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NetApp, Inc. (NTAP)

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, ladies and gentlemen. Welcome to NetApp's Second Quarter and Fiscal Year 2019 Financial Results Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session and instructions will be given at that time.

I will now turn the call over to Kris Newton, Vice President, Corporate Communications and Investor Relations.

Kris Newton

Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

Thank you for joining us on our Q2 fiscal year 2019 earnings call. With me today are our CEO, George Kurian; and CFO, Ron Pasek. This call is being webcast live and will be available for replay on our website at netapp.com.

As a reminder, we adopted the new accounting standard, ASC 606 in Q1. Our historical financial results have been restated to conform to the new revenue recognition rules. Reconciliations of our previously reported GAAP results to the restated ASC 606 GAAP results, as well as our ASC 606 GAAP to non-GAAP results are included in our Q2 earnings release for the applicable period, which is posted on our website, along with our financial tables and guidance, a historical supplemental data table and the non-GAAP to GAAP reconciliation. Unless otherwise noted, we will refer to non-GAAP and ASC 606 numbers.

During today's call, we will make forward-looking statements and projections with respect to our financial outlook and future prospects, such as our guidance for the third quarter and full fiscal year 2019, our expectations regarding future revenue, profitability, cash flow and shareholder returns, and our ability to grow and expand our opportunities, all of which involve risk and uncertainty. 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, including global, political, macroeconomic and market conditions, and our ability to expand our total available market, introduce and deliver new and differentiated products and services without disruption, manage our gross profit margins, capitalize on our market position and cloud strategy, maintain execution and continue our capital allocation strategy.

Please also refer to the documents we file from time to time with the SEC and available on our website, specifically, our most recent Form 10-K for fiscal year 2018 and our current reports on Form 8-K. During the call, all financial measures presented will be non-GAAP, unless otherwise indicated.

I'll now turn the call over to George.

George Kurian

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

Thanks, Kris. Good afternoon, everyone. Thank you for joining us. We delivered another quarter of solid results. Our Q2 revenue was in line with expectations. Gross margin, operating margin and EPS were all above the high end of our guidance range. Our consistent and strong performance reflects the clear differentiation of our technology and the strength of our business model as well as our customers' commitment to NetApp and the significance of our Data Fabric strategy.

In the quarter, we extended our leadership position by introducing new partnerships and substantial innovation across our entire portfolio. Our opportunities framed by the data-driven digital transformation of business and defined by major technology transitions, led by cloud, IoT and artificial intelligence. The adoption of hybrid multicloud environment is changing how modern IT infrastructures are built and consumed and NetApp is at the heart of these transitions.

The NetApp Data Fabric provides unique customer value through an easily implemented catalog of consistent data services, seamlessly connecting on-premises resources to the private and public clouds with unified data services across all environments. This capability enables customers to realize the full potential of their data across edge, core and multiple clouds. Enterprises are responding to our Data Fabric strategy and are signaling their long-term confidence in NetApp by making investments in our software.

As discussed on our Q1 call, we have seen a rising interest in enterprise license agreements or ELAs, a form of broad enterprise agreement. The ELA represents the software-based capacity enablement portion of a multi-year engagement and creates the framework for committed follow-on revenue in the form of systems and support services.

Demand for these agreements is driven by our largest customers and is evidence of our growing importance to their IT strategy. In September, we announced a global strategic partnership with Lenovo, designed to expand our market reach deeper into China as well as to address server-led purchases and SME and commercial segments not traditionally served by NetApp. The partnership also extends the reach of the Data Fabric strategy and capabilities into these new markets.

NetApp is driving the market transition to flash as we help customers modernize, simplify, and consolidate their infrastructure. We are displacing competitors' complex equipment, gaining share in new workload deployments and upgrading our installed base with cloud-connected all-flash solutions.

In Q2, our all-flash array business inclusive of All Flash FAS, EF, and SolidFire products and services grew 29% year-over-year to an annualized net revenue run rate of $2.2 billion. Validating the innovation leadership and momentum of this part of our business, Gartner, for the third year in a row, recognized NetApp as a Leader in its Magic Quadrant for Solid-State Array.

In Q2, we introduced new innovations that further expand our leadership in the all-flash array market. ONTAP 9.5 software delivers leading cloud integration, the highest all-flash performance, and greater efficiency and simplicity. This release furthers our SAN capabilities with improved performance, supported by the industry's first latency guarantee to accelerate critical workloads with industry-leading end-to-end NVMe capability.

At the start of Q2, we announced ONTAP AI in partnership with NVIDIA, which creates a seamless data pipeline across edge, core, and cloud for deep learning deployments. Over the course of the quarter, we extended our participation in the rapidly growing area of AI with the announcement of MAX Data. MAX Data is the industry's first solution to leverage persistent memory in servers to deliver ultra-low latency with flash-like capacity, accelerating the performance of application-level data, and enabling faster processing of data for AI applications, in-memory databases, and real-time data analytics.

