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NetApp, Inc. (NTAP)

Q3 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to the NetApp Third Quarter of Fiscal Year 2024 Earnings Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. Please note, this event is being recorded.

I would now like to turn the conference over to Kris Newton, Vice President, 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, including, without limitation, our guidance for the fourth quarter and fiscal year 2024, our expectations regarding future revenue, profitability and shareholder returns, and other growth initiatives and strategies.

These statements are subject to various risks and uncertainties, which may cause our actual results to differ materially. For more information, please refer to the documents we file from time-to-time with the SEC and on our website, including our most recent Form 10-K and Form 10-Q. We disclaim any obligation to update our forward-looking statements and projections.

During the call, all financial measures presented will be non-GAAP, unless otherwise indicated. Reconciliations of GAAP to non-GAAP estimates are available 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. Thank you for joining us on our Q3 FY 2024 call. I'm pleased to report that we delivered exceptional performance across the board, despite an uncertain macro environment.

Revenue was above the midpoint of our guidance, driven by the momentum of our expanded all-flash product portfolio. This strength coupled with continued operational discipline yielded company all-time highs for consolidated gross margin, operating margin, and EPS for the second consecutive quarter.

Entering FY 2024, we laid out a plan to drive better performance in our storage business and build a more focused approach to our Public Cloud business, while managing the elements within our control in an uncertain macroeconomy to further improve our profitability. These actions have delivered strong results to-date, support our raised outlook for the year, and enhance our position for the long term.

Only NetApp delivers a comprehensive architecture based on a single operating system that supports any application or data type, spans on-premises and multiple cloud environments, and is available in traditional CapEx or as-a-service procurement models.

Our unified data solutions address some of the biggest priorities IT organizations face today: modernizing legacy infrastructure, improving resiliency against ransomware attacks, and building scalable, high-performance data pipelines for AI workloads.

The consistent operations, common management tools, integrated data services, and unique and proven capabilities for hybrid cloud of our unified storage architecture provides customers the ability to simplify at scale and lower storage costs. Our silo-free approach to unified data storage is clearly resonating with customers, driving healthy demand for our products and services, and positioning us well to deliver long-term growth.

Turning to the results of the quarter. We delivered robust year-over-year performance in our Hybrid Cloud segment with revenue growth of 6% and product revenue growth of 10%, driven by momentum from our newly introduced all-flash products and the go-to-market changes we made at the start of the year.

Strong customer demand for our industry-leading all-flash solutions drove all-flash growth of 21% year-over-year to an all-time high annualized revenue run rate of $3.4 billion. In Q3, our all-flash business expanded to approximately 60% of Hybrid Cloud segment revenue. As Mike will detail, we expect a sustainable step-up in our baseline product gross margin going forward with the continued revenue shift to all-flash.

The AFF C-Series all-flash arrays again exceeded our expectations, delivering new-to-NetApp customers and numerous wins over the competition. As customers modernize Legacy 10k hard disk drives and hybrid flash environments, we are displacing competitors' installed bases with our all-flash solutions, driving share gains.

Our newly introduced ASA families of SAN-optimized high-performance and capacity-oriented all-flash arrays also outperformed our expectations. We're excited about the enormous potential in the nearly $20 billion SAN market.

Our modern all-flash SAN arrays, backed by industry-leading data availability and efficiency guarantees, are well-positioned to redefine the competitive landscape.

In Q3, we had numerous competitive take-outs across a broad set of workloads and vertical markets, as customers leveraged our C-Series and ASA products to modernize their legacy infrastructures and deploy new applications like artificial intelligence.

We continue to see strong interest in our advanced portfolio of ransomware protection solutions. We help customers take proactive steps to protect, detect, and recover their data. Competitive solutions focus only on data recovery, but NetApp keeps data protected and secured from the start, with products designed to block cybersecurity risks and mitigate the high cost of downtime. ONTAP is the first enterprise-class storage solution validated by the NSA for the Commercial Solutions for Classified Program, demonstrating the strength of our state-of-the-art data protection and cybersecurity solutions.

We saw good momentum in AI, with dozens of customer wins in the quarter, including several large NVIDIA SuperPOD and BasePOD deployments. We help organizations in use cases that range from unifying their data in modern data lakes to deploying large model training environments, and to operationalize those models into production environments. To best take advantage of Generative AI capabilities, customers are looking to augment foundational models with their own data. Our high-performance, scalable, unified data storage systems create intelligent data pipelines that allow customers to capture, aggregate, and prepare their data for AI.

