Corrected Transcript

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NetApp, Inc. (NTAP)

Q4 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the NetApp fourth quarter and fiscal year 2016 results conference call. At this time, all participants are in a listen-only mode. Later, we'll conduct a question-and-answer session and instructions will be given at that time. [Operator Instructions]

I would now like to hand the conference over to Kris Newton, Vice President, Investor Relations. Please go ahead.

Kris Newton

Vice President - Investor Relations

Hello and thank you for joining us on our Q4 fiscal year 2016 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 first quarter and fiscal year 2017, our expectations regarding future revenue growth, improved profitability, including run rate savings, cash flow, effective tax rate and shareholder returns, our expectations about our ability to drive operational and financial performance and about the impact of the SolidFire acquisition and business, 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 different materially from our statements and projections for a variety of reasons, including the macroeconomic environment, overall growth rate for IT, our ability to successfully pivot to the growth areas of the market and enable customer migrations to our strategic solutions, our ability to expand our operating margin, our ability to reduce our cost structure, streamline the business, and improve efficiency within the planned timeframe, and our ability to continue our capital allocation strategy and invest in strategic opportunities.

Please 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 2015, and our current reports on Form 8-K, all of which can 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 & Director

Thanks, Kris, and good afternoon, everyone.

In Q4, we continued our disciplined execution. Revenue and EPS were within our guidance ranges despite significant and ongoing changes to both the industry and NetApp. Like others, we continued to experience constrained enterprise IT spending, as customers act with caution due to an uncertain macroeconomic environment and shift some of their workloads to the cloud.

As we discussed last quarter, we're making fundamental changes to return the company to revenue growth with improved profitability, cash flow, and shareholder returns. To deliver on this commitment, we are executing a comprehensive and sustained transformation. Let me remind you of the key priorities associated with this plan.

First, we are focused on our Data Fabric strategy and the strategic solutions that form the foundation of how we enable customer success in the data-powered digital era. To provide context for our confidence in the future, we are providing greater transparency into the progress of these solutions. Second, we are substantially reducing cost and systematically streamlining our operations while maintaining our ability to deliver innovation and lead the market. And third, we have a robust capital allocation program, which includes a combination of share repurchases, dividends, and investment for the long-term growth of the business.

I'll start with an update on the first priority, our emphasis on strategic solutions. We are facilitating our customers' success as they navigate through their own IT transformations, which leverage modern architectures and hybrid cloud environments. Our strategic solutions, clustered Data ONTAP, branded E-Series, all-flash arrays including SolidFire, hybrid cloud solutions and OnCommand Insight, enable these transformations and are the basis of our pivot to the growth segments of the market.

In Q4, strategic solutions increased to 61% of net product revenue. For the full year, strategic solutions were 53% of net product revenue and grew 21% from fiscal year 2015. The alignment of our strategic solutions with our customers' IT imperatives underpins our confidence that these solutions will expand our leadership in the fastest growing segments of the market.

As expected, net product revenue from our mature solutions, OEM, ONTAP 7-Mode and add-on for both Q4 and the full year declined at roughly 40% year over year, driven by declines in ONTAP 7-Mode. As mature solutions become a smaller contributor to product revenue, the headwinds they generate will lessen. This will allow the growth of our strategic solutions to drive a reacceleration of the business and return the company to moderated revenue growth in fiscal 2018.

As a part of their IT transformation efforts, customers want scale-out and software-defined storage functionality for the efficient management of data growth and to achieve the agility and flexibility needed for success in the data-powered digital era.

Uniquely in the storage industry, clustered ONTAP enables seamless enterprise data management across flash, disk, public and private cloud footprints for enterprise applications. With clustered ONTAP, IT organizations can consolidate multiple workloads into a single repository, dramatically improving the efficiency of their storage environments when compared to the siloed legacy SAN architectures that we are displacing. Clustered ONTAP was deployed on 85% of FAS systems shipped in Q4, up from 50% a year ago. Customer demand for clustered ONTAP accelerated from Q3, with system shipments growing roughly 80% year over year.

Our install base of clustered ONTAP and 7-Mode systems continues to grow in total, and clustered ONTAP is now running on 26% of that growing install base. In addition, we increased the number of clustered ONTAP customers by almost 90% in fiscal year 2016 from the prior year.

We're pleased with the success of the clustered ONTAP transition program we put in place at the start of the year. In fiscal year 2016, it accelerated migrations at approximately 1,300 install base customers who were ready to upgrade both their systems and their software. The install base mix will continue to shift to clustered ONTAP. However, as we've said before, we anticipate that this transition will happen over the course of years, as these migrations are projects that must fit within our customers' overall IT priorities and budgets.

In the coming weeks, you'll hear about breakthrough innovations as we introduce the next generation of ONTAP, which combines new levels of simplicity with unparalleled storage efficiencies and enterprise data management capabilities. It will simplify customers' IT transformations to modern data centers and hybrid cloud environments; and customers can choose the architecture of their choice, engineered systems, software-defined storage or cloud, all with industry-leading efficiency, performance and density for flash environments, rapid and simplified deployment and greater data protection and security.

