11-Feb-2015

# NetApp, Inc. (NTAP)

Q3 2015 Earnings Call

# CORPORATE PARTICIPANTS

Kris Newton
*Senior Director, Investor Relations*

Thomas Georgens
*Chairman & Chief Executive Officer*

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

# OTHER PARTICIPANTS

Sherri A. Scribner
*Deutsche Bank Securities, Inc.*

Maynard J. Um
*Wells Fargo Securities LLC*

Keith F. Bachman
*BMO Capital Markets (United States)*

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

Rod B. Hall
*JPMorgan Securities LLC*

Steven M. Milunovich
*UBS Securities LLC*

Kathryn Lynn Huberty
*Morgan Stanley & Co. LLC*

James M. Kisner
*Jefferies LLC*

Amit Daryanani
*RBC Capital Markets LLC*

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

Srini S. Nandury
*Summit Research*

Joe H. Wittine
*Longbow Research LLC*

Nehal Chokshi
*Maxim Group LLC*

Ben A. Reitzes
*Barclays Capital, Inc.*

Mark D. Kelleher
*D.A. Davidson & Co.*

# MANAGEMENT DISCUSSION SECTION

## Kris Newton
*Senior Director, Investor Relations*

### FINANCIAL MEASURES

- During the call, we will discuss non-GAAP financial measures
- 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

## Thomas Georgens
*Chairman & Chief Executive Officer*

### Q3 BUSINESS RESULTS

Earnings Summary

- We are clearly disappointed with our top line performance in Q3, and are committed to taking the steps necessary to get back on track
- Despite the soft revenue, we delivered another quarter of solid operational performance with improved gross margins from Q3 a year ago
  - And non-GAAP operating margin at the high end of our prior guidance
- We further reduced diluted share count and delivered EPS within our previous guidance range
- We remain confident in the fundamentals of our business and continue to make progress against our hybrid cloud strategy

FX Impact

- Top line revenue finished below the low end of our guidance, impacted by greater than anticipated FX movement in the quarter, which Nick will quantify shortly, as well as our own sales execution issues
- EMEA and APAC were impacted by FX

U.S. Public Sector Performance

- U.S. public sector, driven by strong performance in federal, had the highest growth but Americas commercial fell short of expectations
- The America's team, bullied by the increase in enterprise large deal activity in H1 the FY, was optimistic about their forecast
  - Deals over $1mm increased yet again in Q3, while we also saw a significant number of large deals slip out of the quarter
- We have new leadership in global and America sales and I'm confident in the team and fully expect execution to improve
- Looking ahead, we see FX headwinds impacting growth for not only NetApp but our customers as well

### Deferral of IT Projects

- As companies lower their revenue expectations for the coming CY, there is an increased deferral of IT projects
- We clearly saw that in January
- Anticipated budget was no longer available as companies delivered updated spending targets for the new CY and deals that were pushed out may not return in the near-term
- We are seeing large tech refresh opportunities being replaced with one-year support renewals, an indication that customers remain committed to NetApp but do not have budget to upgrade at this time

### Deal Growth

- Despite the revenue shortfall, we continue to make progress in key areas
- As I mentioned earlier, Q3 marked our third consecutive quarter of growth in large deals, a point of validation of our enterprise strategy
- In November, we further delivered against our data fabric vision with the availability of NetApp private stores for:
  - IBM SoftLayer
  - The SteelStore appliance
  - And Cloud ONTAP for Amazon Web Services

### Introduction of Data ONTAP

- We also introduced the newest version of Data ONTAP, the industry's number one storage operating system, Data ONTAP 8.3
- To date, ONTAP 8.3 has had the fastest ramp of any of our clustered ONTAP software release introductions
- Shipments of clustered nodes grew 160% from Q3 a year ago
- The attach rate of clustered ONTAP continues to increase and now stands at roughly 40% of FAS controller shipped in the quarter

### Total System Units Shipments

- Total system units shipped increased 9% from Q3 last year
- We saw notable strength in E-Series branded and configurations of all-flash FAS
- The entirety of our portfolio has been refreshed over the past year with the recent launch of the E560 and the EF560
- We continue to see sustained momentum with our broad flash portfolio as flash capacity shipped grew 69% y-over-y
- With flash rate innovation injected into all-flash FAS and the new EF560, we anticipate that our all flash array systems will soon hold two of the top spots in the industry performance benchmark

### OnCommand Insight

- OnCommand Insight also continues to perform well with the number of deals increasing from Q3 a year ago
- Overall, we are confident with our portfolio and pleased with the growth of our emerging products
- As we have discussed in the past, both the market and enterprise IT are undergoing a major transition

  - Likewise, NetApp has been undergoing a transition to position ourselves for the future as we talked about at our Analyst Day last June
- The NetApp Data Fabric vision, our seamless hybrid cloud strategy, is up leveling the nature of the conversations we are having with customers
- We have delivered an unprecedented portfolio expansion, including new offerings in flash, object and cloud integration
- We further augmented our cloud integration with the SteelStore product line acquisition

### Margin Drivers

- We have also highlighted the internal productivity, efficiency and supply line initiatives that have resulted in gross margin and operating margin improvements despite a very challenging growth environment
- We have increased emphasis on our enterprise and cloud service provider customers while maintaining the momentum we have in mid-size business

### Go-To-Market Business Transformation

- We are seeing progress with our go-to-market transformation but it's still a work in process, and in need of ongoing improvement and investment
  - The increase and breadth of the portfolio, and our compelling Data Fabric vision are yielding positive results, but it's clear that to fully realize the value of these new capabilities, we must expand our go-to-market capacity with greater account coverage, product specialists and partner enablement
- Clustered Data ONTAP currently meets the technical requirements of our largest and most demanding customers
- We believe NetApp's engagement in helping them execute the transition to clustered ONTAP over the next year with will unlock deferred tech refreshes
- In prior years, go-to-market capacity expansion in times of high competence in the portfolio proved to be a growth driver even in difficult environments
- We believe we are in a similar situation today