NetApp delivers the data management capabilities for security, performance, and simplicity that enterprises require for their Gen AI workflows. We continue to advance our position with the development of Gen AI-driven cloud and on-premises solutions in partnership with industry leaders.

Demand for consumption options is also growing, as some customers look to increase budget flexibility in an ongoing uncertain macro and higher interest rate environment. However, this is not a universal mandate. Our unified data storage solutions are available as CapEx, as-a-service, and cloud-native offerings, providing customers with the widest range of buying options, enabling them to meet their budget requirements.

Keystone, our Storage-as-a-Service offering, delivered another strong quarter, with revenue growing triple-digits from Q3 a year ago. Keystone is a great solution for customers who want a cloud-like operating model on premises. For customers who are ready to move to the cloud, we uniquely partner with the leading hyperscalers to deliver cloud-native storage services.

Public Cloud segment revenue was $151 million, up 1% year-over-year. First party and hyperscaler marketplace storage services remain our priority and are growing rapidly, with the ARR of these services up more than 35% year-over-year. These offerings are highly differentiated and tightly aligned to customer buying preference. We continue to deepen our hyperscaler partnerships and deliver growth in customer count, capacity, revenue, and ARR with this part of the portfolio.

As I outlined last quarter, we are taking action to sharpen our approach to our Public Cloud business. As a part of this plan, we exited two small services in the quarter. We also began the work of refocusing Cloud Insights and InstaClustr to complement and extend our hybrid cloud storage offerings and integrating some standalone services into the core functionality of Cloud Volumes to widen our competitive moat.

In Q4, we anticipate approximately $20 million in ARR headwinds from unrenewed subscriptions. This will create minimal revenue impact and should be largely offset by growth in first party and marketplace services. We will continue refining our focus in fiscal year 2025, building a stronger base from which to grow.

Our hyperscaler partnerships and natively integrated storage services position us to address the new and emerging Gen AI opportunity in the cloud. A leading open-source developer of Gen AI tools, datasets, and models is leveraging AWS' FSx for NetApp ONTAP as a part of its offerings. The customer was looking for a high-performance and resilient file storage solution to train extensive AI/ML workloads. FSxN gave them a scalable solution with performant storage for intensive AI model training. As a fully managed service, FSxN removes operational burdens, allowing their DevOps teams to focus on business value activities.

In summary, we entered the final quarter of fiscal year 2024 in a much stronger position than we were at the start of the year despite the ongoing macro uncertainty. Our modern approach to unified data storage, which spans data types, price points, and hybrid multi-cloud environments, is resonating in the market. We are successfully executing against our top priorities, growing in all-flash and cloud storage services.

We are well-positioned with an expanded TAM, including block storage and new market opportunities like AI, to drive continued growth and share gains. We are moving to a higher product margin profile, supported by growth in all-flash products. And we will continue to maintain the operating discipline that has yielded record profitability.

I'm very pleased with our momentum and very confident in our ability to deliver positive outcomes for customers and stockholders. Finally, I want to make you aware of our June 11th Investor Day, where we will provide an update on our long-term strategy and business model.

Now, I'll turn the call over to Mike.

Michael J. Berry

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

Thank you, George, and good afternoon, everyone. As a reminder, all numbers I will discuss today are non-GAAP, unless otherwise noted. Our focus and strong execution again delivered record-setting results, reaching all-time highs across key profitability measures, including consolidated gross margin, product gross margin, operating margin, net income, and EPS.

Before I discuss the financial details, let me walk you through the key themes for the quarter. As George noted, we continue to see positive results from our new all-flash products and the go-to-market changes we implemented at the start of the fiscal year. The momentum from our industry-leading flash portfolio, coupled with our operational discipline, drove both top and bottom line growth in the quarter.

Q3 consolidated gross margin of 73% and product gross margin of 63% were both at all-time highs for the second consecutive quarter. Gross margin leverage and operating discipline drove operating margin of 30% and EPS of $1.94, both also setting company records for the second consecutive quarter.

