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NetApp, Inc. (NTAP)

Q3 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to the NetApp Third Quarter Fiscal Year 2023 Earnings Conference Call. All participants will be in a listen-only mode. [Operator Instructions] . After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note this event is being recorded.

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

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

Hi, everyone. Thanks for joining us. With me today are our CEO, George Kurian; and CFO, Mike Berry. This call is being webcast live and will be available for replay on our website at netapp.com.

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 fourth quarter and fiscal year 2023; our expectations regarding future revenue, profitability and shareholder returns; our alignment with the secular growth trends of data driven digital and cloud transformation; our expectations regarding the future growth in the number of cloud customers, their usage of cloud services and the resulting impact on our Public Cloud and Hybrid Cloud segments; our ability to deliver innovation, sharpen our execution and focus on our strategic growth opportunities while optimizing our operating costs; and our ability to strengthen our position, rebalance our sales and marketing efforts and drive sustained growth in both our Hybrid Cloud and Public Cloud segments in a turbulent macroeconomic environment, all of which involve risk and uncertainty.

We disclaim any obligation to update our forward-looking statements and projections. Actual results may differ materially for a variety of reasons, including macroeconomic and market conditions, such as the IT capital spending environment, including the focus on optimization of cloud spending; inflation, rising interest rates and foreign exchange volatility and the continuing impact and uneven recovery of the COVID-19 pandemic, including the resulting supply chain disruption, as well as our ability to keep pace with the rapid industry, technological and market trends and changes in the markets in which we operate, execute our evolved cloud strategy and introduce and gain market acceptance for our products and services, maintain our customer, partner, supplier and contract manufacturer relationships on favorable terms and conditions, manage material cybersecurity and other security breaches and manage our gross profit margins and generate greater cash flow.

Please also refer to the documents we file from time to time with the SEC and available on our website, specifically our most recent Form 10-K and Form 10-Q, including in the Management's Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors section. During the call, all financial measures presented will be non-GAAP, unless otherwise indicated. Reconciliations of GAAP to non-GAAP estimates are posted on our website.

I'll now turn the call over to George.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

Thanks, Kris. Good afternoon, everyone. Thanks for joining us today.

In Q3, we executed well on the elements under our control in the face of a weakening IT spending environment and continued cloud cost optimization. Disciplined operational management yielded operating margin and EPS that exceeded expectations despite revenue coming in at the low end of our guidance. We are delivering on our commitments and responding to the dynamic environment. We adjusted our cost structure, introduced a portfolio of capacity flash arrays to support cost sensitive customers and continue to work with our customers to help them optimize their cloud spending.

On today's call, I will discuss our Q3 results in the context of the current environment and our plans to sharpen our execution to accelerate near-term results and enhance our long-term position. We continued to see increased budget scrutiny, requiring higher level approvals, which resulted in smaller deal sizes, longer selling cycles and some deals pushing out. We are feeling this most acutely in large enterprise and the Americas tech and service provider sectors.

Customers are looking to stretch their budget dollars, sweating assets, shifting spend to hybrid flash and capacity flash arrays from higher cost performance flash arrays, and as our cloud partners have described, optimizing cloud spending. We saw signs of a softening environment early in fiscal year 2023 and took swift action to control costs with increased scrutiny of program spending, a hiring slowdown in Q2 and a hiring freeze in Q3.

At the start of Q4, we implemented a workforce reduction of approximately 8%. Decisions that impact our employees are always difficult. I take great pride in fostering the NetApp culture, and I'm committed to using this difficult action to refocus our team guided by the values and mission of the company.

Our hybrid flash and QLC-based all-flash arrays continue to perform well, benefiting from customers' price sensitivity in this challenging macro. The shift from high-performance all-flash arrays to lower cost solutions, coupled with the lower spending environment, especially among large enterprise and US tech and service provider customers who are large consumers of flash, created headwinds to our product and all-flash array revenues.

In Q3, our all-flash array business decreased 12% from Q3 a year ago to an annualized revenue run rate of $2.8 billion. Public Cloud ARR of $605 million did not meet our expectations driven by a shortfall in cloud storage as a result of the same factors we experienced last quarter.

Spending optimization and the winding down of project-based workloads like chip design, EDA and HPC were headwinds again in Q3. We have a sizable base of public cloud customers with a number of large customers who have grown rapidly over the past year and are now optimizing. Their cost optimizations masked the growth of other customers. We continue to add new customers, and churn has remained consistently low.

Overall, the CloudOps portfolio performed to plan. Cloud Insights have stabilized, and Spot continues to grow nicely, benefiting from the cost optimization trend. Our dollar-based net revenue retention rate decreased to 120%, but is still within healthy industry norms. We are confident that we remain well positioned to take advantage of the secular growth trends of data-driven digital and cloud transformations.

We are aligned to customers' top priorities and have demonstrated success in controlling the elements within our control. Building on that solid foundation, we are sharpening our execution to accelerate near-term results while strengthening our position for when the spending environment rebounds.

We have three areas of focus. First, we will remain prudent stewards of the business, and we'll continue to tightly manage the elements within our control. Second, we are reinvigorating efforts across the company in support of our storage business. Third, we are building a more focused approach to our Public Cloud business.

Starting with the first area of focus, remaining prudent stewards of the business and managing the elements within our control. We will maintain our focus on cost controls, so that expenses do not grow ahead of revenue. We will achieve this by maintaining our scrutiny on program spending and hiring, as well as focusing our investments on the products that represent the biggest opportunity.

We've made difficult decisions to reduce investment in products with smaller revenue potential like Astra Data Store and SolidFire. The results of this focus are visible in our ability to maintain our free cash flow, operating margin and EPS guidance, despite lower revenue.

On to the second focus area, reinvigorating our storage business. As we moved rapidly to embrace cloud, we lost some momentum in our Hybrid Cloud business. We are taking decisive action to strengthen our position and performance by better addressing the areas of market growth, delivering more customer value and realigning our go-to-market activities to better address this opportunity.

We were slow to fully embrace the customer desire for lower cost capacity-oriented all-flash systems. At the start of Q4, we rectified that situation with the introduction of the AFF C-Series, the most comprehensive industry-leading portfolio of QLC-based all-flash arrays that addresses a wide range of workloads and price points. These products will help customers manage through a cost sensitive environment, while at the same time, supporting their pursuit of sustainability targets.

Initial response has been very positive, and we are already quoting deals for customers. The AFF C-Series will drive AFA revenue and support product gross margin, as customers rotate from lower margin hybrid flash to all-flash systems.

