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NetApp, Inc. (NTAP)

Q2 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen. And welcome to the NetApp Second Quarter Fiscal Year 2016 Results Call. At this time, all participants are in a listen-only mode. Later we will conduct a question-and-answer session and instructions will follow at that time. [Operator Instructions] As a reminder, this conference is being recorded.

I'd like to introduce your host for today's conference, Ms. Kris newton, Vice President of Investor Relations. Ma'am, please begin.

Kris Newton
VP, Investor Relations, NetApp, Inc.

Hello, and thank you for joining us on our Q2 fiscal year 2016 earnings call. With me today are our CEO, George Kurian, and CFO, Nick Noviello. This call is being webcast live and will be available for replay on our website at netapp.com, along with the earnings release, our financial tables and guidance, our historical supplemental data table and the non-GAAP to GAAP reconciliation.

As a reminder, during today's call, we will make forward-looking statements and projections with respect to financial outlook and future prospects, such as our guidance for the third quarter and full fiscal year 2016, our expectations regarding our ability to respond to changing demands of our customers in an increasingly uncertain macroeconomic environment, our ability to manage our cost structure portfolio and processes to drive efficiency, profitability and growth, our expectations regarding market acceptance of clustered ONTAP, our ability to drive operational and financial performance, and our expectations regarding our business model in FY 2016, all of which involve risk and uncertainty. Such statements reflect our best judgment based on factors currently known to us and are being made as of today.

We disclaim any obligation to update our forward-looking statements and projections. Actual results may differ materially from our statements and projections for a variety of reasons. We describe some of these reasons in our accompanying press release, which we have furnished to the SEC on a Form 8-K. Please refer to the documents we file from time to time with the SEC, specifically on Form 10-K for fiscal year 2015, subsequent Form 10-Q quarterly report and our current reports on Form 8-K, all of which can also be found on our website. During the call, all financial measures presented will be non-GAAP unless otherwise noted. These non-GAAP measures are not prepared in accordance with Generally Accepted Accounting Principles. A reconciliation of our GAAP and non-GAAP results is provided in today's press release and on our website.

I'll now turn the call over to George.

George Kurian
Chief Executive Officer & Director

Thank you, Kris, and good afternoon, everyone. Thanks for joining us today.

Our Q2 fiscal year 2016 financial results were generally as expected. We continue to make progress as we pivot towards growing parts of the market, scale-out, software-defined, flash, converged and hybrid cloud. Our key investment areas of sales capacity, channel traction and acceleration of the transition of our install base to clustered Data ONTAP continue to show early results. Our focus remains on enabling our customers' success as they navigate their IT transformations to leverage modern architectures and deploy hybrid cloud solutions.

Over the course of our second quarter, I continued to rigorously analyze our business. I traveled around the world and participated in our Insight user conference, meeting with thousands of customers and partners. The feedback I heard was overwhelmingly positive, and reaffirmed my conviction that our data fabric strategy resonates with and is aligned to our customers' strategic technical direction underpinning our confidence in the opportunity ahead.

We've made progress, but we still have more work to do, to become more efficient and agile so that we can best take advantage of our long-term growth opportunities. An increasingly uncertain macro-environment, continued shifts in the market and an aggressive pricing environment have slightly tempered our fiscal year 2016 outlook. By coupling the strength of our data fabric strategy and the benefits we deliver to customers with a more efficient and agile business, we can generate value for customers, partners, employees and shareholders over time.

I have tremendous confidence in our opportunity for success. That said, parts of our business are working well. Some parts need improvement, and other parts we must manage through declines. The IT spending environment continues to be constrained, and the expectation for growth of the overall storage market has decreased to low single-digits.

At the same time, customers are seeking to take advantage of new applications and modern data center storage and data management architectures. Based on our analysis, this has resulted in the traditional standalone hybrid storage market declining at approximately 9%, while at the same time the parts of the market addressed by our scale-out, software-defined, flash, converged and hybrid cloud solutions are growing at a rate of roughly 20%.

Highly disciplined portfolio management is required to address the different growth rates of our markets. We must be more efficient in the parts of our business that aren't growing, in order to generate sufficient profits that can be returned to shareholders and leverage for investment in areas of growth to deliver innovation ahead of the market. We have already sized our investments in OEM, and ONTAP 7-Mode commensurate with the opportunity, and have recently consolidated all of our hardware platform engineering teams into a single group for further efficiency.

IT spending will remain under pressure as customers evaluate cloud and modern architectures. We are growing our install base and have made investments in growth areas that are showing results, although they are not yet enough to offset the decline in our traditional business.

The decline in standalone hybrid storage, most notably, impacts our traditional ONTAP 7-Mode business. The 7-Mode storage operating system was shipped on about 30% of FAS units in the quarter, down from roughly 65% a year ago. ONTAP 7-Mode unit shipments were down almost 60% year-over-year, and Q2 marked the first time that we did not experience growth in the 7-Mode install base.

At a subset of our customers, the normal hardware refresh cycle has been slowed as they plan for the move to clustered ONTAP. We continue to work to smooth this transition for our customers. And at our Insight user conference last month, we announced support for ONTAP 7-Mode through 2020. Customers are also slowing investment in the capacity expansion of their traditional 7-Mode storage environments. The dynamics of our 7-Mode and OEM businesses continue to put downward pressure on product revenue, despite strong growth in other parts of our business.