Q3 operating cash flow came in at $484 million, and free cash flow was $448 million. We expect operating cash flow for the full year to be at least $1.3 billion, tracking relatively in line with net income. The strong execution of our priorities of winning in flash and growing first-party cloud services are clearly paying off. Given our strong execution of results that met or beat our guidance ranges, while driving record-setting profitability measures for the second consecutive quarter, we are once again raising our full year revenue and EPS guidance.

Looking ahead, we are even more confident in our position to drive long-term revenue growth and profitability. Now, to the details of the quarter. Q3 billings increased 7% year-over-year to $1.7 billion and revenue increased 5% year-over-year to $1.6 billion, driven by momentum in our all-flash array product families.

Hybrid Cloud revenue increased 6% year-over-year to $1.5 billion and product revenue increased 10% year-over-year to $747 million. Support revenue grew 2% year-over-year to $631 million. We are pleased with the success of moving the responsibility for the majority of our renewals to the customer success team implemented as a part of our go-to-market focus.

Public Cloud revenue grew 1% year-over-year to $151 million. As expected, growth was driven by our first party and marketplace cloud storage services, offset by declines in subscription services.

Now for our operating results. Q3 consolidated gross margin was 73%. Gross profit margin dollars increased 14% year-over-year to $1.2 billion driven by strong growth of product gross profit dollars. Q3 product gross margin of 63% was 250 basis points higher than the high-end of our guide, primarily driven by better-than-expected mix shift to all-flash products and pricing discipline in what remains a cost-sensitive environment.

Operating expenses of $682 million increased 5% year-over-year and declined slightly from Q2 as expected. As a result of operating leverage and disciplined management, Q3 operating profit dollars increased 30% year-over-year to $485 million and operating margin increased 580 basis points from a year ago to 30%, a record for the second consecutive quarter.

EPS grew 42% year-over-year to a record high of $1.94. Our tax rate was 18%, lower than expected due to an adjustment of our full year tax rate. Normalizing for a tax rate of 21.5%, EPS would still have been a record high of $1.86.

Q3 operating cash flow of $484 million was up 28% year-over-year, and free cash flow was up 40% year-over-year, driven by solid billings and profitability. DSO was 45 and inventory turns were 14, both consistent with expectations.

Year-to-date operating cash flow of $1.1 billion increased 23% year-over-year. During the quarter, we returned $203 million to stockholders through share repurchases and cash dividends, ending the quarter with approximately $526 million in net cash. Year-to-date, we have generated $963 million in free cash flow and returned more than 100% to stockholders.

Our balance sheet remains healthy. Total deferred revenue as of the end of Q3 was $4.1 billion, down 2% year-over-year. We ended the quarter with approximately $2.9 billion in cash and short-term investments.

Before moving to Q4 and fiscal 2024 guidance, I would like to spend a few minutes discussing our product gross margin expectations going forward. We have seen the price increases on NAND from suppliers, and these increases will impact all industry participants. The mix shift to our higher margin all-flash products will partially offset the headwinds from these price increases going forward.

As a result of our shift to all-flash, we expect product gross margin to expand to the upper 50% to 60% from our historical norm of approximately 55%. Please note, in any given quarter, commodity prices, product mix, and the pricing environment will cause product gross margin to fluctuate from this new baseline.

That being said, I want to make sure to reiterate this point: even with the increase in commodity costs, we fully expect our product gross margins to expand to the upper 50% to 60% level driven by the shift to our all-flash portfolio.

Now let's turn to guidance. As George noted, we are pleased with the results of our focus and continued operational discipline. Given our better-than-expected results and our improved outlook for Q4, we are again raising our FY 2024 revenue guidance to a range of $6.185 billion to $6.335 billion, or $6.26 billion at the midpoint. We expect to see continued strength in all-flash products and hyperscaler first party and marketplace services.

FY 2024 consolidated gross margin is expected to be in the range of 71% to 72%. Product gross margin is expected to be approximately 60%, driven by the continued favorable mix shift to all-flash products. Operating margin is expected to be approximately 27% and EPS to be in the range of $6.40 to $6.50, with the assumption of net interest income of approximately $40 million and share count of 212 million. Our full year tax rate is projected to be 20%. We expect operating cash flow for the full year to be at least $1.3 billion.

In Q4, we expect revenue to range between $1.585 billion and $1.735 billion, which, at the midpoint of $1.66 billion, implies an increase of 5% year-over-year. We expect Q4 consolidated gross margin to be roughly 71%, and product gross margin to be approximately 60%.