In addition to expanding our product portfolio, we've introduced a number of innovations to improve the customer experience and bring predictability to their investment process. In Q3, we released BlueXP, a unified control plane that helps decrease resource waste, complexity and the risk of managing diverse environments. As a part of our sustainability commitment, we are previewing a new dashboard in BlueXP to help customers understand their data center carbon footprint across environments.

Early in Q4, we introduced NetApp Advance, our best-in-class portfolio of programs and guarantees, which is already helping us win new customers and drive revenue. We are rebalancing our sales and marketing efforts to better address the significant storage market opportunity, including aligning compensation plans to drive sales of our reinvigorated storage portfolio. We believe that these actions will enable us to drive product revenue growth and regain share in the all-flash array market.

Finally, our third area of focus, building a more focused approach to cloud. While we are reinvigorating our storage business, we have no intention of taking our foot off the pedal in Public Cloud. It represents a huge growth opportunity for us with a gross margin profile that is accretive to the business.

Additionally, our Public Cloud services are highly differentiated with a multiyear advantage over our traditional competitors and create customer preference for NetApp.

We have sharpened the focus in our CloudOps portfolio and have taken actions that could have future revenue and ARR implications. We believe that our CloudOps services will continue to deliver stable, steady growth over the long-term.

Our customer success team has made good progress in driving utilization of our CloudOps services, but we need to do more with our cloud storage and data services. Additionally, we recognize that we have not been using our go-to-market resources to their best effect here.

In addition to refocusing our sales team on the reinvigorated storage portfolio, we are identifying ways to most effectively align our sales resources to the buying centers and consumption models for all our solutions.

Our cloud storage business is predominantly consumption-based and largely driven by our hyperscaler partners. These factors, coupled with the current cloud cost optimization environment, have impacted our ability to forecast ARR.

However, as we grow the business, the impact from a subset of customers will be mitigated, smoothing its growth and improving predictability. I want to underscore my confidence in this opportunity. The migration of enterprise applications like SAP and VMware to the cloud as well as cloud-native applications like artificial intelligence, create a massive market in which we can grow.

We believe strongly that Public Cloud services can be a multibillion-dollar ARR business for us. However, achieving that target will take longer than we initially planned due to the industry-wide slowdown in cloud spending and our recent performance.

In closing, we have seen tangible success from our efforts to manage the elements within our control in a challenging environment. Despite our lowered revenue outlook, we have preserved free cash flow and EPS expectations.

In the first three fiscal quarters of this year, we have returned over $1 billion to shareholders and reduced share count by 4%. We are sharpening our execution to accelerate near-term results and enhance our position for the long-term.

We are taking these steps now so that as we begin FY 2024, we are in a new, more focused operating model to attack the opportunity ahead, drive growth, and deliver shareholder value.

Before turning the call over to Mike, I want to give my thanks to the NetApp team for their operational discipline and rapid response to set us up for better results. I have seen firsthand how hard they are working to navigate the challenging environment, and I really appreciate their efforts.

Michael J. Berry

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

Thank you, George. Good afternoon, everyone, and thank you for joining us.

Before we go through the financial details, I think it would be valuable to reiterate the key themes for today's discussion that George highlighted. Number one, despite the temporary headwinds to revenue, our disciplined operational management yielded op margin and EPS above the high end of guidance.

Number two, the macro backdrop and demand environment continue to be major headwinds. The weakening IT spending environment was most pronounced in our large enterprise and US technology and service provider customers and materially impacted our all-flash revenue in Q3, while significant cloud optimization across all three major hyperscalers continued to weigh heavily on ARR growth. Although the US dollar weakened slightly during Q3, FX continues to be a material headwind to our financial results on a year-over-year basis.

Number three, as we navigate through this fluid demand environment, we remain laser-focused on driving operating margins and free cash flow generation. Towards this end, we took swift action in Q3 to control costs through increased program spending scrutiny and a hiring freeze. And at the start of Q4, we implemented a reduction in force of approximately 8%. In addition to adjusting our own cost structure, we also introduced C-Series, a portfolio of QLC capacity flash arrays to support cost-sensitive data center customers, and we continued to work with our cloud customers to help optimize their spending.

And number four, as a result of our disciplined cost management, we are reiterating our full-year EPS guide of $5.30 to $5.50. We are also confident in our free cash flow target of $1.1 billion, adjusting for the restructuring and one-time cash payment in Q4. From a capital allocation perspective, we remain committed to returning more than 100% of fiscal 2023 free cash flow to investors through dividends and share repurchases.

Now to the details. As a reminder, I'll be referring to non-GAAP numbers, unless otherwise noted. Q3 billings were $1.57 billion, down 11% year-over-year. Revenue came in at $1.53 billion, down 5% year-over-year. Adjusting for the 340-basis-point headwind from FX, billings and revenue would have been down 7% and 2% year-over-year, respectively. Even with the challenging Q3, our cloud portfolio continues to positively impact the overall revenue growth profile of NetApp.

Hybrid Cloud segment revenue of $1.38 billion was down 9% year-over-year. Product revenue of $682 million decreased 19% year-over-year, as customers took a decidedly cautious approach to capital spending. Total Q3 recurring support revenue of $616 million increased 5% year-over-year, highlighting the health of our installed base.

Public Cloud ARR exited Q3 at $605 million, up 29% year-over-year. Public Cloud revenue recognized in the quarter was $150 million, up 36% year-over-year and 6% sequentially. As highlighted by our three major hyperscaler partners, customers continue to optimize our cloud spend as organizations are exercising caution, given the macroeconomic uncertainty. While the timing of the recovery remains unclear, we are confident that secular trends of AI, machine learning, IoT, and high-performance computing, along with the migration of enterprise apps like VMware and SAP, will drive long-term growth in cloud storage consumption.

Recurring support and Public Cloud revenue of $766 million was up 10% year-over-year, constituting 50% of total revenue. We ended Q3 with $4.2 billion in deferred revenue, an increase of 6% year-over-year.

Q3 marks the 20th consecutive quarter of year-over-year deferred revenue growth, which is the best leading indicator for recurring revenue growth. Total gross margin was 67% in Q3, in line with our guidance. Total Hybrid Cloud gross margin was also 67% in Q3. Within our Hybrid Cloud segment, Product gross margin was 46.5%, including a 2-point year-over-year headwind from FX.

