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NetApp, Inc. (NTAP)

Q2 2017 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the NetApp Second Quarter Fiscal Year 2017 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 follow at that time. [Operator Instructions] As a reminder, this call may be recorded.

I would now like to introduce your host for today's conference, Kris Newton, Vice President, Corporate Communications and Investor Relations. You may begin.

Kris Newton

Vice President - Investor Relations, NetApp, Inc.

Hello and thank you for joining us on our Q2 fiscal year 2017 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, along with the earnings release, our financial tables and guidance, a historical supplemental data table, and the non-GAAP to GAAP reconciliation.

As a reminder, during today's call, we will make forward-looking statements and projections with respect to our financial outlook and future prospects, such as our guidance for the third quarter, our expectations regarding future revenue growth and improved profitability, including cash flow and shareholder returns, 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 the macroeconomic and IT spending environments, our ability to successfully pivot to the growth areas of the market, to gain market share, to expand our operating margin, to reduce our cost structure, and to continue our capital allocation strategy.

Please also refer to the documents we file from time to time with the SEC, specifically our most recent Forms 10-Q, our Form 10-K for fiscal year 2016, and our current reports on Form 8-K, all of which can also be found on our website.

During the call, all financial measures presented will be non-GAAP, unless otherwise indicated.

I'll now turn the call over to George.

George Kurian

Chief Executive Officer and President, NetApp, Inc.

Thanks, Kris. Good afternoon, everyone. Thank you for joining us.

Our focus and disciplined execution again yielded solid results on the top and bottom lines. Our second quarter fiscal year 2017 revenue was at the midpoint of our prior guidance range, with both operating margin and earnings per share above our previous guidance; and we expanded our innovation in our industry-leading flash and hybrid cloud solutions during the quarter. These results are clear evidence of our ability to execute while we streamline the business and pivot to the growth areas of the market.

As you've heard from us before, we have three priorities to deliver on our commitment to return the company to revenue growth, with improved profitability, cash flow, and shareholder returns. First, we are executing our Data Fabric strategy and delivering the strategic solutions that create the foundation for how we enable customer success.

Second, we are permanently lowering our cost structure and streamlining operations, while maintaining our ability to innovate.

And third, we are continuing our robust capital allocation program, which includes a mix of share buybacks, dividends, and investment for the long-term growth of the business.

I'll begin with an update on our first priority. Our strategic solutions are aligned to our customers' top IT imperatives and position us to lead in the new era of IT. In Q2, strategic solutions comprised 62% of net product revenue. Growth was relatively flat against a tough compare in Q2 fiscal year 2016, but grew 10% sequentially; an indication that we continue to gain traction in customer environments.

Net product revenue from our mature solutions declined at 29% year-over-year. We expect that over the course of this fiscal year, the headwinds from mature solutions will lessen, allowing the growth of the strategic solutions to return the company to moderated revenue growth in fiscal year 2018. As you saw in the Q3 guidance included in our press release, we expect this shift to begin delivering growth in the second half of this fiscal year.

Much like us, our customers need to drive efficiency in the mature parts of their businesses, while adding flexibility to capture new business opportunities, out-execute the competition, and grow revenue.

To achieve this, they're transforming IT, modernizing their data centers so that they can lower costs, increase agility, get more value from their data and integrate cloud resources with on-premises environments. As customers modernize their infrastructures, they are replacing stand-alone silos of storage and monolithic frame arrays with scale-out, software-defined shared storage platforms.

Clustered ONTAP enables seamless enterprise data management across flash, disk, and public and private cloud environments. With clustered ONTAP, IT organizations can consolidate multiple workloads into a single repository, dramatically improving the efficiency of their enterprise storage infrastructure. We continue to see strong customer demand and are gaining new customers and migrating existing customers to clustered ONTAP.

Clustered ONTAP was deployed on 86% of FAS systems shipped in Q2, up from roughly 70% a year ago. Unit shipments of clustered ONTAP systems grew 14% year-over-year. The installed base of FAS systems continues to grow, and clustered ONTAP is now running on approximately 36% of systems in that large and growing installed base.

At the beginning of the fiscal year, we introduced ONTAP 9, which unifies data management across flash, disk and cloud, bridging current enterprise workloads and new emerging applications. The initial customer feedback has been tremendously positive.

In the first four months since its release, ONTAP 9 has had the highest adoption rate of any of our major ONTAP introductions. In Q2, we expanded the innovation of ONTAP 9 with built-in multi-tenant capable encryption for improved data security, support for massively scalable high-performance NAS containers, and greatly simplified provisioning and operations for enterprise applications.

To gain advantage through greater speed and responsiveness from key business applications, while substantially lowering total cost of ownership, customers are leveraging flash technology as part of their IT transformations. Flash is being used for a wide range of workloads and becoming the mainstream choice for on-premises deployments, requiring that all-flash arrays deliver enterprise-grade data management capabilities.

NetApp is leading the industry in the transition to flash, with our highly differentiated portfolio of all-flash arrays, which provide customers with unrivaled scale, speed, and data services. Gartner recognized NetApp as the leader in its Magic Quadrant for solid-state arrays. IDC ranks NetApp number two in the all-flash array market, with our growth outpacing that of the market and our peers. We expect to gain share again this quarter.

In the second quarter, our all-flash array business tripled year-over-year to an annualized net revenue run rate of over $1 billion, inclusive of all-flash FAS, EF and SolidFire product and services. With flash moving from a point solution to a pervasive technology, we refreshed our portfolio of ONTAP-powered hybrid and all-flash arrays in Q2.