Operating margin is projected to be in the range of 27% to 28%. Implied in this guidance, we expect operating expenses to increase from Q3 due mainly to higher incentive compensation, the timing of marketing programs and targeted investment to drive key product roadmap items.

Our tax rate is expected to be 20%, and EPS is expected to be in the range of $1.73 to $1.83. Also please note that our purchase commitments for NAND for fiscal 2025 demand will impact our cash flow and balance sheet in Q4, which is included in our updated cash flow forecast and will result in inventory turns to be in the 8 to 10 times range.

In closing, I want to thank our customers, partners, employees, and stockholders for their unwavering commitment and investment in NetApp. We continue to prove our ability to manage the elements within our control, and our solid top-line results demonstrate the value that customers realize from our products and services. Our innovative portfolio is well-aligned to priority IT investments, and we remain committed to delivering sustainable long-term value for our stockholders.

I'll now turn the call over to Kris to open the 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: Thank you very much. We will now begin the question-and-answer session. [Operator Instructions] Today's first question comes from Meta Marshall with Morgan Stanley. Please go ahead.

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

Q

Great. Thank you and congrats on the quarter. I guess, George, you went into a lot of detail just around what you're seeing on the AI side. I guess if you could just give a sense of when you're seeing the timing of maybe people making investments versus kind of the various stages of AI. And then maybe just as a follow-up question, just what you're seeing in terms of the competitive environment just in terms of kind of innovative thinking around AI solutions. Thanks.

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

A

Thanks for your question. I think we are in the early phases of the Gen AI opportunity. As you know, we have been in the AI market for a long time and have seen a lot of examples of proven use cases in predictive AI. We are starting to see the early phases of generative AI. And what I mean by that is customers collecting and unifying their data and starting to augment the foundational models with their own data, so that it is more relevant to their business. We expect that to continue for several months or a year, and we think that the deployment of production models and the movement from training to inferencing becomes more relevant as we head into next year.

With regard to the work that we have seen, we had a really strong quarter in the flash business. And we've got several eight-figure deals in Q3. One of the world's largest oil and gas companies built their AI supercomputer on NetApp, one of the world's largest genomics companies relying on our technology to speed up genomic analysis with NVIDIA and NetApp. One of the world's largest media companies is using us to drive some of the early phases of their Generative AI work. And we also have examples in the public cloud, where one of the world's largest open-source model providers is using NetApp's cloud technology to enable their customers to access and train their models.

So we've got real many different examples of success. I think if you [ph] draw out (00:27:10) our strength is scale and performance, super part certification, the fact that we can build a hybrid cloud data pipeline, and the data management capabilities that we've had for many years that allow you to do things like model versioning, security for your mission-critical data, and be able to deploy and connect data pipelines from production back into training. So we feel really good about our strength in the AI market. It's early around Gen AI, and we are doing the work to expand our opportunity there.

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

Q

Great. Thank you.

Operator: Thank you. The next question is from Krish Sankar with TD Cowen. Please go ahead.

Q

Hey, guys. This is [ph] Eddie (00:28:00) for Chris. Congrats on the great execution here. George, I think many people still underappreciate how file services is an AI beneficiary. For example, if you set up an AWS SageMaker account, developers can have plenty of file services options, including NetApp's FSx. So, maybe talk about what differentiates FSx versus other file services, and what kind of customers you attract, what use cases is it used for. And if you can touch on how big ANF and FSx are within Public Cloud, that would be great. I do have another question, please.

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

A

First of all, I think that unstructured data is the vast majority of the value in Generative AI. Generative AI really operates on documents and objects and videos and images and a variety of those datasets. And as you know, NetApp has a huge percentage of the enterprises' unstructured data stored or systems. We help them in a few different ways. One way that we help them is, if their data science team that's building AI training and building some of their models wants to start in the public cloud, you can very quickly and easily take data from your enterprise environment securely into the public cloud and use it in the public cloud.

Second, as you know, we have very high performance scale-out solutions like the one that we referred to on the call, where one of the world's largest open source model providers is using our high-performance scale-out FSxN solutions on Amazon to do model training.

And then the third is, in the enterprise itself, if the enterprise wants to scale that production environment, we have certifications with NVIDIA, for example, that allows them to quickly build a super part with us, train it, and then deploy the trained models into production. So we feel very, very confident about the expanding opportunity in front of us. We've had several good wins and we are investing to expand our opportunity in this space.

