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NetApp, Inc. (NTAP)

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the NetApp first quarter fiscal year 2015 financial earnings call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session, and instructions will follow at that time.

I'd like to turn the call over to your host, Kris Newton, Vice President, Investor Relations. Please go ahead.

Kris Newton

Vice President, Investor Relations, NetApp, Inc.

Hello and thank you for joining us on our Q1 fiscal year 2015 earnings call. With me today are CEO Tom Georgens and CFO Nick Noviello.

This call is being webcast live and will be available for replay on our website at NetApp.com along with the earnings release, our financial tables, a historical supplemental data table, and a non-GAAP to GAAP reconciliation.

As a reminder, 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 second quarter and full fiscal year 2015, all of which involve risk and uncertainty. Such statements reflect our best judgment based on factors currently known to us and are being made as of today. We disclaim any obligation to update our forward-looking statements and projections. Actual results may differ materially from our statements and projections for a variety of reasons. We describe some of these reasons in our accompanying press release, which we have furnished to the SEC on a Form 8-K. Please refer to the documents we file from time to time with the SEC, specifically our Form 10-K for fiscal year 2014, subsequent Form 10-Q quarterly reports, and our current reports on Form 8-K, also on file with the SEC and available on our website.

During the call we will also 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.

In a moment, Nick will walk you through some additional color on our financial results, and then Tom will give you his perspective on the business this quarter. I'll now turn the call over to Nick.

Nicholas R. Noviello

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

Thank you, Kris. Good afternoon, everyone, and thanks for joining us.

NetApp executed well in fiscal Q1. We achieved net revenues above the midpoint of our previous guidance range, evidence that our strong portfolio of solutions is well aligned with the evolving priorities of our customers. And we delivered another quarter of strong operating results, with non-GAAP gross margin, operating margin, and EPS all above Q1 guidance ranges.

Net revenues of $1.49 billion were down 10% sequentially, reflective of typical Q4 to Q1 seasonality, but less than the sequential declines we have experienced over each of the last two years. Branded revenue of $1.36 billion was

91% of net revenues and was up 1% from Q1 FY 2014. OEM revenue continued to decline on a year-over-year basis, consistent with our expectations. OEM revenue of about $129 million was down 23% versus Q1 last year.

Indirect revenue through the channels and OEMs accounted for 79% of Q1 net revenues due to typical seasonality and an increase in large transactions fulfilled directly in Q1. Consistent with historical trends, Arrow and Avnet contributed 22% and 16% of net revenues respectively. Geographic performance came in as expected.

Non-GAAP gross margin of 64.3% was just 10 basis points below Q4 and above our Q1 guidance range. Non-GAAP product gross margin of 57.1% was down almost a point sequentially on less favorable product mix, but up almost four points year over year due to a combination of supply chain savings, favorable product mix, and lower warranty costs. Service gross margin of 62.7% was consistent with Q4 and up more than three points year over year due to higher service revenues.

Non-GAAP operating margin was 15.9%, almost a point above our previous guidance. We continue to invest in the business to deliver innovative data management solutions for the hybrid cloud while at the same time maintaining prudence around overall spending.

Consistent with my comments on the last two earnings calls, effective this quarter we implemented a change in how we report our non-GAAP effective tax rate to be more reflective of our operational results and tax structure. As a result, we have excluded for Q1 and will exclude for future periods from our non-GAAP tax provision the impact of items such as income tax audit settlements and the temporary lapse of tax laws such as the federal R&D credit. Our non-GAAP effective tax rate for the first quarter was 16.5%, in line with our expectations.

Q1 weighted average diluted share count of 329 million shares was below our prior guidance and decreased by approximately 7 million shares sequentially due to share repurchase activity in the quarter and the benefit from Q4 repurchases.

Non-GAAP EPS of $0.60 exceeded the high end of our prior guidance range by $0.02, reflecting an approximate $0.01 benefit from lower share count resulting from Q1 repurchases and the combination of higher than projected revenue and strong gross margins.

Now turning to the balance sheet, we ended the quarter with approximately $5.6 billion in cash and investments, 19% of which is onshore. The sequential increase in onshore cash was due predominantly to our $500 million seven-year senior notes issued in June.

Inventory turns were at 20, and days sales outstanding decreased sequentially to 36 on normal seasonality.

Deferred revenue of $3.1 billion was seasonally down versus Q4, though less so than in each of the last two years. That said, deferred revenue was up $135 million from Q1 last year.

Q1 cash from operations was approximately $216 million versus $286 million in Q1 FY 2014. Free cash flow was 11% of revenue in Q1, and was impacted by higher payments of annual incentive compensation and an audit settlement. The audit settlement had no impact to cash and cash equivalents, as we utilized excess stock option benefits to offset taxes payable related to the audit.

In Q1 we returned over $172 million to shareholders, which included $119 million in share repurchases and $53 million in cash dividends. We remain on track to complete the last $1 billion of our share buyback program by the end of May 2015, consistent with the guidance we provided last quarter. Today, we also announced our next cash dividend of $0.165 per share of the company's stock, to be paid on October 22, 2014.

Now turning to guidance, we are pleased with the momentum we see building in the business but remain conscious of market dynamics. Our target revenue range for fiscal Q2 is $1.49 billion to $1.59 billion, which at the midpoint implies about 3% sequential growth and roughly flat revenue year over year. We expect continued branded revenue growth, including a seasonal uptick related to the U.S. government's fiscal year end in September to be partially offset by continued declines in OEM revenue. We expect non-GAAP gross margins of approximately 64% to 64.5% and non-GAAP operating margins of approximately 17.5% to 18%.

