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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the second quarter 2009 NetApp earnings conference call. My name is Eric, and I'll be your audio coordinator for today. At this time all participants are in a listen-only mode. We will facilitate the question-and-answer session at the end of the presentation. (OPERATOR INSTRUCTIONS) I would now like to turn your presentation over to your host, Ms. Tara Dhillon in Investor Relations. Please proceed.

Tara Dhillon ***NetApp, Inc. - IR***

Good afternoon everyone. Thank you for joining us today. Our call is being webcast simultaneously and will be available for replay on our website at netapp.com along with the earnings release, the financial tables and a reconciliation between the GAAP and the non-GAAP numbers. In the course of today's call we will make forward-looking statements and projections that involve risks and uncertainties, including statements regarding our financial performance in future periods, including Q3 of FY '09, our expectations regarding future growth and market share, and our expectations regarding our future headcount and tax rate. Actual results may differ materially from our statements or projections. Factors that could cause actual results to differ from our projection include, but are not limited to customer demand for products and services, increased competition and the material and adverse global economic market conditions that currently exist, particularly in the credit markets. Other equally important factors are detailed in our accompanying press release as well as our 10-K and 10-Q reports on file with the SEC, and also available on our website, all which have are incorporated by reference into today's discussion.

I would also like to notify you in accordance with SEC guidance published on August 22 of 2008, NetApp will begin to disseminate material information about the Company through our corporate website within the next several fiscal quarters. We intend to designate a separate portion of our website for purposes of these disclosures and will include a prominent link on our site to allow visitors to locate this information, which NetApp will routinely update. The website will supplement, rather than replace NetApp's current channels of information distribution. Before we begin I would also like to highlight one administrative fact to clear up some confusion. Our current fiscal year does not include a 14-week quarter. Our fiscal Q3 ends on January 23rd and our Q4 will end on April 24. It will be Q1 of FY '10 that has 14 weeks, ending July 31st, Now with me on the today's call are Dan Warmenhoven, Chairman and CEO; our president and COO, Tom Georgens; and our CFO, Steve Gomo. Steve will review the second fiscal quarter financials and discuss our outlook for the third quarter of FY '09, Tom will discuss our operations and our opportunities, Dan will share his perspective on the business and the market, and then we will wrap up with Q&A. At this point I'll turn the call over Steve.

Steve Gomo ***NetApp, Inc. - CFO***

Thanks, Tara. Good afternoon everyone. Despite what has proven to be a more difficult macroenvironment, NetApp produced revenue and earnings within our previously-target range. We are pleased with our performance on several fronts and remain optimistic about prospects for long-term growth and market share gains. That said, in the near term the uncertain economic climate makes visibility and confidence in our pipeline less certain. Therefore, our focus will be on controlling the things we can control, like gross margins and expenses, and returning to our target operating profit margin of 16% as soon as reasonably possible. Of course this is somewhat dependent upon future revenue levels, but before we discuss the future I want to walk through our second quarter results. Please note that all numbers are GAAP unless stated otherwise. To see the reconciling items 29 non-GAAP and GAAP refer to the table in our press release and also on our website.

Total revenue for the second quarter was $912 million, up 5% sequentially and up 15% over Q2 of last year. Foreign currency effects increased sequential growth by about 1.3 percentage points and improved the year-over-year growth by 1.5 percentage points. Product revenue of $570 million was up 4% sequentially and up 5% year over year, accounting for 63% of total revenue. Add-on software, which is a subset of product revenue, was 20% of total revenue. Revenue from software entitlements and maintenance was $153 million, or 17% of total revenue. Software E&M was up 6% sequentially and 30% year over year. Total software, the combination of add-on software and software E&M was 37% of total revenue compared to 36% in Q1 and 40% in Q2 of last year.

Revenue from Services was $188 million, and 21% of total revenue, up 7% sequentially and up 41% over Q2 of last year. Service revenues are comprised primarily of hardware maintenance support and Professional Services. Revenue from the largest component, maintenance contracts, increased 6% sequentially and 39% year over year. Professional Services increased 9% sequentially and 40% over last year. Non-GAAP gross margins were 61% of revenue this quarter, up three-tenths of a percentage point from last quarter and in line with our expectations. Non-GAAP product gross margins were virtually flat. Non-GAAP service margins increased 46.7% as a result of higher Professional Services utilization this quarter. Non-GAAP software E&M margins were constant at 98.5%.

Turning to non-GAAP expenses, our operating expenses totaled $455 million, or 50% of revenue. OpEx increased 2% sequentially and 24% year over year. During the quarter headcount increased by 381 people on a net basis, ending up with 8,380 employees. We accomplished our goals for hiring quota bearing sales reps and we plan to keep that capacity in place. Given the current environment we do not plan to add any incremental headcount in second half of FY '09 and will be consider replacement requests only on a case-by-case basis. Also included in Q2 non-GAAP expenses are about $4 million in write-offs associated with our decision to cancel Accelerate, our first user conference.

This quarter our GAAP income before tax includes the impairment of approximately $21 million in investments that had exposure to the Lehman bankruptcy. Also included are the amortization of intangibles from acquisitions, net gains or losses on our other investments, and the effect of FAS 123(R). This quarter we also had a one-time reduction in our GAAP stock compensation expense as a result of a periodic review of the underlying assumptions in the Black-Scholes formula. These assumptions were adjusted this quarter to better reflect our actual experience, creating a one-time catch up, which reduced our option expense compared to last quarter.

Non-GAAP income from operations totaled $101 million, or 11.1% of revenue, in Q2, at the low end of our approached range. Non-GAAP other income, which consists primarily of interest income, was $9.6 million. Non-GAAP net income before taxes was $111 million, or 12.2% of revenue. Our non-GAAP effective tax rate declined slightly to 17% as a result of the congressional extension of the R&D tax credit. The credit is retroactive to January 2008 and in effect for two years. Our GAAP statements reflect the full impact of the retroactive portion of the credit, while the non-GAAP statement reflects only the current portion. We expect 17% to be our new non-GAAP effective tack rate going forward. Non-GAAP net income totaled $92 million, or $0.28 per share, GAAP net income totaled $49 million, or $0.15 per share.