### Shareholder Value Creation

- We also understand the imperative to deliver shareholder value in a low growth environment and the resulting pressure on operating expenses
- We will continue to employ the discipline of shifting resources away from lower yield activities as well as driving productivity and efficiency through the organization to offset as much as possible the impact of high priority investments to expand capacity
- Overall, the growth of the emerging products, the uptake of clustered ONTAP, and the resonance of our vision with customers
  - As well as our operational focus, have been on a positive trajectory
- All of this only compounds our disappointment with our performance last quarter
- External factors such as FX were clear headwinds but our focus is on our own issues and what it takes to get back on track
- We do not see any change to our strategic priorities, and we'll aggressively seek to maximum the return on our product portfolio within the confines of our business model

## Nicholas R. Noviello

*Chief Financial Officer & Executive VP-Operations*

## Q3 FINANCIAL RESULTS

### Margins and EPS

- NetApp delivered strong non-GAAP gross margin and operating margin in fiscal Q3, underscoring the resiliency of our business model
- We delivered non-GAAP EPS within our previous guidance range
    - However, as Tom indicated, the impact of unfavorable foreign exchange, combined with our own sales execution challenges, presented headwinds in Q3 and resulted in revenue below our expectations

### Net Revenues

- Net revenues of $1.55B were up about 1% sequentially but down 4% y-over-y
- FX headwinds reduced the y-over-y revenue comparison by about 1.5 points, only 1 point of which we had anticipated when we gave revenue guidance for Q3, 90 days ago
- Product revenue of $930mm was down 8% y-over-y
    - The combination of software entitlement and maintenance and service revenues totaling $622mm was up 5% y-over-y
- Branded revenue was 92% of net revenues for Q3 and at $1.43B was flat sequentially but down 2% y-over-y due to a combination of unfavorable foreign exchange and execution challenges in our Americas commercial sales geography
    - Adjusted for FX, branded revenue would have been about flat y-over-y
- OEM revenue, which is transacted in U.S. dollars, was $124mm in Q3, up 4% sequentially, but down 21% on a y-over-y basis as expected
- Indirect revenue through the channels and OEM's accounted for 81% of Q3 net revenues
- Arrow and Avnet contributed 22% and 16% of net revenues respectively

### Gross Margin

- Non-GAAP gross margin of 64.6% was up just over 1 point from Q3 last year and just above our prior guidance range, despite FX headwinds
- Non-GAAP product gross margin of 57% was relatively flat y-over-y, driven by unfavorable mix and FX
    - Partially offset by continued supply chain execution
- Sequentially, non-GAAP product gross margin was down just over 1 point due to mix
- Service gross margin of 64.5% was 3.7 points above Q3 of last year and 1.8 points above Q2 due to higher services revenues and lower spending

### Operating Margin and Expenses

- Non-GAAP operating margin for Q3 was 18.5%, at the high end of our previous guidance range
- Non-GAAP operating expenses were 46% of revenue

Tax Rate Share Count and Earnings

- Consistent with our expectations, our non-GAAP effective tax rate for Q3 was 16.5%
- Q3 weighted average diluted share count of 317mm shares was below our prior guidance, down 6mm shares sequentially and down 29mm shares or 8% from Q3 last year due to continued stock repurchase activity
- Non-GAAP EPS of $0.75 was in line with our prior guidance range and reflects the net impact of y-over-y FX headwinds of $0.02

Balance Sheet and Cash Flow

- Our balance sheet remains healthy
- We ended the quarter with approximately $5.3B in cash and investments, 13% of which is onshore
    - The sequential decrease in onshore cash was predominantly due to shares repurchased and dividends paid in the quarter
- Inventory turns were at 19 and DSO were 39
- Deferred revenue was $3.1B, up 2% sequentially and up 5% y-over-y
- Q3 cash from operations was $275mm and FCF was 16% of revenue, impacted by an increase in DSO due to unfavorable linearity

Dividends and Share Repurchases

- In Q3, we returned $251mm to shareholders, which included $200mm in share repurchases and $51mm in cash dividends
- Consistent with the guidance we provided last May, we remain on track to complete the remaining $206mm of our current share repurchase program by the end of May 2015, a year ahead of our original schedule
- Over the last few years, we have evolved our capital structure and delivered on our commitment to return capital to shareholders while continuing to invest in the business
- Through dividends and share repurchases, we have returned a total of $3.2B to shareholders since May 2013
- We are well-positioned to move ahead with the next phase of our capital allocation strategy
- I am pleased to announce that we have increased the size of our share repurchase authorization by $2.5B
    - We intend to complete this additional $2.5B share repurchase program by the end of May, 2018, with the first $1B of repurchases expected to be completed by the end of May 2016
- Today we also announced our next cash dividend of $0.165 per share of the company's stock to be paid on April 23, 2015
- We remain committed to increasing our dividend over time

Summary

- Enhancements to our capital allocation strategy reflect our confidence in the long-term strength of NetApp's business, as well as our ongoing commitment to increasing shareholder value
- We have structured the capital allocation plan to ensure flexibility to support innovation and growth initiatives
- The timing and amount of repurchased transactions under the program, as well as future dividends and dividend increases, will depend on market conditions, business and financial considerations and regulatory requirements