Based on our repurchases in Q1 and in the first 10 days of Q2, we expect our diluted share count for the quarter to be approximately 330 million shares. We expect non-GAAP earnings per share for Q2 to range from approximately $0.66 to $0.71 per share.

Our expectations for fiscal 2015 remain unchanged at this time. We anticipate mid-single-digit branded revenue growth ramping over the course of the year and partially offset by declines in OEM revenue of up to 40% for the full year.

Though ultimately dependent on revenue mix and growth, we continue to expect non-GAAP gross margin of approximately 63% to 64% and non-GAAP operating margin of approximately 18% for fiscal 2015. We continue to expect our non-GAAP effective tax rate for the year to be about 16.5% and full-year non-GAAP EPS growth of just under 10%.

Finally, we expect to continue to generate strong cash flow and, as I indicated earlier, remain on track to complete our existing share repurchase plan by the end of May 2015.

In closing, we are confident in our strategy of helping customers navigate the transformation of their IT deployment as they take advantage of new technologies like flash and new consumption models such as cloud. Our best-in-class portfolio is driving momentum in our branded business, enabling us to invest in continued innovation while delivering shareholder value.

Now I would like to turn the call over to Tom for some additional color on the quarter. Tom?

Thomas Georgens

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

Thank you, Nick, and good afternoon, everyone.

I am pleased with the results the NetApp team delivered this quarter. The strength of our portfolio combined with the continued operational discipline enabled us to achieve revenue over the midpoint of our prior guidance, with gross margin, operating margin, and EPS above the top of our previous guidance ranges.

IT is in the midst of a significant transition. Enterprises are facing the profound challenge of adopting new technologies and delivery options while managing the reality of their current infrastructure and meeting the increasing demands of the business. Customers see the business value of these new options, but also recognize that they cannot abandon or even freeze in place the mature, proven, and compliant solutions that run the business today. CIOs need solutions that continue to enhance and optimize their current environment while simultaneously enabling the full potential of newer architectures and delivery models.

NetApp's portfolio of data management solutions improves the economics, flexibility, and business impact of customers' existing infrastructure, while our cloud and technology vision gives them confidence in our ability to help them navigate the future. This message is resonating, and more large enterprises are placing big bets on NetApp. Consistent with the increase in enterprise buying activity we saw in Q4 of fiscal 2014, we also saw a significant increase in deals over $1 million in Q1 from the same quarter last year.

Cloud is the biggest disruptor to the industry. It can enable enterprises to optimize elements of their IT portfolio in ways that were never available before and provide flexibility and cost benefits for certain workloads. However, the economic benefits are not advantageous for all workloads. Likewise, there are non-economic considerations like security, regulation, and performance that also impact cloud decisions. Our customers are telling us that they want a hybrid cloud. The deployment of internal and external resources combine in a way that is optimized to meet today's needs with the ability to evolve over time.

Seamless data management is integral to the realization of this vision. Once data is created, it needs to be managed forever and therefore accumulates, which makes subsequent movement both time consuming and bandwidth intensive. This makes the requirements for storage different than that for servers and networking, which are more fungible in nature. Only Data ONTAP, the industry's number one storage operating system, addresses these requirements through its rich software functionality that provides a seamless data management experience across internal and external cloud resources. Clustered ONTAP is unmatched in meeting the IT transformation requirements of both the enterprise and cloud service providers.

The rapid adoption of clustered ONTAP continued in Q1, with shipments of clustered nodes growing 177% from last year. The attach rate of clustered ONTAP increased across all product lines. Both midrange and high-end platforms are approaching a 50% attach rate, and the recently introduced cluster-optimized FAS8000 family is above 60%.

The success of clustered ONTAP is due to its ability to provide support for a broad range of workloads and improved operational capabilities while reducing the overall complexity of the storage infrastructure. 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 solutions.

Customers also need a range of performance levels from their storage infrastructure. All data has a life cycle over which its performance and economic value varies, which drives customer requirements for all-flash, all-disk, and hybrid arrays. However, regardless of the attributes of specific data at any point in time, almost all data is ultimately hybrid over its life cycle, necessitating automated data management as a critical component to realize the full potential of flash technology. In fact, the majority of our midrange and high-end systems ship in a hybrid configuration, with a mix of flash and hard drives.

On our Q4 call, I talked about customer demand for all-flash configurations of our FAS arrays. The ability to create all-flash nodes in a larger cluster with unified data management and transparent volume migration is a compelling capability not offered by alternative architectures. In Q1 we built on this momentum and expanded on our flash portfolio by introducing all-flash FAS products to further address a need for ultimate performance while leveraging existing tools and processes. Shipments of all-flash arrays, our EF family, and all-flash FAS products grew 48%, and flash capacity shipped more than doubled from Q1 a year ago.

With the broadest portfolio of array-based flash solutions, NetApp is well positioned to help IT organizations optimize for a wide variety of performance, efficiency, and scalability requirements. I am proud to say that just last week our flash solutions were honored with two awards at the flash Memory Summit for most innovative customer implementation and for the best all-flash NAS array.

In Q1 we refreshed our entry and high-end FAS product lines with the introduction of the FAS2500 family and the FAS8080EX. Year on year, our high-end and midrange FAS shipments grew 14% and 10% respectively. Entry FAS systems were down 19%, consistent with our expectations of the transition to the new FAS2500. Branded E-Series systems, exclusive of the EF products, more than doubled from Q1 a year ago. FlexPod, our converged architecture solution, continues to perform well, with shipments up 25% from last year.

Now let's come back to the big industry disruptor, the cloud. It is generally viewed as a threat to enterprise IT players. But with our differentiated approach, we see it as an opportunity. Enterprises value our seamless data management as do cloud service providers who rely on our proven efficiency, seamless scalability, and non-disruptive operations to support a responsive and profitable public cloud operation.