Now moving to cash flow performance, our cash flow from operations was $207 million, down 17% sequentially and down 9% from Q2 of last year. Capital expenditures were down significantly to $27 million this quarter from $77 million last quarter. Free cash flow, which we define as cash from operations less capital expenditures, totaled $180 million, up 4% sequentially and down 5% from Q2 last year. Expressed as a percent of revenue Q2 free cash flow was 20%. Turning to the balance sheet, our cash and investments totaled $2.3 billion. This balance excludes approximately $131 million of restricted cash related to our secured revolving credit facility. It also excludes about $69 million of auction rate securities, which have been reclassified to long-term investments. The debt associated with our credit facility is $65 million and is classified as entirely a long-term liability. Approximately $1.1 billion, or 47% of our cash balance is overseas. The total deferred revenue balance increased $13 million this quarter to $1.58 billion, a 1% sequential increase and a 29% increase in the balance year over year.

Turning to DSO. accounts receivable day sales outstanding were 36 days compared to 45 days last quarter and 49 days in Q2 last year. Our collections were at the second highest level in our Company's history this quarter. Inventory turns were 18.3 times this quarter compared to 21.7 times achieved in Q1. NetApp did not buy back stock in the second quarter. In the first quarter we achieved our objective of offsetting dilution from stock options and from all previous acquisitions. Given the uncertainty related to the economic environment, we felt it was most prudent to conserve our available US cash balances and keep our future options open.

Now before I turn the call over to Tom I'll discuss our outlook for Q3. Our outlook is based on current business expectations and current market conditions and reflects our non-GAAP presentation. We are making forward-looking statements and projections that involve risks and uncertainties. Actual results may differ materially from our statements or projections for the reasons cited previously. With reduced visibility caused by the recent change in the macroeconomic environment it's much harder to accurately predict a reasonable range for revenues in the third quarter. As a result we will not be providing specific revenue guidance, though Dan will share some thoughts about it. What we can tell you is that we expect non-GAAP gross margins to hold at substantially the same levels as second quarter and non-GAAP operating expenses to be roughly flat from Q2.

We have implemented several measures to reduce expenses, attacking both the discretionary and the structural elements of our operating expense stack. We will control hiring tightly and expect that attrition will reduce employee levels in the second half of the fiscal year. We are also reviewing our capital purchase budgets with the intent to reduce or postpone purchases and the associated depreciation stream. Our diluted share count is expected to remain essentially flat in the third quarter, depending upon the stock price. Our primary focus going forward is to return to our targeted 16% operating profit margins as quickly as reasonably possible. It will, of course, be somewhat dependent on future revenue levels.

With that I'll turn the call over to Tom for his operational update.

Tom Georgens ***NetApp, Inc. - President & COO***

Thanks, Steve. NetApp performed well on several fronts this quarter. We continued to grow in the face of a more challenging economic environment, our SAN business had a great quarter, EMEA was quite strong and our indirect channel business set a new record. At the same time, internally the NetApp team worked quickly to implement expense reductions, allowing us to rapidly respond to the changing economic conditions. We streamlined our expense structure in several areas without compromising our ability to continue to gain share. Going forward we'll monitor the climate and its impact on our pipeline to make sure our actions and our expense levels match what we see unfolding. Our focus will be on increasing our operating margins. I'll go into this in a little more detail shortly, but first I'll review the highlights from the second quarter.

In Q2, EMEA contributed 32% of revenue, up 23% over last year. Asia Pac was up 3% year over year to 11% of total revenue. The Americas contributed 57% of revenue, up 13% year over year. Within the Americas, the federal team had a record quarter, contributing 16% of total revenue. The indirect channel also achieved a record 67% of revenue, primarily due to increase in business from federal and our distributors, Arrow and Avenet, growing to 21% of revenue, with Arrow at 11% and Avnet at 10%. Our continued channel momentum is a result of investments in the channel and quota-bearing reps we started over a year ago. IBM was 4% of revenue this quarter.

On the product side, total storage system units shipped were up 20% year over year, as we continue to install more footprints and acquire more customers. Entry-level units were up 45% and high-end units were up 16%. Our new mid-range product family, the 3100 series, showed solid traction this quarter, but is not yet fully offset the shift that occurred from the older 3000 series to the newer 2000 family. So down modestly year over year, revenue from the mid-range still represents over 50% of systems revenue. The rapid expansion of our entry-level offerings is an indication of continued new account penetration, particularly through our indirect channels. We gained over 600 net new customers this quarter, mostly in mid-size enterprise accounts, but we were also gaining new storage 5000 customers at a higher rate than the last three years.

From a protocol perspective, orders with the fiber channel SAN, or iSCSI components, totaled 43% of our bookings this quarter, up from 40% last quarter, with 33% including fiber channel and 16% including iSCSI. 6% of those orders had overlap, which included both protocols. We are also seeing strong acceptance and interest our SAN screen offering acquired earlier this year, as clients think to plan, optimize and manage complex SAN environments. Overall the strength of our SAN business is being driven by continued share gain in virtualized server environments, increased contribution from our federal business and our timely storage efficiency story, which has seen no meaningful competitive response from the traditional architectures offered by the incumbent vendors. NAS protocols were present in 61% of our storage bookings. Our GX operating system continued its expansion beyond typical high-performance computing environments into the automotive and federal sectors this quarter. This pipeline continues to grow and we remain on track to release our first converged operating system in calendar '09.

To drive even more business on the virtualization front, in Q2 we announced a 50% guarantee initiative. Basically we are guaranteeing that customers will use 50% less storage with NetApp in virtualized server environments than they would with competitive storage products. This quarter NetApp was named Citrix' solution partner for the year for our virtualization capabilities and support. We continue to roll-out compelling examples of how the combination of NetApp storage efficiency features and our world-class SAN products produce best-in-class results. As evidence, our V series platform had its best quarter every as customers are using this solution to achieve greater utilization and functionality from their existing traditional EMC., HP and Hitachi infrastructure. The V series is a great vehicle to introduce the value proposition of our software without requiring the customer to replace their current hardware.

We have now completed our roll-out deduplication across our entire portfolio with the recent announcement of availability on the the V series and our virtual tape library, or VTL. Even before the deduplication availability our VTL business enjoyed its second-largest booking quarter ever on the strength of its other product attributes. Our deduplication continues to be the most rapidly adopted feature in the history of the Company, with over 7,600 more licenses downloaded this quarter and nearly 21,000 licenses to date.