In addition to helping customers deliver better business outcomes with AI, we enable them to harness the growing data sources created by the Internet of Things. The latest version of NetApp StorageGRID, flash-accelerated object storage, delivers low latency performance for the billions of small objects generated by IoT devices and cloud connectivity for best-in-class performance and data management capabilities together with object storage economics. Enterprises choose our converged and hyper-converged solutions to accelerate their digital transformation because we help manage applications, infrastructure, and data as one integrated resource across private, public, and hybrid cloud environments.

In Q2, we enhanced the ease of managing FlexPod environment with NetApp Solution Support for FlexPod and Converged Systems Advisor software to reduce time to resolution for service incident. We also enhanced NetApp HCI, our industry-leading hybrid cloud infrastructure. We announced new Element software capabilities for HCI and SolidFire including the ability to replicate from Element to Cloud Volumes ONTAP for disaster recovery, data migration, and remote backup to public cloud as well as to on-premises ONTAP system.

Additionally, we introduced new options in our HCI portfolio, including support for GPU-based compute nodes to accelerate VDI environment and support for Red Hat OpenShift Container Platform. Through tight integration with the Data Fabric, only NetApp can bring the capabilities, architecture, and experience of public cloud to enterprise private cloud. We are delivering on the hereto unmet promise of hyper-convergence by enabling customers to run multiple applications with predictable performance and efficient scalability and our architectural approach is clearly proving out. We are seeing strong momentum in NetApp HCI with significant wins against all of our competitors.

As you've heard me say many times, our unique differentiator is cloud integration. Our entire portfolio is made stronger by the Data Fabric and our ability to support hybrid multicloud environments. A great example of the value of this integration is the cloud tiering service introduced in Q2. Cloud tiering identifies infrequently used data in on-premises storage and automatically and seamlessly moves it to lower-cost object storage in the cloud, freeing up space on high performance data center systems for frequently used data. When the cloud-tiered data is needed again, the service automatically and seamlessly moves it back to the high performance tier.

Also in Q2, we announced substantial innovation to address distinct customer challenges in using public clouds, container orchestration, cloud infrastructure monitoring and management, data compliance and security, and backup. Immediately following our acquisition of StackPointCloud in September, we launched NetApp Kubernetes Service which dramatically simplifies the deployment of a Kubernetes cluster and applications to public and private clouds.

We also announced Trident, an open-source project which supports the entire NetApp storage portfolio, the combination of NKS and Trident enables application developers to consume high performance storage to build and deploy stateful applications on all of the world's leading clouds and on their private clouds.

To help customers monitor and cost optimize their hybrid cloud infrastructures, we introduced Cloud Insights, a hybrid multicloud infrastructure monitoring and management service. Cloud Insights quickly inventories resources, identifies interdependencies, and assembles the topology of public cloud and on-premises environments. By giving organizations a view into their complete hybrid infrastructure, it helps to reduce cloud infrastructure costs by an average of 33%, proactively identifying prevent failures and improve end-user satisfaction.

Fiscal 2019 is a foundational year for the SaaS part of our business. We are focused on operational readiness and deployment in the primary cloud data centers. While early, the customer response to and demand for these offerings is exciting and reinforces our confidence in our cloud strategy. Based on Q2, our annualized monthly recurring cloud data services revenue is approximately $27 million, up 35% from Q1.

We remain intensely focused on disciplined execution to meet the evolving needs of our growing customer base and to reshape our industry. We are transforming our business to reflect the way customers want to use and consume our technology. We have repositioned the company, expanded our portfolio and focused our execution to win the key market transitions.

We are serving customers in new ways with focused initiatives that help them jumpstart their digital transformation leveraging the innovation of the biggest cloud providers in the world, building enterprise hybrid clouds and modernizing legacy infrastructure. Our strategy is working because our customers know that we are aligned with their IT imperatives and their needs to unlock the value of their data to improve business outcomes.

We heard that clearly at our recent Insight user conference where thousands of customers and partners shared their excitement for our solutions and our Data Fabric strategy. And our performance has been very strong, as a result, we are leading in the areas that represent the biggest opportunities for NetApp. As we continue to grow and transform, we will maintain our focus on operational efficiency, execution and shareholder value.

As you can see by our strong results and capital returns, we are on track to deliver against the compelling long-term model and capital allocation plan we laid out at our last Analyst Day.

Before turning it over to Ron, I'd like to especially thank the customers who spoke on our behalf at Insight. Together with the NetApp team and our partners, we are delivering exceptional results and pushing the boundaries of what it means to be data driven. Ron?

Ronald J. Pasek

Executive Vice President & Chief Financial Officer, NetApp, Inc.

Thanks, George. Good afternoon everyone and thank you for joining us. As a reminder, I'll be referring to non-GAAP numbers unless otherwise noted. Our Q2 results reflect the continued strategic importance of NetApp to our customers as they undertake digital transformations and embraced hybrid multicloud architectures.

As George noted, we expect continued progress throughout fiscal 2019 toward the long-term business model we laid out at our Analyst Day. Before discussing guidance I'll provide detail on our performance in the second quarter. Net revenues of $1.52 billion grew 7% year-over-year, driven by product revenue of $913 million, which increased 11% year-over-year. Product revenue reflected the strength of our all-flash array business, an expanding traction in our HCI platform as well as roughly a $20 million benefit from ELAs.