Of our top customers in Q1, roughly half are companies that offer cloud-based services and purchase NetApp for use in both their internal enterprise IT and external cloud offering. Whether customers are providers or consumers of cloud solutions, NetApp is uniquely positioned to add value.

In Q1 we announced the extension of NetApp private storage solutions to include Microsoft Azure and demonstrate our ability to interoperate between Azure and Amazon Web Services. Additionally, we deepened our hybrid cloud partnership with Equinix. The Equinix Cloud Exchange can dynamically connect NetApp Private Storage customers to multiple public clouds. By maintaining full ownership and control of their data with NetApp Private Storage yet being able to access multiple cloud compute resources through high-bandwidth links, customers can realize the full flexibility and economic benefits of multi-cloud solutions without the risk and regulatory concerns associated with relinquishing data stewardship. We serve a broad range of workloads, with the ability to bridge the enterprise on-premises architectures of today with the cloud architectures of the future.

Clustered Data ONTAP is a data management framework to seamlessly enable enterprise hybrid cloud. E-Series provides us access to new workloads and customers and complements ONTAP as a dedicated high-performance SAN solution. Spanning both ONTAP and E-Series environments are our FlexPod converged architecture and hybrid all-flash solutions. FlexPod helps customers by removing the risk and burden of integration to speed the deployment of new technology. Our flash solutions follow customer requirements for high-performance storage, including the displacement of legacy frame arrays.

The set of workloads and architectures that we address today is unparalleled in the company's 20-year history. With our portfolio of solutions, we are helping the world's largest enterprises transform their IT departments with a better way to manage their environments, deliver new capabilities to the business, and achieve their vision for the hybrid cloud. We are seeing momentum in our key investment areas: clustered ONTAP, flash, cloud, branded E-Series, and expect that momentum to accelerate over the course of fiscal year 2015.

We are confident in our continued ability to win with our best-in-class portfolio that addresses the most predominant customer needs, our track record of innovation, and our enterprise relationships. We are also confident that our strategy and financial performance will translate into shareholder returns. We will continue to drive operating leverage in our business model to support continued investment in innovation and future growth.

I'd like to thank the entire NetApp team for their continued dedication in helping our customers realize their goals while maintaining a high level of operational discipline.

At this point, we will open up the call for Q&A. As always, I ask for you to be respectful of your peers on the call and limit yourself to one question so we can address as many people as possible. Thank you. Operator?

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from Brian Marshall with ISI. Your line is open.

Brian Marshall
Analyst, International Strategy & Investment Group LLC

Q

Great. Thanks, guys, nice quarter, question with respect to FlashRay. Could we get a quick update there on what we're expecting for a back half of the year launch event? It's been over a year since you've made any material acquisitions. I was wondering. Is that reflective of your thought about just being devoid of any innovation on the private company landscape within storage? Do you want to tackle more like FlashRay and build from the ground up going forward? Thanks.

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

A

Okay, first two questions. And as far as FlashRay is concerned, we've been saying for quite some time that that's a this-year product, and we'll actually see customer shipments of that product in fact next month, so really no change from what we've been saying all along and continued progress there.

And in addition to FlashRay, obviously the EF momentum continues to be strong. And we also did our all-flash FAS announcement last quarter. In terms of fleshing out the total portfolio for the different use cases we see, I think we feel really good about the flash portfolio. And we think flash, as we said all along, will live in many incarnations, in hybrid storage, as standalone devices. The compelling component of all-flash FAS is not even an all-flash FAS, it's an all-flash node in a broader cluster leveraging all the data management and the transparent volume migration that comes with it.

I think overall, to answer your flash question, FlashRay is on the way. It has a set of use cases that it's targeted at. I think we're still very, very excited about that. We're excited to get that in the market. Certainly we've had a lot of dialogue with customers and we've had early machines in customers' hands. But the total flash portfolio I think certainly has been a key component of our momentum.

As far as the acquisition side, I wouldn't read anything into the situation. I think we're always looking for substantive acquisitions that are going to be meaningful to fill either gaps or opportunities in our product line, and you should expect to see us continue to do that. As far as larger transactions are concerned, those will be entirely asynchronous. They're going to be functions of timing, availability, cost, executability, so I wouldn't basically signal any fundamental transition or thought or planning around large transactions. But smaller transactions should be somewhat on a regular cadence, and you should expect to see us do that, so certainly no change in our posture on either of those fronts.

Brian Marshall
Analyst, International Strategy & Investment Group LLC

Q

Thanks, Tom.

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

Louis R. Miscioscia
Analyst, CLSA Americas LLC

Q

Okay, great. Maybe it's a bit tied, two questions together.

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

A

I'd rather you didn't.

Louis R. Miscioscia
Analyst, CLSA Americas LLC

Q

Okay. So when I look at the OEM revenue, I thought that that came in a little bit higher than expected and the branded came in a little bit lower. And I realize you reiterated your guidance for the full year for the brand as hitting double digits – excuse me, hitting midpoint, let's say 5% type of growth. If it doesn't hit that, would you consider trying to reduce some of your OpEx, which is a bit higher than some of your competitors?

Nicholas R. Noviello
Chief Financial Officer & Executive Vice President, NetApp, Inc.

A

Lou, it's Nick. Let me start on that one. Tom may have some comments as well. So the indication on OEM was it was going be up to 40% decline, and the discussion on OEM was for the year. And as the business declines, it's going to be dynamic. We've seen some and you all have seen some announcements with respect to N-Series that's going be effective this quarter. So as we decline through pieces, calling a specific by quarter is going to be complicated, and we're not going to do it. And we've talked about an up to 40% for the year decline. I think we're still consistent with that, and that's reflected in my comments.