Our Professional Services business also continues to out perform the overall Company growth. As Steve mentioned, Professional Services grew 40% over Q2 of last year and at the same time our service margins increased. Despite a difficult environment our large customers are still spending on technology and process improvement to drive lower cost in the future. They are increasingly turning to us for mission-critical application solutions and on-site administration. Our Professional Services team is integral to this activity, which is driving customer loyalty and increasing utilization rates across our Services organization. While we feel good about our completive position, with the storage efficiency story. being particularly timely, the overall environment merits considerable caution.

The build out of our sales force, which we described at analyst day, is essentially complete and we believe we have plenty of capacity in place to achieve our previous growth objectives when we return to a more normal environment. With the build out complete, we have now curtailed headcount growth. We've eliminated most discretionary spending, like travel and entertainment. We're reducing the size of our contractor flex (inaudible) and we've reduced our capital spending plans in product development and IT. Our focus in this uncertain environment is managing expenses, both above and below the gross margin line, to allow us to rapidly return to our operating model with more cautious revenue expectations. After our extended period of rapid expansion the past few years this should be achievable without weakening our long-term value proposition.

Despite our renewed emphasis on expense containment we have not in any way relented on our objective to continue to gain share independent of overall market growth rate. The messages we delivered at analyst day around server virtualization, ethernet storage, disk space back up and storage efficiency still play to our strengths. In this environment, storage efficiency is particularly relevant. At Oracle Open World in September I shared with an audience of over 5,000 IT professionals the benefits that Oracle itself has realized using NetApp. Oracle runs nearly their entire company-wide infrastructure, over 700 machines, using both SAN and NAS on NetApp storage. They have been early adopters and codevelopers of technologies like thin provisioning, flex cloning and deduplication. As they transitioned from other vendors' storage they have moved their storage efficiency from less than 40% utilization to over 90%, thereby cutting the unit cost of storage in half. In this difficult environment, I have yet to meet a customer that did not want to hear more about this story.

To wrap up, I'll echo Steve's comments that it is very difficult to forecast the future in this environment. Therefore, our focus is to leverage the investment we have already made in the field, constrain expenses as much as possible and to continue to gain share. With that I'll turn the call over to Dan.

Dan Warmenhoven ***NetApp, Inc. - Chairman & CEO***

Thank you, Tom. Looking at our business going forward from a very broad perspective there are two opposing forces at work right now, one of which we control and the other one we don't. The one we control is the amount of sales capacity we have added combined with the value proposition that we offer. At historical productivity levels, we have the sales capacity to deliver $1 billion revenue quarter in Q3. In addition, we have a value proposition around storage efficiency that is very powerful in budget-constrained environments. In normal times we would expect to achieve significant growth. The opposing force is the global economic situation. It is very difficult to predict the depth and duration of the downturn. The uncertainty around customer IT spending intentions reduces our confidence and the validity of our pipeline. Therefore, we do not have the normal forecasting basis to provide revenue guidance for Q3 or beyond. We can only share with you the factors that will influence it.

Perhaps the best way to portray our situation is to contrast it to Cisco, which announced last week. Cisco said that their bookings in October were down from the prior year. Our bookings in October were higher than last year. Unlike Cisco, we have just completed adding some significant additional sales capacity, which should drive growth. And also unlike Cisco, we are not share limited in our markets and we currently have the strongest value proposition in our history. Given these facts we are slightly more optimistic than Cisco about the future. Our best guess is that Q3 revenue will be flat to slightly up from this past quarter.

Given the high degree of uncertainty in that guess we do not feel that it would be appropriate to provide an EPS forecast. What we can give you is our commitment to keep our expense levels flat in the third quarter and to work on returning to our target 16% operating model and to get our message out to more customers about the unique NetApp value proposition. The past fact of the business model is one of tight expense control and modest revenue growth. Our strategy has not changed. We have confidence in our long-term growth prospects, as well as our ability to gain market share. We will manage the business prudently while working to preserve the investments in place to maximize our ability to come out stronger on the other side of this current economic situation.

On behalf of the NetApp team I thank you for your support and your interest in NetApp. At this point, I'll open the floor to questions. Please limit yours to one question and the return to the queue so we may address everyone in the allotted time. Operator?

QUESTIONS AND ANSWERS

Operator

Thank you. (OPERATOR INSTRUCTIONS) Your first question comes from the line of Benjamin Reitzes with Barclays Capital. Please proceed.

Benjamin Reitzes ***Barclays Capital - Analyst***

Yes, thanks. Good afternoon. Dan , maybe if you could just talk a little bit more about your order trends in October. You said they were up and that your best guess is flat. As you were talking here, Intel and other big -- Bellwether dropped guidance quite a bit, and these are two big companies, and I'm wondering if perhaps do you feel like there's a possibility you could be on a lag or do you think hat you're finding out things in the same real time that these two big juggernauts, and if you could just talk more about your orders throughout the quarter and just how you came up with your view that your best guess is you're flat?

Dan Warmenhoven ***NetApp, Inc. - Chairman & CEO***

Ben, August was actually up pretty good year over year, it was pretty strong. I think we saw the effect of the additional sales capacity coming on board. September was -- really softened up. Right after Lehman Monday things kind of just stopped and then it recovered in

October. October we were up -- I forget the exact number, but about 7% or so year over year. And again I think this is the effect of lots of new sales capacity in the field. That's why I drew the contrast to Cisco. We've added a significant amount of new capacity. We were driving for upwards north of 15% year-over-year growth and so we've completed that build out, which started actually in basically February of this calendar year,even before our fiscal year started. Those people are now becoming productive and you saw that also in the new account list, over 600 new accounts, so our view is we can continue to grow. And again, like I said, the pipeline is substantial. The capacity is substantial.

What we don't know is how that's actually going to convert to revenue. I think we're in a transitional phase in terms of customer buying patterns. Most of our customers, as I'm sure you know, are not going to rebudget for the last two or three months of this year and so there's a lot more ambiguity about what's actually going to get approved through capital purchase committees and so on. I don't know we're going to go exactly where we're at until after we see their budgets get put together in January or so of this year. My biggest risk I think -- or our biggest risk this quarter is actually January. I think we'll do well in November, I'll we'll do well in December. I don't know if you'll see some year-end budget flush, but January for us is always hard. I think it's going to be particularly hard this year as customers try to close their budgets. And keep in mind, our January -- fiscal January ends actually January 24th, a week before the month ends, and that's really pretty early for customers to have a budget in place and execute on it. So it's just going to be -- there's lots of puts and takes. The thing to me that really gives us a lot of hope for our future, even after this quarter,is amount of that new capacity that's in place.

