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NetApp, Inc. (NTAP)

Q4 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, ladies and gentlemen. Welcome to NetApp's Fourth Quarter and Fiscal Year 2019 Financial Results Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session and instructions will be given at that time.

I will now turn the call over to Kris Newton, Vice President, Corporate Communications and Investor Relations.

Kris Newton

Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

Thank you for joining us on our Q4 and fiscal year 2019 earnings call. With me today are our CEO, George Kurian; and CFO, Ron Pasek. This call is being webcast live and will be available for replay on our website at netapp.com.

As a reminder, we adopted the new accounting standard, ASC 606 in Q1. Our historical financial results have been restated to conform to the new revenue recognition rules. Reconciliations of our previously reported GAAP results to the restated 606 GAAP results as well as our 606 GAAP to non-GAAP results are included in our Q4 earnings release for the applicable period, which is posted on our website, along with our financial tables and guidance, a historical supplemental data table and the non-GAAP to GAAP reconciliation. Unless otherwise noted, we will refer to non-GAAP and 606 numbers.

During today's call, we will make forward-looking statements and projections with respect to our financial outlook and future prospects, such as our guidance for the first quarter and full fiscal year 2020. Our expectations regarding future revenue, profitability, cash flow and shareholder returns, and our ability to focus our resources to grow and expand our opportunities, and address the key market transitions, 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 global, political, macroeconomic and market conditions, and our ability to expand our total available market, introduce and deliver new and differentiated products and services without disruption, manage our gross profit margins, capitalize on our market position and cloud strategy, maintain execution and continue our capital allocation strategy.

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 for fiscal year 2018 and our Current Reports on Form 8-K. During the call, all financial measures presented will be non-GAAP, unless otherwise indicated.

I'll now turn the call over to George.

George Kurian

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

Good afternoon, everyone. Thank you for joining us. We made significant progress across key strategic aspects of our business. This was masked by execution issues in the fourth quarter. Along with FX headwinds, these issues resulted in revenue coming at the low end of our guidance range. This is not how I'm used to showing up, and we're taking concrete actions to quickly address the issues. Our opportunity is large and growing, but we need to do more to capture it.

I'll start by reviewing the areas in which we had challenges and our remediation plans and then talk about the substantial progress we've made in our key growth areas. Our execution challenges manifested in three areas; first, we were inconsistent in our go-to-market execution. We are addressing this by improving our focus and coverage. We have efforts underway to shift investments to market and customer segments with higher return on investment. We enabled our European distributors to lead in smaller countries where they are better positioned for success, so that we could focus our resources against the largest markets. We are also increasing the number of sales resources dedicated to acquiring new enterprise accounts to broaden our customer reach. We are making trade-off decisions within the bounds of our financial models and to improve our ability to execute in our targeted growth areas. These investments take time to pay off, but we expect to see their benefit over the course of fiscal 2020.

Second, we did not execute well on renewals in Q4. However, the asset count in our install base is growing and we are making the necessary organizational and process changes to improve our execution.

Finally, our OEM business has been a periodic headwind to our overall business. OEM, while still a relatively small part of our revenue, was down significantly in Q4. We do not expect it to recover and are resetting our expectations. OEM will be materially lower in fiscal year 2020 and will create a slight headwind to growth in the first three quarters of the year. The data center buying behavior of large customers that we saw in January continued through Q4. Customers are buying, but deals are taking longer and require greater effort to close. We have a good sense for the industry trends and are confident that these events are not the result of competitive dynamics. Our strong gross margins in the quarter are indicative of our differentiation and the value customers find in our solution. We are well-positioned in the market and are taking action to capitalize on our opportunity by increasing our focus and investing in targeted sales coverage.

Now, let's turn to the areas where we made solid progress. We gained share in the all-flash market, growing that part of our business 25% from fiscal year 2018. We saw a strong momentum in our private cloud business, delivering large enterprise wins and a number of competitive displacements. And our public cloud services are poised to deliver significant growth in fiscal year 2020 with Azure NetApp Files expected to become generally available in our first fiscal quarter.

In Q4, our all-flash array business inclusive of All-Flash FAS, EF and SolidFire products and services, grew 11% year-over-year to an annualized net revenue run rate of $2.7 billion. I am disappointed by the performance of our all-flash array business in Q4. The issues we experienced in the quarter were felt most acutely here. This is also the place where investments in focus and sales coverage will have the earliest positive benefits, and I remain confident in our position and opportunity for continued success in this market.

We have a leading efficiency guarantee, highest performance and most complete cloud integration in the industry. The runway for this secular transition is still in the early innings and we expect the shift to flash to accelerate with ongoing NAND price declines.