## GUIDANCE

### Q4

- Now to guidance
- We remain confident in our strategy and competitive position
- However, based on our own sales execution issues and the continued challenging IT spending environment, we are building a degree of caution into our top line expectations
- We also expect FX headwinds to continue and impact y-over-y comparisons
  - As a result, our target revenue range for Q4 is $1.55B to $1.65B which, at the midpoint, implies 3% sequential growth but a 3% decline in revenue vs. Q4 last year
- Based on current rates, we have embedded an FX headwind of $50mm into our Q4 revenue guidance
- We expect our strong value proposition to continue to resonate with customers and we will have an ongoing focus on supply chain efficiencies

#### MARGINS

- With that said, we expect non-GAAP gross margins of approximately 63% to 63.5% in Q4, including about a point of FX headwinds
- We expect non-GAAP operating margins of approximately 17% to 17.5%, reflecting about 1 point of FX headwinds as well as investments in our go-to-market capacity

#### SHARE COUNT AND EPS

- Based on our repurchases in Q3, we expect Q4 diluted share counts of approximately 319mm shares, down 5% vs. last year
- We expect non-GAAP EPS for Q4 to range from approximately $0.70 to $0.75 per share, which reflects about $0.05 of dilution from unfavorable foreign exchange vs. last year

### FY2015

- Our full year FY 2015 revenue will be lower than anticipated due to currency headwinds, an incremental caution entering Q4 which I referenced earlier
- EPS is expected to be flat from FY 2014 due to FX headwinds, revenue softness and investments in the business, offset by gross margin improvement and share repurchases

## SUMMARY COMMENTS

- In closing, our product portfolio is as strong as it's ever been, and our discussions with customers continue to evolve to more strategic levels
- Our capital allocation strategy continues to reflect confidence in our ability to generate significant FCF which will enable us to invest both organically and inorganically in the business as well as return significant capital to our shareholders through share repurchases and dividend
- The investments we're making today position us to fully take advantage of the opportunity ahead and we expect to emerge from this transition with greater levels of growth and profitability
  - Through this evolution, we remain committed to our business model and to delivering shareholder value

## Thomas Georgens
*Chairman & Chief Executive Officer*

### BUSINESS OUTLOOK

#### New Technologies and Delivery Options

- We remain confident in our business by continuing to operate in a challenging environment
- We face ongoing macroeconomic uncertainties and FX headwinds
- Our industry is in transition as enterprises manage their existing infrastructure to meet the current and growing demands of the business while adopting new technologies and delivery options
- Our solutions and technology vision are well suited to help customers meet both of these requirements
  - Cloud will play a key role in creating value for enterprise customers and we want to accelerate their ability to realize that value
  - Enterprise will deploy a hybrid model with both cloud-based and on-premise resources in their IT environments

#### NetApp Data Fabric Vision

- Our NetApp Data Fabric vision provides customers with the only consistent way to manage, secure and protect their data regardless of where they choose to store it
- The NetApp Data Fabric we used to get the disparate data elements of the hybrid cloud into a single integrated architecture, giving customers control and choice with the flexibility, elasticity and ubiquity of cloud resources
- Data ONTAP is the foundation of the NetApp Data Fabric

#### Clustered Data ONTAP

- Clustered Data ONTAP delivers true software defined functionality with a set of enterprise-wide data management capabilities independent of the underlying hardware
  - Clustered ONTAP enables customers to grow incrementally and non-disruptively with the flexibility of a wide range of deployment options from converged and integrated systems to third party arrays as well as software-only and cloud options
- We are confident in our ability to help customers take advantage of the evolving IT landscape

#### Business Transition

- Our Data Fabric vision and portfolio of data management solutions offer a differentiated approach that improves the economics and flexibility of customers' existing infrastructure while giving them a path to a hybrid cloud future
- Our best of breed solutions are compelling for existing requirements and are integrated into a broader vision for the hybrid cloud that only NetApp can deliver
- The investments we are making in our go-to-market capacity and in accelerating to migration of clustered ONTAP demonstrate the strength of our conviction in our technology and our strategy
  - During this transition, we remain committed to our business model and delivering shareholder value
- Our expanded repurchase authorization exemplifies this commitment

- We expect to come through the transition in a stronger position with a higher level of growth and profitability

Recognition

- Before moving to Q&A, I would like to thank the entire NetApp team for their continued commitment
- Despite the challenging environment, we are making the right choices and remain focused on innovation and execution which enable us to deliver value to our customers and yield solid operational returns

# QUESTION AND ANSWER SECTION

**Sherri A. Scribner**
*Deutsche Bank Securities, Inc.*

Q

Nick, I was trying to get a sense of how the FX split out between your different segments. Thank you for the detail on the impact this quarter, but was a lot of that in product or was it also in the software and services segment? It seemed like the product revenue was down a lot y-over-y. Thanks.

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

A

Yeah, Sherri, in terms of Q3, in terms of product revenue for Q3, it was all there, so it's about 2 points on product revenue from the FX side of the fence. You have to remember that the SEM line and the services line are substantially coming in off the balance sheet, so the FX is really pointed at the product side of the fence.

**Maynard J. Um**
*Wells Fargo Securities LLC*

Q

A little bit about the execution issues. I guess to start, what gives you confidence that it is execution issues rather than competitive or secular, and I guess what – can you go into the issues a little bit more in particular and how you do intend to fix that going forward? Thanks.

**Thomas Georgens**
*Chairman & Chief Executive Officer*

A

Well, I think from the question about whether it will be secular or competitive. And effectively what we're talking about here, what we saw pushed out, were actually deals in the committed pipeline. So, whether the question that we didn't have pipeline and we didn't have deals that we're pursuing, these are deals that the sales force had committed that reflected in our forecast, reflected in our guidance and reflected in our planning as the quarter proceeded. And so not surprisingly, Monday the quarter ended, I was with our head of America sales and went through what happened to these deals. And went through a relatively long list of deals. Two pages worth of deals that were committed that we expected to count that didn't come in. And, all of them have a story of which competitive and loss deals was a trivially small amount of that.

