be very positive. And it's not only VMware and it's not only server virtualization; I wouldn't rule out Microsoft by any means, and desktop virtualization is starting to come into its own as well.

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

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Okay. And I think at this point, I think we're at the end of our time, and I think we'll wrap up. I'd like to thank everybody for joining us. Once again, I'd like to reiterate my thanks for HP who allowed us to not overlap our meeting so we can both get to communicate with our investor base. And I'd like to thank you all for your time and your interest in NetApp. Take care.

Operator: Ladies and gentlemen, thank you for your participation in today's conference. This concludes the presentation. You may now disconnect. Good day.

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