Moving down the P&L, software maintenance and hardware maintenance revenue of $539 million increased 2% year-over-year, driven by continued growth in our installed base and to a lesser extent our cloud data services business.

Gross margin was 65% and above the high end of our guidance range. Product gross margin of 54% increased one and a half points year-over-year, reflecting continued salesforce discipline, the benefit from ELAs, and some one-time items. Excluding ELAs, product margin was approximately 53%. A combination of software and hardware maintenance and other services' gross margin increased one point year-over-year.

Operating expenses of $649 million were in line with our expectations and increased 1% year-over-year. We remain committed to strong OpEx discipline and continue to expect operating expenses for fiscal 2019 to be roughly flat year-over-year.

Operating margin was 22%. Excluding ELAs, operating margin was approximately 21% and at the high end of our guided range.

During the quarter, we repurchased 6.9 million shares at an average price of $81.41 per share for a total of $561 million. Weighted average diluted shares outstanding were 264 million, down 5 million sequentially and 11 million year-on-year.

EPS of $1.06 increased 33% year-over-year demonstrating the operating leverage in our business model. We closed Q2 with $4.3 billion in cash and short-term investments. Similar to Q1, we again saw healthy growth in deferred and financed unearned services revenue which increased 5% year-over-year.

During the quarter, we paid out $102 million in cash dividends. Our fiscal Q3 cash dividend of $0.40 per share is payable on January 23rd. Our cash conversion cycle of negative 19 days improved 9 days year-over-year, reflecting a 12-day increase in days payable outstanding and a 4-day decrease in days inventory outstanding, partially offset by a 7-day increase in DSO. 5 days of the DSO increase was due to one of our large distributors choosing to not take advantage of our early pay discount.

Cash flow from operations was $165 million. Free cash flow of $122 million represented 8% of revenues. Q2 is typically the lowest cash flow quarter of the year. In addition to seasonality and one of our U.S. distributors not taking advantage of the early pay discount, we also had our first payment for transition taxes associated with U.S. tax reform, which we expect to pay annually each year in Q2 for the next seven years.

It is also worth highlighting that we had a particularly tough year-over-year free cash flow comparison as we delivered an 18-day sequential improvement in our cash conversion cycle in Q2 of last year. In total, we remain confident in driving free cash flow of 19% to 21% of revenues for the full fiscal year.

Now onto guidance. We are keeping a keen eye on changes in the macro backdrop including increased volatility as a result of interest rates, currency headwinds, and trade disputes with China. That said, we continue to focus on execution and managing variables within our control and we remain confident in both our fiscal FY 2019 guidance and our long-term three-year growth forecast for revenue and profitability.

To add clarity, we are providing an estimate for the magnitude of ELAs going forward. We expect ELAs to represent roughly 2% of total annual revenue for fiscal 2019 and future years. It is worth highlighting that the 2% in revenue from ELAs only represents the software capacity license portion of the contracts. As George noted, each contract also carries a specified amount of future hardware systems revenue along with both software and hardware maintenance. To reiterate, we remain confident in our mid-single-digit fiscal 2019 revenue growth forecast plus any benefit from ELAs.

Now to Q3. We expect net revenues to range between $1.55 billion and $1.65 billion, which at the midpoint, implies a 4% increase year-over-year including one point of currency headwind. Consistent with normal seasonal sequential decline in gross margin from Q2 to Q3 associated with product revenue being a larger portion of the overall revenue mix, we expect Q3 consolidated gross margin to range between 62.5% and 63.5%. We expect fiscal Q3 operating margin to be approximately 22%. We expect earnings per share for the third quarter to range between $1.12 to $1.18 per share.

In summary, I'm confident regarding our growth opportunities, especially as it relates to our compelling Data Fabric strategy. Additionally, I'm very pleased with both the disciplined execution and the continued innovation momentum delivered by our team in Q2. We are well positioned to continue to deliver on the commitments we've made to our shareholders, partners and customers.

With that, I'll hand it back to Kris to open the call for Q&A. Kris?

Kris Newton

Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And our first question comes from the line of Rod Hall with Goldman Sachs. Your line is now open.

Rod Hall

Analyst, Goldman Sachs & Co. LLC

Q

Yeah. Hi, guys. Thanks for the question. So I heard Ron, you say that one point of currency headwind to the guidance and I'm wondering if you could just comment on the currency impact of the current quarter as well from a margin point of view.

And then also, I was hoping maybe that you guys could talk a little bit about the cloud services. I mean, the run rate looks pretty good, but obviously, it's not really general [ph] GA yet (22:56). How does that pipeline look? Can you give us any more color on that? Just how you expect that revenue to flow as we look out into the next quarter and beyond? And I mean, if you could say what you're guiding or kind of what the level of guidance is like for those cloud services that would be really interesting? Thanks.