As noted, our large enterprise and US tech and service provider customers have continued to reduce CapEx spend as they right-size their spending envelops. These customers are the most forward-leaning technology adopters and the biggest consumers of all-flash systems in the economy, and their pause in CapEx spending has had a material impact on our total revenue, all-flash mix, and product margins. And while the supply chain component premiums and NAND pricing notably improved in Q3, we had to work through higher cost inventory during the quarter.

We expect the improving supply chain and NAND pricing to be a tailwind to product margin in Q4 and fiscal 2024. Our growing recurring support business continues to be very profitable with gross margin of 93%. Public Cloud gross margin of 69% was accretive to the corporate average for the ninth consecutive quarter. We remain confident in our long-term Public Cloud gross margin goal of 75% to 80%, as the business scales and an increasing percentage of our Public Cloud revenue is driven by cloud and software solutions.

While revenue came in at the low end of guidance, Q3 highlighted our operational discipline and cost controls, with operating margin of 24%, including 2 points of FX headwind. EPS of $1.37 came in above the high end of guidance, and included $0.14 of year-over-year FX headwind.

Cash flow from operations was $377 million, and free cash flow was $319 million. Inventory turns increased to 12 in Q3, up from 9 in Q2, as supply chain challenges eased in the quarter, enabling us to take down inventory by nearly $70 million sequentially.

During Q3, we repurchased $200 million in stock and paid out $108 million in cash dividends. In total, we returned $308 million to shareholders, representing 97% of free cash flow. Share count of 219 million was down 4% year-over-year. We closed Q3 with $3.1 billion in cash and short-term investments, up $108 million sequentially.

Now to guidance. As George discussed, we have seen continued softening in the macro backdrop, with customers taking a decidedly cautious approach to spending. We now expect fiscal 2023 revenue to be roughly flat year-over-year, which includes 3 to 4 percentage points of FX headwind.

In fiscal 2023, we continue to expect gross margin to range between 66% and 67%, as elevated component costs and FX headwinds weigh on product margins. While the timing is uncertain, we remain confident that our structural product margins will normalize back to the mid-50s in the fullness of time, particularly when you factor in our new C-Series portfolio, which will largely displace lower margin hybrid spinning disk systems in our product mix.

Given our disciplined cost controls, we are raising our fiscal 2023 operating margin guidance. We now expect op margin to range between 23% and 24%, which includes approximately 2 points of FX headwinds.

Last quarter, we committed to protecting both EPS and free cash flow during this uncertain macro environment. Today, we are reiterating our full year EPS guide of $5.30 to $5.50, which includes $0.54 of currency impacts. We also continue to expect to generate $1.1 billion in free cash flow, excluding one-time items. From a capital allocation perspective, we remain committed to returning more than 100% of fiscal 2023 free cash flow to investors through dividends and share repurchases.

Now on to Q4 guidance. We expect Q4 net revenues to range between $1.475 billion and $1.625 billion, which, at the midpoint, implies an 8% decrease year-over-year or a 6% decrease in constant currency. In this macro environment, we expect customers to continue to optimize our cloud spend at our three major hyperscaler partners. As a result, we expect cloud revenue and ARR to be approximately flat sequentially in Q4.

Please note, as we head into fiscal 2024, we plan to anchor our cloud segment guidance on revenue dollars instead of ARR. To be clear, we will continue to disclose cloud ARR as a key metric as we go through the year.

We expect consolidated gross margin to be approximately 67%. As we head into Q4, we are forecasting a material reduction in component premiums, decreasing NAND costs and engineering product efficiencies. As such, we are confident that product margins will rise in Q4.

These trends also position us nicely heading into fiscal 2024 to drive the leverage through our business model, particularly as customers begin to reengage on all-flash capacity buildouts and customers mix shift away from hybrid spinning disk systems to new QLC all-flash solutions.

While the exact timing is unclear, large enterprise and US tech and service provider customers are the largest consumers of data and storage in the global economy, and our all-flash ONTAP systems are structurally linked to their data growth cross-cycle.

In Q4, we expect operating margin to range between 23% and 24%. We anticipate our tax rate to be approximately 21%. We are forecasting earnings per share for Q4 to range between $1.30 and $1.40 per share. Assumed in our Q4 guidance is net interest income of $7.5 million and a share count of approximately 218 million.

In closing, I want to thank the entire NetApp team for their continued commitment in such an uncertain economic environment.

I'll now hand the call back to Kris to open the call for Q&A. Kris?

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

Thanks, Mike. Operator, let's begin the Q&A.

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] . And the first question will come from Amit Daryanani with Evercore. Please go ahead.

Amit Daryanani

Analyst, Evercore Group LLC

Q

Yes. Thanks for taking my question. I guess the first one I had was if I think about the delta in cloud ARR from $700 million last quarter that we're expecting to maybe $605 million range right now, how much of the delta or the drop, if you may, is due to macro issues versus something that might be more company-specific? Is there a way to parse that out? And then, do you see the resumption of growth happening in 2024 as you go forward?

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

A

I think the broad themes that we saw were shared across all of the hyperscalers and across a broad range of customers. We continue to see good numbers of new customer additions to our cloud storage offerings. Even though the impact in the quarter from there being acquired is lower, we had – we saw no changes to the churn in our cloud storage business, but we did see optimization, meaning movement of capacity from higher cost, more high-performance levels to lower cost, lower performance levels. And there was no predictable pattern in terms of what types of customers.

As we noted last quarter, we also saw some reductions in spending from customers who wrapped up projects with us. So, I will just say this is part of normal cloud behavior and consumption. We feel good about the additions. We feel good about our engagement with customers. And we feel good about the fact that we continue to broaden the number of use cases and customer value propositions we can address that should benefit us moving forward with a more focused route-to-market approach for cloud as well.

Amit Daryanani
Analyst, Evercore Group LLC
Q

Okay. Got it. And then, could I spend maybe 60 seconds on the gross margin dynamics into April quarter? I think you're essentially saying, I think, gross margins are flat, up 20 basis points sequentially, but that's despite the fact you have a little bit of revenue leverage. And then it sounds like NAND pricing and commodity pricing broadly is coming down. So, I would have thought gross margins could be up a bit more maybe in April quarter. So, maybe just talk about the puts and takes on the gross margin line, that'd be super helpful. Thank you.

Michael J. Berry
Chief Financial Officer & Executive Vice President, NetApp, Inc.
A

Sure. Amit, it's Mike. So, I'll do both, Hybrid Cloud just – and a little bit of cloud margins as well. So, on Hybrid Cloud, what we really saw was if you go back to the two big drivers that we saw in the business, one is with our lower spending in US strategic large enterprise. They are the largest purveyors of all-flash. So, we saw all-flash dollar and mix come down.