So from a competitive perspective, I'd say first and foremost, competitive wasn't the key component. Some of it clearly was closeable deals that we didn't get done, and that's entirely on us, some of it was changes in customer behavior with the change of the CY and companies looking at their own financial forecast and their own FX impact. We certainly sow a deferral of deals that we thought were there.

The other thing is, in order for deals to be in the committed pipeline, there are deals for which substantially we have won the tactical recommendation. So the competitive phase of a lot of these transactions is effectively over. So it was really about either customer's changing budgets, requiring more scrutiny in their approval process or fundamentally thinking about their new budgets in light of the new CY.

I think going forward clearly we need to watch this a lot more closely. We certainly saw elongated sales cycles earlier in the quarter, but the forecast has remained unchanged and the team was still relatively bullish about pulling it out.

So I think that we need to look at some of the data points along the way. Certainly we need to inspect a lot closer. And you can argue that the other side of this, and the message to the team is, if there's uncertainty about closing deals, you need more deals. So what are we going to do to enhance the pipeline? So clearly we're going to be watching this closely.

As we look at our productivity, whether it be pipeline generation per rep and even despite the quarter, in terms of actually bookings per rep, the numbers are actually quite high, relatively high in our history, so sales force productivity is actually still pretty high, yet we didn't get these deals closed, but the feeling is it isn't like the sales force can't sell and productivity is down, that would be more of an indicator of a product problem or there's no opportunity out there.

So our feeling is as long as productivity is high that people are generating pipeline at peak levels historically, that if we could put more feet on the street and get more people out there selling the products, we could drive some more business.

So that of course has the lead time associate with it in terms of hiring and bringing up to speed. But at the end of the day, we didn't have these deals in a committed pipeline. We wouldn't have the pipeline productivity we had, unless we felt strongly about the portfolio and the portfolio was resonating. So I think where we are now, I don't think product is our issue. I think capacity is our issue and that's the bet we're making, and that's what you're going to see from us going forward.

---

**Keith F. Bachman**
*BMO Capital Markets (United States)*

Q

Hi, Tom. I wanted to follow on Maynard's question. Clearly every enterprise company is suffering from FX and so let's remove that from the conversation, but we haven't heard many or very, very few companies talk about elongated sales cycles in the current macro with the recent string of companies that have reported, including Cisco tonight. And so I just wanted to try to understand, what's your thoughts on why NetApp in particular seems to be seeing some issues on deferrals or pipeline not coming through? Is it something related to the storage side in particular? But just wanted to get some more thoughts about why you think NetApp in particular is seeing some of those elongated sales cycles.

---

**Thomas Georgens**
*Chairman & Chief Executive Officer*

A

Well, I think a few things. I think some of those, I'll say, I don't think we quite know. I think we need more data. All we really understand is our own point of view here. So certainly we see the FX. That's purely a mathematical exercise. We get that.

---

**Keith F. Bachman**
*BMO Capital Markets (United States)*

Q

Yep.

Thomas Georgens
*Chairman & Chief Executive Officer*

A

Likewise, we see FX not only in our industry but we also see FX impact on our customers and that's got bleed-through into the decisions that they make. So, I don't really know the answer to your question until we see actually more companies that are reporting January quarters. So our assumption is FX is purely mathematical and everything else is our responsibility to get on to and fix. And like I said, if we look at these individual accounts, there's no doubt that we had closeable deals that we didn't get done in time and that's just pure execution and those will fall into Q4, but we've also seen elongated approval cycles and we've also seen people reevaluating what their plans are for the year.

Now that the CY has changed, people thought they had budget when we put this in the pipeline that don't now, and I think the return of those transactions is as yet unknown. So I think from our perspective, we just clearly need to do better on that. I'm certainly not ready to say that there's a broader trend until I see some more data points. But for our point of view is that, we're going to focus on our deals and our pipeline and we're going to do a better job executing this quarter.

Keith F. Bachman
*BMO Capital Markets (United States)*

Q

Tom, was everything on track the first two months and the wheels kind of came off the last month of the quarter?

Thomas Georgens
*Chairman & Chief Executive Officer*

A

Well, certainly the forecast hadn't deteriorated materially over the quarter – from at the beginning so we were obviously this is a quarter where you've got kind of the end of the quarter push and you've got the end of the CY push which is a little bit different than other quarters, but from our point of view is certainly we saw bullishness going into the end of the year and then still we had expectation of a relatively strong normal quarter end in January and a fair amount of that business didn't come through the way we would have thought. So I think we did see the budget flush. Maybe we can debate whether it is as robust as we thought, but certainly close enough.

But we certainly had a lot of January business that was the normal part of our final month of a quarter that we'd see being back-end loaded, that didn't come in. And like I said, every deal has a story but when you go through 40 deals and only one or two are competitive and the rest of them are deal specific, I don't think the competition is really the issue. And on top of that, the feedback from the field was optimistic all quarter. Yeah, we still did a record number of millions or increased number of million dollar deals. So it wasn't like they were searching for business. They had business that they had that was lined up and they thought they were going to close and they didn't.

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

Q

Thank you for the question. For, Tom, with respect to the deferral of spending you're talking about, I guess this comes after a period of time when there's already been a prolonged period of deferrals. So, I guess at some point your customers in your installed base just need to spend too much [indiscernible] (29:56). And despite all the efficiencies out there, why isn't that helping your visibility at some point? I'm just kind of curious, we've had a period of sluggish drop in storage in the industry, frankly, not just with your numbers. And so I'm curious as to how you would think about that dynamic going through last year and then now having this added issue?