And the branded revenue growth, the discussion was mid-single digit. You saw branded revenue growth, and I think that accelerates over the course of the year, really consistent with our view at Financial Analyst Day, consistent with what we said in the fourth quarter, so I don't think there's any net change here.

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

A

We moved from a negative position last quarter into a growth position this quarter, so I think that that's a start, the march as we expect to build as the year progresses.

As I think about the year and as it plays out in terms of where we're going to get continued growth, certainly the compares on the federal side of the house get a little bit easier in the second half of the year. And if I think about where we are today and things that are coming to market for where we are a year ago, whether it be clustered ONTAP in production. We had a very strong E-Series quarter, OnCommand inside our software portfolio. Flash, we just refreshed all the platforms. We laid out our cloud strategy. So I see a number of stimulants to our business that were not available to us a little over a year ago, even six months ago.

As far as the broader question about operating expense, we're sized to our plan for this year, and we're off to a good start. So certainly if there's a major reversal to that, we'll have to change our plan, just like always, but I think we're on track, and that's not top of mind right now. Right now it's making the investments necessary to continue to fuel the growth, and so in no way defensive about our OpEx spending at this point in time. We have a plan, and we are executing to it. We haven't made any changes to it.

Louis R. Miscioscia
Analyst, CLSA Americas LLC

Q

Okay, thank you.

Operator: Your next question comes from Brian White with Cantor Fitzgerald. Your line is open. Brian White, please check your mute button. Your line is open.

Brian J. White
Analyst, Cantor Fitzgerald Securities

Q

Tom, I'm wondering if you could just walk us around the world in terms of the trends you're seeing by geography. It looks like EMEA outperformed APAC and Americas, so maybe some color there. Just what are you seeing on emerging markets? Some companies are seeing weakening again. Some aren't. So I'm just curious of emerging markets also, thanks.

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

A

I think [ph] energy (26:30) I'll break down. There's a couple elements. Obviously, it includes some of our OEM business, which distorts the number to some degree, and then also timing of revenue relative to bookings. I'd say if you think about it from a bookings perspective, which is a little bit more current, EMEA carried us and actually did a really good job last year. But I'd say that the biggest thing that we saw last quarter that was different is we saw strength back in the enterprise. We saw larger big deals, particularly U.S. enterprise, and for a variety of factors. But it felt like it's been improving for the last six months, whether it's maturity of clustered ONTAP and adoption of the technology or macro in nature. But I'd say from where we stand today from six months ago, clearly the return of enterprise spending is probably the biggest notable change, and we see that across the board.

So in terms of activity levels, the U.S., both commercial and public sector were probably the stronger areas this quarter, which is probably unlike last year. But around the world, EMEA is still after a pretty good year. I think they continued along at that pace but not quite as good as the U.S. and the public sector.

To your question on emerging markets, one thing is that we're not as penetrated and equally invested in all of the emerging markets. But the two where we've made significant investments are clearly India, where we have a big infrastructure. That has actually seen some momentum in the last six months, so we're actually pleased about the progress there. And China was also in the plus category for us. There are other segments. Brazil and Russia have other complexity to them, but those are not major contributors to NetApp at this point in time. So I don't think I've got any real relevant macro commentary there given our market share. But China and India still are contributors to us, and we're positive about that. And probably the biggest difference we saw last quarter and the end of the prior quarter was probably a rebound in enterprise spending in the U.S.

Brian J. White
Analyst, Cantor Fitzgerald Securities

Q

Great, thank you.

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

Andrew J. Nowinski
Analyst, Piper Jaffray & Co (Broker)

Q

Good afternoon, thanks for taking the question. So I just wanted to ask you a question on clustered ONTAP. It's ramping nicely, and you're seeing a big attach rate across all of your platforms. I guess can you give us any insight on what improvements are coming with 8.3? And then based on the new features that customers are asking for, how much of an impact do you think it will have on your win rates against the competition?

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

A

I'll talk about 8.3 in a second. But I think overall, the ramp of clustered ONTAP has been pretty gratifying. I think in the early days of the ramp, it is primarily brand new to NetApp accounts, moving into new workloads in existing accounts. And now it's becoming clearly a lot more mainstream in our larger accounts and the predominant selling motion by our sales force, so I think the rep has been quite good. A year ago we were talking about feature parity. And you know what, you get in 7-Mode in clustered ONTAP, we're not having nearly that much of a conversation at this point in time. And on top of that, the transition tools that were in the 8.2 release are being widely deployed and helping customers make the transition from 7-Mode to clustered ONTAP as well.

So 8.3 has got things like MetroCluster. It's got a whole bunch of other performance enhancements. MetroCluster is a product that we use for high availability and disaster recovery. It allows us to compete with recovery times that are basically superior to all of our competitors, including the frame arrays, and it's something that we use to basically sell to enterprise accounts. It's a clear differentiator for us and this will not necessarily be the MetroCluster of clustered ONTAP. It will actually be a brand new set of functionality that will deliver that capability and a lot more. So that's probably the big payload component of 8.3.

We probably do have some customers waiting for it. But we're certainly not in a category we were a year ago where we had a substantial amount of our customer base waiting for feature parity before they moved forward. I think for the vast majority of our customer base, certainly on a unit basis, those days are past and the migration has begun.

Andrew J. Nowinski
Analyst, Piper Jaffray & Co (Broker)

Q

All right, great. Thanks a lot, guys.

Operator: Your next question comes from Ben Reitzes with Barclays. Your line is open.

Benjamin Reitzes
Analyst, Barclays Capital, Inc.