As a part of their IT modernization efforts, customers want scale-out and software-defined storage functionality for efficient management of data growth and cloud service provider-like flexibility. Clustered ONTAP enables seamless data management across flash, disk and cloud footprints for enterprise applications like databases, virtualization and e-commerce. The software-defined architecture of clustered ONTAP provides a consistent way to manage data across public and private clouds, regardless of underlying hardware. Clustered ONTAP was deployed on approximately 70% of FAS systems shipped in Q2, up from 35% a year ago. And unit shipments of clustered ONTAP systems grew over 95% year-over-year, demonstrating continued strong customer demand.

At the beginning of the fiscal year, we created a set of clustered ONTAP transition programs to accelerate the migration of installed base customers who are ready to upgrade both their systems and their software from ONTAP 7-Mode to clustered ONTAP. These programs offer customers and certified partners transition support, temporary gear and financial incentives.

We saw strong uptake in Q2, almost all of which was done with the tremendous support of our channel partners. While these programs help migration-ready customers move, migrations themselves are projects that must fit within the overall IT priorities and budgets of our customers.

The low growth of overall IT spending has an impact on the pace of migration. As we have stated before, we anticipate that the transition of the install base will happen over the course of years. The clustered ONTAP install base continues to grow, and now represents 17% of total installed FAS systems and almost 30% of installed FAS capacity. The number of customers, who purchased clustered ONTAP systems in Q2, grew by 85% from Q2 last year. And in that same period, the number of new to NetApp customers, who purchased clustered ONTAP in Q2, grew by 95%.

Customers are deploying high-performance flash technology to gain advantages from accelerating business transactions, processes and their supporting enterprise applications. Our All Flash FAS products offer enterprise-grade flash technology, combining built-in data protection, multiprotocol support, scale-out performance and seamless data movement from flash to disk to cloud.

After introducing flash essentials with optimized read performance, inline compression and inline zero-based de-duplication in Q1, we improved both the list price and form factor for our All Flash FAS by 40%, as well as announced a controller upgrade program, a seven-year extended warranty, and a 3x performance guarantee. These enhancements garnered positive feedback in the channel, and drove rapid adoption of our All Flash FAS products with unit shipments accelerating 445% year-over-year; the sixth consecutive quarter of triple-digit growth.

To meet the requirements of ultra-high performance, low latency applications, customers opt for our EF products. Units of the EF-Series grew 65% from Q2 a year ago. In order to achieve the performance, availability and cost requirements of new webscale and analytic applications like Hadoop and Splunk, and the increase in the amount of data retained online for business insight and cybersecurity, customers are deploying our E-Series platform.

For customers who are increasing their cybersecurity defenses with real-time analysis, the E-Series capability to store hot and cold data under the same data management architecture, substantially improves the efficiency and flexibility of their environments. We are aggressively targeting this part of the market, and continue to see growth of the E-Series with unit shipments up over 20% from Q2 last year.

Our hybrid cloud solutions comprise NetApp Private Storage for cloud, cloud ONTAP, StorageGRID Webscale and AltaVault. While these solutions do not contribute materially to revenue today, they are important in positioning us for leading-edge hybrid cloud deployments, a large European manufacturing company chose NetApp for our cloud integration coupled with converged and All Flash solutions and the ability to manage it all under a single framework in clustered ONTAP.

Similarly, we had wins at a global law firm, a large global security vendor, a U.S.-based software management company and many others, because of our ability to deliver highly competitive storage solutions and have a broader strategic discussion encompassing cloud-ready integration and enablement with the world's leading cloud service providers. This is the power of the data fabric at work.

For customers looking for pre-integrated converged solutions, NetApp offers FlexPod in conjunction with Cisco. NetApp and Cisco introduced FlexPod five years ago and have generated $5.6 billion in shared revenue, delivered by more than 1,100 partners to more than 6,300 customers worldwide. In Q2, we announced a Cisco-validated design for All Flash FAS FlexPod with Cisco's Application Centric Infrastructure, ACI. You will continue to see exciting innovations from our strong partnership with Cisco.

Our customers are transforming themselves, using digital technology, connected with pervasive broadband networks and cloud computing, to improve the efficiency of their businesses, build global business systems and better serve their customers. Data is at the heart of that transformation.

At the same time, they are scrutinizing the value that they have gained from past investments in IT, reducing IT budgets and rethinking how they consume IT. This evaluation is creating caution on traditional storage system transactional spending, and is diverting spending towards transformational projects and modern architectures like scale-out, software-defined, flash, converged and hybrid cloud where our data fabric strategy gives us an advantage over the competition.

NetApp is the only company that can help customers manage their data seamlessly across multiple cloud architectures and provide the scale and modern architectures needed to accommodate the exponential data growth of the digital era.

NetApp is changing to position the company for long-term growth. We expect to gain share in the traditional part of the market, but that alone won't be sufficient to overcome the decline of that market and drive overall growth for NetApp. We will continue our pivot towards modern architectures such as scale-out, software-defined, flash, converged and hybrid cloud. The growth in this part of our business is strong and encouraging.

Customer and partner feedback drives strong conviction that our industry-leading portfolio and differentiated data fabric strategy will expand our opportunity and drive long-term growth. However, this transition will take time, as the growth is coming off a smaller base than our traditional ONTAP 7-Mode footprint. We are investing to accelerate growth, and are taking action on the cost structure of the business to ensure value creation for customers and shareholders through the duration of this transition.