And then the other clarification is despite this deferral of spending that you talk about, you're not really assuming any of that comes back in the near term, just to be clear, just to be conservative. Is that correct?

**Thomas Georgens**
*Chairman & Chief Executive Officer*

A

Yeah, I think certainly you don't end with the surprise that we had where committed deals didn't close and they had assumed they're all just going to come back that simply. I think clearly we need to derate some of the feedback that we get and I think we need to embed some caution into this. And likewise, frankly, I think we need to see what other companies are reporting that have January close and see if this is common or not. So I think that there's just a natural sense of conservativism both in terms of the forecasts we receive and likewise our own judging of those forecasts as a result of this.

I mean, simply put, we came out of last quarter relatively bullish. I mean, when I lay out the lay of the land, we were pushing the cloud story, it came out of insight with a lot of momentum, the feedback on the cloud and the hybrid cloud from customers and partners has been tremendous. We did a dramatic expansion of the portfolio with refreshes of E-Series, introduction of the StorageGRID Webscale. We acquired the SteelStore product, the release of 8.3. So felt very strong about the portfolio, felt very strong about the forecast, and I think we came out of this last call, actually, relatively excited about where we were heading. So that's why we're really doubly disappointed about all of this.

I don't – in the end, if suddenly there was a competitive disjoint or some type of quality issue or some type of product issue, but there's really none of that. So things were pretty much normal as far as we looked at the quarter as it played out until we got to the end.

**Operator**: Thank you. Our next question comes from the line of Rod Hall with JPMorgan. Your line is now open. Please proceed with your question.

**Rod B. Hall**
*JPMorgan Securities LLC*

Q

Yeah, hi, guys. Thanks for taking my question. I guess I want to circle back around in this January commentary and see if you guys could – the 40 deals, I guess, Tom, that you're talking about, is there any regional pattern that you spotted? I mean, did you see particular regions worsening in January and others not? Did you see just sort of across the board in January, things not coming through as you had expected?

And then, I also, just as a follow up to that, wanted to see if you could comment. Do you think that – have you had any direct feedback from people suggesting that maybe budgets got reset and they come back to the table in January and they can't do the deal because there's some sort of a trend in terms of enterprise budgets? Thanks.

**Thomas Georgens**
*Chairman & Chief Executive Officer*

A

Yeah, I mean, the budget reset is exactly what I'm saying so I think that that's clearly the case.

I think in terms of markets in general, certainly energy was one that kind of jumped out. People being very, very cautious, obviously, with the movement of the price of oil and I think certainly on the oil and gas, it has a negative impact. Presumably it will help the rest of the industry, but I think that's a lot more diffuse and that'll take more time to flow through. So I think probably the only segment that I'd say that we can clearly identify with relatively urgent caution would be oil and gas. But I'd say most of the rest of the business is spread around.

I mean, other sectors were very robust. I mean, one of the things that we talked about in prior calls is our belief that we're going to see solid growth on the federal side H2 the year over easier compares last year. That entirely came through. So if I think about the road map as we went into this year as, we communicated at analyst day, we talked about a rebound in federal in terms of growth rate in H2. We certainly saw that. We focused on the enterprise and we certainly saw record million dollar deals, we certainly saw that. We saw growth in million dollar deals, and I think overall it seemed like a number of those things were on track and that's what we kind of left last quarter with in terms of how we felt about H2.

So I think some of the things came together, but other ones didn't. I think we sensed that FX was clearly an issue. That was certainly a comment that we had last quarter. And I think that's proven to be a bigger issue than we originally thought, and Nick quantified that. And likewise, it's not just an issue for us or our competitors, it's also an issue for our customers which has an impact on their buying.

**Steven M. Milunovich**
*UBS Securities LLC*

Q

Tom, did you say that there was a change in sales management? Could you talk a bit more about, if that's true, who is in place now? And you also talked about investments in go-to-market. Could you talk a bit about what those investments are and, Nick, are we going to see kind of a pickup in the SG&A to revenue ratio in Q4?

**Thomas Georgens**
*Chairman & Chief Executive Officer*

A

Yeah, I don't think it's any secret that I'm – certainly we hired a new Head of Global Sales, and we also have new leadership in the Americas Commercial business. I should point out that the leader of that business is the person who led our federal business to number one market share in the federal space. So it's a person that has a very strong track record and somebody we have a lot of confidence in.

So could it be some measure of them not being familiar with their guys and judging the forecast? I think certainly that's a factor. But I think in general, these are people that were pleased with the work that Randy is doing, certainly Mark has had a great history, and so we're still confident in the team. So, I wouldn't want to signal any of this message that there's a change in the team.

Perhaps there's some change in process, perhaps that impacted the forecasting. I'm guessing that that's a factor, but we're talking about two people who practice really deep inspection, and like I said, on the Monday the quarter was over, I had a very, very detailed report on what happened the quarter before in terms of deals that happened, deals that didn't happen, why didn't they happen and what we should expect going forward.

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

A

Steve, it's Nick. Let me just add to that comment and answer your question on SG&A revenue. When we look at operating expenses, what Tom mentioned in his comments, this is also going to be an environment where we're going to position our investments for highest return activities. So to the degree we're investing in certain areas and pushing investments in some, we're going to be holding investment in others, and I think that's really important from the perspective of the business model and running the business go forward, so I don't see a material change in Q4 as an example of SG&A to revenue.

Certainly, and we'll give guidance in May for next year, and we'll talk about Q1, we'll go a quarter at a time and give you a perspective a quarter at a time. You know, you always – a lot of times Q1 looks a little disjointed. Why? Because top line – there's a substantial sequential decline in top line from Q4 to Q1 so we'll go through all of that math. But to your specific question of Q4, I don't see a substantial or a material change in the SG&A or the operation expense to revenue ratios here.