In fiscal year 2016, we accelerated the adoption of clustered ONTAP and moved into a leadership position in the flash market, and we expect to break away from the pack with the next generation of ONTAP.

As customers build private clouds or move to hybrid cloud environments, they need to monitor and manage their storage as an end-to-end service across heterogeneous public and private clouds. OnCommand Insight addresses this requirement and enables customers to simplify their operations and substantially lower costs. Together, clustered ONTAP and OnCommand Insight give customers the ability to bring tremendous efficiency to their IT environments.

One of the largest children's hospitals in the U.S. chose all-flash FAS running clustered ONTAP to replace legacy high-end frame arrays from our leading competitor and will also utilize OnCommand Insight to manage their entire heterogeneous storage infrastructure across multiple data centers.

Flash plays a key role in customers' IT transformation efforts as they seek to gain advantage through greater speed, responsiveness and value from key business applications while substantially lowering total cost of ownership. The continually improving performance and economics of flash is enabling modern modular storage systems with scale-out software to replace legacy frame array SAN architectures.

Flash is becoming the de facto technology for primary workloads, as customers look to realize performance and economic benefits by replacing hard disk installations with flash. As they make this transition, customers cannot forego enterprise data management and data protection capabilities. With a highly differentiated and complete portfolio of all-flash array offerings, NetApp is, without question, far better positioned to enable customers to accomplish this transition than any other vendor.

We won a multimillion-dollar deal over emerging all-flash competitors at a U.S.-based customer in the transportation industry, with all-flash FAS and EF for its production database, VDI and disaster recovery environments. They chose NetApp due to the reliability and rich feature set of our product portfolio.

Reflecting the strength, our all-flash array business, inclusive of all-flash FAS, EF and SolidFire products and services, grew 35% from Q3 to an annualized net revenue run rate of over $700 million. The majority of this growth was driven by high demand for the all-flash FAS.

In addition to providing a complete set of enterprise data management and protection capabilities, we enable customers to preserve and leverage existing investments while taking advantage of new technologies and rapidly improving cost curves by supporting mixed capacity SSDs within a single system, something that most of our competitors cannot do.

Soon, we will become the first vendor to give customers the ability to take advantage of 16-terabyte solid state drives. Our support for mixed capacities will create even greater customer value with the introduction of these high-capacity SSDs, by allowing further workload and system consolidation, dramatically reducing data center space requirements.

I'm pleased to report that the integration of SolidFire is going well and progressing as planned. The NetApp sales team is selling SolidFire as part of the portfolio and introducing it into new accounts. We're winning against and replacing footprints of both established and emerging vendors in customers building next generation data centers. Execution of the product road map is on track and we'll have exciting SolidFire innovations to announce in early June.

NetApp has an extraordinary opportunity to help customers as they move to modern architectures and hybrid cloud solutions. Our Data Fabric strategy enables data management that seamlessly connects disparate clouds and data centers. We enable our customers to manage, secure and protect their data across flash, disk and public and private cloud resources, all at the scale needed to accommodate the exponential data growth of the digital world.

A leading telecommunications and service provider in the Asia Pacific region has embraced our hybrid cloud strategy, leveraging clustered ONTAP, our flash technologies and Data Fabric capabilities to evolve its cloud offerings. They are deploying a solution that leverages the public cloud, while retaining data sovereignty. It will give their customers choice, control and confidence and improve business agility by enabling the movement of data in and out of multiple clouds from an on-premises private cloud into a public cloud and perhaps back again, all seamlessly.

The service provider is so confident in the solution themselves that they are moving their primary workloads to it in order to solve their own data management challenges. Ron will go into depth about cost savings and capital allocation, but I want to underscore our commitment to both of these priorities.

We've launched a comprehensive program to reduce the cost base of our business even while investing in strategic opportunities such as SolidFire. In Q4, we took the first significant step in achieving these savings, and I want to thank the NetApp team for remaining focused on execution while making difficult restructuring decisions. We are also fully committed to executing our capital allocation programs and creating value for shareholders.

In conclusion, I want to spend a little time reflecting on the strides we've made this year. When I took over as CEO, NetApp was dealing with several internal challenges. We were late to the all-flash array market; we were not prepared to assist our install base of customers in migrating to clustered ONTAP; and we had limited traction in the hybrid cloud.

Over the course of the year, we've made substantial progress. We have moved into a leadership position in the flash market, with a broad portfolio that addresses multiple workload requirements and deployment styles. We regained ground with our channel partners by successfully enabling them to migrate the install base to clustered ONTAP. Our Data Fabric strategy has proven effective and positioning us to win leading-edge cloud deployments.