Q

That's very helpful, George. Thank you. And one for Mike quickly. Can you give a fresh, please, our memory about how customer behavior has historically changed when NAND prices increase aggressively in short periods of time? Like do they usually reduce purchases of all-flash arrays and go more to hybrids? Or is NAND a small percentage of the bill of materials today, because of a very low pricing, where a 50% increase in NAND prices, for example, will not meaningfully change the system price you guys charge customers. That's it for me. Thank you.

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

A

Yeah. [ph] Eddie (00:31:05), hey. There was a lot of questions in there. What we'd say is a couple of things. Remember, customers' budget based on dollars, and that's the way that they purchase. We haven't seen anything like in the last year in terms of really NAND prices declining as much as they did.

More than anything, we think that that has made SSD flash technology more affordable, all the benefits that you get around environmentals and economics as well as energy now make that a much better economic decision for them. So that's really the change that we've seen. Short term – other short-term changes really don't change the market that much because, again, these are long-term decisions companies are making.

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

And just to add to that, SSDs are not 50%. They are less than 50% of our bill of materials or probably anybody else's bill of materials.

Operator: Thank you. The next question comes from Samik Chatterjee with JPMorgan. Please go ahead.

Joseph Cardoso
Analyst, JPMorgan Securities LLC
Q

Hey. Thanks for the question. This is Joe Cardoso on for Samik. Yeah. So, first one for me. It seems like you continue to see strong momentum with the C-Series and the other new flash products that you guys have introduced and they even appear to be outperforming your expectation in each quarter.

So, just curious, if you could talk to how momentum for those products have tracked through 3Q and into 4Q to-date. It doesn't sound like you're seeing any signs of that momentum slowing down, but can you just confirm that? And do you expect that we're still very much in the early innings of these product cycles with your customers? And then I have a follow-up. Thanks.

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

Yeah. Maybe I can address that in three ways. I think the C-Series product cycle is to modernize both traditional hybrid flash systems as well as deploy new private cloud environments, and we are seeing strong advantages there. That's the first use case. And you can see we do not see any end to that.

The 10k drive transition is a multiyear transition. We're in the early stages of that. On the private cloud side, I think some of the changes in licensing that some of the software vendors have, have renewed interest in our technology as a vehicle to give customers a path to the future.

The second opportunity is the ASA product family. NetApp has had a long history in the block storage space. We've had tens of thousands of customers using our technology to serve block workloads, and we are in the early innings of bringing out a package solution that's focused solely on the block market. And we've been pleased with both of those use cases.

And then the third area, of course, which is set for rapid expansion and growth is AI. And we feel really, really good with the focus and execution. Every time we've set a set of targets internally, we've beaten them and we've raised them externally. And so, we got strong momentum. We're going to stay focused and disciplined in our execution going forward.

Joseph Cardoso
Analyst, JPMorgan Securities LLC
Q

Got it. I appreciate the color there, George. And then just as my second one, it appears the appetite from customers to consume storage more on a consumption basis is increasing based on our checks with the channel as well as comments from you and your peers.

I know you touched on the driver being in some part due to this uneven macro that we're seeing. But are you seeing anything else as a driver there, like the maturity around the offerings or go-to-market motion. The reason

I'm asking, it just feels like it wasn't too long ago when the opportunity here felt more theoretical and there was not as much appetite coming from the customers. So would just be interested to hear like has anything changed on that front? Thank you.

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

A

I think there's probably two or three things. I think the maturity of the offerings; I think customers' comfort around how they would procure cloud-like models. I think the second is the increase in interest rates that on the margin causes certain customers to think about CapEx versus OpEx.

And then the third, of course, is customers that are in transition from one environment to another. For example, when you're in a datacenter transition and you've got a portion of the life of a datacenter environment that needs to be continued, moving to an as-a-service model is a good transition point. We have offered as a service for many years. Clearly, the most flexible, the fastest and the easiest to build an elastic environment is around true public cloud.

We also have solutions with colocation providers like Equinix that allows the customer to get a full cloud-like opportunity in a colocation environment, connected to the public cloud. And our Keystone service in the customers' datacenters had another really strong quarter. We are up year-to-date almost more than triple-digits, including this past quarter. So we see strong momentum in that category. And we do not see a mandate for it, but it's a nice new way for us to address a set of customer buying preferences.