Ronald J. Pasek

Executive Vice President & Chief Financial Officer, NetApp, Inc.

A

So, Rod, the first part of your question, as it relates to the guide for Q2, currency had very little impact on the guide for Q2. And it's about – as I said, it's about a one point headwind for the Q3 guide. We saw a little bit of that. You'll see a little bit of that in margin in Q3 as well, but it's factored in the guide there. That's one of the reasons it's down sequentially.

George Kurian

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

A

With regard to cloud data services, we are in the build-out phase within the hyperscale data centers. I think the pipeline has been good. We are certainly seeing the success of our software called Cloud Volumes ONTAP within the hyperscale marketplaces. It is the big chunk of the progress in terms of the revenue to-date of cloud data services. So as the Cloud Volumes Service targeting application developers comes online through the course of this fiscal year, we should be in a really good position to expand that set of bookings.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Thanks, guys.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks, Rod. Next question?

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

Andrew James Nowinski
Analyst, Piper Jaffray & Co.

Q

All right. Thank you. Just a question on the gross margin. So, if we exclude your ELAs this quarter, it looks like your product gross margin was actually up sequentially from last quarter. But your fiscal Q3 and your 2019 guidance does suggest it goes down pretty significantly from here. Given the decline in NAND prices, I was just wondering if you could maybe discuss the puts and takes on the margin guidance? Thanks.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer, NetApp, Inc.

A

Yeah. Thanks, Andy. So, we typically see a pattern as you saw last year and the year before, where we go down in margin from Q2 to Q3. The biggest factor in the past years and including this year has been just the weighting of product revenue, which is higher in Q3 than Q2 to services revenue. That's the biggest part of the change. We also have – we'll have in Q3 lower ELA revenue this year and there were some one-time benefits I referred to in Q2. But it is a normal seasonal pattern you see.

Andrew James Nowinski
Analyst, Piper Jaffray & Co.

Q

Got it. Thank you.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer, NetApp, Inc.

A

I will add, if you look at product margins for the last six quarters from Q1 of 2018 to the quarter we just reported, without ELAs it goes from [ph] 49.5% up to 53% (25:45). So we are making progress on the product margin for the company.

Andrew James Nowinski
Analyst, Piper Jaffray & Co.

Q

Thanks, Ron.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks, Andy. Next question?

Operator: Our next question comes from the line of Katy Huberty with Morgan Stanley. Your line is now open.

Kathryn Lynn Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Thank you. Good afternoon. Just a clarification and then a question. On the clarification side, does the January quarter guidance include any assumption around ELA revenue? And if not, just any color as to whether your pipeline would suggested that you might have some ELA deals?

And then for a question, AFA run rate growth of 29% was a slowdown? Can you just talk about whether that deceleration was slower systems growth or was it entirely driven by lower NAND prices flowing through to ASPs? Thank you.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer, NetApp, Inc.

A

So, Katy, the first part of your question, I tried to bound ELAs for the full year, this year as 2% of revenues. And just to recall, we did about $90 million in Q1 and $20 million in Q2. So you're pretty much there to the full year forecast for ELAs. We might see a little bit – so the forecast assumes – it's just the forecast. There might a little bit, but it's not going to be a lot.

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

A

With regard to the all-flash arrays, I think, first of all, we are growing 29% year-on-year. The predominant percentage of that was due to shipments. We have not adjusted prices to deal with NAND. So as we said, we're going to monitor what other people do and then make the appropriate adjustments.

Kathryn Lynn Huberty
Analyst, Morgan Stanley & Co. LLC

Q

And, George, why do you think shipment growth slowed in the quarter?

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

A

I think there is a mix between flash and hybrid flash. I think the percentage of our business that's today all-flash arrays is very large. And if you look at it sequentially, in Q1, we had some benefit from ELAs for all-flash arrays. As you saw, in Q1, our number was a very large number year-on-year. So I think it's just more of a sequential compare against a one-time set of metrics in Q1.

Kathryn Lynn Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Understood. That's helpful color. Thank you very much.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thank you, Katy. Next question?

Operator: Our next question comes from the line of Aaron Rakers with Wells Fargo. Your line is now open.

Aaron Rakers
Analyst, Wells Fargo Securities LLC

Q

Yeah. I kind of – I wanted to go to the last question that was asked and kind of understand maybe what you're seeing from a competitive landscape perspective in the all-flash market. And as we start to or as you guys evaluate what some of the competitors are doing, how you see the potential playing out for demand elasticity as it relates to your installed base opportunity that's not yet upgraded to flash? Maybe metrics around that would be helpful as well.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer, NetApp, Inc.

A

I think the – from an installed base perspective, we still have a very small percentage of our installed base on all-flash arrays. It's in the mid-teens. And so there's plenty of headroom. I think that we are going to balance the ability to upgrade the installed base with the – getting the best value for our offerings. We think that our offerings are very competitive in the market and we're going to try to extract the maximum value for that.

I think in terms of competition, we don't see any fundamental change in the competitive landscape. I think that we are seeing more new competitors as we attack the hyper-converged market. So we are expanding our competitive assault on hyper-converged market and we're seeing, as a result of that, some newer players. But no fundamental change in the competitive dynamics.