Additionally, we've added key new leaders with fresh insight and deep experience to the management team and the board of directors and took the first step to permanently lowering our cost base.

Heading into fiscal year 2017, our momentum with customers is accelerating. Data is at the heart of our customers' IT transformation efforts, and this is where NetApp has a profoundly important role to play. Our strategic relevance to customers' digital transformation road maps is evidenced by the growth of our strategic solutions. We're making meaningful progress, but still have work ahead of us and remain focused on execution.

I remain highly confident in NetApp's potential. The leadership team is sharply focused on our business model and committed to returning the company to long-term growth and our target operating margin.

The fundamental transformation we're undertaking to streamline the business and reduce the cost base will position us for future success by allowing investment in strategic opportunities, while accelerating our ability to deliver shareholder value in the form of improved profitability and cash flow.

I'll now turn the call over to Ron to take you through the numbers. I'm sure many of you already know him. In our search for a CFO, I looked for someone who is forward-looking, operationally astute, collaborative and an effective leader with high standards of ethics and integrity. We found that in Ron, and I'm very excited that he's on board as part of this leadership team.

Welcome, Ron.

Ronald J. Pasek

Chief Financial Officer & Executive Vice President

Thank you, George, and good afternoon to everyone on the call. I'm looking forward to meeting with many of you in the coming months. Before I get started, I'd like to thank the board and George for the confidence they've placed in me; and the NetApp team for the warm welcome I received. I'm excited to be joining the team at this time for a number of reasons.

As a long time NetApp customer, I know firsthand that innovative products and passionate employees that are core to NetApp's strong foundation. In the short time I've been with NetApp, I continue to be very impressed with the commitment of employees, the dedication and quality of the management team and the relentless focus on customer success. I look forward to building on NetApp's strong foundation and leveraging my experience to help execute our transformation efforts to drive long-term growth and streamline the business.

Now before providing detail on our fiscal 2016 performance and forward-looking guidance, I'd like to first discuss our results for Q4. As a reminder, unless otherwise noted, I will be referring to non-GAAP metrics today.

Q4 net revenues of $1.38 billion were relatively flat on a sequential basis and down 10% year over year. Product revenue was up about 1% sequentially and declined 17% year over year. While branded product revenue was in line with our expectations, discounting and promotions remained high, and we had six points of impact sequentially and four points of impact year over year from weaker than expected OEM business.

As George discussed, revenue from strategic solutions continued to grow but are not yet sufficient to offset the headwinds from mature areas of our business. As expected, revenue declines in our mature solutions continue to put pressure on overall product revenue. The combination of software maintenance and hardware maintenance and other services revenue was down 2% sequentially and relatively flat year over year.

Our gross margin was 61.1%. Product gross margin of 46.8% was down about seven points year over year. The decline in ASPs outpaced the decline in average unit cost, largely due to discounting and product promotions.

Software maintenance gross margin was essentially flat year over year, while hardware maintenance and other services gross margin was up approximately five points, largely reflecting the continued services infrastructure cost efficiencies and ongoing improvements in product quality.

Operating margin of 13.4% decreased four points sequentially and two points year over year, driven by lower revenue, lower product margin, and the acquisition of SolidFire, partially offset by the lower cost of hardware maintenance revenue and OpEx.

As outlined last quarter, we're driving to achieve a gross run rate savings of $400 million across both cost of revenue and OpEx by the end of fiscal 2017. We will reinvest some of these savings into strategic opportunities such as SolidFire and other initiatives, yielding a net run rate savings of roughly $130 million by the end of fiscal 2017.

In Q4 we took significant steps forward by reducing our head count by approximately 11% sequentially. This action resulted in a GAAP restructuring charge of approximately $80 million and a gross savings of approximately $32 million in Q4. To be clear, aligning our cost structure with the opportunity ahead of us is my top priority, given it's completely within our control.

We're driving additional changes that include implementing tighter cost controls over indirect spending, improving supply chain efficiency, portfolio streamlining, operational process redesign, and organizational restructuring and realignment. We will report back quarterly with more specifics as we realize these savings.

Our effective tax rate was 13.1% for the quarter, lower than our previous guidance, reflecting the impact of our geographic sales mix. EPS was within our guidance range of $0.55 per share. Weighted average diluted shares outstanding were approximately 287 million.

Moving on to cash and balance sheet metrics for Q4, we generated $345 million in cash flow from operations during the quarter, down 13% year over year. Free cash flow of $310 million was about 22% of net revenues, down 1% sequentially and 14% year over year. Deferred revenue and financed unearned services revenue of $259 million was up 8% versus Q3 and 6% versus last year. Inventory turns increased to 22 turns and DSO was 54 days, reflecting a back-end loaded quarter. Finally, we repurchased approximately $262 million of stock and paid $51 million in cash dividends in the fourth quarter.