We also enhanced ONTAP Select to support flash from commodity servers. Our new hybrid array systems span the requirements of large enterprise data centers to small enterprises and mid-sized businesses, offer dramatically increased speed and responsiveness compared to our previous hybrid arrays, and scale up to 14 petabytes in a single system and out to 172 petabytes in a cluster.

Our new all-flash systems offer the industry's best data management features, with up to twice the performance of prior systems at half the latency and are designed for easy setup in less than 10 minutes.

Our new all-flash FAS systems are included in our flash promotion, which offers 3x guaranteed performance and a 4-to-1 guaranteed increase in storage efficiency over competitive disk arrays, as well as a risk-free upfront trial, free storage controller upgrade, and support extension to simplify ongoing operations.

The majority of our growth in the all-flash array market is driven by the all-flash FAS. Customers are deploying the all-flash FAS to improve existing infrastructure and processes, lower costs, and enhance flexibility.

A North American financial services company chose the all-flash FAS to create a modern alternative to their expensive legacy monolithic fiber channel SAN array from a competitor. Another North American financial services company replaced a competitor's NAS footprint with an all-flash FAS cluster connected to a disk-based cluster with SnapLock backup services to create a tiered cloud service model for its next-generation FAS services platform.

We're gaining new customers and new footprint at existing customers with our all-flash arrays. For the first half of calendar 2016, NetApp is the fastest growing SAN vendor, as measured by IDC, a clear indicator that we're moving outside of our traditional install base and expanding our market opportunity.

For enterprises and service providers who want to build multi-tenant public and private clouds, SolidFire delivers a Webscale style architecture for next-generation data centers. Through the expanded reach of NetApp, we're acquiring new customers, introducing SolidFire into existing NetApp accounts, and bringing NetApp solutions to SolidFire customers.

A global financial services company is moving to NetApp after years of preference for a competitor. They're building a next-generation data center environment to power the digitization of their services by deploying ONTAP as the storage infrastructure for their OpenStack environment, SolidFire for their IT DevOps environment, and StorageGRID Webscale for their third platform solutions and archiving.

Each of these products address unique requirements in the customer's environment, while delivering the performance and reliability needed for a global digital enterprise. SolidFire is a key area of focus and investment for the long-term growth of NetApp, and is performing to plan.

Customers are also leveraging the hybrid cloud in their IT transformations to capitalize on the value of their data. Our Data Fabric strategy enables data management that seamlessly connects disparate systems, software stacks, clouds, and data centers, allowing customers to architect the IT environment that best meets their needs utilizing a mix of flash, disk, and public and private cloud resources, all at the scale needed to accommodate the exponential data growth of the digital world.

Customers can innovate faster by leveraging the scale of on-demand cloud capabilities, while maintaining data visibility with a single consistent view of data and infrastructure across clouds and on-premises resources.

Earlier this month, we announced new Data Fabric solutions and services that maximize control and improve the secure movement of data across the hybrid cloud along with updated versions of AltaVault, StorageGRID Webscale, and SnapCenter technologies, to help customers extract the value of their data from anywhere in the hybrid cloud.

We expanded the use case for ONTAP Cloud to include Microsoft Azure and announced Cloud Control for Microsoft Office 365, a simple way to control and protect critical data stored in Office 365 with support for data retention in cloud services such as Amazon S3, and Azure, as well as on-premises storage.

Additionally, we introduced NetApp Private Storage as a service, an OpEx-based consumption model available through a growing partner delivery ecosystem. We're engaging with the broadest set of partners to help customers plan and evolve their hybrid cloud deployments to fit their changing business needs. And more and more customers and cloud service providers are choosing NetApp, because we enable their hybrid cloud strategies.

While Ron will go into depth about cost savings and capital allocation, I want to re-emphasize our commitment to both priorities. At the start of the third quarter, we announced a reduction in force as part of our planned transformation and cost reduction efforts. This action was taken in alignment with real structural changes to make our business more streamlined and agile.

We are making substantial progress against the $130 million cost reduction goal, net of reinvestment, that we outlined on our Q3 fiscal year 2016 earnings call. We are on target and expect to achieve the remainder of savings through the normal course of business.

I want to thank the NetApp team for remaining focused on execution, while making difficult restructuring decisions. We're pleased with our progress, but still have more work ahead of us. We're advancing our product and solutions portfolio, evolving our ecosystem of partners, streamlining our business processes, and enhancing our go-to-market model.

We've sharpened our focus, accelerated our innovation, and are funding the investments against the fastest-growing parts of the market, like all-flash arrays, next-generation data centers, and hybrid cloud solutions, while accelerating our ability to deliver shareholder value in the form of improved profitability and cash flow.

We're on track to return the company to long-term growth and to our target operating margin range, but we must remain focused and continue our disciplined execution. Our second quarter results and third quarter guidance are evidence that our strategy is working, and I am more confident than ever in the NetApp team's ability to successfully evolve the company for leadership in the data-powered digital era.

I'll now turn the call over to Ron to walk through our Q2 financial performance and expectations for Q3. Ron?

Ronald J. Pasek

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

Thanks, George, and good afternoon, everyone. As a reminder, we will be referring to non-GAAP numbers today.

As you heard from George, we continued to make significant progress toward our pivot to the growth areas of the market, while at the same time transforming the company. Q2 marks another quarter of solid execution, albeit against a difficult year-over-year compare.