In fact, we're conducting a fundamental assessment of every aspect of our business. Structure, portfolio and process to reduce complexity and drive efficiency while improving our velocity and investing for long-term growth. This will require making some important decisions about topics crucial to our business, from our product portfolio to our go-to-market approach and our supporting functions. We must both invest for the long-term growth of our business and preserve our current growth initiatives that are showing early results while streamlining and improving the efficiency of our business.

We will lower the cost structure of the company, but we'll not take actions that improve our short-term results at the expense of our long-term strength. There is growth to be had in this industry, and we believe we have the right strategy and technology to capture that growth in the long-term and deliver increased shareholder value over time.

NetApp has the innovation, scale and open ecosystem needed to solve the data management challenges for the enterprise. The changes to larger players in the market create opportunity for us. NetApp is the only company able to span flash to disk to cloud, and the only company delivering the ability to manage data across multiple clouds and on-premises today. Many elements of our portfolio are growing strongly, and we need to capitalize on them by maintaining our sales capacity, continuing our channel efforts and making it easier for our install base to migrate to clustered ONTAP.

Customer wins and partner feedback indicate that we are on the right path. We have a portfolio of differentiated IT and a growing install base. We are delivering tremendous value to customers in their strategic IT transformation. It is critical that we build a stronger, more efficient company that solves customer challenges while delivering profitability and earnings growth in a moderated IT spending and storage market. You can expect tangible results from this process over the remainder of this fiscal year and beyond.

Before turning the call over to Nick, I'd like to thank the entire NetApp team for their hard work and dedication as we evolve our great company for future growth and sustained success. And I would like to extend a special thank you to you Rob Salmon, President, who, after 22 years, announced his intent to retire from NetApp at the end of the fiscal year. We appreciate all he's done for the company and his work to ensure a smooth transition.

I'll now turn it over to Nick.

Nicholas R. Noviello

Chief Financial Officer & Executive VP-Operations

Thank you, George, and good afternoon, everyone.

Before we get started, as a reminder, I will be referring to non-GAAP numbers in today's discussion, unless otherwise indicated. Overall, we are pleased with our Q2 financial results and the progress we are making related to our key investments in sales capacity, in the channel, and in accelerating the migration to clustered ONTAP.

Starting with revenues. Net revenues for the second quarter were $1.45 billion, up about 8% sequentially and down 6% year-over-year. FX headwinds had an unfavorable impact on the year-over-year comparison by about 4 points. As George indicated, the overall IT spending environment is pressured. This, coupled with the uncertain macroeconomic environment, has affected us in different ways across our geographies.

For example, our U.S. Public Sector business declined 22% year-over-year in Q2, while at the same time, excluding impacts from foreign exchange, EMEA and Asia Pacific were up 8% and 3% year-over-year respectively.

Product revenue of $815 million was up 23% sequentially, in line with expectations, but was down 12% year-over-year. The year-over-year decline reflects favorable clustered ONTAP momentum, which was more than offset by about 5 points of FX headwinds and declines in ONTAP 7-Mode revenue, which we expected, as well as OEM revenue due to the changing business dynamics of our OEM customers.

The combination of software maintenance and hardware maintenance and other services revenues primarily derived from existing new and renewed service contracts was up 3% year-over-year, but down 6% sequentially, reflecting the return to a 13-week quarter. As a reminder, we had an extra week in Q1 which resulted in about a $40 million increase to Q1 maintenance revenue. Indirect revenue accounted for 77% of net revenues, similar to Q1.

Gross margin of 62.5% was down about 2.5 points year-over-year, and about a 0.5-point below our prior guidance range. FX headwinds had an unfavorable impact of about 1-point year-over-year. Product gross margin of 51.8% was up about 0.5-point sequentially, and was down about 6.5 points year-over-year, driven by about 2.5 points of FX and roughly equal impacts from higher discounting and unfavorable product mix.

On a year-over-year basis, software maintenance gross margin was roughly flat while hardware maintenance and other services gross margin was up 2 points, reflecting a favorable mix shift towards hardware maintenance as well as infrastructure cost efficiencies.

Q2 operating expenses totaled $684 million and were down 8% quarter-over-quarter and 6% year-over-year. This sequential decline reflects a combination of a return to a 13-week quarter and prudent expense management. Operating margin for the second quarter of 15.2% was 7.5 points higher than last quarter and was just above our previous guidance range.

Our effective tax rate for the quarter was 17% as expected. Weighted average diluted share count of 296 million shares decreased by approximately 12 million shares sequentially and 8% year-over-year due to share repurchase activity.

Q2 EPS of $0.61 was $0.01 above the high-end of our prior guidance range.

Now turning to cash and balance sheet metrics. We closed Q2 with $4.8 billion in cash and short-term investments, 14% of which was held by our domestic entities. Deferred and financed unearned services revenue decreased by $20 million in Q2 versus Q1 and was flat year-over-year. Inventory turns increased to 17, in line with our expectations. And day sales outstanding normalized to 37 days from 30 days in Q1, reflecting the return to a 13-week quarter.

Q2 cash flow from operations was approximately $145 million versus $381 million in Q2 a year ago. Free cash flow of $99 million was about 7% of net revenues, down substantially from Q2 a year ago, due to lower net income and a return to normal levels of DSO and accrued compensation net of improved inventory turns related to the 14th week in Q1.

Finally, we repurchased approximately $183 million of stock and paid $53 million in cash dividends during the quarter. Consistent with our previous guidance, we remain on track to complete our share repurchase program by the end of May 2018, with the first $1 billion of repurchases expected to be completed by the end of May 2016. Today, we also announced our next cash dividend of $0.18 per share of the company's stock that will be paid on January 20, 2016.