Now turning to fiscal year 2016 results, net revenues for the full year of $5.55 billion were down about 9% from fiscal 2015. Gross margin of 62.5% was down about 1.5 points from fiscal 2015, reflecting discounting and product promotions we ran throughout most of fiscal 2016. Operating margin of 13.5% was down 3.5 points versus fiscal 2015.

Our effective tax rate for the year was 15.4%. EPS for the year was $2.13, down about 21% from fiscal 2015. We ended the year with approximately $5.3 billion in cash and short-term investments, with approximately 10% held by our domestic entities. Over the course of the year, we generated $814 million in free cash flow.

We continue to deliver on our capital allocation strategy. Over the course of FY 2016, we returned over 140% of free cash flow to shareholders through a combination of dividends and share repurchases. Finally, we completed the first $1 billion of the $2.5 billion repurchase program we announced in February 2015, ahead of our original schedule. Through dividends and share repurchases, we have returned approximately $4.6 billion to shareholders since May 2013. This represents over 150% of free cash flow generated during that timeframe. We remain on track to complete the remaining $1.5 billion of the share repurchase program by the end of May 2018.

Today, we also announced an increase in our next cash dividend of $0.19 per share, which will be paid on July 27, 2016.

Now to guidance, we are confident in our competitive positioning and long-term growth potential. However, we expect fiscal 2017 to be a year of transition while we transform the company in order to streamline the business, improve efficiency, and rapidly address the changing market.

Consistent with what was said last quarter, we expect that the growth of our strategic solutions will offset the declines in our mature solutions and ultimately drive moderated revenue growth as we emerge from FY 2017. For FY 2017, we are forecasting gross margin of 61% to 63%. We expect an operating margin of 15% to 17%, including about two points of dilution from SolidFire.

We expect our effective tax rate for the year to be approximately 16.5%. And we expect to generate significant free cash flow, enabling us to invest in the business, as well as to continue to again return significant capital to our shareholders. Finally, we remain committed to delivering meaningful EPS growth, including dilution from SolidFire through leverage in our business model.

Turning to our outlook for the first quarter of fiscal 2017, we're targeting a net revenue range of $1.2 billion to $1.35 billion. At the midpoint, this implies a year-over-year decline of 4.5%, which reflects a reduction in declines as strategic overtakes mature. As a reminder, year-over-year compares are against the 14-week quarter we had in Q1 of fiscal 2016, which benefited software maintenance and hardware maintenance and other services revenues.

We expect gross margin of 62% to 63%, reflecting the impact of continued product promotions, partially offset by cost savings initiatives. We're targeting operating margin of approximately 10%, and an EPS range of $0.34 to $0.39.

In closing, I'm excited to be here and want to emphasize that everyone at NetApp is focused and committed to permanently transforming the business by pivoting towards the growth areas of the market and reducing costs, while also delivering near-term results. While our transformation is far from complete, we have made significant progress and are confident about our future.

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

Kris Newton

Vice President - Investor Relations

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of Jim Suva from Citi.

Justin Wainwright
Citigroup Global Markets, Inc. (Broker)

Q

Yes, hi. This is Justin on for Jim Suva. I just had a quick question in terms of the overall linearity in the quarter. If you could just talk about – a little bit about the demand, was it deteriorating, stabilizing or improving? And how is the demand looking now in May? Is it shaping up in the same sort of format, either deteriorating or stabilizing? Thank you.

George Kurian
Chief Executive Officer & Director

A

First of all, the demand for enterprise IT is shaped by the global macroeconomic environment, and we did see the effects of an uncertain macro in certain parts of the world. At the same time, when you compare Q4 with Q3, where the last month of our Q3 was in January, we saw a generally improving environment in Q4. We, in our business, saw accelerating momentum through the end of the quarter; and so we feel pleased with the progress we've made through the quarter and as we finished.

Kris Newton
Vice President - Investor Relations

A

Thanks.

Ronald J. Pasek
Chief Financial Officer & Executive Vice President

A

Just a reminder, we were back-end loaded in Q4, reflecting that demand.

Kris Newton
Vice President - Investor Relations

A

Thanks. Next question?

Operator: Our next question comes from the line of Amit Daryanani from RBC Capital Markets.

Irvin Liu
RBC Capital Markets LLC

Q

Hi, guys. This is Irvin Liu calling on behalf of Amit. I just had a question about your product gross margin. They fell below 50% for the first time in quite a while. Can you just talk about the discounting and promotional activity? Is it geared more towards some of your mature revenues or strategic revenues?

Ronald J. Pasek
Chief Financial Officer & Executive Vice President

A

No. We ran a couple of promos for strategic products, mainly flash and cDOT. Those ran most of the year. We also had some significant discounting across the board, which is just what you see in the market today.

George Kurian
Chief Executive Officer & Director

A

The promotions are essentially to help our customers offset the cost of the need to migrate to clustered ONTAP. We've seen good results from the promotion. We've also seen progress with our all-flash array momentum as we've outlined on the call. We intend to continue the promotions, but we're offsetting the impact of those promotions with the cost take-out activities on both the cost of revenue, as well as the cost of service infrastructure.