Net revenues were at the midpoint of our guidance at $1.34 billion. This was an increase of approximately 3.5% sequentially and a decline of about 7% on a year-over-year basis. Product revenue of $710 million increased 7.5% sequentially, and declined 13% year-over-year. As we've discussed, we expect the growth of our strategic solutions to improve our product revenue growth trajectory over the course of fiscal 2017.

The combination of software maintenance and hardware maintenance and other services revenue of $630 million was relatively flat sequentially and year-over-year. Gross margin was 62.7% and within our guidance range. Product gross margin of 48.2% decreased about 3.5 points year-over-year, and increased 1.5 points sequentially. Software maintenance gross margin was relatively flat sequentially and year-over-year, while hardware maintenance and other services gross margin increased just over 3 points year-over-year.

Operating expenses of $636 million decreased 7% year-over-year and 2% sequentially, reflecting the benefit of our ongoing transformation efforts. Operating margin of 15.2% was above our guidance range, evidence of the progress we're making toward the operating margin range we guided for the year.

Aligning our cost structure with the opportunities ahead remains my top priority. As I said on our last earnings call, part of the planned transformation efforts would include additional steps to permanently lower our cost structure, including head count reductions.

As such, on November 3, we initiated a reduction of approximately 6% of our worldwide head count, which will result in a one-time charge of $50 million to $60 million, primarily in Q3 fiscal 2017. This action will yield an annual run rate savings of approximately $130 million.

As a reminder, we are driving to permanently reduce our cost structure across both cost of sales and OpEx. In Q3 2016, we announced our plan to reduce our cost structure by $400 million gross, annualized by the end of fiscal 2017. We said some of those savings will be reinvested into strategic opportunities, such as SolidFire, and will yield a net run rate savings annually of roughly $130 million by the end of fiscal 2017.

We have made meaningful progress against this plan by implementing tighter cost controls over indirect spending, improving supply chain efficiency, streamlining our product portfolio, evolving business processes, and reducing head count. Given the progress we've made to-date, we remain confident in our ability to achieve our goal on schedule.

Our effective tax rate for the quarter was 17.3%. Weighted average diluted shares outstanding were 284 million. EPS of $0.60 was $0.04 over the high end of our guidance range, reflecting improved gross margin, lower operating expense, and the benefit of our share repurchases.

Our cash and balance sheet metrics remain healthy. We closed Q2 with $4.4 billion in cash and short-term investments, with approximately 10% held by our domestic entities. We remain committed to completing, by the end of May 2018, the remaining balance of our share repurchase program announced in February 2015.

In Q2, we repurchased $117 million of our stock and paid approximately $52 million in cash dividends. Today, we also announced our next cash dividend of $0.19 per share, which will be paid on January 25, 2017, to shareholders of record as of the close of business on January 6, 2017.

Deferred and financed unearned services revenue was up 5% year-over-year, and down 3% sequentially. Q2 cash flow from operations was $158 million, up 9% year-over-year. We generated free cash flow of $102 million, an increase of about 3% year-over-year.

We are aggressively managing our working capital metrics, DSO, DPO, and days of inventory outstanding. DSO were flat year-over-year, while DPO increased by eight days, and days of inventory outstanding improved by three days. As a result, our cash conversion cycle was nine days, which was an improvement of 12 days year-over-year, but three days longer sequentially due to the seasonal increase in DSO.

Now, onto guidance. As we outlined today, our transformation efforts are resulting in a stronger, more focused, and agile company. We remain committed to driving productivity, while at the same time continuing to shift our investment and focus toward the growth areas of the market. We are increasingly encouraged by the early signs of progress that we're seeing. While we still have work to do, we remain confident in our ability to continue to execute against the plans we outlined for fiscal 2017 on our Q1 earnings call.

For Q3, we expect net revenues to range between $1.325 billion to $1.475 billion, which at the midpoint implies a sequential increase of approximately 4% and a 1% increase year-over-year. We expect Q3 gross margin in the range of 61.5% to 62.5%, and operating margin between 18% and 18.5%. And finally, we expect earnings per share for the third quarter to range from approximately $0.72 to $0.77 per share.

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

Kris Newton

Vice President - 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. Thank you for your cooperation. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of Jim Suva with Citi. Your line is now open.

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

Q

Thank you very much.

George, you'd mentioned the workforce realignment or changes, I believe, it was like in early November of this year. Can you just clarify – or earlier this month. Can you just clarify, is that incremental to prior rounds of restructuring?

And if so, are we at the point where you have now made all your announcements and done all your realignments? Or is this kind of like phase 2 or 3 and still more to come? Because your OpEx has really been quite impressive. I'm just trying to kind of measure of where you're at along that phase of going through that. Thank you very much.

George Kurian
Chief Executive Officer and President, NetApp, Inc.

A

Thanks, Jim. We announced a program to reduce the cost structure of the company permanently as part of our Q3 fiscal year 2016 earnings call, and we are making substantial progress against that. We took an action, as you can recall, in Q4 of fiscal 2016 to accelerate the pace of transformation. And we've taken a second action in November in alignment with the prior transformation efforts.

We took these actions in two steps to allow the business to make the structural changes necessary so that we can sustain the cost savings going forward. At this point, we have accomplished a substantial portion of the cost-savings activities, and we think that we can accomplish the remainder of the savings through the ongoing course of our business operations.