In addition, we've talked about seeing lower capacity, i.e. folks buying less terabytes per system. That happened within both flash and hybrid. So, those two added together brought our margins down in Q3. We didn't really see a benefit on NAND or premiums yet. This is hopefully the last time I'm going to say this on a call, because we fully expect in Q4 that to finally start to realize in the P&L. We will see the benefits of a lot lower premiums.

And finally, the lower cost NAND as we work through the inventory will roll through the P&L. So, we feel good about the gross margins projection in the April quarter being at least 50%. And then cloud margins, hey, it's really dependent more than anything on scale. We feel good about getting to the mid-70s as we scale that business, but we do need to drive higher revenue. So, hopefully, that helps.

Amit Daryanani
Analyst, Evercore Group LLC
Q

Super helpful. Thank you.

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

All right. Thanks, Amit. Next question.

Operator: The next question will come from David Vogt with UBS. Please go ahead.

David Vogt
Analyst, UBS Securities LLC
Q

Hey, great. Thanks guys for taking my question. Maybe, George, I just want to go back to your comment that you mentioned that you lost some momentum in Hybrid Cloud. Just wanted to drill down on that comment. Can you maybe elaborate on a little bit more specifically, what did you mean by that? Obviously, it's a key driver of the business and an important cash flow engine, but just would love to get some more color on that. And then I have a follow-up. Thanks.

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

A

I think there are three elements of that. I think the first, we have been a little bit later than we would have liked to introduce lower cost more value oriented capacity flash arrays. We've corrected that. We feel really good about the early interest in our C-Series.

The second was that we have moved resources to the more stable, steady growth parts of the market like the commercial market and lower parts of the enterprise from the cyclical large enterprise segment; we haven't done as much as we need to, and we'll continue to do that heading forward.

And the third is that from a compensation and goal alignment perspective, we're going to sharply focus certain parts of our field organization to drive our flash portfolio while aligning other parts of our field organization to focus on the cloud business.

David Vogt
Analyst, UBS Securities LLC

Q

Got it. And then maybe just a follow-up to that is, so typically, what is the lead time? Or how does the cycle or the sales cycle work from, let's say, start to traction for these initiatives? Should we expect sort of a recovery in, let's say, the second half of fiscal 2024 in these particular markets driven by the strategy? Or does it take a little bit longer or maybe shorter to see some tangible benefits? Thank you.

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

A

I think, first of all, we are excited about the C-Series products. They will be available this quarter. I think the material impact of those product portfolios will be in the first half of next fiscal year. The large enterprise segment will continue to be a place of caution for us. I think that we will need – we are working with our customers to understand their buying behavior. My sense is that and my hope is that they are back buying more aggressively than they have been in the second part of next fiscal year.

So, we hope that – the product portfolio is in the market this quarter. Commercial and lower-end parts of the enterprise should see some benefits from that in the first half of next fiscal year. But the large enterprise segment, we're a bit more cautious about. And your expectation is more accurate around second half of next fiscal year is our hope.

David Vogt
Analyst, UBS Securities LLC

Q

Great. Thank you very much, guys.

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

A

Thanks, David. Next question?

Operator: The next question will come from Steven Fox with Fox Advisors. Please go ahead.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Hi. Good afternoon. Just following up on those last comments around the commercial versus large enterprise. I guess, how do we think about just sort of a pivot back so that you prepared for the cycle? Like what are you looking for in order to maybe have the right resources ready for when the large enterprises do come back and you need to be prepared to service them in a more aggressive manner? And then I had a follow-up.

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

A

We are very closely engaged with these customers. We've known them for decades. I think the fundamental pattern is the improvements in their business prospects. So, as soon as they see that, they start the discussions with us on purchasing.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Okay. That's helpful. And then just in terms of the benefits now with NAND and other component costs low, can you just talk about – give us a sense for how much of your sales are benefiting from the low-cost NAND in this current quarter? And how much more there would be to go before you like at 100% of where NAND prices are? Thanks.

Michael J. Berry
Chief Financial Officer & Executive Vice President, NetApp, Inc.

A

So, this quarter, on the low-cost NAND, it's not a big number, Steve, in this quarter. We do expect that that will be a significant contributor going into fiscal 2024. I would just – hey, take a step back on the margin side. There are two significant drivers to our optimism as we look at product margins in 2024. One is the premiums. We've talked about that. It's about $50 million a quarter. It is a material improvement going into next year.

NAND, as we all know, has come down materially every quarter since in the last three quarters. We're finally going to be able to realize in our P&L as we got – as we move through the high-cost inventory. And then you talked about the mix that will also benefit product margins going into next year and then goodness, hopefully, FX also helps. So I would add all four of those together when you look at product margins in fiscal 2024.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Great. That's helpful. Thank you.

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

A

Thanks, Steve. Next question.

Michael J. Berry
Chief Financial Officer & Executive Vice President, NetApp, Inc.

A

Thank you.

Operator: The next question will come from Wamsi Mohan with Bank of America. Please go ahead.

Wamsi Mohan
Analyst, BofA Securities, Inc.

Q

Yes. Thank you. It sounds like you were impacted by both share and weaker demand in all-flash. Is that correct? And is the share loss because of product gap that you are now filling with AFF C? It just seems like a large decline coming just from the low end of the AFF market? So, any color there would be helpful. And I have a follow-up.

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

A

Yeah. I think that our exposure to the large tech and service provider segments and our large market share in markets like Germany exposed us when those segments and countries slowed down in their purchasing behavior. I think that having a smaller number of QLC products, also concluded us from participating in some purchasing activities, some RFPs in the past couple of quarters. And I think we are excited about the return to having the best lineup of flash, both performance and capacity flash. And we've got to see progress in terms of – continued progress in our enterprise and commercial customers over the next few quarters to wait for the large enterprise purchasing to come back.

Wamsi Mohan
Analyst, BofA Securities, Inc.

Q

Okay, okay. Thanks, George. And you're exiting this year with somewhat worsening momentum, given the macro from down 2% constant currency in Q3 to guiding down 6% in Q4, despite sort of this new introduction of new products.

Any early thoughts into fiscal 2024? I know you commented on the margin improvement and the confidence there, but anything on the revenue side that you can help us with would be super helpful. Thank you.

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

A

Yeah. I think, first of all, you have seen us be disciplined stewards of the business in good times and bad. You should expect us to continue to maintain operating expenses tightly managed until we see growth.