Aaron Rakers
Analyst, Wells Fargo Securities LLC

Q

Thank you.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks Aaron. Next question?

Operator: Our next question comes from the line of Steven Fox with Cross Research. Your line is now open.

Steven Fox
Analyst, Cross Research LLC

Q

Hi. Good afternoon. Just one question from me. George, you mentioned traction on the HCI side. I was wondering if you can expand on that and talk about where you're seeing that and what you expect for the rest of your fiscal year from HCI.

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

A

We're very pleased with the progress on hyper-converged. I think, as we said, we have a differentiated architecture that's resonating in the marketplace. We saw a broadening book of business, an accelerating pipeline and a growing number of competitive wins. So it proves out the thesis that we've had all along that the enterprises want a solution that enables hybrid cloud infrastructure that allows IT to operate like a service provider that allows applications, infrastructure, and data to be seamlessly managed whether it's on-premises or across multiple clouds.

And so our strategy is working. We've got work to do to continue to expand the scaling of our go-to-market pathways and to expand the number of price points that we need to address. But we are very, very pleased with where we are year-to-date.

Steven Fox
Analyst, Cross Research LLC
Q

Great. Thank you very much.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.
A

Thanks, Steve. Operator, next question?

Operator: Our next question comes from the line of Wamsi Mohan with Bank of America Merrill Lynch. Your line is now open.

Wamsi Mohan
Analyst, Bank of America Merrill Lynch
Q

Hi. Thank you. I had a quick clarification as well on the product gross margins. Ron, you mentioned some one-time benefits a few times and I was wondering if you could call out what those were and what the magnitude of that was. And George, can you comment on the broader spend environment, both in the enterprise and hyperscale players? And any color by region would be helpful. It sounds like your guide is gated by some caution there? Thank you.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer, NetApp, Inc.
A

So, Wamsi, the one-time benefits relate to some reserves and it was about 0.5 point, so not material, but just something to be aware of.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.
A

With regard to our – the macro, no particular color that I want to share. I think we just – we saw some movement in some of our U.S. public sector deals where they were in quarter command programs. These are multi-year programs that are not tied to any particular budget cycle that just had spending come out in Q3 as opposed to in Q2. So we feel very good about our ability to capture that business in Q3.

And then overall, I think nothing unique that we want to comment on. I think you see the public markets reflecting some stress in some parts of the emerging markets. I think that's really the summary of the comments.

Wamsi Mohan
Analyst, Bank of America Merrill Lynch
Q

Okay. Thank you.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.
A

Thanks, Wamsi. Next question.

Operator: Our next question comes from the line of Mehdi Hosseini with Susquehanna. Your line is now open.

David Ryzhik
Analyst, Susquehanna Financial Group LLLP

Q

Thanks so much for taking the question. This is David Ryzhik for Mehdi. Ron, would you be able to give us some insight into just the product revenue growth expectations embedded in the Jan quarter and for the balance of 2019? And then within that would love to get your sense of how material the Lenovo relationship can be and would that be included in strategic or would that be in mature revenue? Thanks so much.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer, NetApp, Inc.

A

Well, David, we don't guide below the total revenue number. We'll talk about revenue after the facts and compare year-over-year, but I don't guide those specific items. Yeah, go ahead.

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

A

With regard to Lenovo, Lenovo is started to be in market with our products. They bring complementary pathways to the customer. They allow us to access new decision makers. We are starting to see the first wins, but it will take us a good amount of time to get them fully scaled in terms of their – all of their geographies knowing our products and taking into market. There is very little overlap in our customer base, which is a positive. There is a reasonable amount of common channel partners but there is work to be done.

And in terms of strategic versus mature, we are no longer going to be using that breakout of the business because the majority of the mature business is now add-on storage, reflecting the strategic products sale. So you'll see us just comment about product revenue and services revenue on a go-forward basis.

David Ryzhik
Analyst, Susquehanna Financial Group LLLP

Q

Thanks so much.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thank you, David. Next question.

Operator: Our next question comes from the line of Ananda Baruah with Loop Capital. Your line is now open.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Hey. Good afternoon. Thanks for taking the question. A quick clarification and then one question. George, clarification, so just with regards to spending environment, is the takeaway that you're not really seeing anything material yet and you want to leave it at that for right now? And then I have a quick follow-up as well.

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

A

I think with regard to the spending environment, there is no particular impact of tariffs that we saw. It's too early to comment. I think we're just generally cautious trying to maintain our track record of providing clear guidance and meeting or beating it, right? I don't think there's anything that you should read into the commentary that is less in confidence or have specific color around the economic outlook. We are monitoring it. There's a lot of news and – but we haven't seen specific items change in terms of their trajectory.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Perfect. Thanks. And then just a question is coming out of the user conference, what – I guess what was sort of the vibe coming out of the user conference? What were some of the common themes from users? There seems to be – I mean there is a lot of participants this year, the energy was great. People were talking about putting on new projects. What were the common themes coming out that you guys saw?