Q

Can you just talk a little bit more about your comment about the pickup in enterprise spending? What in particular did you see? Did you see some more excitement with regard to your new products, or what were you really getting at there and the sustainability of what you're seeing in the U.S.?

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

A

I think first and foremost, I think the message is size of deals. We saw a pickup in $1 million-plus deals in Q1, which is generally not the quarter we do that. And we saw it in our enterprise accounts. We saw it in a fair number of service providers, big investments in the service providers; and as we indicated in the earnings call script, a lot of customers that are both enterprise consumers of technology and also service providers themselves. So we've seen it really in those two categories.

I wouldn't allot it to any individual industry. I'd say most industries are – there are some clear aggressive buyers. Even financial services has had some good aggressive buyers and a lot of people that are pulling back at the same time. So I wouldn't say it's universal, but I'd say probably the biggest indicator of confidence in the future is large transactions and also enterprise license agreements, which is once again a long-term commitment to NetApp they're willing to make up front. So I think that momentum is heartening. Obviously, it's early to tell. It's not ready to call a trend. So we've certainly seen more of that in the last four months than we've seen in quite a while. And enterprise and the cloud service providers, enterprise is where the money is, cloud service provider is where the growth is, and it's good to see momentum in both of those and certainly interest in the technology.

Now that said, independent of just deal size and what appears to be more availability of budget, we are certainly seeing a broader range of our products being sold into these accounts. E-Series brand had another very, very strong quarter. In fact, it almost overpowered Q4 to Q1 seasonality. So that's up substantially year over year. OnCommand Insight, which is a portfolio of products that we acquired and integrated over the years, had some very, very large transactions, a $9 million transaction at a major energy company, so we're seeing momentum with that too. Big push that we've been telling our team is that in these enterprise accounts, we need to be selling the entire portfolio because we have compelling solutions there. So that's been a big push over the last six months. So we're certainly seeing that.

To your second point, I certainly think that the strength of the portfolio and the breadth of the portfolio is giving us more selling opportunities into those accounts. But that said, the broader trend of larger transactions and longer-term commitments is gratifying as well, and I think that's independent of the portfolio.

Benjamin Reitzes
Analyst, Barclays Capital, Inc.

Q

Thank you.

Operator: Your next question comes from Amit Daryanani with RBC Capital Markets. Your line is open.

Amit Daryanani
Analyst, RBC Capital Markets LLC

Q

Good afternoon, guys. I was just hoping you could talk a little bit when it comes to your October quarter guide, specifically how you're thinking about the public sector tracking end of the quarter. I think historically that business, that segment has been up 40% – 45% for you guys on a sequential basis. Do you expect a comparable level of growth going forward in this half of the quarter, or do you have a different set of expectations there?

Nicholas R. Noviello
Chief Financial Officer & Executive Vice President, NetApp, Inc.

A

Sure, Amit. It's Nick. We are going to expect a sequential increase in the business for sure. But as you know, over the last couple of years here, we've moved through sequestration. We've moved through a shutdown. We've moved through a variety of things that have obviously impacted the end result of the U.S. public sector. So we have, just like every quarter, really started with a bottom-up forecast of the business, including in the U.S. public sector. We expect a sequential increase. We're not calling a specific percentage for that. I wouldn't want to do that on this call. It's built into the guidance we've given you. And we look at that just like we look at the Americas commercial, just like we look at the things Tom talked about in terms of enterprise buyers and large transactions, so all of that is built in. Again, we expect a sequential increase for sure. We've got a little bit more budget clarity here for sure. We at least hope we don't see a shutdown. There's nothing like that on our horizon right now, but that's all built in.

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

A

I'd just echo Nick's comments about more budget clarity. Last year we were finishing a fiscal year which the sequester was in effect and then transitioning into a period where the government could conceivably get and ultimately did get shut down, both of which happened within our quarter. I'd say that where we are now, it isn't that we've seen a massive reflexive bounce-back in spending, but there's a lot more budget certainty. So I think we have a little bit better understanding that the end of the fiscal year dynamics of the government will be more reminiscent of prior years than last year, and that's baked into the guidance that we gave going forward.

Amit Daryanani
Analyst, RBC Capital Markets LLC

Q

That's helpful. Thanks a lot and congrats on the quarter, guys.

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

A

Thank you.

Nicholas R. Noviello
Chief Financial Officer & Executive Vice President, NetApp, Inc.

A

Thank you.

Operator: Your next question comes from Mark Kelleher with D.A. Davidson. Your line is open.

Mark D. Kelleher
Analyst, D. A. Davidson & Co.

Q

Thanks for taking the question. Most of mine have been asked and answered. I was just wondering if you might give us an update on the Amazon partnership. I know you talked a little bit about cloud, but I don't know if you could talk a little bit more about that one specifically.

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

A

I think we're looking to do a number of things both in terms of partnering and as a leverage of their infrastructure. But one of the things that we're clearly doing with NetApp Private Storage [NPS], and the concept of NetApp Private Storage is that the data will reside on the customer's network, likely at a co-lo facility but connected to the customer's network, and have access through a set of technologies that give them high-bandwidth access to the compute farms.

And the long and the short of it is for an Amazon Web Services type of analogy, what the customer can do is maintain control and data stewardship of their data, yet have access to the elastic compute and the ability to have instant access to a very, very large server farm and likewise downsize it at the same time, and basically have all the benefits and the flexibility of the elastic compute of Amazon without having to have any of the concerns about security and data ownership. So they maintain control of their data and have access to the flexible compute and get substantial value of the flexibility that the hyperscalers could provide at a fraction of the risk.