Kris Newton
Vice President - Investor Relations

A

Thanks, we'll take the next question.

Operator: Thank you. Our next question comes from the line of Lou Miscioscia from CLSA.

Louis Miscioscia
CLSA Americas LLC

Q

Sure. Can you talk about the industry headwinds that you are running into? You mentioned in your opening comments that you're actually seeing more business shift to the cloud. I assume that when it goes there, you end up not having the majority of the storage sales from that, especially if it's obviously going to AWS. And maybe combine that with a server-side flash and software-defined storage. Our check suggests that there is improvement in that area and now you can use software-defined storage to pull together all the storage in servers where before they were islands. So is that also going to be a big competitive threat going forward? Thank you.

George Kurian
Chief Executive Officer & Director

A

First of all, we said in the prepared remarks that the majority of the uncertainty in the spending environment is due to the macro, not from a secular shift to the cloud. We did not see any sort of substantial trend between Q3 and Q4 in terms of the cloud.

In terms of our positioning for the cloud, we have substantially improved our own positioning over the course of the year, force being serving customers with workloads on the cloud; and let me articulate that in three ways. First, as a supplier of technology to cloud providers, both people in enterprises building their own clouds, as well as service providers building clouds, we've seen strong progress with both our clustered ONTAP offering, as well as SolidFire that allows us to build both traditional cloud environments, as well as next generation cloud.

We are also the leader from an enterprise storage and data management technology company, without question, in the OpenStack cloud deployment, where we have seen strong year-on-year growth. In terms of the hyper-scalers, our solutions that combine hyper-scaler cloud computing environment with our technology like NetApp Private Storage and our Data Fabric solutions have seen good growth through the course of the year.

It's early, but as we noted, we are winning our share of leading-edge hybrid cloud deployment and are the only enterprise vendor who has the capability to combine a hyper-scaler cloud with enterprise data management.

Finally, as you note, through the course of the year there are several examples of customers that started out on public cloud and decided to either migrate data and storage footprints to on-premises environments, and we are uniquely positioned to capture those workloads as they transition either on-prem to the cloud or from the public cloud back on-prem.

Kris Newton
Vice President - Investor Relations
A

Thanks, Lou. Next question?

Operator: Thank you. And our next question comes from the line of Steven Fox from Cross Research.

Steven Fox
Cross Research LLC
Q

Thanks. Good afternoon. On the cost reductions, it sounds like you guys got off to a good start with the plan to exit this fiscal year at $400 million. Can you help us on the slope of the cost or the shape of the cost reductions for this fiscal year, whether we should see it more front-end loaded and if there's much difference in that shape between gross and net? And within that gross and net, if there's any discounting that's being factored into the difference? Thank you.

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

You'll see the cost reductions both in COGS and OpEx throughout the year. They will tend to be a little more back-end loaded, but they will be throughout the year. You should see us realigning our go-to-market to the opportunity we see in the marketplace. We're going to be simplifying product offerings, which will benefit the entire company. You'll see us aggregating back office functions to a shared services model, and we will be doing business process redesigns, organization realignment and further the streamlining of our portfolio.

So some of those things will take a little bit of time. We talked about them last quarter. They've been ongoing. You'll see the benefit some extent throughout the first quarter and into the second quarter and throughout the year.

George Kurian
Chief Executive Officer & Director
A

We're taking it systematically so that we can permanently and systematically reduce the cost base of the company. So what we're really trying to do is not do a short-term action that precludes us from fundamentally re-engineering that business process so that it can be permanently reduced to a lower cost basis. So, as Ron said, we're being thoughtful and deliberate, but you'll see us make progress on the $400 million that we committed to. We've demonstrated progress this past quarter and we're taking it on systematically and rigorously.

Kris Newton
Vice President - Investor Relations
A

Thanks, Steve. Next question?

Operator: Thank you. Our next question comes from the line of Simona Jankowski from Goldman Sachs.

Simona K. Jankowski
Goldman Sachs & Co.
Q

Yes, hi. I wanted to ask you first if you can quantify how much SolidFire might have contributed to the quarter and what you're expecting for the current quarter? And then in terms of the competitive environment, we saw significant announcements from a bunch of your competitors, including EMC, Pure and Nimble during the quarter. So just wanted to see what your thoughts are on the competitive environment in response?

George Kurian
Chief Executive Officer & Director

A

SolidFire was immaterial during the course of this quarter. We felt good about the progress we've made. And you'll see us continue to execute our integration plan focused on the team, the product road map, as well as the go-to-market. From our internal benchmarks, we are ahead of our plan. So we feel good on the start with SolidFire.

In terms of the all-flash array segment, you'll see us not only demonstrate leadership with the progress we've made this quarter, where we are clearly outpacing both traditional vendors as well as the pure play all-flash array start-ups, without question, representing the maturity of our portfolio and the ability to address the largest part of the flash market opportunity as customers transition mainstream storage environment from legacy SAN architectures to modern flash-based storage system.