Benjamin Reitzes *Barclays Capital - Analyst*

Thanks a lot, Dan.

Operator

Your next question comes from the line of Aaron Rakers with Wachovia. Please proceed.

Aaron Rakers *Wachovia - Analyst*

Thanks for taking the question, I guess kind of building on Ben's question there and the commentary around capacity, as you look at what you laid out at the analyst day with regard to headcount growth and now noting that you're effectively done I guess I'm trying to understand why -- if we see some modest sequential growth going into January and then think about a seasonal April quarter why we couldn't think a 15+% Op margin is doable. Is there still some fixed cost elements that are rolling into the model that you can help us understand?

Steve Gomo *NetApp, Inc. - CFO*

Actually it is possible. I don't want to guide you to it but it's certainly possible. Basically we are scaled right now. If you do some round numbers with me, $1 billion of revenue is 61% gross margin, and $450 million of expense yields a 16% operating income. So the question is how do you get to $1 billion in revenue and that recovers the model. If we grow at 3% sequentially it occurs in three quarters, if we grow 5% sequentially it's there, as you forecasted, in Q4. You pick the growth rate. I don't think we're in a position to give you any specific number for what that growth rate's going to be, but I think we feel as though we've kind of hit the floor, that the initial capacity should cushion us for any down side and it's a question of how fast we can push it up.

Aaron Rakers *Wachovia - Analyst*

And what is your assumption around attrition rates as we go to the back half of the year? Sorry if I snuck that in.

Steve Gomo *NetApp, Inc. - CFO*

Oh, our attrition rates for the back half of the year, we've traditionally run around just north of 10% as a Company. With the downturn we see in the economy we've actually seen a reduction in that and --

Dan Warmenhoven *NetApp, Inc. - Chairman & CEO*

In the last downturn we actually had one quarter where we had no departures from the Company.

Steve Gomo *NetApp, Inc. - CFO*

Right. So it's softened dramatically. Right now we're anticipating something on the order of net 4% type of thing, but we'll have to see. That could change.

Aaron Rakers ***Wachovia - Analyst***

Thank you.

Operator

Your next question comes from the line of Louis Miscioscia with Cowen and Company. Please proceed.

Louis Miscioscia ***Cowen and Company - Analyst***

Okay, thank you. I'm not sure if you're willing to go out this far, but as we look to '09 why wouldn't we unfortunately be in a tough situation that companies really start to pull back as the obviously horribly ugly macroenvironment makes them really pull in their horns here?

Dan Warmenhoven ***NetApp, Inc. - Chairman & CEO***

Tom, go ahead.

Tom Georgens ***NetApp, Inc. - President & COO***

I think all of that is certainly possible. At this point if we look at the trends clearly we survived a very difficult September and October rebounded probably to a greater degree than some other people. But I think Dan put it right into perspective is that I think a lot of budget is still in place. I don't think people went through long complicated process to recap their budget just for the final two months of the year. But the concern is what will January look like, will it be new budgets, will it be resolved early in the year? I think there are a number of factor in play and I think the macro is going to be a very difficult thing for us to predict. I think we made that clear in this call.

But our focus is market share. Market share has no context. Up market, down market, we believe our competitive position around storage efficiency and around server virtualization and some of the other items are opportunities for to us take share. And as long as there's an opportunity for to us take share, particularly with the added capacity we brought on board, then I think there's an opportunities for us to outperform. But in terms of the aggregate market growth rate I don't know that we -- any of us feel confident to really make any claims as to where that's heading.

Louis Miscioscia ***Cowen and Company - Analyst***

Okay. And just one quick one then on pricing. When you look actually to pricing as you go forward --

Dan Warmenhoven ***NetApp, Inc. - Chairman & CEO***

We've got a bad pattern going here, guys. How about we move on to the next caller, Go back in the queue. We shouldn't let the first one go by.

Operator

Your next question comes from the line of Min Park with Goldman Sachs. Please proceed.

Min Park ***Goldman Sachs - Analyst***

Great, thank you. There's been a lot of anecdotal data coming out that tightening credit may be hampering channel sales to a certainty degree and given your heightened emphasis on indirect business have you experienced that in your own business and do you have any plans to help on the credit side to facilitate sales going forward?

Dan Warmenhoven ***NetApp, Inc. - Chairman & CEO***

No, most of our channel sales are actually through fairly-well capitalized distributors, such as Arrow. I think Arrow was 11% this quarter, Avnet was 10% this quarter, IBM, Fujitsu Siemens, the US federal guys are all the systems integrators like Lockheed Martin and Northrop Grumman. These guys have the big balance sheets, they don't need the help. In fact, that's actually why they're in place. Arrow and Avnet take the credit risk for the downstream resellers. So, no, I don't think we've got any issues that way at all. If anything we'll see some issues on the international reseller side. Last time when the Asian currency crisis hit we extended them some extended terms or looked past their credit worthiness maybe is the way to put it, and then put that in deferred revenue where you basically hung it up on the balance sheet until they're able to pay. But that's the only case I can think of and that's not going to be very widespread.

Min Park ***Goldman Sachs - Analyst***

Great, thank you.

Operator

Your next question comes from the line of Katie Huberty with Morgan Stanley. Please proceed.

Katie Huberty ***Morgan Stanley - Analyst***

Thanks. How do you match up the comments that October rebounded with the meaningful drop in receivables at the end of the quarter? Was linearity within the month front-end loaded or were you collecting faster given the environment?

Steve Gomo ***NetApp, Inc. - CFO***

This is Steve here. So I mentioned that we had the second highest level of collections in the Company's history -- and the collection folks who are listening, congratulations, we really knocked the ball out of the park this quarter. So you combine super collections with relatively slower growth, substantially slower than we've seen, obviously, over the past couple of years and you get to a situation where you drive your receivables down and that's exactly what happened.

Operator

Your next question comes from the line of Shebly Seyrafi with Calyon. Please proceed.