Moving to our private cloud solutions, SolidFire, NetApp HCI and StorageGRID are the building blocks for private cloud deployments, enabling customers to bring public cloud-like experience and economics into their data centers. The momentum of our private cloud business that began in Q2 continued through the year delivering triple-digit year-over-year growth in each of Q2, Q3 and Q4. Our private cloud business, inclusive of SolidFire, NetApp HCI and StorageGRID products and services, achieved an annualized net revenue run rate of over $600 million in the fourth quarter. These solutions are a significant contributor to our fiscal year 2020 growth expectations.

Turning to Cloud Data Services, our NetApp Cloud Data Services enable enterprises to deliver meaningful business outcomes quickly and cost efficiently, eliminating lengthy IT processes and complexities. Our partnerships and solutions with the hyperscalers are unique. Only NetApp offers a comprehensive set of data services available across multiple clouds. I'm honored that NetApp was named 2018 Google Cloud Technology Partner of the Year for Infrastructure at Google Cloud Next '19 for our achievements in the Google Cloud ecosystem helping customers build and run applications on the Google Cloud quickly and at scale.

Based on the last month of Q4, our Cloud Data Services annualized recurring revenue accelerated to approximately $51 million, up 55% sequentially from Q3. We continue to see a healthy mix of customers new to NetApp in our Cloud Data Services and expect that they will continue to drive new customer acquisition.

We remain confident in the fiscal year 2021 exit run rate revenue target we gave at our April 2018 Investor Day. And as with private cloud, this business is a significant contributor to our fiscal year 2020 growth goal. Our opportunity is fueled by digital transformation initiatives, which are driving data center modernization projects and cloud-first strategies. Each of our solution groups are highly competitive individually, but the true value of NetApp is in the strength of our integrated portfolio, in our Data Fabric strategy which radically simplifies the management of a customer's hybrid multi-cloud environment. Enterprises increasingly view NetApp as a strategic partner who can enable their digital transformations and meet their needs from the edge to the core to the cloud.

Our Data Fabric strategy and expanding portfolio of data services is driving deeper and more strategic engagements with customers, and will ultimately lead to growth and share gains in the cloud and on-premises.

In closing, I want to emphasize that we're moving quickly to do the work needed to return to growth. We are examining every aspect of our business execution, driving focus and aligning resources against the biggest strategic markets, while staying within the bounds of our financial model. Throughout FY 2020, we will continue to evaluate initiatives that enable us to maximize our market opportunity. I'm confident in our position as we move into fiscal year 2020. We expect to gain momentum as our investments and focus and coverage play out, we will keep you updated on the progress of these initiatives on future calls.

With that, I'll now turn the call over to Ron.

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

Thanks, George. Good afternoon, everyone, and thank you for joining us. As a reminder, I'll be referring to non-GAAP numbers unless otherwise noted. Despite some of the execution issues George highlighted, we again improved gross margins and delivered strong free cash flow with continued momentum in both our Cloud Data Services and private cloud businesses. Before discussing our full-year results and guidance, I'll provide detail on our Q4 performance.

In Q4, net revenues of $1.59 billion were within our guidance range and down 3% year-over-year, including over 2 points of currency headwind. Product revenue of $1 billion decreased approximately 2.5% year-over-year and would have been flat if not for currency headwinds. Moving down the P&L, software maintenance and hardware maintenance revenues of $526 million decreased 3% year-over-year. As George noted, we did not execute well on our maintenance renewals. However, our asset base continues to grow.

Deferred revenue, which was up over 9% year-over-year in Q4, continues to be the best measure of the health of our maintenance business and our customers' long-term commitment to NetApp. As a result, we expect maintenance revenues to grow in fiscal 2020.

Gross margin of 65.2% was above the high end of our guidance range and includes a 0.5 point of currency headwind. Product gross margin was 55.3% which is an increase of more than 2.5 points year-over-year. The product margin expansion was driven by continued sales force discipline, growth in our software-only products and approximately $30 million of ELAs.

ELAs benefited product margins by less than one point. The expansion in product margin was offset by more than a point in currency headwinds. Q4 2019 was the ninth straight quarter we increased product margins year-over-year, even when adjusting for the benefit of ELAs. Strong performance in gross margins reinforces our confidence in achieving our long-term targets provided at our Analyst Day.

The combination of software and hardware maintenance and other services gross margin of 81.9% increased by 100 basis points year-over-year. Q4 operating expenses of $680 million were flat year-over-year but came in higher than anticipated largely due to variable compensation associated with product-specific sales incentives. Operating margin was 22.5%, up 50 basis points year-over-year. EPS of $1.22 was at the low end of our guidance range and increased 9% year-over-year. We closed Q4 with $3.9 billion in cash and short-term investments.