Now turning to our business outlook. We remain confident in our strategy and long-term growth potential. As I discussed last quarter, fiscal year 2016 is one of transition. We are realizing results from our investments in sales capacity, actions to regain traction in the channel and programs to accelerate the migration to clustered ONTAP.

Coming into the year, we anticipated that topline predictability would improve in the back half, but the uncertain macroeconomic environment, continued shifts in our market and an aggressive pricing environment have resulted in continued limited visibility.

While we have made progress in rebuilding our pipeline, these factors have slightly tempered our outlook. As a result, we expect revenue for fiscal 2016 to be down just over 5%. Though ultimately dependent on revenue mix, growth and our continued actions to drive down costs, given the environment, we now estimate fiscal 2016 gross margin to be down 1 point to 2 points from fiscal 2015 and operating margin to be down about 2 points for the year.

We expect second half operating margin of approximately 18%, the low end of our target operating margin range. Although off to a low start in the first half, we expect free cash flow as a percentage of revenue for the second half of the year to be in the mid-teens.

Finally, we expect to reduce share count in fiscal 2016 by approximately 6%. And between dividends and share repurchases, we will again return over 100% of free cash flow generated in the fiscal year to shareholders.

As George discussed, we are assessing every aspect of our business to drive efficiency and velocity. We will lower our cost structure, including cost reduction actions in the second half of fiscal 2016. We will drive greater efficiency across the business, and at the same time make investments in growth areas leading to increased profitability, longer term growth and increased shareholder value.

For Q3, we expect net revenues to range between $1.4 billion and $1.5 billion, which at the midpoint implies flat revenues versus Q2 and a 7% decrease year-over-year. We expect Q3 consolidated gross margin of approximately 61.5% and operating margin of approximately 17%. Based on our share repurchases in Q2 and in the first 10 days of Q3, we expect our weighted average diluted share count for the quarter to be approximately 297 million shares and earnings per share for Q3 to range from approximately $0.66 to $0.71 per share.

In summary, we are confident in the opportunity ahead of us. Customer wins and feedback from partners indicate that our data fabric strategy is differentiated and well aligned with their most critical IT imperatives. We must improve our efficiency and agility to take full advantage of those opportunities and to set NetApp on a path for increased profitability, long-term growth and increased shareholder value.

I will now turn call back to Kris to open the call for Q&A. Kris?

Kris Newton

VP, Investor Relations, NetApp, Inc.

Thanks, Nick. We'll now open the call for Q&A. Please be respectful of your peers and limit yourself to one question so that we can get to as many people as possible. Thanks for your cooperation. Operator?

QUESTION AND ANSWER SECTION

Operator. Thank you. [Operator Instructions] Our first question is from Jayson Noland of Robert Baird. Your line is open.

Jayson A. Noland
Robert W. Baird & Co., Inc. (Broker)

Q

Okay, great. Thank you. I wanted to ask George on the transition program. Could you provide some more detail on the economic incentives that are behind cTAP, and then how are the credits accounted for on the P&L?

George Kurian
Chief Executive Officer & Director

A

The credits are essentially discounts related to the product bookings that were registered as part of that program. So every transaction that is qualified for the cTAP incentives goes through our deal registration process that we administer. In terms of the program itself, the incentives and enablement that we have conducted include the availability of temporary swing gear on a loan basis to customers that need temporary capacity, some set of incentives around professional services to help them ameliorate the cost of the overall migration effort.

A majority of the transitions have been done through the partners, and there have been strong uptake and good feedback from the partners. In the second quarter of this year, the number of partners that participated in the clustered ONTAP acceleration program expanded substantially from Q1 across all of the geographies in the world, as well as the number of customer transactions also expanded substantially from Q1. So we're pleased with progress. We thank our partners for leaning in with us on this important effort.

Kris Newton
VP, Investor Relations, NetApp, Inc.

A

Thanks, Jayson.

Jayson A. Noland
Robert W. Baird & Co., Inc. (Broker)

Q

Thank you.

Operator: Thank you. Our next question is from Jim Suva of Citi. Your line is open.

James Dickey Suva
Citigroup Global Markets, Inc. (Broker)

Q

Thanks very much. George, can you give us a little bit more color on, you'd mentioned that you were doing the strategic reviews and a lot of the efficiencies and stuff like that. Is there anything we can judge or put as milestones or look ahead to see how quickly you're assessing these items?

And then for Nick, can you talk a little bit about cash flow, whether it be an extra week last quarter and not the extra week this quarter? If you sum up the two quarters in total, it kind of, in my view, washes out the extra week factor. And when you look at the two quarters together, the cash flow looks down significantly year-over-year. Is that kind of the new run rate we're looking at for cash flows as a percent of revenues? Or how should we think about cash flows as it seems like it's kind of directionally stepped back a little bit? Thank you.

George Kurian
Chief Executive Officer & Director

A

Okay. I'll take the first question, and then hand over to Nick. I'd appreciate the next few callers to just stick with their one question. In terms of the overall assessment that we have conducted, it's really focused on both efficiency as well as velocity. And what I mean by that is, efficiency around all aspects of our business: structure, portfolio, business process, so that customers find it easier to do business with us as well as partners.

In terms of velocity, we feel that having accomplished the efficiency aspects of the program, we will be able to transition our business more quickly in response to changing market landscapes. We'll just be a leaner, more efficient company that can be more agile in response to the changing market environment. You will hear more from me over the second half of this fiscal year and over the next few quarters beyond that as we go through the program. Stay tuned. It is a fundamental reassessment of all aspects of our company.