Joseph Cardoso
Analyst, JPMorgan Securities LLC

Q

Great. Appreciate the questions.

Operator: Thank you. [Operator Instructions] The next question today comes from Mehdi Hosseini with SIG. Please go ahead.

Mehdi Hosseini
Analyst, Susquehanna International Group

Q

Yes. Thanks for taking my question. George, just wanted to better understand the current competitive landscape for fiber storage market, especially given the AI application. And I have a follow-up.

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

A

It's always been competitive. There are different vendors that come and go in the market. I think if you look at the installed base of unstructured data that becomes the vehicle to build data pipelines for AI and ML applications. NetApp has a very strong position. And we have the only solutions that allow customers to build hybrid cloud pipelines to build solutions that are super scalable and high performance. But also have the security, protection and data management that AI will need as these models get scaled. So feel really good about our position and look forward to continue to expand our presence in that market.

Mehdi Hosseini
Analyst, Susquehanna International Group

Q

Maybe perhaps I could rephrase my question. Mike just raised his product gross margin to 60%, which is pretty much what you're guiding for the January quarter. You're also increasing use of QLC. So should we anticipate some flexibility with pricing that QLC gives you but remaining competitive with your competitors? Because I don't see gross margins are already at where the new target is. So, where do we go from here?

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

A

Listen, I think that, first of all, the mix shift from hard drives to flash in our business continues. And it's an important kind of underlying factor that gives us confidence that we are raising the structural baseline product gross margin, as Mike said, from the mid-50s, which has been a historic norm to the upper-50s and up to 60%. The mix shift is the most important lever in that equation. The second, of course, is the value of our ONTAP software and the ongoing management of the commodity supply chain. I think all of those factor in.

I think that we are uniquely positioned with our operating system to benefit from using QLC in a broad bench of applications. Currently, only another one other vendor has QLC based all-flash arrays, and it gives us an opportunity to go target other vendors who don't have QLC support. So we feel really good about our solution. And I would tell you that AI and all of these enterprise applications are not just about price, right? They're about value, and we built a real good value for our customers over many years.

Mehdi Hosseini
Analyst, Susquehanna International Group

Q

Thank you.

Operator: The next question comes from Asiya Merchant with Citigroup. Please go ahead.

Michael Anthony Cadiz
Analyst, Citigroup Global Markets, Inc.

Q

Hi. Good afternoon. This is Mike Cadiz for Asiya at Citi. So, my one question is, given ongoing – in the AI field, given ongoing security and data sovereignty concerns by many companies, is there anything notable in the customer conversations regarding AI model placements, whether on-prem or in the cloud or any other architecture preferences that they may have?

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

A

Listen, I think that data is the foundation on which AI is built. And if you look at what enterprises are doing today, they are augmenting foundational models with their own data to bring the relevance of AI to their business and their organizational needs.

As a result, issues like malicious injection of bad data into a data landscape can cause huge impacts on AI, the ability to maintain data security, privacy and lineage are all conversations that are happening regardless of the regulatory environment, and they will only get stronger as regulations get enforced like you are seeing, for example, in the European Union.

This gives the needs to have data management across the life cycle of AI extreme importance. And we are exceptionally well-positioned, having the capabilities to build secure, private environments in the public cloud, as well as in customers' datacenters.

Michael Anthony Cadiz
Analyst, Citigroup Global Markets, Inc.

Q

Okay. Got it. Thank you very much. Have a good day.

Operator: Thank you. The next question comes from Nehal Chokshi with Northland Capital Markets. Please go ahead.

Nehal Chokshi
Analyst, Northland Securities, Inc.

Q

Yeah. Thanks and congrats on the strong results here. Mike, can you give us some early thoughts on fiscal year 2025? And what are the key things we should be thinking about when modeling fiscal year 2025 here?

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

A

Yeah. Thanks for the question, Nehal. So when going into fiscal 2025, we've talked about it, hey, we feel really good about the momentum that we have in Q3, as well as the guidance that we built into Q4. We've talked about the momentum around C-Series. George talked about all the industry trends that are also tailwinds for us. And when you look at all of the priorities that our customers are looking at, we feel like we're really well-positioned.