Kris Newton
Vice President - Investor Relations, NetApp, Inc.

A

Thanks, Jim. Next question?

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

Q

Thank you so much for the details. Thank you.

Operator: Our next question comes from the line of Brian White with Drexel. Your line is now open.

Brian J. White
Analyst, Drexel Hamilton LLC

Q

Hey, George. I'm wondering if you could talk a little bit about how the Dell-EMC combination has offered opportunities thus far. Kind of, what are you seeing out in the field right now? Thank you.

George Kurian
Chief Executive Officer and President, NetApp, Inc.

A

Dell and EMC continue to be a formidable competitor, and we compete with them in the broadest range of both customer and reseller opportunities. As I've communicated on the call, we are taking core customers from EMC, but because of the strength of our technology, both in solid-state, as well as next-generation data centers, and increasingly because of the relationships that we have with the hyperscale cloud providers.

They continue to compete aggressively. They're a formidable competitor, and we need to stay focused. But we do feel that in this transaction or this combination, we do see opportunities, both in terms of recruiting new channel partners, as well as winning customer footprints that are net new to NetApp.

Brian J. White
Analyst, Drexel Hamilton LLC

Q

Great. Thank you.

Kris Newton
Vice President - Investor Relations, NetApp, Inc.

A

Thanks, Brian. Next question?

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

Q

Hi, guys. This is [ph] Victor (27:19) in for Simon. I wanted to drill in on your all-flash products just a little bit. Some of the discussions that we've had with our checks in distributors suggested that the success of some of your competitors early on with all-flash was more attributed to timing. And the positive reception that they're seeing to NetApp solutions more recently implies that those customers may have preferred NetApp's offering all along, if it had been available at that time. So can you just comment to the degree that that's consistent with what you're seeing and kind of what that means for headroom in terms of improvements in share gains?

George Kurian
Chief Executive Officer and President, NetApp, Inc.

A

First of all, the market, as we said before, has transitioned from an early adopter market to a mainstream replacement of performance drives with solid-state arrays. In that transition, customers are looking for consistency in their business processes, risk management, as well as the maturity of the technology solutions.

And our solid-state portfolio, we feel, is the best positioned in the market, without question, because we combine state-of-the-art technology, efficiency, and scale-out architectures with the world's best data management features for enterprise data centers with all-flash FAS and for Webscale data centers with SolidFire. We have gained share in solid-state, and we continue to feel confident about our prospects going forward.

Kris Newton
Vice President - Investor Relations, NetApp, Inc.

A

Thanks, [ph] Victor (29:02). Next question, please?

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

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

Q

Okay, great. Thank you. Congrats on the quarter. I wanted to ask, George, on NVMe and cross-point and how important are these new technologies? What's the timing look like and how are you positioned? AFA is so strong recently. I'm wondering what this holds for us in F 2017 and in 2018?

George Kurian
Chief Executive Officer and President, NetApp, Inc.

A

I think there are lots of innovations to come in the solid-state storage market. The two that you referenced are certainly things that we have in our technology portfolio. And we will, as I said, make those offerings available when they are mature and ready for mainstream customers, just like we have done with all-flash storage solutions.

There's a long road map of success ahead on 3D NAND technology, then there's evolutions to that. And what I'll tell you is that even with 3D cross-point and NVMe, the same values that we have brought to the enterprise all-flash array market will continue to have value for customers, proven software, mature enterprise systems technology, and the track record and experience of large successful storage and data management companies.

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

Q

Thank you.

Kris Newton
Vice President - Investor Relations, NetApp, Inc.

A

Thanks, Jayson. Next question?

Operator: Our next question comes from the line of Steve Milunovich with UBS. Your line is now open.

John M. A. Roy
Analyst, UBS Securities LLC

Q

Great. Hey, it's John Roy in for Steve. [ph] Wanted to get the question (30:45) are you kind of saying that the competitive environment has allowed product gross margins to essentially reach a bottom here at around 48%? Is that what you kind of think going forward?

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

A

It's difficult to tell. The environment changes constantly. I'd like to think it's the bottom. That would be good. We are doing some work to improve product gross margins. It'll take some time for that to pay off. But at this point, I think I'd like to think it is the bottom.

John M. A. Roy
Analyst, UBS Securities LLC

Q

Great. Thank you.

Kris Newton
Vice President - Investor Relations, NetApp, Inc.

A

Thanks, John. Next question?

Operator: Our next question comes from the line of Amit Daryanani with RBC Capital. Your line is now open.

Irvin Liu
Analyst, RBC Capital Markets LLC

Q

Thanks, guys. This is Irvin Liu calling in for Amit. First of all, congrats on the great quarter. And I just wanted to ask about your mature product revenues. They declined by about 29% year-over-year. And I was wondering if there is a sort of a maintenance level run rate for the mature business going forward? And if so, how close are we to reaching those levels?

George Kurian
Chief Executive Officer and President, NetApp, Inc.

A

So just to set context, the mature bucket includes the OEM business, both E and N series, the ONTAP 7-Mode business, and the add-on storage components. Of the mature buckets, we see that the predominant declines are behind us and we are reaching a point where the forward-looking declines should be less material than they have been in the past. As you can see, even this past quarter, the rate of decline sequentially continues to moderate relative to what we saw in 2016.

Add-on storage, which is a large percentage of the mature bucket, is not going to decline at anything like the rates of 7-Mode or OEM. And so, we feel that going forward we should see some degree of stability in the mature business.