Product margins, as Mike said, should have significant upside as we roll into fiscal year 2024 as both mix shifts towards all-flash and component costs in all-flash come down, as well as premiums go away.

In terms of returning to growth, listen, I think that we will – we are aligning our resources to be much more focused on our respective businesses. In the flash market, you should expect us to continue to track the progress of our flash market share. I think that, as I said, both enterprise and commercial segments should see growth, while the large enterprise takes some more time to come back.

And then, I think in terms of cloud, listen, I think consumption will continue to be a headwind for a period of time, as our cloud provider partners have also said. That does not mean that we are going to not continue to accelerate new customer acquisition. And a more aligned go-to-market model for flash and for Public Cloud services, respectively, will help us do that, execute better against each of those opportunities. We'll tell you more when we guide fiscal year 2024.

Wamsi Mohan
Analyst, BofA Securities, Inc.
Q

Okay. Thank you, George.

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

Thanks, Wamsi. Next question?

Operator: The next question will come from Mehdi Hosseini with SIG. Please go ahead.

Mehdi Hosseini
Analyst, Susquehanna Financial Group LLLP
Q

Yes. Thanks for taking my question. It seems like April being the fourth quarter fiscal year helps with a little bit of sequential bump in revenue, but should I expect a rather seasonal trend into Q1 fiscal year 2024? And I have a follow-up.

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

Listen, at this point, we are being appropriately conservative in our guidance. I think that we see the impact of a tough macro environment on customer spending. And both Mike and I are being appropriately prudent in our Q4 guide. We're not guiding Q1 at this point. We'll guide fiscal year 2024 and Q1 when we do that. But at this point, I want to be prudent about what we see in the market.

Mehdi Hosseini
Analyst, Susquehanna Financial Group LLLP
Q

Got it. And then, for Mike, should I assume that the full impact of the head count reduction is dialed into the April quarter, or would you be able to reduce the OpEx into July quarter?

Michael J. Berry
Chief Financial Officer & Executive Vice President, NetApp, Inc.
A

Yeah. Thanks, Mehdi, for the questions. So, we'll get a portion of the restructuring, call it, 70% to 80% because of notifications and other things. So that is baked into our Q4 implied OpEx of about $675 million, which is down from our previous number of about $715 million. Most of that is restructuring and some incentive comp.

And then, hey, the other thing – again, we will guide Q1 when we get there. I just want to add two other things to George's great summary going into next year. We talked about product margins. We talked about OpEx. Keep in mind, too, that FX has been a material headwind for us this year, and we expect – hope that that is at least flat.

The other thing is, keep in mind, from a tax rate perspective, we've grown EPS even with a significantly higher tax rate. So, hey, lots of good things going into fiscal 2024 that give us confidence in being able to drive the bottom line.

Mehdi Hosseini
Analyst, Susquehanna Financial Group LLLP
Q

Got it. Thank you.

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

A

Thanks, Mehdi. Next question.

Operator: The next question will come from Tim Long with Barclays. Please go ahead.

Tim Long
Analyst, Barclays Capital, Inc.

Q

Thank you. Maybe two questions, if I could. First, just curious on the flash C product. Could you talk a little bit about – it sounds like you're expecting that'll cannibalize or replace some of the disk and hybrid-based systems. Any risk there that there is some impact on the higher performance flash? And what would that mean to margin structure or revenues? And then, I have a follow-up on the cloud after that.

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

A

I think the capacity flash arrays that we recently announced have a workload profile and a performance profile that's distinct from the performance flash array. Performance flash are typically sub-millisecond kind of latency. In capacity flash, it's about two to three milliseconds. So, they are distinct use cases. Capacity flash will be an upsell on the hybrid flash array and will, over time, impact the percentage of our business mix that's hybrid flash.

Tim Long
Analyst, Barclays Capital, Inc.

Q

Okay. Thanks. That's helpful. And then, on the cloud part and the recovery, two-parter. One, have you noticed any level of engagement? And we've got the pushouts that's going around. But any different level of engagement by the big cloud players?

And then, related to that, how have you guys progressed with transitioning ONTAP on-premise customers to also start taking some of your cloud-based services in their hybrid cloud deployments? Thank you.

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

A

We continue to have great engagement with our cloud provider partners. As I mentioned, customer acquisition continues to be a good part of our cloud business. The impact in the quarter is limited because the initial deployments are small. So that's the first.

Second, with regard to cross-selling multiple cloud services after the initial use case, we have done well, and I'm pleased with progress. In terms of the customers that we are engaged with on consumption, there is no churn difference, right? So, the pattern is they are reducing the performance level of the storage use case, but they're not churning off our service. So, I feel really good. Actually, I think it's the best part of being a partner is to help your clients use the right use combination of services.

And then in terms of penetration of our installed base, while it's early, we continue to see that moving forward steadily. I think the penetration in our NetApp managed enterprise accounts is much higher than in our commercial segment.

Tim Long
Analyst, Barclays Capital, Inc.

Q

Okay. Thank you very much.

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

A

Thanks Tim. Next question.

Operator: The next question will come from Samik Chatterjee with JPMorgan. Please go ahead.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Hi, thanks for taking my question. I guess I had two on the Public Cloud. And if I can just start with just the broader trends that you're seeing in relation to Public Cloud and the pressures around consumption and optimization. It does indicate that not every use case that the enterprises were leveraging were critical in the cloud. I mean, how do you think about some of the addressable market that you were defining around the cloud storage and CloudOps? Just in relation to that, I guess, enterprises don't see everything as being critical in the cloud, and there's a lot more room for optimization as is being demonstrated during these budget cuts. And I have a follow-up.

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

A

First of all, I think that the long-term trend towards cloud continues to be a strong trend. I think even if you look at the most recent data from analysts as well as from the cloud providers, the public cloud market growth is higher than data center infrastructure growth. So that's one.

I think second is, we are learning the behavior patterns of different workload profiles in our customer base. I actually think the fact that customers can spin up and spin down environment is a benefit to the cloud model over the long-term because the real cost of operating a cloud environment will then be lower than what you would see on premises.

We are, for example, being able to understand, and as we spread the consumption of our cloud services across a much larger customer base, the impact of any particular customers change in behavior will actually be much less than it is today. So, we remain bullish about the cloud opportunity. We're more sharply focusing our go-to-market resources to go after it and continuing to sharpen the customer success motion to allow our customers to benefit from the use of our technology more completely.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Okay. And maybe on the same line, just digging a little bit deeper, like, what are you seeing in relation to the difference in engagement on Spot versus Cloud Insights? And when you have net revenue retention rates of around 120%, how does that break down between Spot and the rest of the portfolio may be seeing a bit more challenges?