Our cash conversion cycle was a positive 3 days, up 17 days year-over-year. DSO of 70 days were up 12 days as revenue shipments were usually backend loaded. The underperformance in revenue in the quarter drove DIO to 21 days, a 3-day increase. Given the transitory nature of these impacts, we expect to return to a negative cash conversion cycle in fiscal 2020.

Despite the cash conversion cycle headwinds, cash flow from operations was $399 million, free cash flow of $364 million represented 23% of revenues. Our confidence in our ability to execute and long-term vision continues to be reflected in our capital allocation strategy. During Q4, we repurchased 7.3 million shares at an average price of $68.97 for a total of $500 million.

Weighted average diluted shares outstanding were $249 million down $24 million year-on-year representing a 9% decrease. We have $1.9 billion remaining on our current share repurchase authorization and we'll continue to be opportunistic given NetApp's free cash flow yield and return on invested capital profile. During the quarter, we paid out $97 million in cash dividends. In total, we returned $597 million to shareholders representing a 164% of free cash flow generated in the quarter; today we also announced a 20% increase to our quarterly dividend which will now be $0.48 per share per quarter.

Turning to our full-year 2019 results; net revenues of $6.1 billion increased 4% year-over-year, including one point of currency headwind. Gross margin of 65% was up 1.5 points compared to fiscal 2018 and was above our original guided range of 63% to 64%, operating margin of 22.6% improved 3 points versus fiscal 2018 and was above our original guidance of 22%. EPS of $4.52 increased 27% year-over-year demonstrating the operating leverage in our business model.

Fiscal 2019 represents the third consecutive year of 25% to 35% growth in EPS. We generated free cash flow of $1.2 billion in fiscal 2019 which represented 19% of net revenues. We continued to deliver on our capital allocation strategy with $2.1 billion in share repurchases and over $400 million in dividends, representing a total shareholder return of 215% of free cash flow. Over the last three years our capital allocation strategy has returned $4.4 billion to shareholders.

Now on to guidance; in fiscal 2020, we expect revenues to grow at the low end of our mid-single digit range, driven by continued momentum in our private cloud business and an inflection in our Cloud Data Services as solutions on Azure and other services become more broadly available. We also expect to reaccelerate growth in all-flash arrays. These fiscal 2020 growth drivers will be somewhat offset by a decline in our OEM business.

Sequential growth within the year will be consistent with our normal seasonal patterns, except for the volatility introduced by ELAs. We expect gross margin to be in the range of 64% to 65% and operating margin to be in the range of 23% to 24%. Implied in this guidance is our expectation that operating expenses will remain roughly flat year-on-year in fiscal 2020.

We are committed to delivering low-teens EPS growth without buybacks and expect our effective tax rate to be approximately 19.5%. Additionally, we expect to continue to generate meaningful free cash flows in the range of 19% to 21% of revenues. We managed our supply chain to minimize the impact of China tariff and as a result we do not expect tariffs to have a material impact on our business in fiscal 2020. Please note that we will be adjusting the definition of our strategic mature product categories in fiscal Q1 as planned to better align them with how we manage our business.

Now on to Q1 guidance; we expect net revenues to range between $1.315 billion and $1.465 billion, which at the midpoint implies, a 6% decline in revenues year-over-year. It is worth noting that our fiscal Q1 revenue guidance includes over a point of currency headwinds with no ELAs. The Q1 2019 compare is very challenging as we grew the revenues by 12% year-over-year including $90 million in ELAs.

Adjusting for currency and ELAs, our fiscal Q1 total revenue guide implies a 1% growth year-over-year. In Q1, we expect consolidated gross margins to be approximately 65% and operating margin to be between 17% and 18%. We expect earnings per share for the first quarter to range between $0.78 and $0.86 per share. To address the execution opportunities George highlighted, we conducted workforce realignments in both Q4 2019 and Q1 2020, as we continue to focus investment dollars towards the best market opportunities in key growth initiatives.

The realignment charges are GAAP-only and do not affect our non-GAAP results. As we look out to fiscal 2020 and beyond, I remain confident in our ability to grow and deliver on our long-term profitability targets. We are diligently focused on improved execution, our business model leverage and secular tailwinds created by market transitions to flash, private cloud and public cloud will enable us continue to deliver on the commitments we've made to shareholders', partners and customers.

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

Kris Newton

Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

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

QUESTION AND ANSWER SECTION

Operator: Thank you [Operator Instructions] Again we ask that you please limit yourself to one question and return to the queue for any follow-ups. [Operator Instructions] Our first question comes from Rod Hall with Goldman Sachs.

RK Raghunathan Kamesh
Analyst, Goldman Sachs & Co. LLC

Q

Hi, this is RK on behalf of Rod, thanks for taking my question. Given that some of your competitors are also reporting weak results; could you comment on the overall demand environment? And what could be driving the weakness and also talk about when you aim to return to a product revenue growth?