As a simple data point, the attach rate of fiber channel environments in our all-flash configuration is three times higher than in our disk-based configuration, representing without question the fact that we are gaining share at the expense of the legacy fiber channel vendors; and stay tuned. In a few weeks, we'll have exciting announcements, as I mentioned on the call, with both SolidFire and ONTAP 9 announcing major progress and expanded leadership in the fastest growing category in storage.

Kris Newton
Vice President - Investor Relations

A

Thanks, Simona. Next question?

Operator: Thank you. Our next question comes from the line of Mark Kelleher from D. A. Davidson.

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

Q

Great. Thanks for taking the question. I just wanted to follow up on the operating margin guidance. I think you said 10% for Q1. That seems to be a pretty significant step down sequentially. You talked about some cuts and some savings that you made and your reduction in force. Gross margins are going to hold in there. Can you just give some detail on where there's some negative leverage going into Q1 on the operating lines? Thanks.

Ronald J. Pasek
Chief Financial Officer & Executive Vice President

A

The only real negative is we having SolidFire in there now. That's in the run rate for OpEx. We do have a little lower revenue in Q1, but we did get significant savings from the reduction we had in Q4. It benefited the quarter significantly, about $50 million for run rate in Q1.

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

Q

Okay, thanks.

Kris Newton
Vice President - Investor Relations

A

Thanks, Mark. Next question?

Operator: Thank you. Our next question comes from the line of Sherri Scribner from Deutsche Bank.

Sherri A. Scribner
Deutsche Bank Securities, Inc.

Q

Hi, thanks. I just wanted to ask. It looks like the strategic solutions growth decelerated from 26% last quarter to somewhere around 15% this quarter. I just wanted to know what was driving that. And thinking about fiscal 2017, I think you said that strategic solutions growth should offset the declines in the mature solutions. So does that suggest flat revenue? I'm trying to understand how to think about that. Thanks.

George Kurian
Chief Executive Officer & Director

A

First of all, the growth of strategic solutions accelerated through the quarter. If you saw the shipments of clustered ONTAP, unit shipments were up substantially, 80% year on year; and if you do the math, 16% growth in aggregate on a sequential basis in strategic revenue.

The all-flash segment as well shows us accelerating our all-flash array shipments, and the growth rates continue to be strong off larger footprint. So in aggregate, we are actually very confident about the strategic solutions. We saw accelerating momentum with them in Q4 and through the course of the quarter. And we look forward to, over the course of fiscal 2017, having strategic solutions more offset the decline in the mature category.

Kris Newton
Vice President - Investor Relations

A

Thanks, Sherri. Next question?

Operator: Thank you. And our next question comes from the line of James Kizner from Jefferies.

Jason D. North
Jefferies LLC

Q

Hi, this is Jason North for James. Following up on that last question, as you look into Q1, are you expecting mature solutions decline to lessen year over year? Or conversely, do you think mature solutions could increase year over year to get you to the midpoint of your revenue guidance? Thanks.

George Kurian
Chief Executive Officer & Director

A

We do not expect mature solutions to be substantially different than the FAS we've had. It will not increase as a percentage of our business and will continue to be a smaller part of our business on a go-forward basis. So we expect through the course of next year that strategic solutions will maintain their growth trajectory and will be an ever-increasing part of both product revenue and total company revenue.

Kris Newton
Vice President - Investor Relations

A

Thanks, Jason. Next question?

Operator: Our next question comes from the line of Andrew Nowinski from Piper Jaffray.

Andrew James Nowinski
Piper Jaffray & Co. (Broker)

Q

Great, thank you. I just wanted to ask a question on the FlexPod. So Cisco obviously launched their own hyperconverged platform called HyperFlex, and Nimble is partnering with Cisco now. So it seems like the revenue opportunity for FlexPod might be getting a little bit smaller. I guess how do you view the opportunity with Cisco? And then more broadly speaking, how do you view NetApp's position in the broader hyperconverged market relative to leaders like Nutanix and EMC's VxRail? Thanks.

George Kurian
Chief Executive Officer & Director

A

Let me address those with – those are two questions. I had asked if you just ask a single question. But on FlexPod, we just announced several new exciting innovations that we've been working on with Cisco for a while, an all-flash configuration of the FlexPod that allows us to improve the performance and latency of traditional converged systems as well as FlexPod systems by over 20x.

We've announced the FlexPod lifecycle automation solution, which is a capability that allows us to provide a highly automated deployment model for FlexPod customers that allows you to shrink the time from receiving equipment to serving data to less than an hour. This is competitive with the hyperconverged solutions that are shipping in the market.

And third, with SolidFire, we get the extreme ease of deployment, the simple scalability, and the ability to offer through the use of solutions like OpenStack the benefits of hyperconverged technology, meaning rapid time-to-value and ease of deployment and administration without the compromises that hyperconverged solutions offer.