Shebly Seyrafi ***Calyon - Analyst***

Yes, thank you very much. So I just -- I guess I want more color on your path to higher operating margins. You talked about the math being $1 billion in revenue with the constant gross margin and the $454 or so million in OpEx getting you there, it does work but won't you need to add salespeople to get your revenues to $1 billion? How much of your OpEx is variable versus fixed? Thanks.

Dan Warmenhoven ***NetApp, Inc. - Chairman & CEO***

It's 45 -- $450 million, 45% I believe is the number in OpEx, it's not 54 as you stated. And sales capacity is something that grows over time assuming you don't have turnover in the sales force. A lot of the people we just added are climbing up a productivity curve. If we hold constant right now they'll gain additional capacity of about 10% over the next two to three quarters and what you'll see is that total capacity will continue to increase. So, no, we don't need to add any more salespeople to achieve. Basically we were staffed to achieve a plan that had us well over $1 billion by Q4. We're at basically $1 billion of capacity in Q3, and like I said they'll continue to become more productive as time goes on.

Steve Gomo ***NetApp, Inc. - CFO***

Yes, the only thing I want to add is that we haven't terminated our program to hire these quota-bearing reps [and the expansion] of our sales force. We basically completed the that we set out -- that we began before analyst day. So I don't think the question is at all capacity, it's really a question of productivity in this environment. Under normal environments we have the capacity to meet the plan that we had already set in place for analyst day in our original forecast. So at this point capacity's not going to be our issue, it's going to be productivity and what is the customer behavior going to look like. But be real clear, we didn't terminate the capacity building program in midstream. We actually completed the investment that we said we were going to invest in at analyst day.

Shebly Seyrafi ***Calyon - Analyst***

Okay, thanks.

Operator

Your next question comes from the line of Bill Choi with Jefferies. Please proceed.

Bill Choi ***Jefferies - Analyst***

Okay, thanks. Can you guys provide your typical revenue by verticals and just discuss whether the pipeline uncertainty you guys are seeing is really any particular vertical? And I guess somewhat related to that you guys had $1.7 million in allowance for doubtful accounts. Can you just address that as far as that increase? Thanks.

Dan Warmenhoven ***NetApp, Inc. - Chairman & CEO***

While Tom's getting the vertical numbers. I want to comment on our vertical mix at a very high levels sense. Some of our verticals are not cyclical, like government, telcos, healthcare. Some are more exposed to the macroeconomic environment, certainly the tech sector, which is heavily consumer-based these days with companies like Invidia, T.I., et cetera. They're building largely components for consumer products. Certainly the financial services, which we've talked about in the past, has been under some degree of stress. Automotive and major manufacturers, haven't heard any good news there lately. But the point is its not 100% cyclic. A lot comes from verticals like telco and government that have a tendency to keep on as far as linear path independent of macroeconomic business cycles. That said let me turn it over to Tom, he's got the verticals here for you.

Tom Georgens ***NetApp, Inc. - President & COO***

So, yes, another one that I think is not very cyclical that remains robust is healthcare. But in terms of the numbers we talked about in the earnings -- in the prepared text about government at 16%, financial services at 12%, overall tech at 13%, and those are the big hitters. Telecom at 8% and then the other ones are basically low single digits.

Bill Choi ***Jefferies - Analyst***

And the doubtful account part?

Tom Georgens ***NetApp, Inc. - President & COO***

Doubtful account question.

Steve Gomo ***NetApp, Inc. - CFO***

Oh, we had about just under $2 million allowed for doubtful accounts this past quarter. Where was that -- that's obviously a sudden increase there. Can you talk a little bit more about it? Oh, that was Lehman. Lehman was the customer and most of that was in the UK.

Tom Georgens ***NetApp, Inc. - President & COO***

Those are receivables from Lehman Brothers and if one of you guys wants to volunteer to pick up their tab we would appreciate it.

Bill Choi ***Jefferies - Analyst***

(LAUGHTER) Okay, thanks.

Operator

Your next question comes from the line of Mark Moskowitz with JPMorgan. Please proceed.

Mark Moskowitz ***JPMorgan - Analyst***

Thank you, good afternoon. Dan , I had a question in terms of the sales force build out. You've completed it, done a nice job there, but just curious what type of stock do you think in place in terms of preserving your gross margins in this tough time? You've got a lot of folks on the ground that want to get out there and sell. What type of IT systems and CRMs do you have in place to keep the pricing

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Dan Warmenhoven ***NetApp, Inc. - Chairman & CEO***

The methodology is built into the approval process for any kind of discount. The best example I can give you is take a look at what happened after the bubble burst back in 2001 and '02. We had a -- I think the gross margin fell one quarter to 58%, mostly because of volume-related effects, then it bounced right back over 60% the next quarter. And it's a very strong discipline in the sales organization to basically sell value and that's reflected in the margins. It's obviously propped up by the software mix, but you look at the cost per gig of a basic system from us, it's extremely competitive with a bare bones system from anybody else so there's not a need to discount that a lot and there's not a lot of margin to take it out of anyway. All the real value's in the software and that's a question of how much the customer's going to buy and that's all, if you will, fairly proprietary, right? It only works on our systems. All together the model seems to work. There's multiple layers of approval throughout the sales organization until you get to five layers up for a deep discount deal and it keeps the discipline in place.

Mark Moskowitz ***JPMorgan - Analyst***

Thank you.

Operator

Your next question comes from the line of Brian Freed with Morgan Keegan. Please proceed.

Brian Freed ***Morgan Keegan - Analyst***

Good afternoon, thanks for taking my call. You guys continued to generate great cash flow, I think you said it was 20% of revenue this quarter and historically 20% to 23%. Looking forward do you think that's a sustainable percentage of revenue to drive to the free cash flow line or do you see a material change in that?

Steve Gomo ***NetApp, Inc. - CFO***

This is Steve here. A lot of that obviously depends on revenue levels and profit levels, which we're really not talking about at this point in time. So you can expect that we're going to be a net cash generator and the only question is how much we're going to generate and that's going to depends on business volumes and profitability.

Brian Freed ***Morgan Keegan - Analyst***

Do you have a target?

Steve Gomo ***NetApp, Inc. - CFO***

Not that we are sharing.

Dan Warmenhoven ***NetApp, Inc. - Chairman & CEO***

It's intuitive. Pick a revenue number he can tell was he thinks it's going to be.

Brian Freed ***Morgan Keegan - Analyst***

All right. Thanks.