We've given you a good view of where we think our product gross margins will land. The support business continues to be an important driver of profitability as well. And we will continue to be prudent around our investment to make sure that we drive growth. We want to do that. We want to make sure that we are disciplined in our spending. But, hey, there are some things that we also need to do and want to do to be able to continue to drive the top line.

Think we've done a lot of great work around cloud to be in a much better position for next year. George talked about the 35%-plus growth in cloud storage in first-party marketplace. And [ph] Eddie (00:43:35) asked that question as well. In the quarter, cloud storage continues to grow as a percentage. It's now closer to 65% from a revenue perspective so that's where the growth will be.

And then, we will continue to do the right things around return of capital to shareholders. We always want to leave flexibility for investments. But we also want to make sure that we're mindful of our share count. So, without trying to guide 2025, that's probably the best reader's digest version I can give you.

Nehal Chokshi
Analyst, Northland Securities, Inc.

Q

That's fantastic. If I may, how should we think about the support revenue? You're coming off four quarters of year-over-year product revenue declines. Now that you're back into year-over-year growth on the product revenue, how long do you expect for the support revenue start to flip back up basically?

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

A

Yeah, great question. And we look at this a lot, obviously. So, in the last two quarters, we've seen deferred revenue actually decline year-over-year. Couple things, Nehal. Keep in mind that what you see on the balance sheet is total deferred, it also includes cloud, that has declined a little bit more than the support business in the last two quarters. 90%-plus of support will come off the balance sheet, so you can take a hard look at that.

But what we've also seen is a different trend, where instead of tech refreshes, we've seen a lot of customers renew their support for up to a year, and that has also helped continue to drive support revenue. You don't see that as much in deferred. But the big driver will be growth in product revenue drives additional support revenue, the multi-year support. You'll see that in billings. You'll see that in deferred revenue. So we feel good about being able to get that growth in support.

I think it was 2% this year. Hopefully, at least [ph] that and (00:45:21) going forward, if product – when product revenue grows, support revenue should follow. It will be a little bit of a lagging indicator a couple quarters, but it will definitely follow because of the business model.

Nehal Chokshi
Analyst, Northland Securities, Inc.

Q

Fantastic. Thank you.

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

A

Thank you.

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

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Yeah. Good afternoon, guys. Thanks for taking the question. Yeah, congrats on a strong number of quarters here and really good ongoing execution. And I guess, George, that's, I guess, what I'd like to ask, I guess the first question is – and sorry if you spoke to some of this, I was – there's a few calls going on tonight. So I came on late.

But to what degree the last couple quarters or so, do you think that the strong product growth that you guys have put up – I'm going to try to ask you to parse this to the degree it's parsable – is the result of new product features, kind of new products, things that customers are doing, beginning to do sort of differently with their data? It sounds like not really a material Gen AI benefit yet, which makes sense. But if you could parse – if there's any way to parse through those things, that would be helpful.

And then, I guess the second part of the question is, I think I heard you make mention of you think there is like a tail to this going forward. And is part of what you're saying is that you think the product demand sort of outlook begins to look a lot different as you go through calendar 2024 and then maybe even beyond? I know that's a lot but I'd appreciate that. Thanks.

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

A

Yeah. Listen, I think, first of all, the macro has stayed relatively consistent the whole time. It is uncertain. It's not getting worse, but it is not the fundamental reason for the improvement in results. The second is the two biggest reasons for improving our results. One is product and the second is focus in go-to-market execution.

Let me hit on product. In terms of product, we brought the world's best operating system to two or three major new opportunities. We brought it to a price point in the all-flash market that we have not addressed before with the QLC flash offerings. We brought the world's best operating system to a block storage opportunity that's multibillion dollars, multiple tens of billion dollars that we had never built a purpose-built block storage product for. And we are continuing to see an expanding range of AI opportunities as customers are doing both training as well as building context called retrieval-augmented generation, RAG. And so all of those have driven improvements in our results.

I think the other part of the equation would be to recognize the benefits that we've had from focus in our go-to-market. We have prioritized two areas: the hyperscaler marketplace and first party cloud storage services in public cloud; and we have focused on our all-flash portfolio as the two major priorities. And we've had strong results in both of them, and I'm very pleased with the results.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

That's great context. I appreciate that. And just a quick follow-up for Mike here. Mike, you talked about attach in some context. And I guess I just wanted to ask you, with the operating margins already in the high 20s, philosophically, is there any reason why with everything you have going on with mix and attach over time you couldn't touch 30% operating margin?