What we've done this past quarter is that we've actually added Azure to that mix. And as a result, they can do the same thing with Azure. At our Analyst Day that we did this year with our industry analysts, we demonstrated the ability to interoperate between the two and basically run an application in one, sail it over and operate it in the other. And the value of that and the extension of the NPS vision, which initially was really about data stewardship and access to flexible compute, is now really about multi-cloud. Now, I can effectively have a legitimate multi-cloud strategy that I can have resources available to me from Amazon. I can have resources available to me from Microsoft. And if I hold the data, then I can truly broker the multi-cloud environment for our customers.

That's really where we're heading with the NetApp Private Storage is the idea of multi-cloud. Our customers are not giving control of their data and therefore being locked into a specific cloud provider. They can have access to the flexible computing network and have multiple players, yet they still own their data and they still have all of have data stewardship, all the data responsibility, and all the security protection that they would have as if it was on their own infrastructure. So that's really the vision of NetApp Private Storage, access to flexible compute and the flexibility and the economics of the server and networking that that provides, yet maintain control of their storage without subjecting themselves to any of the intellectual property and security risk.

So that's really where we're going with that. I think it has really significant value to enterprises. There are a lot of customers for whom the appeal of maintaining control of their data, whether it be for flexibility or cloud mobility, has tremendous value to them, but they also want the elasticity of the compute models that Microsoft and Amazon and an ever-increasing set of other cloud providers can ultimately provision for them. That's really the play there, is how do we bring the cloud as a resource to bear with its economics and its flexibility, and how do we make that consumable by the enterprise in a seamless and secure fashion that they can make it an integral part of their overall operating environment.

Mark D. Kelleher
Analyst, D. A. Davidson & Co.

Q

Okay, thanks.

Operator: Your next question comes from Katy Huberty with Morgan Stanley. Your line is open. Katy Huberty, please check your mute button.

Kathryn Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Tom, can you help us reconcile the commentary on more large deals and just an overall better enterprise and service provider spending environment with still low single-digit growth in the branded business? And does enterprise and service provider strength come at the expense of deals through the channel given the indirect mix decrease for the first time since 2008 this quarter?

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

A

I think there are a couple of points there. I think one of the other outlets for the renewed activity that we see – like I said, the bookings and the revenue have a certain time lag to them, and one of the areas where a lot that will go is into the deferred balance. We actually saw deferred revenue increase $135 million year over year. Some of the things that we do, I talked about the large transaction we did in OnCommand. That's entirely a ratable deal for us. That's entirely in the deferred balance and not recognized in this particular quarter. And a lot of the longer-term transactions we're doing with our partners, whether it be enterprise license agreements or enterprise service agreements, those are also ratable over time.

So some of the manifestation of increased momentum would be in revenue growth, and the branded improved a bit from last quarter but admittedly slowly, 1%. On the other hand, we're also seeing a big increase in the deferred balance, which is another place where some of that business activity will ultimately lie. And that will come back through the revenue line over time, of course. And the other question was?

Nicholas R. Noviello
Chief Financial Officer & Executive Vice President, NetApp, Inc.

A

I think your question was on...

Kathryn Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Should we expect indirect declines of your business...

Nicholas R. Noviello
Chief Financial Officer & Executive Vice President, NetApp, Inc.

A

Oh, the indirects.

Kathryn Huberty
Analyst, Morgan Stanley & Co. LLC

Q

...through service providers.

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

A

I think two things on the indirect, one of which is in the indirect number is the OEM business. And if you back the OEM business out, the percentage of our business through the channel in Q1 this quarter was actually higher than it was each of the last three years. But that said, with the enterprise business, some of that enterprise business does flow through our more sophisticated and larger channels partners, and some of it does not. So I think that as we do more enterprise business, the likelihood that some of that will flow through some of our purely direct channels is higher. And as a result, that will also take the number down.

So it's not a consequence of any strategy that we've made or any change of investment, at least not in the near term. It's more just that we see more of the enterprises. The enterprises are more likely to be direct than the midsize business. As a result, we see some variability, but overall no change of strategy. And even on a Q1-to-Q1 compare over the last three years, we still saw channel as a greater percentage of the mix than any of those prior years.

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

Aaron C. Rakers
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Thanks for taking the question. I'd like to go back to the opportunity with Data ONTAP and cluster mode capabilities. With now having a full refreshed product family in your portfolio, is there any quantitative context you can provide with regard to how much of your installed base is running cluster mode today, what the age of that installed base looks like? What I'm really trying to get at is what the upgrade cycle, how you're thinking about that opportunity over the next several quarters.

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

A

I think it's safe to assume that the installed base, which has been assembled over a very long period of time, is still primarily 7-Mode, and some of that will stay. Some of our customers will stay in 7-Mode and just put new applications in clustered ONTAP. I think it varies across the board.

I think what we see in general is that most of the upgrade activity to clustered ONTAP also comes in conjunction with a hardware upgrade, so they don't do the transition twice. And when there's a significant gap in time between when they believe they'll be able to go live with clustered ONTAP, they're more likely to basically do a hardware upgrade now and then basically waiting time. But the closer they get together, they would love to do the hardware upgrade and the software upgrade at the same time.

And I think that's some of what we've been seeing over the last six months is that customers have evaluated the product. They've tested it. It has the feature set that they need. They've proven it in their lab. And now, particularly with the hardware refresh, they can go ahead do a hardware refresh in their environment and do the upgrade at the same time. If they were not confident in clustered ONTAP, then I suspect they would be deferring hardware purchases. So I don't think we're completely through that cycle, and it's not a concern anymore. But I certainly believe that waiting for the release of clustered ONTAP that they could actually run in production, delaying hardware purchases, while I still think there's some of that, I think that that has been diminished over the last six months.

Operator: Our next question comes from Jayson Noland with Robert Baird. Your line is open.