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

A

We were very excited by the number of net new customers that were at the conference, reflecting our ability to grow footprint into new parts of the market that were historically not NetApp customers. We were excited at the number of customers that validated our solutions and our direction for hybrid multicloud IT as their path going forward.

And of course, there was an extraordinary amount of innovation that we delivered at our Insight conference. And it leads us to continue to have really, really good confidence that we are gaining share in the markets that we are competing in, expanding our addressable market through new solutions like our hyper-converged solution, solutions for artificial intelligence and changing the industry landscape through the unique combination of applications infrastructure and data for hybrid multicloud IT. So we feel really good about where we are positioned and look forward to finishing out the year strongly.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

That's great. Thanks a lot.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks Ananda. Next question?

Operator: Our next question comes from the line of Joe Wittine with Longbow Research. Your line is now open.

Joseph H. Wittine
Analyst, Longbow Research LLC

Q

Hey guys. Nice numbers, especially given the competition out there. George, I wanted to do a quick follow-on to your prior HCI comments. We also picked upon some acceleration this quarter including what seemed to be some nice-sized wins against players that I would consider to be higher-end traditional reference architecture type converge solutions. So is it fair to say you're seeing interest with HCI and the field now for a while in either more advanced customers or more mission-critical applications than you had visioned at launch?

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Absolutely. Our belief was that we are building on the only architecture that was designed to operate a multi-tenant service provider class HCI offering. And by bringing that to the enterprise, we are uniquely advantaged versus other players that started from a small office dedicated appliance. And that is proving out clearly in Q2 and in our go forward pipeline. So people are excited about our offering.

I think as we integrated more tightly into our hybrid multicloud Data Fabric, it both locks out players trying to enter our installed base as – also allows us to capture a bigger footprint, like you said, in the enterprise data centers that we don't have footprints in. So we're really – our thesis on the HCI market that it was time for disruption with a mainstream enterprise-grade offering like in the all-flash arrays, absolutely playing out. We can't be more excited looking forward.

Joseph H. Wittine
Analyst, Longbow Research LLC

Q

Perfect. Thank you.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks Joe. Next question?

Operator: Our next question comes from the line of Simon Leopold with Raymond James. Your line is now open.

Simon M. Leopold
Analyst, Raymond James & Associates, Inc.

Q

Great. Thanks for taking the question. During your Insight event you talked about multicloud and in your prepared remarks, we heard it a lot again. And it's definitely an intriguing narrative and it feels like an inflection point. I think I'm struggling to figure out how to attach this to our forecasting and may be broadly, do you look at the emergence of multicloud as an element that can lead to reacceleration of year-over-year growth? Or is it basically just replacing older technologies? Is it sort of a natural evolution or an accelerating factor? Thank you.

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

A

Multicloud plays into our business in multiple ways. The first is it allows us to access completely cloud native customers that do not have a data center. I think at Insight, you saw us as a customer of that type called, WuXi NextCODE which is a genomics company that is built on the cloud, never had a data center.

The second is that it allows us to expand our footprint within existing customers where the combination of cloud plus data center gives us unique benefit. Those could be net new customers like we are displacing people who have legacy data centers with our flash technology combined with cloud or it could be expanding footprints within existing customers, where we displace one of our competitors in the SAN market with a cloud flash alternative.

And then the third is it allows us to bring more efficiency to our existing customers in some cases, where they want to, for example, leverage the cloud for analytics, a footprint that we historically didn't serve. So there's a lot of avenues. I think that it's already helping us in leadership in flash where the cloud brings a unique angle to our flash solutions that others do not have. And then from a pure cloud solution standpoint, you will see that reflected in the CDS business on a go-forward basis.

Simon M. Leopold
Analyst, Raymond James & Associates, Inc.

Q

Thank you.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thank you, Simon. Next question?

Operator: Our next question comes from the line of Alex Kurtz with KeyBanc. Your line is now open.

Alex Kurtz
Analyst, KeyBanc Capital Markets, Inc.

Q

Yeah. Thanks for taking the question. George, at the outset of the call here, you mentioned that – it sounds like the top-line was more in line with expectations versus beating on the margins. Is there different verticals or regions that outperformed or underperformed, any kind of additional clarity on kind of how the quarter played out would be helpful.

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

A

I think U.S. public sector was a little bit soft relative to our expectations. APAC and U.S. commercial conversely were very strong. EMEA dealt with a point of forex being as a headwind. So most of the [ph] theaters (42:18) did really well. On U.S. public sector, as I mentioned in my comments, we have a broad book of business. Some aspects of that business are tied to multi-year programs and the trajectory of spend within a specific quarter can vary. They're not tied to the typical year-end federal spending pattern. And so we saw some of those programs move spending from Q2 to Q3. So we feel good about our ability to capture that business in Q3.

Alex Kurtz
Analyst, KeyBanc Capital Markets, Inc.

Q

Okay. Thank you.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks, Alex. Next question?

Operator: Our next question comes from the line of Erik Suppiger with JMP. Your line is now open.