Kris Newton
Vice President - Investor Relations

A

Thanks, Andrew. Next question?

Operator: Thank you. Our next question comes from the line of Rod Hall from JPMorgan.

Q

Hi, guys. This [ph] RK (41:54) on behalf of Rod. Thanks for taking my question and congratulations to Ron. My question is around services revenue growth. Now that has been deteriorating through the course of FY 2016. Could you help us think about that going forward? Would it just continue to deteriorate at a lag to product revenue growth?

Ronald J. Pasek
Chief Financial Officer & Executive Vice President

A

So no. We still are increasing our install base, therefore are increasing our services revenue. You saw a large increase as well in deferred revenue this quarter, a little over $200 million. So I think even though you have mature business declining, it's still adding to the installed base, as are our strategic solutions. As well what you see is the services business is becoming more profitable. So I don't know if that answers your question, but I think we don't see that being a drag on the business.

Kris Newton
Vice President - Investor Relations

A

Thanks, [ph] RK (42:53). Next question?

Operator: Thank you. Our next question comes from the line of Brian White from Hamilton.

Brian J. White
Drexel Hamilton LLC

Q

Hey, George. I'm wondering if you could give us some color on the growth rate NetApp had with the hyperscale cloud providers in fiscal 2016 and some type of range around a percentage of revenue. Obviously, this is a big theme and it's having an impact on the industry. So how did you grow in fiscal 2016? Thanks.

George Kurian
Chief Executive Officer & Director

A

We're not going to break out numbers. They are small numbers, but we had good growth off the solutions that connect to the hyper-scale providers. Essentially, we have NetApp Private Storage that provides customers with secure data management capabilities and allow you to use the compute cloud of hyper-scale providers. We have AltaVault that provides backup as a service to the cloud providers, where essentially a customer can use a cloud provider as a repository and use it as an alternative to on-prem backup solutions; and we have cloud ONTAP.

All of those had substantial growth, but of small numbers. We actually measure the impact of those solutions in the way they allow us to beat competitors that are building closed proprietary stacks. And we've seen – as I said on the call, we had substantial wins in several parts of the world where our open Data Fabric strategy, allowing people to combine public hybrid clouds with on-premises data centers gives us a strategic advantage over people who are building proprietary clouds.

Kris Newton
Vice President - Investor Relations

A

Thanks, Brian. Next question?

Operator: Thank you. Our next question comes from the line of Steve Milunovich from UBS.

John M. A. Roy
UBS Securities LLC

Q

Thank you. Hey, it's John Roy for Steve. So real quick, on the outlook for flash pricing and the upcoming 16-terabyte SSDs, is that going to help you guys with margins or is that something you think you're going to have to pass through to customers? And how does the pricing environment kind of look going forward?

George Kurian
Chief Executive Officer & Director

A

First of all, we feel good about the progress that these promotions have enabled us to achieve. We've gained channel mindshare. We have essentially come from a long way back in the flash market to rapidly outpacing everybody, big and small, in that market into a leadership position. And we've enabled our install base of clustered ONTAP customers to move to our clustered operating system. We have those promotions in place. We intend to continue them, but we do have to control for how long we run them, first of all.

The second is as we introduce the next versions of ONTAP, we will continue to expand our leadership in enterprise data management, as well as introduce particular patent-pending storage efficiency techniques that allow us to be more cost effective than we have been so far. And you'll see us take advantage of that by improving the margins over time.

Ronald J. Pasek
Chief Financial Officer & Executive Vice President

A

Right now, I think you should assume the margins are neutral. They're really not any different.

Kris Newton
Vice President - Investor Relations

A

All right. Thanks, John. Next question?

Operator: Thank you. Our next question comes from the line of Maynard Um from Wells Fargo.

Munjal R. Shah
Wells Fargo Securities LLC

Q

Yes. It's Munjal on behalf of Maynard. The question was that if we look at strategic revenue, that's 61% in Q4; for the full year it was 53%. So it's already more than half of your business. Then why do we view fiscal 2017 still as a transition year? And should we be looking at the mix of all-flash array as a better gauge to see when your top line turns this around? And then just a clarification, do you still expect 2% growth from SolidFire in fiscal 2017?

George Kurian
Chief Executive Officer & Director

A

So, first of all, with regard to the comment about being a transition year. It's a transition year with regard to product revenue, where the absolute dollar decline of the mature category is still a drag in fiscal 2017. 61% is not 100% yet, right? And so, it will be a drag until we transition the mature business to where it's a far less important part of our business. In terms of SolidFire, the outlook for SolidFire is the same as we communicated last quarter, which is about 2%.

Kris Newton
Vice President - Investor Relations

A

Thanks. Next question?

Operator: Thank you. Our next question comes from the line of Katy Huberty from Morgan Stanley.