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

Q

Great, thank you. Tom, I wanted to ask about FlexPod, strong again, and we hear good things from the channel. We're seeing more converged solutions and hearing more about [ph] hyper (44:40) converged. FlexPod is likely a material percentage of revenue now. Is there still innovation that can be done there, and is the growth rate sustainable?

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

A

The answer to both those questions is yes. And we've got a long line of things around innovation, particularly around some of the value proposition of clustered ONTAP and translating that to the entire FlexPod, whether it be non-disruptive operations or scalability. All of those types of things I think are all really, really big important plays for us. It takes FlexPod actually even further up market into more mission-critical applications, so I think we clearly see a lot of strength there.

We've also seen integration of FlexPod with E-Series now. So basically target a different set of workloads. And obviously, some joint development activity around newer technologies like OpenStack that is strategic to both of us, particularly in the service provider space. So I think there's no end – certainly no near-term end of innovation that we can be doing together to basically drive this business forward, and that is only on the product side.

There's also go-to-market side in terms of positioning the products, better alignment of our partners, more global deployment of this technology. So in my interaction with Cisco and my interaction with John Chambers, there's no congratulation here. The question is how do we take the business to the next level and continue to generate growth for both of us. This is a meaningful business for us. Even at their scale, it's a meaningful business for them.

They've made that abundantly clear to us. And as a result, doubling the business from here over some timeframe is meaningful for both of us. Those are the types of things that we're trying to talk about, and those are the types of things we're trying to get into the budget that's planned and moving forward. So yes, I don't think there's any letup on FlexPod. Certainly I don't think that we've reached terminal velocity of that product by any means.

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

Q

I appreciate the color, Tom.

Operator: Your next question comes from Maynard Um with Wells Fargo. Your line is open.

Maynard J. Um
Analyst, Wells Fargo Securities LLC

Q

Hi, thank you. Looking at your free cash flow as a percentage of sales, it's about 10.5%. Q1 is usually seasonally low. So presumably, you're on track to that 17% to 19% target. But when you look at what's happening now in the ELA cycle helping the deferred revenues, are you just being conservative on that ratio for the year, or do you think you can get to the low 20s% like you have in the past? Can you just walk us through some of the dynamics to those numbers? Thanks.

Nicholas R. Noviello
Chief Financial Officer & Executive Vice President, NetApp, Inc.

A

Hi, Maynard. It's Nick. I think first of all, I would say the guidance for the year and the discussion in that high-teens type of level stands. It's the first quarter. We have a lot of pieces of the business. We talk about the dynamics of the business for the rest of the year, how we've maintained guidance at this point in time. Sure, there's a difference in terms of Q1 versus Q1 last year in terms of free cash flow as a percentage of revenue. There's a couple of points, and I made those points in the script on those. But this is a strong cash generating company, and we continue to do quite well there. That is built into the guidance, and I think our expectations remain consistent at this point in time, no net change. Obviously as things or if things do change, we'll give you that point of view when it's necessary.

Maynard J. Um
Analyst, Wells Fargo Securities LLC

Q

I guess the real question was just if the deferred revenues are increasing because of the ELAs, I guess what are the offsetting items that are not allowing that deferred revenue to drive that cash flow to a greater level this year?

Nicholas R. Noviello
Chief Financial Officer & Executive Vice President, NetApp, Inc.

A

So just in Q1, as an example, so on a year-over-year basis, the cash is that deferred revenue is up $135 million. That is better than we've done in the past. The sequential decline is less. We'll have to look at all those pieces. ELAs are not an occurrence that is happening every day in every form. There are elements of this business model as it grows. And as we look at different business models and sell those, all of those will be built into our guide over time, but they're emerging. So these are pieces of business that deferred revenues for the company are over $3 billion.

So in terms of moving the needle on free cash flow as a percentage of revenue and that type of number, that's going to be – it's not an immediate light switch. One way of 20% or another way of 20% is the way I'd look at it. And as things change over time, we'll certainly give you that guidance over time. The net is strong cash flow generating company; it's going to continue that way. And the ELAs, how we sell business, we're going be thinking about the cash generating side as well along the way.

Maynard J. Um
Analyst, Wells Fargo Securities LLC

Q

Great, thank you.

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

A

And specifically for Q1, I think I wouldn't put Q1 as a trend. Clearly, we had bonuses that were paid in Q1. And I think thanks to our employees, the numbers were higher than last year, so that's a compare. We had a tax settlement. We had a few other things that were out there. But I think the long-term cash generation of the business, particularly when you add in the higher gross margin and the higher operating margin, I think still remains very, very robust.

Operator: Your next question comes from Jim Suva with Citi. Your line is open.

Jim Suva
Analyst, Citigroup Global Markets Inc. (Broker)

Q

Thank you and congratulations to you and your team there. My question is concerning gross margins. It looks like you had much better than expected gross margins, so congratulations on that. And if I recall back at your Investor Day in June, you were implying or stated that gross margins for the year should be 63% to 64%. So can you help me understand the cause behind the beat and the solid guide and how I bridge that with your full-year guidance of 63% to 64%? It looks like we're actually tracking quite a bit above that gross margin goal for this year. Thank you.

Nicholas R. Noviello
Chief Financial Officer & Executive Vice President, NetApp, Inc.

A

Sure, Jim, it's Nick. So yes, certainly we gave that 63% to 64% guide for the year. The two pieces here, and I talked about it a little bit in the scripted comments, are on the product gross margin and the services gross margin. So each of them has a couple of different pieces to it, and let me walk you through it.