Kathryn Lynn Huberty
*Morgan Stanley & Co. LLC*

Q

How do we reconcile the comments on the weak January and delayed deals with DSOs that were up six days at the end of the quarter. And then also, does the limited recovery in branded growth after refreshing the product portfolio change your thinking on acquisitions as it relates to just broadening out the product portfolio? Thanks.

Thomas Georgens
*Chairman & Chief Executive Officer*

A

I think the DSO is a function of the timing of shipments and invoicing more than anything else. So while there were elongated sales cycles, we still were back-end loaded even though we didn't take all this business at the end. But that said, I don't think there's really anything more to the DSO story. The other question about acquisiti ons, I think acquisitions – I don't think this changes our opinion on acquisitions. I think we will continue to move ahead with tuck-in acquisitions that expand our portfolio. We did two this past quarter. The SteelStore one is the one that got more headlines. And I think we will continue to do that, and that should be a normal course of business. I wouldn't expect that to neither accelerate nor decline.

I think on the question of larger deals, those tend to be very, very asynchronous and hard to predict. So I think from our point of view, if I look at transactions that we've done, E-Series branded had a very, very strong quarter, up 100% again. I look at OnCommand Insight, which is also an acquired technology, that was also – had a very, very good quarter. So I think the success of our acquired businesses has been very good. So from my point of view, I think we'll continue to do tuck-in acquisitions. In terms of larger deals, we don't get to predict when they're going to be available or when they're going to come about. But certainly our recent track record's been pretty good and for the right transaction at the right price, when that's executable, we'll certainly move ahead with that. But I wouldn't want to predict any rate or any either increased desire or a decreased desire to pursue those.

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

A

And maybe just a comment to really take that DSO comment, Katy, and take it up one level to overall cash. I think that cash and cash conversion as a percentage of revenue in Q3 was perhaps a little bit lighter than we typically do. However, we will have a strong quarter in front of us here as well, so when I look at the overall statistics and the overall expectations in terms of cash generation this year, I don't see any change there at all, and I see us landing right inside the types of metrics we've talked about and modeled for the three-year period of time, certainly, that we talked about at our last financial analyst day.

James M. Kisner
*Jefferies LLC*

Q

Okay. Just wanted to verify something. Was there any particular product lines at all that sort of saw more deal slip-outs? And I guess just regionally, I'm looking at the y-over-y rates in both Europe and Asia, they're both down a lot sequentially here on a y-over-y basis, but Asia had a tough compare. Was there any kind of regional differences in terms of the activity you're seeing?

Thomas Georgens
*Chairman & Chief Executive Officer*
A

I would say one thing to bear in mind with the y-over-y compares of Asia and especially EMEA is clearly you've got the currency component of that. There is some currency component because of Canada and South America in the U.S. number as well, or the Americas number, but not that big. So I'd say certainly the FX one, there's really two questions, I think, in play. One of them is the relative performance and the other one is deals that we actually had the in the pipeline that we're expecting to close. So, I think we're looking at both of those differently. Overall, in terms of our International business, the EMEA team dealing with FX, obviously the Russia situation, even the French situation late in the quarter, were all factors, and I think overall from a booking perspective they did quite well.

So I'm actually – while the numbers don't show it, I'm actually quite pleased with the EMEA team. Asia Pac is not a unified region. All the different geographies perform differently. But I think overall they did pretty well. We saw growth in China again, certainly the China headlines haven't been great, but I think the team there continues to make progress. And so I think that the biggest surprise relative to where we thought we're going to be is in the Americas, and particularly the Americas nonfederal.

James M. Kisner
*Jefferies LLC*
Q

Any particular product lines to follow up that under-performed or had more slip-outs, I should say?

Thomas Georgens
*Chairman & Chief Executive Officer*
A

Not in terms of slip deals. I think that the category on slip deals is really a function of size rather than product.

Amit Daryanani
*RBC Capital Markets LLC*
Q

Tom, I guess a question for you. You talked a fair bit about I think adding more boots to the ground, adding more product specialists. Just trying to get a sense, I mean, how much headcount increase do you anticipate doing and what's the timeline to doing that? Is it one quarter or two or three quarters? And what sort of payback do you expect in terms of, in my head I guess, branded growth accelerating? Maybe just walk through what kind of headcount additions you want to do and how do you think that pans out on the other side in terms of branded growth?

Thomas Georgens
*Chairman & Chief Executive Officer*
A

So I think at this point we're not ready to quantify that. I think that's a model that we're working through on our own. But obviously it will be something that we think is going to move the needle and something that we want to move the needle this coming FY. So it's not something that's going to move the needle in the immediate term. I don't think that we're going to hire people and they're going to be on full quarter in a very, very short period of time. There will be a sliding scale in terms of how they ultimately ramp up. So the real impact of that are probably towards the middle or the end of next year. But the investment will be front ended.

And as Nick indicated, in terms of, as we think about our full year business model, it's our full intention to operate within the bounds of the business model that we have previously communicated. But if I look at it, it's independent of the individual issues at the end of last quarter. If I look at our ratios and I look at our investments, we've got a substantial expansion of the portfolio. Within that portfolio has been carve outs for specialist to drive things like E-Series and OnCommand, and I think that's paid off quite nicely for us. As we think about adding new products to the portfolio, whether it be StorageGRID or SteelStore, we're going to have to do some of that. So I expect all of those investments to come in, while in the meantime we still need to be cultivating new accounts and new opportunities for clustered ONTAP.

And the other one is I think that our partners are a key part of this. I think investing in the partners as they come up to speed on the new products, so they are pitching and successfully be self-sufficient and pursuing these opportunities. And likewise helping our customers with the migration to clustered ONTAP as they're all go-to-market activities that I think have immediate impact or relatively near-term impact on the business.