Jerry Yuan Liu
Morgan Stanley & Co. LLC

Q

Hey. This is Jerry Liu for Katy. Can you guys talk about for the first quarter of 2017 what's driving that gross margin improvement sequentially? Is it less discounting, is it sustainable, or is it product mix and other things? Thanks.

Ronald J. Pasek
Chief Financial Officer & Executive Vice President

A

It's mainly product mix, within products; and then to some extent the products and services piece, too.

Kris Newton
Vice President - Investor Relations
A

Thanks. Next question?

Operator: Thank you. Our next question comes from the line of Aaron Rakers from Stifel.

Andrew Shinn
Stifel, Nicolaus & Co., Inc.
Q

Hey, this is Andy Shinn on for Aaron. Thanks for taking the question. So I think that I heard you guys say that product gross margins were lower just due to promotions to incentivize customers to switch over to cDOT, but I'm curious why didn't you see relatively more the install base upgrade to cDOT versus the 26% you reported? And basically what percent of that install base is at risk of leaving NetApp?

George Kurian
Chief Executive Officer & Director
A

So let me answer that question in a couple of ways, right? First of all, the total install base of 7-Mode systems and clustered ONTAP systems is growing. So our install base in not declining, it's actually growing, and clustered ONTAP is growing as a percentage of that. The install base is a very large number, so even 26% of that install base is actually a substantial number.

We've run promotions through the course of the year to enable customers to transition from 7-Mode to clustered ONTAP. As we noted, about 1,300 customers accelerating through the course of the year decided to move forward from 7-Mode to clustered ONTAP. The percentage of the install based number that you see sometimes lags the point at which they actually decide to convert because we have to see that show up in our reporting systems. We also see as they migrate that some of those smaller systems get replaced potentially by fewer larger clustered ONTAP systems, so the percentage of systems under clustered ONTAP actually underrepresents sometim es the total value of the systems that we have transitioned.

In terms of the overall outlook for clustered ONTAP, we continue to stay focused on the total percentage of our install base look like total percentage of shipments. And as you see, the percenta ge of shipments is very much clustered ONTAP, 85% of shipments off the factory and capacity under management which is now close to 40%.

Kris Newton
Vice President - Investor Relations
A

Thanks. Next question?

Operator: Thank you. [Operator Instructions] Our next question comes from – is a follow-up from the line of Lou Miscioscia from CLSA.

Louis Miscioscia
CLSA Americas LLC
Q

How did I know this was going to happen? When you look at the flash marketplace, do you think that actually due to the dynamics of flash there will actually be an upward cycle or are you seeing most customers just actually replacing? They're obviously spinning disk drives or their hybrid drives with flash as the environment comes around.

George Kurian
Chief Executive Officer & Director

A

I think we see, first of all, the flash market transitioning from a place where it was essentially a performance use case to one where it replaces performance drive; meaning, staff drive in the market. As customers make that transition, what they really want in the sort of the majority move is they want the enterprise data management features. And how they choose to use it can be one of three ways.

The first is greenfield, where for new deployments of enterprise applications they choose to deploy an all-flash configuration as opposed to a hybrid or disk-based configurations. The second could be a retrofit of an existing architecture where in the case of clustered ONTAP, we are able to give people a completely transparent way to upgrade a disk drive system to an all-flash system. And so, if you've got temporal needs or need for additional performance at a particular point in the season, you can do that very, very easily with us. And the third, as we have noted, is all-flash systems or the new SAN configuration. And we have replaced in customer after customer traditional cyber channels frame arrays from our incumbent competitors with all-flash storage systems.

Kris Newton
Vice President - Investor Relations

A

Thanks, Lou. Next question?

Operator: Thank you. And that concludes our question-and-answer session for today. I would like to turn the conference back over to NetApp for any closing comments.

George Kurian
Chief Executive Officer & Director

Thank you for your attendance on the call this afternoon. In closing, let me reiterate my confidence in NetApp's potential. We're committed to fundamental change and remain sharply focused on the execution of our three key priorities: pivot to growth with our differentiated portfolio of strategic solutions; reduce cost, improve speed and focus by streamlining our business; and a robust capital allocation plan that includes shareholder return and investment for the long-term growth of the business.

We're building on a lot of positives. Our Data Fabric strategy is aligned with our customers' strategic IT imperatives. The strategic solutions are greater than 60% of product revenue and growing well. We have a large and growing install base. And we saw accelerating customer momentum in Q4. And in the coming weeks, we will further advance our leadership position in flash and the next generation data center with exciting ONTAP and SolidFire innovation.

I'm confident in our potential and I'm excited to have new leaders on board. FY 2017 will be a year of transition. We expect that the growth of strategic solutions will outpace the declines and mature, returning the company to growth in fiscal year 2018. I look forward to speaking with you all again next quarter. Thank you.

Operator: Thank you. Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program and you may now disconnect. Everyone, have a good evening.