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

A

Spot has done well, and Cloud Insights has stabilized and met our internal targets. So, the shortfall was mostly from the cloud storage business. I think that in Spot, it's the opposite, right? When people are concerned about cost optimization, Spot is a perfect tool for that, and they had a good quarter.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Okay. Got it. Thank you.

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

A

Thanks, Samik. Next question.

Operator: The next question will come from Krish Sankar with Cowen and Company. Please go ahead.

Krish Sankar
Analyst, Cowen and Company

Q

Yeah. Hi, thanks for taking my question. The first one is it seems like despite the cloud optimization service being 40% of your portfolio, the cloud portfolio – the magnitude of decline from Public Cloud service seems to be more than offsetting, any improvement there?

Second is, can you just tell us how was the performance of this? And do you think at some point this year – calendar year, it could get to be more than 50% of your cloud ARR? And then I have a follow-up.

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

A

We continue to add new customers to our – all of our cloud services, CloudOps and cloud storage. The impact of those customers in the first few quarters of they're being acquired is actually small because they typically find small deals, and they are testing out the services or they deploy a development and test environment rather than a production environment. Those customers were actually – the benefits to our business from those customers was overrun by the reduction from some of the large customers who contracted their spending in the quarter.

So, we feel good about new customer additions. Can we do more there? Surely, but I don't think that was the material issue in the quarter.

Michael J. Berry
Chief Financial Officer & Executive Vice President, NetApp, Inc.

A

And if I could. It's Mike. We've talked about, Krish, hey cloud storage is about 60%. CloudOps is about 40%. We don't see that changing materially. It'll move around a little bit by quarter, but we expect that to remain relatively consistent over the next several quarters.

Krish Sankar
Analyst, Cowen and Company

Q

Got it. Got it. Super helpful, George and Mike. And then as a quick follow-up, George, kind of like what is your visibility today? Like how many months visibility do you have? And also to an earlier question, George, you mentioned that when a customer's business gets better, they'll start spending again. I mean I just wanted to find, is it as simple as that? Or do you have to look at other metrics like kind of how you said, deal sizes are small, and maybe deal size gets larger, you don't need a CFO approval for purchases? Are there any other leading indicators to look into? Thank you.

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

A

We do a whole lot of account level analysis. Especially for our larger customers, we look at their total wallet. We look at whether we are gaining share or losing share. We look at are we – do we need to bring new business models to the customer. We have done well with our consumption business.

Our Keystone offering, there are many customers that have chosen to use that over the past couple of quarters rather than go the CapEx route. So, we're heavily involved with customers, right? I'll just tell you that it's a daily conversation with customers. I'm just starting to sort of paint the broader theme that, in general, what we see with the larger customers is that when their business outlook improves, they generally start to purchase.

Some segments that typically go ahead of GDP and economic performance lead the market, and other parts of that large enterprise segment come along when GDP turns around. So, look at the business cycle of those customers, that's probably the best leading indicator.

Krish Sankar
Analyst, Cowen and Company

Q

Thanks, George.

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

A

Thanks, Kris. Next question.

Operator: The next question will come from Matt Sheerin with Stifel. Please go ahead.

Matthew John Sheerin
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Yes. Thank you. I had a question on the pricing environment. Are you seeing any incremental pricing pressure from competitors given the slower demand environment? And with the expectation of lower input costs, both on components and NAND give you an opportunity to be more aggressive on pricing? Or is that not part of the playbook?

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

A

I think it's always a competitive environment, and it continues to be a competitive environment in a tough demand environment. I don't see any player doing anything kind of out of the ordinary. I think that just like everyone else, we see the opportunity, especially with QLC-based flash arrays, to be competitive in the market.

Matthew John Sheerin
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay. Thank you.

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

A

Thanks, Matt. Next question.

Operator: The next question will come from Sidney Ho with Deutsche Bank. Please go ahead.

Sidney Ho
Analyst, Deutsche Bank Securities, Inc.

Q

Great. Thank you. You guys have seen a few downcycles in the past 10 years where you saw multiple quarters of overall revenue declined 10% or more on a year-over-year basis. I think that was in 2016, 2020. Curious how you think this cycle will shake out. Maybe just help us compare and contrast with the previous cycles in terms of the depth and duration of the downturn. Maybe they're completely different. But – and then I've a follow-up question.

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

A

Listen, I think that, we've got a different mix of business today than we did in the past. I think there's a growing percentage of our business from more recurring revenue business models like the cloud business. I think we have tried to move more of our resources to parts of the market that are less cyclical, and that allow us to acquire new customers to broaden our customer base. I would say we've done a good job, not enough, but we've certainly seen good progress. And we will continue to pivot in that direction.

I think the large customer segment behavior pattern is quite similar to what we've seen in the past. I think that 2016 is quite similar to what we see today. The only thing that I would point out is that the – for many customers, 2020 was a very difficult year. And so, there's – it hasn't been – this downturn has not been presaged by many, many years of economic expansion. So we're hopeful that customers will be back buying in a more predictable pattern than they have in the past.

Sidney Ho
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. That's great. Maybe a quick follow-up here. Just on the earlier answer on the operating expenses. You talked about holding OpEx flat until you see growth. But to be clear, are you expecting OpEx to be down in the July quarter from the $675 million level in the April quarter, which I know it's seasonally down for OpEx anyway for the July quarter? And you hold expenses at those levels going forward until revenue growth resumes? Is that how we should think about it?

Michael J. Berry
Chief Financial Officer & Executive Vice President, NetApp, Inc.

A

Yeah. Sidney, it's Mike. So, there's a couple of nuances. I'll try to keep this brief – is that in the Q4 number, we do have a portion of the restructuring benefit. We'll get all of that in Q1. The thing that will come back in Q1 is incentive compensation, hopefully will come back.

You've seen this, Sidney, in the last – you talked about some of the downturns. You've seen this coming out of it as well. So, on an absolute dollar perspective, it's probably up slightly Q4 to Q1, just based on that. But everything else from a controllable perspective, we will try to keep that as flat as we can outside of movements in incentive comp.

Sidney Ho
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. Great. Thank you.

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

A

Thanks, Sidney. Next question?