Erik Suppiger
Analyst, JMP Securities LLC

Q

Yeah. Could you compare the prospects for your multicloud with your HCI solution? I presume the multicloud is further along in terms of contribution. But can you talk about what you think – how you compare the two different prospects there?

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.
A

Multicloud will inherently become a part of what most hyper-converged solutions will have to offer. If you think about an IT department, most of them will want to have the ability to build their own clouds or manage a portfolio of applications and say, hey, I don't want to run those in my own data center, I just want to use the public cloud. We are clearly uniquely positioned in the public cloud marketplace for having the ability to connect applications, infrastructure using NetApp Kubernetes Service and data using a technology called Trident that we have to make multicloud – hybrid multicloud deployable today across all the major cloud providers.

When we combine that with hyper-converged, you now not only get to do that on the public clouds, but also on-prem. And we do that in a way that is unique because unlike some of the other hyper-converged vendors, we're allowing you to use the public cloud services. All the other hyper-converged vendors have some form of [ph] walled garden their (44:39) building in the public cloud that doesn't give you the benefits of real public cloud.

So, we're excited. You'll see that play out and we're just going to keep our head down and prove that out. We think we've got a really strong start, the first half of the year, in hyper-converged. Look out, here we come.

Erik Suppiger
Analyst, JMP Securities LLC
Q

And then secondly, any comments about NVMe? Did you see any more adoption during the course of the quarter?

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.
A

NVMe has two flavors. One is the NVMe connection between disks and storage systems. That's nice, but not massively differentiated. We have it. We've seen customers adopt it as they adopt NVMe drive, so we're pleased it's in line with expectations.

NVMe over Fabrics, which is the truly strategic part of the NVMe roadmap, is now deployed at a few customers. It's early, it's applicable for truly low-latency applications and we're excited. We are pioneering that part of the market and we're excited at both, the support that we have from the ecosystem as well as customer interest. But it will take time to adopt like any new storage protocol.

Erik Suppiger
Analyst, JMP Securities LLC
Q

Okay. Thank you.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.
A

Thank you, Erik. Next question.

Operator: Our next question comes from the line of Eric Martinuzzi with Lake Street. Your line is now open.

Eric Martinuzzi
Analyst, Lake Street Capital Markets LLC
Q

Yeah, a question on playing with potential new bigger player in cloud. NetApp plays well with Amazon and Microsoft Azure and Google Cloud. Given the IBM acquisition of Red Hat, which is expected to close in the second half of 2019, I'm interested to hear your thoughts on what this means for enterprise hybrid storage environment.

And then secondly from a product development, wondering if there's any initiatives that NetApp is entertaining to maybe benefit from that pending merger acquisition?

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

A

Just a couple of things. I think the first is the acquisition or planned acquisition of Red Hat by IBM is yet another endorsement of hybrid multicloud, right? I think that the combination of Red Hat together with IBM gives enterprises the ability to deploy multiple clouds on hybrid cloud.

We already have strong relationships with both sides of that transaction. With Red Hat, we have done a lot of work across multiple solutions both standalone storage, converged systems and hyper-converged systems, to support OpenShift as well as a variety of other Red Hat Enterprise Linux platform combinations. We just announced this quarter the ability to deploy OpenShift alongside NetApp HCI.

And then with IBM, we have a longstanding relationship with IBM Cloud all the way from the time of SoftLayer. They are a large NetApp partner. We have hybrid cloud solutions alongside the IBM Cloud, where you can deploy Cloud ONTAP Volumes (sic) [Cloud Volumes ONTAP] on the IBM Cloud and there's a variety of innovation going on together with them as well. So we feel that this is a good combination. It affords us yet another player to work with to make hybrid multicloud a reality for customers.

Eric Martinuzzi
Analyst, Lake Street Capital Markets LLC

Q

Understand. So more of an opportunity that you guys are already well positioned for than something you need to design new product for?

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

A

That's correct.

Eric Martinuzzi
Analyst, Lake Street Capital Markets LLC

Q

Thank you.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks, Eric. Next question?

Operator: Our next question comes from the line of Jim Suva with Citi. Your line is now open.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you very much, George and Ron. A question about the past 12 to 24 months, memory pricing has been a headwind. Can you remind us what you did historically during that time period? And I think on your conference call, you've mentioned you'll assess going forward kind of what the competitive landscape does. So hypothetically, what does that mean if memory prices keep coming lower? Will you lower your prices? Will you [ph] mirror (49:05) the percent change? How should we think about that? And is it in a lagging basis or just-in-time basis? Or how should we think about just the future impact of memory prices versus the past history of 12 to 24 months? Thank you, gentlemen.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer, NetApp, Inc.

A

So Jim if you remember about 18 months ago, we did in fact increased list prices for products carried NAND. And that was simply because that was what our [ph] experience (49:29) was with the supply base. We were very fortunate to be able to secure supply of that entire time. And in fact knew that the pricing would eventually come down starting earlier this year and in fact did. As we've said a number of times, we're not going to be the leaders in reducing list prices now that NAND prices are coming down. We're going to watch it and see what happens.