Nicholas R. Noviello
Chief Financial Officer & Executive VP-Operations

A

And Jim, just quickly, with respect to the cash flow, I think this is consistent with the slow start up of the year, right? The first half was intended to be a rebuild, both of the pipeline and a rebuild of the business condition. You saw that in terms of even the operating margins as we grew up in the first half here. You can see it in net income.

The second point would be that, as we look at the second half, our view is that we're going to be in the mid-teens in terms of cash flow as a percentage of revenue in the second half. So that clearly washes out all of the implications of timing, 13-week versus a 14-week quarter and all of those pieces.

Kris Newton
VP, Investor Relations, NetApp, Inc.

A

Thanks, Jim. Next question.

Operator: Our next question is from Lou Miscioscia of CLSA. Your line is open.

Louis Miscioscia
CLSA Americas LLC

Q

Okay, great. When you look at your operating expense, sales marketing, R&D and G&A, you did a good job year-over-year and obviously quarter-over-quarter taking out the prior week. Should we expect it to more or less stay flat absolute, at this level going forward? And then, if you could comment where do you think it could go even more into the future, into 2017 and beyond? Because it sounds like you want to continue to take a good cost out or take cost out.

Nicholas R. Noviello
Chief Financial Officer & Executive VP-Operations

A

Hi, Lou, this is Nick. So a couple things. I think if you back through the guidance, you'll see an implied reduction quarter-over-quarter, so a sequential between Q2 and Q3 reduction in operating expenses overall. Also I'd say that

47% of revenue in Q2 is not the type of level we expect for the business in the long-term or in the long-term models. So more to come. We'll talk more about that. George indicated that he'd spend more time talking about the portfolio and all of the things we're looking at. But suffice it to say, for purposes of the Q3 guide, you can back through that and see that we expect operating expense to be down sequentially and down even as a percentage of revenue versus Q2.

Kris Newton
VP, Investor Relations, NetApp, Inc.
A

Thanks, Lou. Next question.

Operator: Our next question is from Kulbinder Garcha of Credit Suisse. Your line is open.

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

Thanks. A question for both of you, I guess, on the gross margins on the product side. I understand the pressures this year that you're seeing currently, but they kind of feel almost permanent, the currencies are where they are. And then on top of that, pricing seems intense, but it's always kind of intense in this industry. And you're going through a prolonged transition, which I assume opens you to more competitive attacks. So would I be right in concluding that this level of gross margin is probably what we're going to see for some time? Or are there some other drivers or initiatives at work to bring them back to historic levels? Thanks.

Nicholas R. Noviello
Chief Financial Officer & Executive VP-Operations
A

Sure. Kulbinder, let me start with that. So certainly if you look at the gross margins and specifically the product gross margins for the quarter, on a year-over-year basis, we have a 2.5-point impact alone from foreign exchange. We don't expect that type of thing. And in fact, that'll start to mitigate as we get certainly to Q4. We do have higher discounting, I made that clear. Last quarter and actually in Q4, I talked about higher discounting. It's about 2 points impact on a year-over-year basis to product gross margin this quarter. That we have to work through. That is the aggressive pricing actions going on in the industry right now. We have to work it. That said, over time, we've shown that we can move margins here, and, in fact, over a several years, we did exactly that.

Finally, I would say that on the services side of our business, the team has done a really good job in terms of leveraging the cost base and servicing the enormous installed base of customers that we have. So I think it's a combination of items. Certainly the aggressive pricing environment is something that we have to be reflective of. The portfolio is something we spend a lot of time working on and thinking about. And the uptake of clustered ONTAP with customers and those actions on the hybrid cloud portfolio over time, we expect to be benefits to margins of the company.

Kris Newton
VP, Investor Relations, NetApp, Inc.
A

Thanks, Kulbinder. Next question.

Operator: Our next question is from Sherri Scribner of Deutsche Bank. Your line is open.

Sherri A. Scribner
Deutsche Bank Securities, Inc.
Q

Hi. Thank you. I was hoping you could give us a little bit of geographic detail in terms of what you saw across the world. It looks like the Asia business saw some nice uptick in the quarter. Just curious what that's about. And it looks like maybe the public business was maybe a bit softer. So hoping to get some more detail. Thanks.

Nicholas R. Noviello
Chief Financial Officer & Executive VP-Operations

A

Okay. Sherri, let me start on that for a second. So if I take the impact of currency out, our EMEA business actually did really well in the quarter. And that EMEA business year-over-year, without currency, was up 8%. Asia was up 3%. The challenge obviously was in the U.S. Public Sector, down 22%, no foreign currency impacts there.

I think that to start, and I'm sure George may have a comment or two as well, I think the EMEA team has done an incredible job really over the course. I'm going to say now, of the last year plus of taking clustered Data ONTAP and the promise of the portfolio and the data fabric and bringing that to customers. I think it started there.

In Asia, we obviously have some very strong areas. We have some that are more challenged, and we have some macroeconomic implications in Asia that we're just going to have to work through. And the team there is working through it. In the U.S. Public Sector, there's a variety of things going on that we just have to be aware of. I would say that we are not anticipating a recovery in the U.S. Public Sector as we move into Q3.