Irvin Liu
Analyst, RBC Capital Markets LLC

Q

Got it. Thanks.

Kris Newton
Vice President - Investor Relations, NetApp, Inc.

A

Thanks, Irvin. Next question?

Operator: Our next question comes from the line of Mark Moskowitz with Barclays. Your line is now open.

Mark Moskowitz
Analyst, Barclays Capital, Inc.

Q

Yeah. Thanks. Good afternoon. I wanted to see if we could kind of better understand kind of the [ph] trend line through the underlying (33:07) business. Strategic revenue growth fell to 1% versus 24% in July and 16% – and then storage system revenue declined nearly 13% after almost flattening in last quarter. I guess I'm just kind of concerned [indiscernible] (33:23) major deceleration despite all the good strides you've made in both revenue and also OpEx containment?

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

Yeah. So, Mark, I think part of the challenge last year was Q2 was our single highest quarter. So it's really a difficult compare. So you saw last quarter we actually had product revenue roughly flat. When we guided for Q2, we knew that it would be a difficult compare. We knew it was going to be down double-digits. If you impute the guidance we gave going forward, that starts to get better as we move forward to Q3 and Q4.

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

All right. Thanks, Mark. Next question?

Operator: Our next question comes from the line of Rod Hall with JPMorgan. Your line is now open.

Rod B. Hall
Analyst, JPMorgan Securities LLC
Q

Yeah. Hi, guys. Just came off the Cisco call and the commentary there relates to a little bit of underlying weakness in enterprise. Obviously, the forward-looking was more service provider, but a lot of the numbers suggest some weak enterprise spending, particularly in the mid-sized business environment. So I wonder if you guys could comment on what you're seeing from that point of view.

And then, I guess, I also would ask you to comment a little bit on the cash return policy. Obviously, we're looking at potentially lower tax rates now and some changes with the administration coming up, the Trump presidency. So could you just talk a little bit about how that might affect your thinking with regards to cash return? Thanks.

George Kurian
Chief Executive Officer and President, NetApp, Inc.
A

Okay. Let me take the economic environment. As we've said on the call, it remains a uncertain macroeconomic environment. I think spending decisions are not materially different than they were in the prior quarter, but you have to compete for every opportunity. And we've done that through the course of this quarter, and we intend to do that successfully through the course of next quarter.

I would say that the geographic mix of our business reflects the economic environment across the globe. It's a diverse landscape and we have strength in some parts of the world where the economic environment is stronger, and our execution has been better and it's been mixed in other parts of the world. I'll let Ron talk a little bit about our cash return policy.

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

Yeah. There is a couple things being discussed. We would prefer fundamental corporate tax reform as opposed to a one-time holiday. We'll wait and see what that looks like and decide what the best return policy is based on that. And I think during the holidays is beneficial, it might be advantage to take – for us to take advantage of that. But to fix the permanent disadvantage U.S. companies have in the world will require a fundamental corporate tax reform.

Rod B. Hall
Analyst, JPMorgan Securities LLC
Q

Okay.

George Kurian
Chief Executive Officer and President, NetApp, Inc.

A

In short, [indiscernible] (36:15) that it's a little early for us to comment. We're going to wait to see what the new administration defines to be its policies, both on trade and tax. And then, we'll communicate our plans soon thereafter. Thanks.

Kris Newton
Vice President - Investor Relations, NetApp, Inc.

A

Thanks, Rod.

Rod B. Hall
Analyst, JPMorgan Securities LLC

Q

Great. Thanks, George.

Kris Newton
Vice President - Investor Relations, NetApp, Inc.

A

Thanks.

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

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

Q

Yeah. Thanks for taking the question. I wanted to talk a little bit differently about the competitive landscape. I know Cisco was mentioned in the prior question. Cisco has obviously got a strategy of trying to push their HyperFlex product. We now see Nutanix out in the market as a public entity. I'm curious how you guys are currently seeing the hyperconverged market? Where you see that may be competitively showing up? And if not, why that wouldn't be?

George Kurian
Chief Executive Officer and President, NetApp, Inc.

A

First of all, our relationship with Cisco has been strong. The all-flash FAS has driven a really strong business, together with FlexPod, and is allowing us to compete in parts of the data center with FlexPod that we couldn't before. The second is, as we've said, hyperconvergence has a value to customers who require rapid time to provisioning or a very simplified configuration for departmental and small office work loads.

We have two approaches to compete with hyperconverged solutions. One is a set of innovations that we brought to the FlexPod family, called FlexPod Automation; and the second is with SolidFire, which provides a zero-touch storage provisioning solution. The release of SolidFire that we introduced in the summer of this year, called Fluorine, allows us to compete very well with hyperconverged solutions in VMware environments and we have been seeing wins. So we realize there's value to customers from hyperconverged offerings, and we have solutions to respond to those customer needs.

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

Q

Thank you.

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

Thanks, Aaron. Next question?

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

Louis Miscioscia
Analyst, CLSA Americas LLC
Q

Okay. Great. Can you maybe help us out with the guidance, both on the high end and the low end? In essence, the high end, if you're actually able to do and if I'm doing my math right, would suggest a quarter-to-quarter product revenue number, given that [indiscernible] (38:41) services is a pretty steady number of $127 million quarter-to-quarter in absolute dollars.