But the simple fact of the matter is, if sales force productivity was the issue and they were not anywhere near quota and they were sub optimal because we didn't have competitive products and we didn't have competitive technology, then I think we'd be making an entirely different investment choice.

But the feeling is that the portfolio are strong and we just don't have enough people out there promoting it, selling it, serving customers, and that's the investment that we want to make, within the confines of the business model that we talked about.

---

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

Q

Great. Thanks very much. It's Jim Suva here from Citi. NetApp has been going through a little bit of shifting with its sales people over the past 12 months to 24 months out of certain areas into focus of other areas. And then today on the conference call you mentioned a need to really get kind of feet going, and the right people at the right place. But yet the expense area to be within a relatively normal of what you expect. So can you help me explain what's different? Meaning you have kind of been shifting around a little bit in the past months 12 to 24 months, and you're saying it's still within the realm. So what's different or how should we think about what you're truly doing different to address these needs, especially if the expenses are not going higher?

---

Thomas Georgens
*Chairman & Chief Executive Officer*

A

Well, I think that there is really two questions here. One of them is the shifting of the resources within an envelope, and the other one is the total envelope. So I think clearly we've been doing shifting of resources within the envelope. I think across the entire company we've worked very hard at that. And I think that manifests itself in terms of the engineering choice that we made and the price that we're bringing to market. And we were able to do that by de-emphasizing other products and perhaps moving out of certain spaces. We have certainly seen it in terms of carving out part of the sales resource to focus on some of these newer products, as I talked about E-Series and OnCommand and that has worked out well for us.

And I also talked – in fact, we spoke at the analyst day around the enterprise strategy and getting our partners more self-sufficient in the mid-size business, so we can migrate some of our resources against the bigger opportunities in the enterprise. So we've seen that million dollar deals. And so if we look at that data, and that is more specialists around the new product generates sales, if we look at moving more resources towards the enterprise, we generate more million dollar deals, if we can continue to make our partners self-sufficient and continue that, and widen the total umbrella, the total number of people engaged in that, I think, we're hard pressed not to conclude that there's an opportunity for growth in that and that's the knob that we want to turn.

Certainly clustered ONTAP has been a big investment, 8.3 is a culminating release for that. We absolutely needed to get that done, we needed to get customers migrated to it. We certainly had to finish investments that we are making in other key technologies around all flash FAS and flash in general, but I think we're ready to shift that transition towards field-going activities now that the product arsenal is ready.

---

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

And, Jim, I guess I might just add, in the context of an operating expense envelope of just under $3B on an annual basis, we believe we have the opportunity to shift investment for highest-return activities.

---

**Srini S. Nandury**
*Summit Research* **Q**

The question I have is that regarding your FlashRay. I don't know whether you commented on FlashRay during the call. I must have missed my earlier part of the call. The question is that you have a single-controller device and it's limiting your adoption in market. As you look at the FlashRay opportunity out there, what does it take NetApp to become a dominant FlashRay provider, perhaps second in the market, at 22% to 25%?

---

**Thomas Georgens**
*Chairman & Chief Executive Officer* **A**

Well, you're just talking about one product in the portfolio. We actually have the EF product, which is doing quite well. We've got the FlashRay product and we also have the All-Flash FAS. So, and then we've got the hybrid arrays that also have Flash. We certainly talked at Analyst Day, and our view of this is that Flash is a compelling technology. It's got a compelling set of deployments and they're all different form factors. There's flash in the host, there's all flash arrays, there are hybrid arrays, and all of those are going to be important. The key component for us ultimately is not any of the individual products or any of the individual categories, it's about total flash under management which was up huge y-over-y.

So from our perspective I think we're absolutely in the Flash game. I think FlashRay has been a key driver of innovation for us. We've seen not only FlashRay in its own incarnation but FlashRay technology integrated and introduced in the form of all flash FAS and EF as well. But all flash FAS clearly is a product that the team is familiar with. Actually had a very, very big growth quarter, and overall I think that the idea of an all flash FAS instead of a standalone point product to actually be a node of a cluster that's compatible with all of our other data movers and all of our storage efficiency and all of our scale-out capability is a compelling value proposition.

So I think FlashRay is going to serve a segment of the market. We continue to invest in it. It's in customer's hands and we're getting feedback around the key efficiency and performance and ease of use components, but that's not the totality of the Flash portfolio. In fact, the overall majority of our Flash is in the other products. And in fact, the all flash FAS, which was only introduced about a quarter-and-a-half ago, is actually the one that's actually ramping the hardest of all of those, and we're actually pretty pleased with the use cases.

And what you'll see from that is – in fact, from a number of our products – are compelling performance benchmarks that we're going to publish in the very, very near future. So I think from a performance perspective, certainly all flash FAS has a feature set far beyond any other flash array and compelling performance and compelling efficiency. I think you'll see a lot more of that product in the near future as well while we continue to evolve and develop FlashRay to serve the segments that it's targeted at.

---

**Joe H. Wittine**
*Longbow Research LLC* **Q**

On the headcount you're adding, I think you're saying you need more product specialists. So what exactly are you referring to? Is it more resources for the ramping flash business or maybe the service provider business or certain market verticals? I think just a little bit more clarity would be helpful. Thanks.

---

Thomas Georgens
*Chairman & Chief Executive Officer*

A

Yeah, I don't want to leave a misperception there. I think first and foremost, we're adding people that are carrying numbers, whose job it is to close business and bring business in. So product specialists, I talked about them in the category of, the price specialists have been successful, but within the fixed-size envelope they've come at the expense of generalists that are selling the standard product and pursuing new accounts and those types of things. I think we want to be able to do both of these at the same time. So I think we have invested in an overlay. I'd say the increment from here will not be nearly as significant percentage-wise. What we're really looking to do is getting more people out there, getting in front of new customers, new customer acquisitions, and deeper into our largest, biggest customers.