Operator

Your next question comes from the line of Bill Schultz with Credit Suisse. Please proceed.

Bill Schultz ***Credit Suisse - Analyst***

Okay, great. Just off of that question, how should we think about the sensitivity of the deferred revenue portion of your cash flow? Do you think -- looking at the environment now if gets worse do you think you'd see significant incremental pressure on that component of cash flow as users potentially buy systems with less software and services content?

Tom Georgens ***NetApp, Inc. - President & COO***

Bill, I think what you're going to see is its going to be tied somewhat to the growth rate of our overall business. It tends to be highly correlated with our invoicing and base level of business, and if the base level of business picks up you're going to he see deferred cash pick up. Over the long haul as we look forward, I would expect that our free cash flow will be 20% or north when viewed as a percent of revenue. And we may have a quarter or two where we don't hit that, but over the long haul I think certainly we have the capability to deliver those kind of results.

Bill Schultz ***Credit Suisse - Analyst***

Okay. Thank you.

Operator

Your next question comes from the line of Bill Fearnley with FTN Midwest.

Bill Fearnley ***FTN Midwest - Analyst***

The question for Dan, in the past you said you need to get yourself into more deals so you can transfer the win rates into more opportunities. Are you getting more pitches to hit in terms of quoting proposals? Are there any significant changes in your win rates and or share gains here? Are you getting the pitches to hit in terms of proposals and the decision cycles are being stretched out? Could you provide some more color there?

Dan Warmenhoven ***NetApp, Inc. - Chairman & CEO***

If you look at some of the metrics we look at such as the new account activity, pipeline associated with new accounts, thing of that nature, you have to conclude, yes, we're getting more opportunities to participate. The feedback from the branding and awareness work that we've done is that more of our potential customers are aware of NetApp and so they're contacting us, there's more unsolicited hits on the web. More EBC visits, our executive briefing center visits. This is more activity. That said it's very hard to determine how that's going to translate. Our pipeline is at basically an all-time high and there's a higher percentage of that pipeline which is coming from what would classify as new accounts. The thing we don't have a good handle on is conversion rates. I can tell you that last quarter our win rates against the key competitors actually improved, but we're still not in enough deals. So the next question you're going o ask is, why did HP do so good? My answer is we don't compete with them all that frequently. They're doing a lot of bundled deals in the channel and it's hard to intercept them and that's really the issue. We've got to get into more of those. It's not just a question of big deals that customers send our way, it's also a lot of flow through a channel.

Tom Georgens ***NetApp, Inc. - President & COO***

From the new customer account perspective we talked about 600 new accounts in the first half of this fiscal year, the percentage of our bookings coming from net new NetApp accounts is higher than it's ever been before. Even our action significant rate on the storage 5000 has been modestly better than the last three years where clearly we had higher aggregate growth rates but we're actually acquiring customers at a faster rate today. So the new customer acquisition part of the equation I think is actually the good part of the story. The growth rate in some of the larger accounts, particularly in the financial services side, when you've got the big accounts growing at a very slow rate or roughly flat clearly that drags on the overall number. But if we had some modest performance level, or historical performance level from the large accounts, the once where we're deeply penetrated, I think the growth rate would be quite strong. So overall, the new customer account part of the equation here I think is actually the thing that gives us the most optimism.

Dan Warmenhoven ***NetApp, Inc. - Chairman & CEO***

I do want to point out that in the period that occurred in 2002 and '03 -- and we think it's starting to occur again -- we got an opportunity to get into more new accounts during that period than ever before and the reason is because the customers were open minded to considering new alternatives. When things are going good and you're focused as a customer on scaling and new apps and build out it's not a time to change your infrastructure vendors. However, when times get tough and the focus turns to grinding down the cost structure you've got to do more with less budget that's the time when they start really thinking about, can I do this with a more cost-effective solution and that's when they open the door to us to actually demonstrate what we can do. So we're actually pretty optimistic that new accounts are going to be a big piece of the gain going forward and that -- as those [rebound] would tell you we think when this recession finally ends and things turn up those will fuel a significant growth rate again.

Tom Georgens ***NetApp, Inc. - President & COO***

Just to pile on -- on this point, is that the new customer account activity has been substantially on the SAN side of the business. The SAN side of the business was particularly robust last quarter and storage efficiency, the server virtualization part is clearly there. But I think the storage efficiency story, in particular, resonates against the really large infrastructures and as a result it's actually the SAN environments that are really attaching to the story at a higher rate and the SAN part is clearly the fastest growing component of our business right now.

Bill Fearnley ***FTN Midwest - Analyst***

Thanks, guys.

Operator

Your next question comes from the line of Tom Curlin with RBC. Please proceed.

Tom Curlin ***RBC - Analyst***

Hey, good afternoon. I'm not sure if you commented a lot on the international side but I'm just curious what you're seeing in terms of the demand trends international versus North America. North America's been weakening for awhile, but what do you see in Europe and Asia?

Tom Georgens ***NetApp, Inc. - President & COO***

Well, in Europe clearly we just came off a pretty good quarter. We actually grew over 23% in Europe. I think there's a mix of factors in play. Certainly we're very strong in the UK and Germany. There are other parts of Europe which are relatively new to us that represent not quite greenfield but certainly growth opportunities to gain share where we've been -- have less share than we have in the aggregate. Clearly I think some slow down in some of the larger economies, the impact of the Euro in terms of budget capacity, I think those are clearly weighing us in one direction. But there's also a lot of countries in Europe who we've not had a strong presence that we're growing quite well in. On on balance Europe's doing okay, but I think the large economy growth rates are clearly concerned just as they are in the US.

Tom Curlin ***RBC - Analyst***

Okay, thanks very much.

Operator

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

Brent Bracelin ***Pacific Crest Securities - Analyst***

Thank you. Dan, we really wanted to follow up on the demand side. We can appreciate the benefit of increased sales coverage here, but what are you generally hearing from some of your larger enterprise customers? Are they asking for better pricing? Are you seeing them place smaller purchase orders? Obviously you've had some large enterprise customers that saw a slow down from the last year, have you seen them come bank? What's your general sense in how long they can defer spending on storage? Is it six months, 12 months, two years? Any additional color on what some of your larger customers are telling you would be helpful.