And going back over the six, seven years, never really got close to anything like that. Usually, going into this quarter, usually doing about somewhere between, let's say, $50 million or $55 million. So how would you ever get to that high-end number? And then alternatively, maybe if you could comment on why there would be a possibility of product revenue down $22 million quarter-to-quarter from an absolute number standpoint?

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

Yeah. So we're taking a broad range. We look back, and there are quarters where we were up sequentially, probably not as high as what you're quoting on product revenue. But we want to give a wide berth both ways, and it's just really being conservative. As you saw in Q2, we gave that same forecast of $150 million. We hit it spot on. So I think it is a difficult environment. It's unpredictable, and we're trying to make sure we're in the range somewhere close to midpoint.

Louis Miscioscia
Analyst, CLSA Americas LLC
Q

And maybe just following on the [indiscernible] (39:47) not predicting your budget flush as we finish the year. Are you getting any visibility into that one way or another? I realize your quarter ends in January though.

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

Difficult to tell, different customers, in different markets, in different geographies. Certainly, sometimes certain customers have December as their year-end. Not all customers, obviously. And then as you said, our quarter ends in January.

Louis Miscioscia
Analyst, CLSA Americas LLC
Q

Okay, great. Thank you.

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

Thanks, Lou. Next question?

Operator: Our next question comes from the line of Simona Jankowski with Goldman Sachs. Your line is now open.

Simona K. Jankowski
Analyst, Goldman Sachs & Co.

Q

Hi. Thank you. I just had a follow-up first, or a clarification on the improvement in product gross margin. Can you just unpack for us what drove that to the extent some of that was from the perhaps slightly more benign pricing environment versus the cost reductions you've been implementing versus mix? Because I'm just trying to get to the go-forward and how many of those drivers might be permanent?

And then, I just wanted to follow up on the comment you made about better exposure or greater exposure to hyperscale customers. Could you quantify for us roughly what percent of your revenue now goes into those kinds of customers? Thank you.

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

A

Well, Simona, I think if you look, we do tend to have a seasonal bump up in product gross margins from Q1 to Q2. You could call it customer mix, if you'd like. So that's what you saw to a large extent. Part of that will continue in Q3, but not to the same extent.

Also, in Q3, what we have is higher product revenue, which puts a little pressure on the overall margin rate.

George Kurian
Chief Executive Officer and President, NetApp, Inc.

A

I think, in aggregate, Simona, what we are doing to address gross margins is both continuing to drive transformation into our services business, which has allowed us to improve the gross margins of that business over the last few quarters. And on the product side, being deliberate about the use of promotions, as well as improving the pricing and discounting approaches in our transactions. So we're generally focused in gross margin in aggregate, and we have enough levers to keep the gross margin within the ranges that we shared with you.

In terms of the hyperscale question, what I was referring to was the fact that we are building hybrid IT solutions that combine on-premises data centers with the data center and IT architectures of the hyperscale providers. This includes solutions like NetApp Private Storage for secure cloud storage. It includes solutions like the AltaVault solution, and it includes the use of our software as part of hyperscale marketplaces.

And what we're doing is while that part of our business is not material, they are allowing us to win on-premises transactions because of a compelling forward-looking hybrid IT road map that customers can buy into.

Simona K. Jankowski
Analyst, Goldman Sachs & Co.

Q

Great. Thank you.

Kris Newton
Vice President - Investor Relations, NetApp, Inc.

A

Thanks, Simona. 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

Hi. This is David Ryzhik for Mehdi Hosseini. Thanks so much for take the question. What percent of cDOT shipments in the quarter were all-flash FAS? And regarding ONTAP 9, how much of a factor is that in your migration from 7-Mode to cDOT? And do you think there was some customer [ph] claws (43:25) ahead of ONTAP 9 and should ONTAP 9 catalyze additional migration? Thanks so much.

George Kurian
Chief Executive Officer and President, NetApp, Inc.
A

I would say that in terms of all-flash FAS solutions, all of the all-flash FAS solutions are based on clustered ONTAP as an operating system. And so, they count towards our aggregate clustered ONTAP numbers. They're a growing percentage of the clustered ONTAP business, not yet the majority. So we have room to go.

In terms of the installed base, there are a variety of reasons why customers choose to migrate from 7-Mode to clustered ONTAP, and flash is certainly an important part of that transition. The fact that we have a very compelling all-flash FAS solution is encouraging customers to move, in some cases, their upgrade schedules up.

David Ryzhik
Analyst, Susquehanna Financial Group LLLP
Q

Great. Thanks. And regarding ONTAP 9, have you seen that drive any incremental interest from 7-Mode customers?

George Kurian
Chief Executive Officer and President, NetApp, Inc.
A

ONTAP 9 continues to provide compelling technology for customers of both traditional NetApp customers, as well as net new to NetApp customers. The combination of scalable NAS containers, volume granular encryption, unparalleled storage efficiency and performance, together with the new platforms that we recently announced, all give customers more reason to upgrade from 7-Mode to cDOT, or for competitors to come to us. So we feel very good about the progress we've made.

David Ryzhik
Analyst, Susquehanna Financial Group LLLP
Q

Great. Thank you so much.

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

Thanks, David.

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 evening. Just on the top-line outlook for the quarter, you've accelerated the return of year-over-year growth by about a quarter versus what you said on the prior call. So I was just curious, what was the main two or three drivers in sort of pulling in that return of year-over-year growth into this current quarter? Thanks.

George Kurian
Chief Executive Officer and President, NetApp, Inc.