On a net price basis, we are still very competitive, so we're watching that effect, too. So there's what you do with list prices and then what you do with Street prices. So we're going to keep watching as we go forward.

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

A

We also continue to make investments in software that allows us to maximize the value that a customer gets from a piece of memory. And we announced that NetApp Insight, the availability of ONTAP 9.5 that has further advancements in our already industry-leading storage efficiency technology.

The second is I think as flash prices come down it makes all-flash arrays, where we are extraordinarily well positioned, more and more a meaningful opportunity for a broader and broader mix of workloads within our customers. And so as that [ph] capitalizes (50:30) re-platforming opportunities in the customer base it's clearly an opportunity for us that we're going to take advantage of.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you so much for the details, gentlemen.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thank you, Jim. Next question, please?

Operator: Our next question comes from the line of Nehal Chokshi with Maxim Group. Your line is now open.

Nehal Sushil Chokshi
Analyst, Maxim Group LLC

Q

Yes. Thank you. So results and guidance were definitely within the guidance parameters that you provided previously as well as your Analyst Day. However, when I exclude the impact of ELAs, I do see a slowdown in your year-over-year product growth albeit still within your long-term model. So I think from 11% year-over-year in the July quarter and now it's around 9% year-over-year for this quarter. Your guidance implies that it's probably going to be around 5% year-over-year. So, is there a narrative that we need to be concerned about as far as why we're seeing this product revenue year-over-year growth slowdown albeit still within the guidance?

Ronald J. Pasek
Executive Vice President & Chief Financial Officer, NetApp, Inc.

A

So I think what we have been doing is we got the services business [ph] totaled (51:44) back to where it's not a headwind. That was what we were seeing last year. Some of that product growth was making up for the headwind we had on the services side. I think as you look at the second half of last year, we grew the Q3 quarter 9% year-over-year in total and the Q4 11% that's total revenue growth. Product growth within that was quite a bit higher. So we are looking at some pretty tough compares. We did guide the year to mid-single digits. We're very confident we can still do that and that's without the benefit of ELAs.

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

A

I think the only other additional comments that I would add was last year in some parts of the world forex was a tailwind. This year it's a headwind. I think that we feel very, very good about our innovation portfolio. If you look at it this time last year, we were strong in flash, but not yet had meaningful progress on the other two alternatives, which is hyper-converged and public cloud. I think this year – heading into the second half of this year, we feel very good about flash, but we feel much more – we can have much more line of sight into the strength of our hyper-converged and public cloud business. So overall, we're focused on execution. We have good start to the fiscal year. We remain committed to our outlook which was to grow mid-single digits without ELAs for the year. And so we're going to execute to that plan.

Nehal Sushil Chokshi
Analyst, Maxim Group LLC

Q

Okay. Thank you.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks, Nehal. Next question.

Operator: Our next question comes from the line of Rob Cihra with Guggenheim. Your line is now open.

Robert Cihra
Analyst, Guggenheim Securities LLC

Q

Hi. Thank you very much. Just a question on your flash versus hybrid mix. So the AFA obviously growing rapidly but obviously not a 100% of your revenue. So with that other, whatever call it half of your business that's hybrid or drive based, are you seeing that sort of selling into the installed base as add on, that sort of thing? Or do you see enough genuine application sort of cold storage Hadoop whatever, where those hybrid platforms are actually still best? And so there's some mix where you're – it's not like you're ever going to get to a 100% flash? I hope that question makes sense. Thanks.

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

A

Yeah. I think if you look at the hybrid arrays there are two forms of hybrid arrays. One is where you've got a piece of solid-state storage front-ending SaaS drives, meaning performance drives. The second is a form of hybrid array where you've got flash front-ending capacity drives, meaning 7200 rpm capacity drives. There is still some percentage of our business in the former of the two categories, which will eventually get replaced by all-flash arrays as the price point of NAND gets better over the next year, there is going to be an enduring portion of our business for capacity-oriented workloads for sequential workloads for example video, which don't benefit from solid-state where the second form of hybrid array will continue to be an ongoing percentage of our business for as long as I can see.

Robert Cihra
Analyst, Guggenheim Securities LLC

Q

Right. Okay. Thank you very much.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks, Rob. Next question.

Operator: And I'm showing there are no further questions. So with that I'd like to turn the call back over to NetApp for closing remarks.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

Great. Thank you.

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

I'm really excited about the opportunity ahead. We introduced a tremendous amount of innovation in Q2 that helps us drive share gains, expand our available market and set the industry agenda. NetApp is uniquely able to help customers solve the challenges of multi-hybrid cloud environments with the Data Fabric.

Our Data Fabric strategy is paying off through growing importance to our customers and yielding strong financial results. We are relentlessly focused on execution and on delivering against our plan and we remain confident in both our fiscal 2019 guidance and our long-term three-year growth forecast for revenue and profitability. I look forward to talking with you again next quarter.

Operator: Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program and you may all disconnect. Everyone, have a wonderful day.