George Kurian
Chief Executive Officer & Director

A

Just to add some color to that. I think when I look across the geographies, our large enterprise customers continue to do good business with us across all the geographies. To add some color to the Asia-Pac and Public Sector comments, in Asia-Pac, you certainly saw the impact of the slowdown in China, in the countries that were dependent on China either for investment or as suppliers to the Chinese economy. So it was, while the overall business met expectations, there was a wide range of different countries.

I think in terms of the Public Sector itself, we do a large amount of business through the global system integrators and their business was challenged within the public sector model. We also saw, in some cases, program delays or prioritization of spend towards priorities such as cybersecurity. We feel confident of our position in the Public Sector business. We are the number one provider of storage and data management, and we continue to win our preponderant majority of new opportunities within the public sector.

Kris Newton
VP, Investor Relations, NetApp, Inc.

A

Thanks, Sheri. Next question.

Operator: Our next question is from Ananda Baruah of Brean Capital. Your line is open.

Ananda P. Baruah
Brean Capital LLC

Q

Hey. Thanks guys for taking the question. This could be for either George or for Nick. Just what, I guess, anecdotally is the right way to think about the levers around the R&D? It certainly seem to be, just if we take a look at this quarter, one of the contributor is the OpEx. The OpEx, I'd say, kind of catalytic performance. But it just seems like this year is going to be a little bit softer than last year. And in the context of – I know you're not going to give specifics now, but like looking at the overall portfolio, is there anything that you can tell us now philosophically how you're looking at the R&D going forward, given that we've already seen it come off a little bit? Thanks.

George Kurian
Chief Executive Officer & Director
A

When we look at portfolio management, we look at it on both products and product markets as well as customer segments, geographies and all aspects of the business. As I said in my prepared remarks, we run a very disciplined portfolio management process, which means that for capabilities that are mature in the market, we continue to reduce our investments in those parts of the business, whether they are pathways, whether they are customer segments or on the product portfolio side, and reinvest some of that into the faster growing emerging parts of the market. We returned some of that certainly to shareholders and some of that we reinvest to the faster growing parts of the market. So that's our portfolio management approach. And we've implemented it. It's certainly part of the model that you're seeing being implemented in the company going forward. And that's what's driving discipline in the operating expense stack.

Kris Newton
VP, Investor Relations, NetApp, Inc.
A

Thanks, Ananda. Next question.

Operator: Our next question is from Amit Daryanani of RBC Capital Markets. Your line is open.

Amit Daryanani
RBC Capital Markets LLC
Q

Thanks a lot. Good afternoon, guys. I guess, George, I just want to understand the cost containment strategy. I thought the expectation in the last earnings call was you would have more update this time around. So I'm curious, what are you seeing or what's driving this announcement or cost optimization to be more further pushed out? And then broadly, as you think of your business, if you have 0% to down 5% revenue trajectory, what do you think the right OpEx number is? Is it 20% or 40% for you guys? Thank you

George Kurian
Chief Executive Officer & Director
A

We have done a thorough analysis of the business and identified a number of areas to drive fundamental transformation. That fundamental transformation is both to improve the efficiency of the business and also make it easier to do business with NetApp. To do those actions will take time to achieve the full desired outcome, but it is what will help the company both transform our operating expense stack as well as make it easier to do business with us so that we can drive topline velocity. The things that we have done are already showing results in the quarter, so we have taken some action in the quarter and we said we will take further actions through the second half of the year. And you will see more progress updates as we take those actions on. So we are not saying that we're pushing out any action to next fiscal year. We're going to start and we're going to continue to do it over multiple quarters.

Kris Newton
VP, Investor Relations, NetApp, Inc.
A

All right. Thanks, Amit. Next question?

Operator: Our next question is from Brian White of Drexel. Your line is open.

Brian J. White
Drexel Hamilton LLC

Q

Yeah. Hey, George. I'm wondering if you can give us a little color on how you're thinking about the Dell EMC deal and the opportunities it may open up or the threats you see from this transaction. Thank you.

George Kurian
Chief Executive Officer & Director

A

First of all, I would say, that my opening comment is that the Dell EMC transaction is yesterday's solution to tomorrow's customers' problems. It does not fundamentally address the hybrid cloud, it does not fundamentally address the data management opportunity that customers are forced to deal with. It is really about trying to build efficiency in an integrated hardware business rather than the software-defined data center of the future.

I think in the near-term, based on discussions with multiple customers and partners, it is generating a lot of uncertainty for customers and resellers. And that is clearly an opportunity for NetApp, which we intend to take advantage of. In the long-term, the absence of a compelling story around the IT architecture of the future will make their customer value proposition something that we can debate and capitalize on. We are taking actions to improve the efficiency of our business to be able to deal with larger scale competitors and be more agile than they are. And I'll summarize at that.

Kris Newton
VP, Investor Relations, NetApp, Inc.

A

Thanks, Brian. Next question?

Operator: Our next question is from Maynard Um of Wells Fargo. Your line is open.

Maynard J. Um
Wells Fargo Securities LLC

Q

Hi. Thank you. George, you talk about portfolio management, but it sounds more like you're looking for areas of de-emphasis and declining products. You obviously have a pretty strong customer install base, even in large enterprises. So I'm curious why you wouldn't look to more aggressively broaden out your portfolio to cross-sell more products into your existing install base, and then across your broad channel.

And I know you've done acquisitions like buying Riverbed's SteelStore product, but why not have a more aggressive product acquisition strategy, maybe even larger to increase your revenue per customer, rather than returning the cash to shareholders? And I guess the question really boils down to NetApp being either a growth versus value company, and which one you think is right for the company long-term? Thanks.