Operator: The next question will come from Jim Suva with Citigroup. Please go ahead.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you. I have different questions, one for George and one for Mike. I'll ask them at the same time, and you all can answer them in any order. But George, in the past several years, you have gained significant market share, very significant.

With this slowdown, I'm wondering if you're seeing any share shifts. Are you continuing to gain share? Are you seeing any competitive pricing get even more aggressive? I know it's a competitive market, but your past several years have spoken multiple leagues of share gains. And so, I'm just kind of wondering from that perspective.

And then for Mike, can you comment on the FX? Are we looking at kind of maybe two more quarters and then a lapse or three or four more quarters, because the FX headwinds are very severe, and you're still keeping your full year guidance, which is remarkable, but the FX, you simply can't just discredit it, because it was so material. So, any looks of when we start to lap that? Thank you.

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

A

I think on the share part, our exposure to the large enterprise is bigger than some of our competitors. And so, I think in a downcycle, we will probably concede share given our exposure to those customers.

I think the second is, now that we have a more kind of full lineup of capacity flash arrays, I feel good that we can compete in all the segments of the flash market, which are key to driving share gains, and keep the Hybrid Flash segment where we have a strong offering moving forward.

And then, I think, as I noted in my comments, we are going to better align our execution in the field, so that we can more sharply focus on the storage market and more sharply focus on the cloud market in a more tailored go-to-market model for each.

Michael J. Berry
Chief Financial Officer & Executive Vice President, NetApp, Inc.

A

And Jim, it's Mike. On your FX question, for a full year now, this is on revenue. We expect it to be about a 350-basis-point headwind for the full year, about 140 basis points in Q4 compared to 340 basis points in Q3. I would expect that it would be almost zero, but slightly a headwind in Q1 and then lap in Q2.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you so much for the details and clarifications.

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

A

Thank you, Jim. Next question.

Operator: The next question will come from Jason Ader with William Blair. Please go ahead.

Jason Ader
Analyst, William Blair & Co. LLC

Q

Yeah, thank you. Hey, George. Are there any headwinds that you guys are seeing on the revenue side from NAND pricing coming down sharply on your AFA business? In other words, just street pricing because we know some of your competitors have kind of a cost-plus – cost model – a margin model.

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

A

I think that overall customers budget in dollars and so we segmented the market and the use cases quite distinctly for performance versus capacity flash. I don't think there's going to be material cannibalization between the two. I think it really comes down to customer budget dollars being available.

Jason Ader
Analyst, William Blair & Co. LLC

Q

Got you. So, is this different than what we saw back in, like, 2018, 2019 where NAND prices came down really drastically and it affected kind of revenue for the whole industry?

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

A

I think that we've always seen customers buy in dollars, and they budget in dollars. So, I think if you ask me right now, I don't actually see the NAND pricing coming down being the real headwind, I really do think its customers' budget and IT spending that's the more material area of focus for us.

Jason Ader
Analyst, William Blair & Co. LLC

Q

Okay. Thank you.

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

A

Thanks, Jason. Next question.

Operator: The next question will come from Meta Marshall with Morgan Stanley. Please go ahead.

Meta A. Marshall
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thanks for fitting me in. On the CloudOps portfolio, you guys have spoken to kind of a more aligned or sharpened go-to-market motion. I just wanted to get a sense of some of the integrations of that product portfolio that was going to happen and just whether that's a part of that kind of refined go-to-market and where we are on that?

And then the second kind of piece of that question is just on the cloud storage piece. You guys have had a little bit less of visibility into kind of that customer set, just getting a sense of, are some of these sharpening go-to-market motions kind of overlay sales? Just anything that's happening on the cloud storage to increase visibility there. Thanks.

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

Yeah, I think first, Meta, on the CloudOps piece, we brought together the sales teams for Instaclustr, CloudCheckr and Spot into one unified CloudOps selling motion. And we've seen good momentum with the integrated team. I think, particularly Spot and Instaclustr, there's good synergy in terms of customer buyer and buying motions that we hope to exploit over the next few quarters. It's too early to call it a success yet.

In terms of the product portfolio, we brought some of the functionality of CloudCheckr into Spot already for compliance, and you should see us bringing more of those capabilities into Spot.

With regard to cloud storage, listen, I think the most important work that we're doing is to be closely aligned with the hyperscaler cloud providers and some of the key application motions that are going on, SAP or chip design or VMware. And I think that what we are going to do as we head into FY 2024 is even more closely align our hyperscale sales resources with those buying motions. I think that that will give us a better understanding of customer behavior. We've seen good adoption of our customer success capabilities in our subscription cloud storage business, but we are yet to see the full impact from doing so in the consumption cloud business, and that's work ahead of us.

Meta A. Marshall
Analyst, Morgan Stanley & Co. LLC Q

Great. Thanks.

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

Thanks, Meta. Next question.

Operator: The next question will come from Shannon Cross with Credit Suisse. Please go ahead.

Shannon Cross
Analyst, Credit Suisse Securities Research Q

Thank you very much. I'm wondering, how should we think about the impact of your 8% head count reduction on your top line? I know you mentioned a couple of areas you've invested, but can you provide some more details on where the cuts were made and how much of it was, I don't know, the proverbial back-office versus revenue-focused head count? And then, I have a follow-up. Thank you.

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

I think that those cuts are factored into our guidance for this quarter. And when we guide next year, you should expect us to factor those into the guidance. Broadly speaking, we focused our resources on the biggest market opportunities, and the places that we impacted were less significant contributors to revenue for us. I think in the cloud portfolio as well as in CloudOps, we've made some decisions that will have impact to ARR going forward, but I think that those are in the spirit of let's focus on the best markets and the best opportunities. Our guidance for the quarter envisages those changes.

Mike, you want to add anything?

Michael J. Berry
Chief Financial Officer & Executive Vice President, NetApp, Inc.
A

No, no. I think that's a great answer. It's all baked in and we did it across the board. We've tried to focus where we didn't have productivity or revenue issues, as George said, a little bit of ARR. Outside of that, we feel good that we focused on the right areas.

Shannon Cross
Analyst, Credit Suisse Securities Research
Q

I guess, were there any cuts in Hybrid Cloud? And then, my second question is, what drove the year-over-year increase in stock-based comp given all of the pressures you're seeing? Thank you.

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

In Hybrid Cloud, as I noted in my comments, we impacted Astra Data Store. We are able to solve the Kubernetes use case better through a combination of Astra Control, which we continue to invest in, and ONTAP rather than a completely separate architecture like Astra Data Store. And then, we had a small business in SolidFire that we continue to sustain, but we don't plan to grow going forward.