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

A

So we did this quarter, Ananda. So, hey...

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Sorry, you know it's funny. I haven't – yeah, I apologize. With all the numbers out, I actually didn't – that's a miss on me. So, well, let me just ask you then. Let's start there. Like, should we just expect mix up then going forward? How are you thinking about like showing the margins in the P&L versus doing something else with the op income dollars as mix continues to work in your favor? Thanks.

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

A

Yeah. And no apologies necessary. I know you folks are busy today. So, hey, we're super excited about the 30% margin. And a lot of that, hey, it's all 12,000 employees that helped us on that number. We've guided to 27% to 28% in Q4. What I would say is that we very much want to continue to be able to grow the business. And even as the CFO, I know, hey, we need to invest in some areas. There are some product investments that we need to make. We want to make sure that the go-to-market continues to have sales capacity.

We've said it at the last Analyst Day, we'll say it again, which is we want to invest. Our goal is always to grow OpEx at a lower rate than revenue to drive the margins up. Where those go really depends, I think, on a couple of things. One is how well we can continue to grow product revenue. That's obviously a big piece. And that then drives storage, which was Nehal's question around support which is a big piece.

So we don't have a target in mind. And quite frankly, the other thing I just want to make sure and underline, this is both product gross margins and operating margins. Hey, we love the margin percentages, but we love the dollars more. And so our goal is to be able to drive dollars. That may mean that, hey, margins stay relatively consistent or they go up or down in a quarter. Our goal is to drive more revenue, more gross margin dollars, more operating that then goes to EPS. So I don't want to give you a target now. We'll talk about this a little bit in June. There is that trade-off.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Thank you. No, that's super helpful. Thanks a lot, Mike. Thanks.

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

A

Thanks, Ananda

Operator: Thank you. [Operator Instructions] The next question is from Amit Daryanani with Evercore ISI. Please go ahead.

Irvin Liu
Analyst, Evercore ISI

Q

Hi. Thank you for the question. This is Irvin Liu on for Amit. George, you mentioned new customer wins resulting from the displacement of competitor 10k hard disk drive and hybrid deployments with C-Series. But can you give us a sense on what the upsell opportunity looks like for some of your other product lines such as A-Series and public cloud services, particularly with these new customers?

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

A

Listen, we always start with one environment and then we can cross-sell other environments into the customer. I think what we have seen quite clearly in the market is that the idea of having multiple different operating systems and storage landscapes in a customer is causing cost complexity and security vulnerabilities. And the idea of going to one consistent architecture across multiple landscapes is clearly seeing resonance in customers.

And I think that, as we have got obviously both unified as well as block-focused offerings across high-performance AFF A-Series as well as more value-oriented C-Series products, we see opportunity to not only win one part of our customers' footprint, but over time, win all of their footprint. The work that we've done in public cloud allows us to penetrate accounts that we don't have a relationship with using the public cloud sales motion. And as we have shared many times, the number of new-to-NetApp customers in the public cloud sales motion is very strong, and we're excited about that. We continue to see good progress on that front even this past quarter.

Irvin Liu
Analyst, Evercore ISI

Q

Thanks. I also had one follow-up just on the dip in your mix of US public sector revenue. Was there anything to call out here just in terms of government IT spending?

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

A

It's just normal seasonality. I think public sector actually was a strong number for us across the globe and nothing other than normal seasonality for us.

Irvin Liu
Analyst, Evercore ISI

Q

Got it. That's all I had. Thank you.

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

All right. Thanks, Irvin. I'm going to pass it back to George now for some closing comments.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

Thank you, Kris. Let me reiterate my strong confidence in our position to drive continued growth and profitability despite the uncertain macro. We've sharpened our focus, improved our execution and successfully introduced new products that expand our addressable market. Capacity flash, block storage, and AI all represent enormous opportunities for us.

We are performing well in these areas and expect continued growth. We have taken the actions needed to improve the health of our cloud business, creating a healthier business to drive growth in fiscal year 2025. We are capitalizing on our share gain opportunity and we'll maintain the operating discipline that has yielded record profitability.

Thank you for your time today, and I hope to see you at our June 11th Investor Day.

Operator: The conference has now concluded. Thank you for your participation. You may now disconnect your lines.