George Kurian
Chief Executive Officer & Director

A

I would tell you that we are in a changing market landscape where some parts of the market are declining and some parts of the market are growing quickly. I would say that it's important for us from a management perspective to apply discipline and maturely harvest the categories of the markets that are declining. We do believe that we can continue to gain share even in those declining markets.

At the same time, we balance every dollar that we have incremental in terms of investing in new market opportunities or returning it to shareholders, and that's a careful balance that we continue to have.

In terms of our emerging portfolio of products, as I said on the call, we are very pleased with the progress in terms of the growth rates of the emerging portfolio, the All Flash arrays, the E-Series portfolio, the hybrid cloud solutions. We're very pleased with the progress, both in terms of the growth rate as well as the number of channel partners selling it, as well as the number of customers that are adopting multiple products from NetApp to the point you just made. So we'll continue to stay disciplined. We have a disciplined market and strategic evaluation process that looks at our portfolio and compares it to the market trends, and it's an ongoing evolution in a changing market. So thanks.

Kris Newton
VP, Investor Relations, NetApp, Inc.

A

Thanks, Maynard. Next question?

Operator: Our next question is from Steve Milunovich of UBS. Your line is open.

Steven M. Milunovich
UBS Securities LLC

Q

Great. Thank you. You talked about the company in two pieces, standalone storage and on the other side, scale-out, software-defined and cloud. What percentage of the company is in each bucket today and what do you expect maybe exiting the year in a couple quarters?

George Kurian
Chief Executive Officer & Director

A

I would say when we talked about traditional standalone storage systems, we were talking about our 7-Mode operating system and the OEM business. I think when you look at the use cases for the E-Series through the branded channel, there are a large number of third platform use cases that are built around the data center of the future. The clustered ONTAP operating system is also part of the data center of the future, combining scale-out, software-defined and All Flash architectures to enable customers to operate their environments like cloud service providers. So traditional storage, we were referring to more particularly around 7-Mode and OEM.

Kris Newton
VP, Investor Relations, NetApp, Inc.

A

Thanks, Steve. Next question?

Operator: Our next question is from Andrew Nowinski of Piper Jaffray. Your line is open.

Andrew James Nowinski
Piper Jaffray & Co (Broker)

Q

Okay. Thanks for taking the question. So I just like to ask about linearity in the quarter. You said product revenue was down 12% year-over-year, product gross margin was down, I think, in part due to higher discounting. But then your DSO has also spiked up, which seems to imply the quarter may have been a little bit backend loaded. And your guidance for the January quarter was a bit lower than the Street was expecting. So I guess when you look at those three metrics together, it seems that you may have pulled in some revenue into the October quarter. So just wondering if you can provide any color on that dynamic and whether the sales pipeline for the January quarter is up on a year-over-year basis. Thanks.

Nicholas R. Noviello
Chief Financial Officer & Executive VP-Operations

A

Yes. Andrew, it's Nick. Let me get started on that. Part of the first half activity, as we talked about it back in May and then again in August on our calls, was to rebuild pipeline. And the team has been doing a really important effort around just that, putting sales capacity in, rebuilding channel partner relationships, et cetera. So I think the work continues to go on there. That's not something that's going to end, it's going to be something that continues.

In terms of linearity in the quarter, the second quarter is a quarter that encompasses both a federal year-end in September and then our quarter-end in October. When I look at our position at the end of the quarter versus sort of the end of the quarter a year ago, there's not much difference there. So the linearity, I think, is pretty normal in terms of overall what has happened year-on-year. I realize [ph] the pieces (50:17), there are anomalies in this 14-week quarter from Q1, which we see every six years. So hopefully, we will not have that type of thing talk about for another six years. But other than that, the linearity is really consistent with what we expected and our position going into Q3 consistent with what we had going into Q3 even last year.

Kris Newton
VP, Investor Relations, NetApp, Inc.

A

Thanks, Andy. Next question?

Operator: Our next question is from Rod Hall of JPMorgan. Your line is open.

Rod B. Hall
JPMorgan Securities LLC

Q

Yeah. Hi, guys. Thanks for the question. George, I guess, I wanted to ask about the penetration of cDOT. You said it was 17%, I think, in this quarter. That's a little bit of a slowdown in penetration rate from the last quarter. So I wanted to just get you to comment on that. Yet you're talking about a pretty high transaction rate there. So just trying to juxtapose those two things. And then also on that same line, you said 30% of capacity is penetrated. Can you guys give us the last two quarters of that number, so we can compare that capacity penetration rate? Thanks.

George Kurian
Chief Executive Officer & Director

A

So let me just say that our prior quarter was at 15%, and the current quarter is at 17%. So we don't see this as a slowdown. We see this as a constant sort of trajectory of customer environments transitioning from 7-Mode to cDOT as well as new shipments getting deployed in our install base. When a new shipment gets sold by NetApp to the customer, it usually takes a little while before it actually shows up in our install base measuring system, because of the time it takes for the customer to get it ready and deploy it. So sometimes the quarter boundary is not the perfect answer. And so we see this as part of our ongoing trajectory.

In terms of capacity deployed and capacity managed, we don't break out those numbers. They are essentially a measurement of the value of clustered data ONTAP, in terms of being able to consolidate multiple systems and provide for large scale data management in a very efficient fashion for customers. So we're pleased with that statistic as well

Kris Newton
VP, Investor Relations, NetApp, Inc.

A

Thanks, Rod. Next question?