A

We've always said that our plan was to return the company to growth in aggregate in fiscal 2018 and that our plan was to return product revenue to growth in the second half of this year. We're on plan for that. And we feel even more confident than we were a few quarters ago, both because the mature products are stabilizing in terms of their go-forward, as well as the strength of our strategic solutions.

Steven Fox
Analyst, Cross Research LLC

Q

So there's not one or two things you would say are the bigger drivers, because obviously I think most people were thinking that was going to happen in the fourth quarter. So I'm just curious if there's something that you would say has increased that confidence more than other things?

George Kurian
Chief Executive Officer and President, NetApp, Inc.

A

I would just say, our aggregate execution against the plan and the fact that we've been consistently meeting expectations, I think that's the real basis for where we are. And as I said, the mature products are less material a part of our business and the majority of the declines are behind us, and the strategic solutions continue to perform well. So we've got to keep our head down and execute the plan, and I would just tell you that that's my focus right now.

Steven Fox
Analyst, Cross Research LLC

Q

Fair enough. Congratulations on the results.

George Kurian
Chief Executive Officer and President, NetApp, Inc.

A

Thank you.

Kris Newton
Vice President - Investor Relations, NetApp, Inc.

A

Thanks, Steven.

George Kurian
Chief Executive Officer and President, NetApp, Inc.

A

Thanks very much.

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

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

Q

Hi. Thank you. I was hoping you could provide us with some additional detail on the SolidFire business. How much did that grow in the quarter and do you expect that to continue to be a significant growth driver? Thanks.

George Kurian
Chief Executive Officer and President, NetApp, Inc.

A

SolidFire is, as we have outlined, an important part of the focus and investment for us, because it allows our customers to build architectures for their next-generation data centers with us that they can't with anyone else. As we laid out at the time of the acquisition of SolidFire, SolidFire would contribute about 2% to our revenue for this year and would offset the operating margin by roughly 2%. And I would tell you that we are on track to those plans.

We have been gaining new customers to NetApp using SolidFire. We've been introducing NetApp customers to SolidFire. And we're executing according to plan that we laid out. So we feel good about where we are with SolidFire.

Kris Newton
Vice President - Investor Relations, NetApp, Inc.

A

Thanks, Sherri.

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

Q

Thank you.

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. Thanks for taking the question. It looks like the only region or vertical you had year-over-year growth in this quarter was the U.S. public sector. Just wondering if you could give us any more color on that growth, whether the budget flush was larger this year than last year, or whether you gained share in the space?

George Kurian
Chief Executive Officer and President, NetApp, Inc.

A

Public sector's procurement cycle was according to what we had thought and was in alignment with plan. We didn't see any unusual activity upward or downward in the public sector markets. We have continued to execute well to capture the share of opportunities that are out there. And so, I would just say the budget flush that we saw in public sector was normal.

Andrew James Nowinski
Analyst, Piper Jaffray & Co.

Q

Thank you.

Kris Newton
Vice President - Investor Relations, NetApp, Inc.

A

Thanks, Andy. Next question?

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

Maynard J. Um
Analyst, Wells Fargo Securities LLC

Q

Hi. Thanks. Congratulations on the quarter. Can you clarify whether there was any product gross margin benefit from the shift in marketing that you talked about last year? And it seems like you see scope for more improvement in product cost going forward, partially from marketing shift, also from restructuring. Can you just talk about how you prioritize gross margin improvement versus market share gain?

I heard you mention that you're hopeful this is the bottom in product gross margin. I guess I'm asking the opposite question. As we look forward in our modeling, should we be looking at product gross margins going up, going forward, mix aside? Or will you sort of trade that for revenue market share gain? Thanks.

George Kurian
Chief Executive Officer and President, NetApp, Inc.

A

I would just say, in aggregate, we operate to the gross margin guidance that we have laid out, and it's a combination of improvements in service and product gross margins. I would say, right now, what we're focused on is capturing footprint with our all-flash arrays, as well as converting customers and facilitating the conversion of customers from 7-Mode to clustered ONTAP.

We've said that we have put in place promotions that facilitate both of those objectives that are strategic to the company in the market. And we constantly monitor the value of those promotions and their impact in terms of achieving our strategic objectives. The product innovations that we have made over the last year-and-a-half continue to provide us with a really solid platform for differentiation.

And so, at any point in time, we reserve the right to continue those promotions or to remove them from the marketplace. And we constantly tradeoff the benefits of those with the benefits to improvements in gross margin.

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

A

Maynard, just to be a little clear. On the services side is where you see most of the improvements we've made via transformation, okay? So that to some extent helps with the gross margin overall for the last couple of quarters.

Maynard J. Um
Analyst, Wells Fargo Securities LLC

Q

Great. Thank you.

Kris Newton
Vice President - Investor Relations, NetApp, Inc.

A

Thanks, Maynard.

Operator: Our next question comes from the line of Tim Long with BMO Capital. Your line is now open.

Timothy Patrick Long
Analyst, BMO Capital Markets (United States)

Q

Thank you. George, you mentioned the geographic performance kind of tracking with what we're seeing from a macro standpoint. Could you talk a little bit about EMEA and APAC? It looks like the last few quarters they probably lagged the performance in North America and the Americas at least on a year-over-year basis. Anything to that from either a product standpoint or execution standpoint? And how can we think about those starting to catch up? Thank you.

George Kurian
Chief Executive Officer and President, NetApp, Inc.