Dan Warmenhoven ***NetApp, Inc. - Chairman & CEO***

Yes, it's all over the map to be very honest with you. This is quite a different period, though, than it was roughly six years ago when the bottom fell out after the bubble burst. At that point there was a significant amount of unused or excess capacity in the storage infrastructure in most large accounts. Over the last roughly five years most of those have turned to some form of storage on demand model, whether it be purchases every quarter or whether it be a lease kind of arrangement where they just add to the lease or whatever it is. Typically the capacity they acquire is scaled to match their needs. So my guess is there's very little excess capacity installed in general and also in general most of them are going to continue to purchase on a metered basis.

I think the real variable in this forecast going forward is to what extent do they consider into what I would consider to be reengineering of their infrastructure, whether it be through server virtualization or reengineering back up where they use secondary storage instead of tape or whether they push for more replication strategies through business continuity, that's the thing that generates incremental demand. So I think the underlying demand, actually, for basic primary storage they're going to stay pretty constants. I don't think it's going to -- this is still a consumable, right? You fill it up, you need some more. But that is not the big driver of high growth. The big driver of high growth lately has been secondary storage and that's the big unknown. We don't know whether customers are going to keep pushing for rapid ROI projects, like eliminating tape, or whether they're going to sit still. I tell you another one that really gives us great oper -- great optimism is the server virtualization. It's got typically such a fast ROI that we think that's actually going to gain momentum and it will be a big -- will really play to our strength, so I personally think we've got the best server virtualization complementary server infrastructure storage around.

Tom Georgens ***NetApp, Inc. - President & COO***

If I could add to that. I kind of see two dynamics at play. One of them is where you started the question and that is how are they going about satisfying their incremental demand and I think they're satisfying their incremental demand as close as possible to actual utilization rates as they possibly can, so relatively small incremental purchases, the minimum necessary to get by, and they're basically looking one quarter at a time. And I think that's going to generate one level of growth rate.

The other dynamic that's significantly in play, there's lot of firms that are out there that realize that their budgets are going to be perpetually less than they used been and are looking to fundamentally lower the cost of their infrastructure. They've done large server virtualization projects which have changed the economics of their server infrastructure and they're looking aggressively at doing something similar on the storage side. The scope of those, the complexity of the transition the time to ROI are all factors of the speed at which they go ahead, but the number of people that are looking aggressively, particularly resonating around a storage efficiency story and they're going to cut their cost of storage dramatically, is [making] people take a long-term look. So in addition to satisfying incremental demand I think a big part of our story going forward is really getting customers to take a hard look at their broader existing infrastructure and plan to ultimately swap that out to get to a much lower cost -- lower operating cost place and I think NetApp can help with that a lot and that might actually be our biggest opportunity through this downturn.

Brent Bracelin ***Pacific Crest Securities - Analyst***

Very helpful. Thank you.

Operator

Your next question comes from the line of Juan Villanueva with Merrill Lynch. Please proceed.

Juan Villanueva ***Merrill Lynch - Analyst***

Thank you. Can you comment at what level of revenue growth will you look for managing costs beyond the hiring freeze (inaudible) and everything else you normally do in the course of your business. So if the market really struggles over the next year or so and there's actually year-over-year declines in revenues would you still try to maintain similar to increasing operating margins? How do you think about your costs in a real worse case scenario?

Steve Gomo ***NetApp, Inc. - CFO***

It is extraordinarily difficult to speculate without having some more specific question about what you expect the revenue level to be. You just asked a question anywhere from modest growth to decline. I gave you the modest growth scenario. We're going to scale into it. If we're not that scenario then we'd have to stop and reassess and make a determination at that time. But it'd be wild speculation at this point to make any comment about how we'd react in that -- in such a speculative question.

Tara Dhillon ***NetApp, Inc. - IR***

Next question?

Operator

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

Chris Whitmore ***Deutsche Bank - Analyst***

Thanks very much. I know you typically don't comment on backlog, but given the uncertain environment can you give any color at all as to the backlog you built or didn't build during the quarter? What's the backlog look like heading into fiscal Q3? And relatedly, what kind of conversion rate on that pipeline is built into that flat up to slightly expectation for revenue going forward? Thanks.

Dan Warmenhoven ***NetApp, Inc. - Chairman & CEO***

For the backlog it's a little bit better than it was coming into Q2, that's all I'm going to say at that one. It's not depleted, it's actually up a little bit. The conversion rate is not even so much on the pipeline, it's a question of productivity, total capacity. The pipeline at the start of the quarter is a leading indicator, but a lot of these deals are done in 30 or 60 days and aren't in that initial pipeline, you've got to look at total productivity available and typical normal based line productivity rates and at that point you conclude, well, you got the capacity for over $1 billion. Another question is what's the discount you take for decreased productivity as a result of customer push outs or reduced spend or whatever it may be and that's very hard to determine. It's actual that point that kept us from giving a firm revenue guidance forecast for this next quarter.

Operator

Your next question comes from the line of Alex Kurtz with Merriman Curhan Ford. Please proceed.

Alex Kurtz ***Merriman Curhan Ford - Analyst***

Yes, thanks for taking the question. It's another look at the demand issue. Is the lack of near-term visibility specific to the customer segment, meaning are you seeing more pain among your top enterprise accounts versus, say, mid-size enterprise? Thank you.

Tom Georgens ***NetApp, Inc. - President & COO***

Could you please repeat the question? Sorry.

Alex Kurtz ***Merriman Curhan Ford - Analyst***

Yes. Are you seeing more weakness among your top enterprise accounts relative to mid-size enterprises, or is the pain being felt across all customer segments?

Dan Warmenhoven ***NetApp, Inc. - Chairman & CEO***

I think it's across all segments. I think we've got more opportunity in mid-size enterprise. We've got more channel capacity focus there at this point and so I think we are getting greater contribution there, but I think that everybody's feeling the pain pretty much equally.

Tom Georgens ***NetApp, Inc. - President & COO***

Yes, I think the mid-size enterprise is that there's just plain more of them and so therefore it's a lot easier to diversify away. You get some of the large enterprise accounts and they represent substantial amounts of our revenue and if they -- you know the financial services story as well as anybody, if they're not spending it's hard to make that up with a bunch of other accounts. So clearly the drag on our growth rate now is not our new customer performance, it's actually some of our top enterprise accounts,particularly in some of the verticals that Dan talked about earlier that appear to be feeling a lot of pain.