Michael J. Berry
Chief Financial Officer & Executive Vice President, NetApp, Inc.
A

Yeah. Hey, Shannon, on your question on stock-based comp, every six months, we have to do a look back on our ESPP program, and there was about an $11 million, I'll call it, catch-up entry in the quarter to take into account the lower price of those purchases. And you'll see that typically every six months when we do our ESPP, depending on the price movement of the stock during that period of time.

Shannon Cross
Analyst, Credit Suisse Securities Research
Q

So, that catch-up is done now. And assuming your stock stays where it's at, there will be another catch-up, so you'll be at that $50 million or $60 million level going forward? Just to be clear.

Michael J. Berry
Chief Financial Officer & Executive Vice President, NetApp, Inc.
A

So, it stays in the run rate. It won't drop down. And what happens in six months is dependent on where the stock price is at that purchase date.

Shannon Cross
Analyst, Credit Suisse Securities Research
Q

Okay. Thank you.

Michael J. Berry
Chief Financial Officer & Executive Vice President, NetApp, Inc.

A

Yeah.

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

A

Thanks, Shannon. Next question.

Operator: The next question will come from Nehal Chokshi with Northland. Please go ahead.

Nehal Chokshi
Analyst, Northland Securities, Inc.

Q

Yes. Thank you. What has been the year-over-year demand trend in the month of February relative to the January quarter? Has it worsened as implied by the guidance even with the C-Series now available?

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

A

We're not going to comment about what's happening this quarter. I think broadly speaking, we're cautious, as you can see in our guidance, about the pattern of IT spending for the year. I think many parts of our business performed well, but the large enterprise, particularly in the Americas, high tech and service provider segments and certain parts of Europe, particularly UK and Germany, have not performed as well and we're concerned about how robust spending will be there in the short term.

Nehal Chokshi
Analyst, Northland Securities, Inc.

Q

Okay. And what's the postmortem on why you guys were late with the lower capacity product on all-flash arrays?

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

A

We have hybrid flash arrays that serve those use cases. We believe that we could continue to support those use cases with hybrid flash. A few months ago, we – a few quarters ago, we created a capacity flash product. We had started to see strong pickup, but it was at the high end of our lineup, and we realized that we needed to introduce the full lineup. And that has taken us a little bit more time than we expected. So, I feel good about our lineup now. It is the most comprehensive in terms of functionality, use cases, guarantees and price and capacity points in the market.

Nehal Chokshi
Analyst, Northland Securities, Inc.

Q

Okay. Thank you.

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

A

Thanks, Nehal. Next question.

Operator: The next question will come from Ananda Baruah with Loop Capital. Please go ahead.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Hey. Thanks, guys. Appreciate it. Hey, George, just sort of circling back to your remarks about concentration with financial services and service provider. Do you feel the company has greater – get greater exposure to those end markets than your key competitors? And is there anything that you can do or that you're focused on to try to diversify that exposure? And then, I have a quick follow-up. Thanks.

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

A

Listen, I don't want to comment about our competitors. I should let you ask them that question. I think what we have seen is that, we have got a large base of high-tech and service provider customers and large enterprise customers. They are demanding customers, and they are forward-leaning and there's lots of benefits to having those customers. But when they are in a downcycle, it does impact our business.

Over the years, we've done a few things to expand our business. I think, one, we've continued to invest in the commercial segment. It's too early to call that a broad push, but we've seen good results. We've also broadened the number of enterprise customers. We signup below the large enterprise. And perhaps most importantly, has been the push to grow our cloud business. Cloud has been the single most strongest vehicle for new customer additions for us, and I'm very pleased with that route-to-market that we've enabled over the past few years.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

That's great context. And the quick follow-up is, both you and Mike in your prepared remarks – or Mike, I think, in his prepared remarks and yours in response to a question made reference to mix shift in all-flash in 2024 – sorry, not mix shift – industry shift to all-flash in 2024. So, I was just wondering, is that something that you guys see as being distinct from what current trend is? Do you see a break in the trend? And that's it. So, an amplification of the trend. Thanks.

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

A

I think broadly speaking, as we have said in past cycles, when the price of NAND comes down, you see a mix shift towards a flash-based system. Disk-based systems cost has been more steady than sort of up and down like flash. So, that's the broad trend.

In our case, we expect that shift to also benefit from the fact that we now have two complete lineups, high-performance flash, which will benefit from NAND, and capacity flash, which will also benefit from NAND.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

I got it. I appreciate the context. Thank you.

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

A

Thanks, Ananda. Next question?

Operator: Our last question will come from Kyle McNealy with Jefferies. Please go ahead.

Kyle McNealy
Analyst, Jefferies LLC

Q

Hi. Thanks very much for the question. Can you talk a little bit about the positive impact you expect to have from AI on the business? What's the positive impact? Where it will come from? Is it a higher mix of high-performance, low-latency all-flash? Is it sheer data growth or both those factors?

And do you think we'll have to get past the near-term softer macro environment that you've been talking about through 2023 until we see some kind of material new AI workload growth? Thanks.

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

A

AI workloads continue to grow in parts of the market that are more resilient to commodity cycles. So, for example, life sciences, certain elements of financial services, industries that are more countercyclical have done well, and we continue to see that moving forward.

AI workloads, especially those that do image and audio analysis, for example, in life sciences, cancer detection or various types of diagnostic cases are perfectly suited to NetApp.

I mean, we store a large number of files in a very high-performance system. And so, we are benefiting from those use cases today. And certainly, as the range of AI tool chain continues to grow, we expect that to be a more material contributor to our business going forward.

Kyle McNealy
Analyst, Jefferies LLC

Q

Great. Thanks. That's helpful.

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

Thanks, Kyle. I'm going to pass it back to George for some closing comments.

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

Thanks, Kris. Our strategy is aligned to the long-term secular growth trends of data-driven digital and cloud transformation. We address key long-term priorities for our customers with strong positions in each of our key markets and have demonstrated success in controlling the elements within our control.

Over the course of our history, we have been through several challenging macroeconomic periods that we have used to sharpen our focus, attack new opportunities and emerge in a better position. We are committed to doing that again.

You can expect us to remain prudent stewards of the business, tightly managing the elements within our control, reinvigorate efforts across the company in support of our storage business and build a more focused approach to our Public Cloud business. We'll give you updates on our progress in the coming quarters. Thank you.

Operator: This conference has now concluded. Thank you for attending today's presentation. You may now disconnect.