A

I would say that in EMEA and APAC, they are vastly different geographies with different macroeconomic situations. I think that we've seen strength in certain parts of EMEA and APAC, where the economic landscape have stayed relatively benign and we've gained share in those environments. In others, where there is more uncertainty, you see that impacting transactions. And so, we've had to compete for to maintain share, and we've done a good job doing that.

I would say that we're going wait to see what the economic outlook looks for those countries, and we've built a fairly conservative outlook into our guidance. And so, we are continuing to focus on gaining share wherever we can gain share, but do so with an outlook that builds into the forecast that – the macroeconomic situation in those countries. Emerging markets is the same, which falls into our Americas geography. The preponderant part of the Latin American geography is in our Americas business.

Timothy Patrick Long
Analyst, BMO Capital Markets (United States)

Q

Okay. Thank you.

Kris Newton
Vice President - Investor Relations, NetApp, Inc.

A

Thanks, Tim.

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

Eric Martinuzzi
Analyst, Lake Street Capital Markets LLC

Q

Yeah. Just curious in working with your channel partners, some of your channel partners have been representing maybe competitive all-flash arrays out in the market. What incentives or what steps are you taking so that maybe for an account that isn't kind of a NetApp install base, where an all-flash array from NetApp would be a layup, kind of a greenfield opportunity, what are you doing to make that a NetApp install as opposed to a competitor product install with your channel partners?

George Kurian
Chief Executive Officer and President, NetApp, Inc.

A

I think it starts with the customer. It starts with making sure customers understand the value of NetApp technology, and I think we've made substantial progress there. Analyst commentary, customer references, the portfolio of products from NetApp, and our intense focus on raising our profile in the all-flash array markets, as well as candidly the success and momentum that we've demonstrated substantially outpacing the market, as well as our peers, gives us access to more customer conversations than we've ever had before.

Some of that also is reaching those customers through new low-cost, innovative digital marketing channels, which our Chief Marketing Officer is an expert at doing. And then the third is enabling the channel so that they focus their attention on NetApp portfolio. I think we're using all of those levers, and we feel good about the progress. This is an unending – I would just tell you, this is an ongoing game, right. So as I've said on my call, we're very pleased with the momentum. We're going to keep our heads down and we've got more work to do, and we're doing that every single day; staying focused on execution.

Eric Martinuzzi
Analyst, Lake Street Capital Markets LLC

Q

Thank you.

Kris Newton
Vice President - Investor Relations, NetApp, Inc.

A

Thanks, Eric.

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

Thanks. Good afternoon. Question about support attached to the strategic business versus mature. Curious whether there is a different dynamic or attach rate? Because hardware maintenance is down year-on-year and deferred revenue declined more than seasonal this quarter despite the fact that install base is growing. So just trying to understand the implications for the maintenance business? Thanks.

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

A

There is no difference in the attach rate between strategic and mature. We are still, as you said, seeing a growth in install base, although it is a little bit low. What we have is very, very good growth in obviously the new cDOT products. But as you recognize, product revenues for the last several quarters have declined. That puts a little pressure on the install base. But it is growing.

Deferred is growing significantly year-over-year. There were some seasonal things that happened quarter-to-quarter. Remember, renewals – it's mostly renewals. And those happened, to a larger extent, in the second half of the year. So it leaves a little bit of a trough in the first half.

Kathryn Lynn Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Thank you.

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

A

All right, Katy.

Kris Newton
Vice President - Investor Relations, NetApp, Inc.

A

Thanks, Katy.

Operator: And your last question comes from the line of James Kisner of Jefferies. Your line is now open.

Q

Hi. This is [indiscernible] (56:56) for James Kisner. George, you mentioned the 3D NAND road map and your flash businesses doing really well. But are you seeing any negative impact from NAND shortage this year? And I don't know what's your visibility into NAND pricing. Are you signing long-term contracts?

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

A

We're able to secure what we need for NAND. It is a tight supply. No one's signing long-term contracts right now. So I think we're able to get what we need, and prices are tight.

George Kurian
Chief Executive Officer and President, NetApp, Inc.

A

I think just to add to Ron's comments, I think ensuring supply is a combination of both technological, as well as commercial relationships with the NAND suppliers; and we have excellent relationships with multiple of them. So we feel good about where we're at, but it is a constrained market.

Kris Newton
Vice President - Investor Relations, NetApp, Inc.

A

Thank you.

Q

All right. Great. Thank you.

Kris Newton
Vice President - Investor Relations, NetApp, Inc.

A

Thanks.

Operator: I would now like to turn the call back over to Kris Newton for any closing remarks.

Kris Newton
Vice President - Investor Relations, NetApp, Inc.

And I'll hand it over to George.

George Kurian
Chief Executive Officer and President, NetApp, Inc.

I wanted to just summarize the comments that I made at the start. I am pleased with the progress that we've made, both in the top line and the strategic portfolio of products that align with our customers' priorities, as well as with the productivity and efficiency of our business.

We are increasingly confident to bring additional innovation to customers, add new customers, working with the hyperscaler ecosystem that drives the next-generation of IT, as well as transforming to be a more agile, focused, and faster moving company.

We've achieved an enormous amount of progress, and I want to thank the NetApp team, and are closer to returning the company to growth than we have been in a long time. We have more work to do to bring excellence to all facets of our business. And we're going to stay focused and delivering yet another quarter of meeting our commitments to our shareholders. Thank you, and we'll see you on the next call.

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