So, I'd say that the reason why I brought up the product specialists is, within a fixed envelope, the more product specialists you have the less generalists you have. And our view is that we need more generalists out there pushing the ONTAP-based products. Pursuant to our enterprise strategy, we've proven that we can get big deals if we move in that direction, and now we want to get more people out there cultivating new accounts, deeper in existing accounts, and bringing in more big deals.

---

Nehal Chokshi
*Maxim Group LLC*

Q

The large deals that have been pushed out in favor of extending service agreements, is there any correlation to Cloud ONTAP having become generally available? Is this potentially creating any further evaluation? Do you expect this to become a material part of these large deals? And can you give any metrics around Cloud ONTAP at this point in time as well?

---

Thomas Georgens
*Chairman & Chief Executive Officer*

A

I don't think that Cloud ONTAP is changing that. I don't think Cloud ONTAP is a substitute necessarily for the types of systems that we're selling with clustered ONTAP on premise. I think Cloud ONTAP is a completion of a story. It's an option for test and development and backup and flexibility and DR, but I don't think it's changing the dynamic of do I buy an on-premise system or do I buy that.

Now, there's actually been a fair amount of activity around Cloud ONTAP. The number of hours is in the 40,000 range. So those are people kicking the tires, playing with it, some people are actually using it in production. But really what I see Cloud ONTAP, it's a completion of our end-to-end seamless data management story with the cloud. So, I can run in Cloud ONTAP on one extreme, I could run on-premise, NetApp Private Storage, which has actually seeing a lot of acceleration, that's actually one of my favorite use cases. But overall I don't think that that's really disrupting it. I think the Cloud ONTAP is basically, at this point it's symbolic and emblematic of NetApp's end-to-end seamless cloud strategy and proving that it's real. But I don't think its intercepting near-term business. That's actually not a concern of mine.

---

Ben A. Reitzes
*Barclays Capital, Inc.*

Q

My question is around gross margin. What is the implied FX hit sequentially to the gross margin vs. the pricing hit and mix? And to that end, what are your – do you feel you've got to get more price aggressive, is sort of the premise of the question as well, and vs. some of the upstart competition? Thanks.

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

A

Ben, if you're talking about Q4 gross margin guidance, there's about 1 point of FX in there. So, I think you need to consider that. I wouldn't suggest that in there is any additional price aggressiveness. I think that pricing has really been at this rate for some time, right? So there is dynamics in pricing. And from time to time we did deeply discount. There are all of those types of things that we manage as part of managing the business. So there is not an incremental built into our gross margin guidance. We also, inside our structure, inside our COGS structure, drive a set of efficiencies, and frankly over the last several years have been driving an increasing set of efficiencies. So I think all of that levels out in the end and I think the thing to remember is there's a point of FX in that – y-over-y impact of FX in that Q4 guidance.

Ben A. Reitzes
*Barclays Capital, Inc.*

Q

All right. What's the sequential impact of FX?

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

A

Boy, I think – I can't have that off the top of my head here, Ben.

Mark D. Kelleher
*D.A. Davidson & Co.*

Q

All right. Most of my questions have been asked by now, but let me just ask about SteelStore. Where does that fit into your expectations going forward, particularly on the cost side, but also on the top line for the next few quarters?

Thomas Georgens
*Chairman & Chief Executive Officer*

A

Yes, I think what SteelStore effectively is, is a backup appliance that's integrated with the cloud. And clearly from our point of view and those of you who were at Insight and certainly Analyst Day, we talked about the economics of the cloud and cloud being a resting place for very low utilization data like backup and archive.

So a way to seamlessly extend traditional backup all the way to the cloud is something that we felt very, very strongly about as an opportunity, and that was really the motivation for pursuing SteelStore. So I'd say that post transaction, a couple of things came out, one of which was this is a product with a fair amount of visibility within Amazon, and the Amazon relationship is developing quite nicely around Cloud ONTAP, around NetApp Private Storage, and this one has become a third leg of the stool in that relationship. In fact, they've actually referenced – actually gave us some reference accounts to pursue with this.

So I think at this point it's not material to the number that Nick just gave. It will be certainly not zero. In fact, it's already been non-zero. I think it's ahead of our initial forecast, but certainly we're on the very, very front end of that curve. So I think so far so good, no regrets, but I think it's a little bit too early to tell. But the real goal there is ultimately, how do we enable the next generation of backup that successfully integrates the cloud but is compatible with all backup methodologies that people currently deploy on-premise.

## Thomas Georgens

*Chairman & Chief Executive Officer*

### CLOSING REMARKS

- You know, as I think about the quarter that we just completed and I think about where we were last quarter, the evolution of the road map, we introduced more new technology in the last six months, whether it be:
  - Clustered ONTAP 8.3
  - The acquisition of SteelStore
  - StorageGRID
  - OnCommand Insight
  - E-Series
  - FlashRay
  - All-flash FAS
- And the momentum that we saw both in terms of last quarter, the forecast for this quarter, I think we felt very, very good about the business
- So as I talked in the prepared text, clearly disappointed with the set back that we had. Probably a little more than disappointed, probably downright angry because I felt like we were in very, very good shape, and we need to do better than that.
  - So as I think where we go forward, I think we are – my belief and it's in as good a shape as we are with the portfolio is unshaken
- The execution issues we will fix and we're going to make key investments within the bounds of our business model to fully exploit the full potential of this portfolio and drive growth for this company and that's our commitment