Alex Kurtz ***Merriman Curhan Ford - Analyst***

Okay, thank you.

Operator

Your next question comes from the line of Keith Bachman with BMO Capital Markets. Please proceed.

Keith Bachman ***BMO Capital Markets - Analyst***

Hi, guys, thanks for taking the question. Tom or Steve, I wanted to see if you could talk a little bit about regardless of scenario how you see the distribution of revenues between the categories of product software and systems, This quarter products was a little bit -- products was weak but off a tough comp, and just wanted to try to understand how you see that relationship going forward, at least for the next quarter? And related, does FX have a different impact on the different line items?

Steve Gomo ***NetApp, Inc. - CFO***

So I'll start with the second half of the question and the answer is that FX does have a slightly different impact on the different parts of the revenue lines. Impacting the nondeferred stuff that we recognized in the period obviously is the key difference.

Keith Bachman ***BMO Capital Markets - Analyst***

Right.

Steve Gomo ***NetApp, Inc. - CFO***

In fact, as we move forward, Keith, I think I noted in the script that if you look year over year we actually were aided by FX this quarter on the year-to-year comparison.

Keith Bachman ***BMO Capital Markets - Analyst***

Yes.

Steve Gomo ***NetApp, Inc. - CFO***

When we move forward one quarter we're going to find a headwind in FX because of the big changes that we've seen, particularly in those last three weeks of October.

Keith Bachman ***BMO Capital Markets - Analyst***

Sure. And it's going to impact your next couple of quarters, as well.

Steve Gomo ***NetApp, Inc. - CFO***

Right. As far as our product mix, given we're not projecting any revenue for it it's kind of hard to comment about it, I wouldn't be expecting any significant changes in mix, from where we are this past quarter. We may see some slight shift, but I don't know of anything that's going to change things dramatically.

Tom Georgens ***NetApp, Inc. - President & COO***

No, I don't see any big mix changes either. I think this quarter we had software up a little bit as a percentage of the revenue, we had Services up a bit as a percent of revenue, but I don't see any big changes. Clearly as we go into the end of the calendar year, that's IBMs fourth quarter, we sort of expect some more activity for IBM. It's a traditionally strong quarter for Europe. But I don't expect it to be anything that's really going to significantly alter the model as a result what we're seeing in the macro economy.

Keith Bachman ***BMO Capital Markets - Analyst***

Okay. Thank you.

Operator

Your next question comes from the line of Kaushik Roy with Pacific Growth Equities. Please proceed.

Leo Troy ***Pacific Growth Equities - Analyst***

Hi, guys, this is [Leo Troy] filling in for Kaushik. Just got a couple questions here. Considering EMC's (inaudible) grew more than 40% last three quarters, you got Dell doing pretty well, Equallogic and HP not doing poorly in storage, are you guys still expecting to grow two times the market growth rate for storage systems? And maybe you can comment on what kind of currency headwind you guys are expecting in the January quarter, you guys doing any kind of currency hedging? Thanks.

Tom Georgens ***NetApp, Inc. - President & COO***

Well, as far as the multiple of the market I think philosophically we're clearly there. When the market's growing single digits twice as much isn't that impressive. Likewise, if the market declines we don't want to shrink twice the rate of the market. So our objective here is clearly on market share, right? In the fiscal calendar quarter of this year we passed IBM and HP for the first time to be number two in revenue market share and we're focused here is on market share. We want to exit this year as the clear number two, and as long as we're continuing to gain share then I think the fundamental business is healthy regardless of what the macro does. So I'd say that at numbers very close to zero the multiplier of the industry growth rate might not be so relevant, but philosophically the focus on market share remains just as intense and in fact, our likelihood of achievement is just as strong now as it was on analyst day.

Steve Gomo ***NetApp, Inc. - CFO***

Yes, Steve here. With respect to currency, yes indeed we do hedge the currency and that's always netted into the number that I provide for you. If the currency stayed right where it is today we'd probably see something on the order of a 2% year-over-year headwind with respect to foreign currency.

Leo Troy ***Pacific Growth Equities - Analyst***

Thank you, guys.

Operator

Your next question comes from the line of Clay Sumner with FBR. Please proceed.

Clay Sumner ***FBR - Analyst***

Thanks. Hey, Tom, last quarter we talked a bit about software as a percentage of system revenue and guys were talking about how last quarter you had strong new customer acquisition. Traditionally new customers start I guess with one application and a relatively-low software attach rate and grow over time. You had another quarter of strong new customers, but can you share any metrics or talk about if you're seeing that traditional software richening over time with the more seasoned customers?

Tom Georgens ***NetApp, Inc. - President & COO***

Certainly we've seen in this quarter attach rates of some of our software products increase a little bit. We actually saw -- certainly within the bounds of normal variability we saw software as a percentage of total revenue go up a little bit. I would say that what we talked about last time we clearly see and I see it in the attach rates. I see it a little bit in software moving. But I wouldn't say it's a dramatic move, but I would say that we haven't certainly seen anything different this quarter that would be inconsistent with what we said last time.

Clay Sumner ***FBR - Analyst***

Okay. Thank you.

Operator

Next question comes from the line of Glenn Hanus with Needham. Please proceed.

Glenn Hanus ***Needham - Analyst***

Thanks. On gross margins, Steve, can you talk a little bit about puts and takes on the gross margin here that getting to flat? Are product -- are you looking for product margins to be flat this quarter? Last quarter you were impacted by the mix towards the lower end and some lower volumes Any color around that? Thanks.

Steve Gomo ***NetApp, Inc. - CFO***

Sure. So if mix and everything else were just to stay exactly the same as it was in Q2, you'd end up with the same type of margin. We're not making any projections about the -- any mix shifts here, so we're just saying that things are going to look pretty much similar to what we saw this quarter. There's no other puts and takes going on here.

Glenn Hanus ***Needham - Analyst***

Okay. Thank you.

Operator

Ladies and gentlemen, we have no more time for questions. We will not be taking follow ups. I would like to turn the call over to Mr. Dan Warmenhoven for closing remarks.

Dan Warmenhoven ***NetApp, Inc. - Chairman & CEO***

Thank you very much for joining us today. We look forward to doing the same again in 91 days. Everybody have a great day. Take care. Bye-bye.

Operator

Thank you for your participation in today's conference. This concludes our presentation. You may now disconnect and have a good day