So on the product gross margin, I talked about product mix. I talked about supply chain savings, and I talked about warranty. Now those things can move around. And in fact, in past quarters what I've indicated on the supply chain savings is we generally realize it or recognize it. And then we pass some of it through or a lot of it through depending upon what it is. If it's on commodities, we pass it straight through to customers. And there will be a timing difference between the time we update the price list versus sometimes when we recognize the save. Okay, so that's something that will move. So if you were to say hey, Nick, at this point in time product gross margin should just continue to go up, that's not necessarily – I wouldn't necessarily agree with that because we have to look at the timing of the pass-through of items, the type of business we're doing, and blend that all together on product gross margins.

On service gross margins, a little bit of a different set of statistics going on. Number one is we have to look at service revenues and what types of service revenues those are and if those are hardware maintenance contract revenues or if those are professional services revenues. Those have different margin profiles associated with them. And the other thing on services that we have to look at and we talked about from time to time is investments in the services infrastructure because in Q1 versus Q4, I would look at the performance here as a bit of leveraging the expense base of the structure that's there. But as we look at installed base and installed base growth, remember, we invest ahead of it to make sure that we are fully capable of servicing that installed base as it comes to fruition. So yes, benefits on gross margin here in the first quarter of the year, we feel very good about that. We're going continue pushing on all of those levers. But we're not changing that full-year view because on the product side of the fence, the pass-throughs, sometimes the competitiveness we want to put into transactions or the services side on the investments in the infrastructure, those things can change, and we will run those levers over the course of the year.

Jim Suva
Analyst, Citigroup Global Markets Inc. (Broker)

Q

Congratulations again, got it.

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

A

Thank you. The one thing I want to add on the gross margin side is Nick talked about the savings. I think the team, we've talked a lot about products and go-to-market, but I think the team has done a remarkable job operationally to really drive efficiencies into our supply chain. We realized that benefit last year. We're looking to drive it this year.

The other thing I wouldn't underestimate is I don't think it's any coincidence that the gross margins have improved as the value proposition of clustered ONTAP became better understood by our sales force and our customers. The industry is littered with companies that are talking about declining gross margins. And NetApp is at the highest gross margins in our history and up three points year over year, so I think we feel really, really good about that.

Now on the other hand, we also reserve the right to use that gross margin advantage to create opportunities for ourselves where we see them, whether it be new markets or new accounts or new opportunities. So that's also factored into this, is that if we believe there's an opportunity, not to broadly lose discipline on discounting because we certainly don't want to do that. But for strategic markets or strategic accounts, we're certainly willing to be very, very aggressive with the product line.

So I'm really pleased operationally. I think we've done really, really strong things there. But I think it's a validation of the value proposition in particular that our margins are increasing while others are decreasing. But we also reserve the right to use that for competitive advantage in the right circumstances.

Jim Suva
Analyst, Citigroup Global Markets Inc. (Broker)

Q

Great, congratulations again.

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

A

Thanks.

Operator: Our last question comes from Steve Milunovich with UBS. Your line is open.

Steven M. Milunovich
Analyst, UBS Securities LLC

Q

Thanks. I wonder if you know what percentage of your capacity shipped today is flash and what impact that has on margin as it increases.

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

A

Steve, I don't have that off the top of my head. I do know that our capacity increased 23% year over year in the aggregate. And flash is a greater percentage than it's been in the past, not surprisingly. Although we ship flash in many incarnations, that's disk capacity. We also ship flash as plug-in cards as a caching product.

In terms of overall gross margin, I can't imagine it has a material impact at this point in time, and we ship it in various points. So I would not make the claim that flash overall is either driving the gross margins up or taking it down. But at the end of the day, flash as a capacity driver is not the biggest one. Clearly if customers are looking for capacity, they're going go to hard drives. So flash is primarily a performance driver. So the likelihood that's going to be a very large percentage of our revenue at any point in time I think is pretty low.

I just don't think that's what the data center looks like. Flash is going to accelerate low-latency high-performance workloads. And as a result, it will be optimized for that. But the economics of it are such that it will always be cheaper to store less critical, less active data on solid-state drives. I think the challenge and the ultimate value-add to be provided to the enterprise is a company that can actually manage that migration over the data life cycle, to put the most important data on flash and everything else on hard drives, recognizing that over time the active data becomes idle and there's new active data that needs to be stored, and that's a key part of our value-add.

So a long answer to your question is I don't expect flash to be a meaningful or a very large percent of our overall capacity, even though it's growing very, very quickly. And not all of our flash is going to be in the form of hard drives. Some of it will also be in the form of plug-in boards because I think that flash and all of its substantiations are going to matter to the enterprise, and we intend to do all of them.

Steven M. Milunovich
Analyst, UBS Securities LLC

Q

Thanks.

Operator: This ends our Q&A session today. I'll turn it back to management for closing remarks.

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

So first of all, thank you for your interest in NetApp. I think we're pleased with the outcome of the quarter coming in above where we thought we would on the guidance and obviously very, very strong on the EPS and the profitability side. Gross margin is at an all-time high and very, very strong operating margin in roughly flat environments still generating a point of operating margin leverage.

So I think we see clearly momentum around clustered ONTAP, around our branded E-Series, around OnCommand. This past quarter we spent a fair amount of time with industry analysts and financial analysts and customers. In found myself particularly talking about our cloud strategy and where we go from here.

I think our ability to win and gain share in the market as it exists today I think is very, very strong. I think we've reinvigorated our core offerings when I think a lot of the core offerings of our competitors are languishing. But more than today, we've also talked about where we're going in the future, how we're going to help customers get from where they are today to where they want to go, particularly in integrating the cloud and how NetApp is going to continue to be relevant and a leader and an attractive opportunity going forward. So thanks again for your time and see you again in 90 days.

Operator: Ladies and gentlemen, thanks for participating in today's program. This concludes the program. You may all disconnect.