Operator: Our next question is from Brian Alexander of Raymond James. Your line is open.

Brian G. Alexander
Raymond James & Associates, Inc.

Q

Yeah. Just going back to the geographic performance, why do you suppose Europe has been so strong the last couple quarters? I think you said up 8% in constant currency. The macro backdrop in Europe obviously isn't all that favorable. So what's different about your business or your competitive position there that's allowing you to have a pretty strong growth in constant currency versus the performance in the Americas?

George Kurian
Chief Executive Officer & Director

A

I would say there's two or three factors. The first is, I want to thank our European sales leadership team. We have a deep experienced, well-executing sales leadership team and a group of loyal channel partners who we've enabled with our technology sets. And that has driven consistency in terms of the execution of the European organization. It is also translating our investments in the channel as well as the capacity investments we've made in the field into results.

The second is, we have introduced capabilities that were specific to the European market. So for example, clustered Data ONTAP, there's a high availability configuration of it called MetroCluster that is built with European data centers in mind. And that gives us a far superior solution for Europe than any other competitor in the market. So it's both technology as well as great execution on the ground.

Kris Newton
VP, Investor Relations, NetApp, Inc.

A

Thanks, Brian. Next question.

Operator: Our next question is from Aaron Rakers of Stifel. Your line is open.

Aaron Rakers
Stifel, Nicolaus & Co., Inc.

Q

Yeah. Thanks for taking the question. I wanted to go and discuss the free cash flow guidance. I believe, last quarter you had talked about 15% free cash flow relative to revenue. I know that you've tempered slightly your revenue outlook for this fiscal year, but now you're talking about 15% for the back half of the year, which by my math would suggest a decent decline in the full-year free cash flow contribution. I'm just kind of wondering what necessarily has changed so significantly in the free cash flow expectation relative to the slight guide down on the income statement?

Nicholas R. Noviello
Chief Financial Officer & Executive VP-Operations

A

Yeah. Aaron, actually if you go back to some of the discussion that actually happened in May, we were talking about a cash from ops for the year that was going to be coming in, in, let's say, the high $800 million range if you back through the math. And then redeploying to shareholders over $1 billion, so over 100% redeployed to shareholders. When I look at our forecast today, they are moderately south of that, but we're not talking about material numbers. So it is, mid-teens is the expectation for the second half of the year. There's obviously been some pressure here in the first half. There's been some noise in terms of Q1 versus Q2, but overall for the year, we should be generating a cash from ops range in the $800 million to $900 million range. And that's not that significantly different from what we even talked about back in May.

Kris Newton
VP, Investor Relations, NetApp, Inc.

A

Thanks, Aaron. Next question.

Operator: Thank you. Our last question is from Joe Wittine of Longbow Research. Your line is open.

Joe H. Wittine
Longbow Research LLC

Q

Thanks. George, I think everyone appreciates your pragmatic view on market growth, splitting out kind of the traditional on-prem areas that are shrinking. I think you said 9% in the [ph] growthy (56:11) portions, converged, All Flash, et cetera, are growing 20%. Give us a sense of what is NetApp's current breakdown? I think it just helps complete the story and helps us do the math as far as when topline growth could return. Thanks.

George Kurian
Chief Executive Officer & Director

A

I would say that first of all, it's hard for us to break out specific segments because essentially our All Flash arrays are part of our core clustered Data ONTAP business. I would point you in terms of the places where the business is declining to 7-Mode and our OEM business, as we said, the 7-Mode business is down to 30% of new shipments, down from a much, much larger number a year before; clustered Data ONTAP is 70% of new shipments. And so, you can draw your conclusions in terms of when that transition will happen. The majority of our business has already transitioned to the go-forward platforms. I will leave you with that. The majority of our business has already transitioned to the go-forward platforms; in the E-Series, branded versus OEM, in the ONTAP and FAS business, clustered ONTAP versus 7-Mode.

Kris Newton
VP, Investor Relations, NetApp, Inc.

A

Thanks, Joe. I'll give it back to George for a couple summary comments.

George Kurian
Chief Executive Officer & Director

Thank you for joining us today. I'd like to conclude by saying, we continue to make progress as we pivot towards growing parts of the market, scale-out, software-defined, flash, converged and hybrid cloud. Our key investment areas are sales capacity, channel traction and the acceleration of the transition of our install base to clustered ONTAP are showing early results.

Clustered ONTAP, flash and other emerging pieces of our portfolio are growing strongly, although not yet enough to offset the decline in our ONTAP 7-Mode business. Our customers are transforming themselves using digital technology, connected with pervasive broadband networks and cloud computing, to improve the efficiency of their business, build global business systems and better serve their customers.

Data is at the heart of that transformation, and where NetApp has a unique and valuable role to play. Feedback from customers and partners is overwhelmingly positive, and reaffirms my strong conviction that our data fabric strategy is aligned to our customers' strategic technical direction for IT.

NetApp is the only company that can help enterprises manage their data seamlessly across multiple cloud architectures with the scale and modern system architectures needed to accommodate the exponential data growth of the digital era. NetApp is changing to position the company for long-term growth. We are conducting a fundamental assessment of every aspect of our business, structure, portfolio and process to reduce complexity and drive efficiency while improving our overall velocity. We will build a stronger, more efficient company that solves customer challenges while delivering profitability and earnings growth in a moderated IT spending and storage market.

Thanks for joining us, and I'll speak with you again next quarter.

Operator: Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program. You may now disconnect. Everyone have a great day.