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

A

I think if you look at the overall demand environment for data center spending, I think it reflects two broad themes, in some parts of the world where there are notable changes in the macroeconomic outlook, people are taking a bit longer to define their annual budget plans or building a contingency budget model and buying for what they need or requiring more number of approvals for larger transactions, like we said last quarter, we saw some of that reflected in our European business this past quarter.

In other parts of the world where the economy is stronger, we do see people looking at sort of their data center priorities, what would they refresh within their data center, what would they think about moving to public clouds, we are well-positioned to capitalize on that trend using our Data Fabric strategy that is reflected in some of the acceleration of our data services results this quarter.

We plan for next year for a low a growth environment, as Ron mentioned the investments we're making to capitalize on the strength of our portfolio should pay off through the course of the year and for the whole year, you should see strength in the product revenues materialize especially in the back half of the year. You know, I feel like this is an environment that we are particularly well set up for, we have demonstrated our ability to execute against our topmost priorities, we are entering fiscal 2020 with a much stronger portfolio than we've had even in years passed and we are demonstrating our ability to meet the financial targets we set out by prioritizing carefully with trade off decisions across the company.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks RK, Next question?

Operator: Thank you. Our next question comes from Karl Ackerman with Cowen.

Karl Ackerman
Analyst, Cowen & Co. LLC

Q

Hi, thank you for taking my question. In regards to your outlook, I think your implicit guide $4 or $5 plus in EPS for fiscal 2020 does assume a fairly sizable increase or ramp beyond the July quarter. I'm curious what EPS in revenue contributions are you assuming for ELAs for the full year? And I guess how would you characterize your own level of visibility into the channel and at key OEMs? Thank you.

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

A

So, yeah, Karl, we didn't guide EPS explicitly, but you're right your calculation is probably roughly correct. But we saw this year was about 2% of revenue for ELAs, it wasn't evenly spread by quarter as you noticed. We would assume that for next year, in the Q1 guide there are no ELAs right now, so you have to assume that the other 2% of total year occurs in Q2, Q3 and Q4.

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

A

I think with regard to your question about visibility to the channel and the OEM, I think in the OEM business, we are prioritizing our focus on a few players and are restructuring our agreements on the smaller OEMs, which is why we have indicated that OEM will be a materially step lower going forward.

With regard to our distribution channel, we have a broad-based distribution channel that covers a large part of the market. We have a lot of access to our largest customers. We cover probably 95% of the Fortune 1000 and a high number of the global 2000's are customers of NetApp and a majority of them are strategic customers, meaning buying large amounts from us. So very, very close to them and close to the channel, and we expect that we'll be able to see the visibility on any turn faster than most people.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks, Karl. Next question?

Operator: Thank you. Our next question comes from Andrew Nowinski with Piper Jaffray.

Andrew James Nowinski
Analyst, Piper Jaffray & Co.

Q

Great, thank you. I want to ask you a question on Cloud Data Services, so you mentioned that Azure will be generally available in Q1 and I think Amazon is already GA. So is Google – if you could just give us any color as to when Google will be GA? That's it from me, thanks.

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

A

We are in beta with Google and we are seeing good success with them. I think we will have to update you on when we expect that to be generally available at the right point in time. We are doing all of the necessary things to get that service to general availability, and it does not preclude us from being able to take revenue-generating customers on the Google Cloud platform. Ultimately, the general availability of these services are determined by the hyperscalers, and so we do everything that we need to do to make them comfortable, to make it generally available, but it's in their hands.

Andrew James Nowinski
Analyst, Piper Jaffray & Co.

Q

Thank you.

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

Thanks, Andy. Next question?

Operator: Thank you. Our next question comes from Steve Milunovich with Wolfe Research.

Steven Mark Milunovich
Analyst, Wolfe Research LLC
Q

Thank you. If my numbers are right, Americas commercial was up about 12%, public was down 11%, Europe was down 17%. You said a little bit about Europe, but can you give us some more color on each of those and kind of what you expect going forward?

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

Yeah. Let me characterize each of them. I think in the Americas business, our strength in the portfolio as well as the opportunity to invest more in the Americas enterprise segment continues to give us real good confidence about the performance of our business. We had really good traction with our largest customers as well through the course of the year with these strategic agreements.

I think with the public sector business, we've been doing a couple of things there. I think we've been working to transition some of our investments over to opportunities like SLED, state and local and education, as well as healthcare. And those transitions have paid back in really materially strong results this year. We are going to expand the range of offers that we have for the public sector market. We are working with both the hyperscalers to offer FedRAMP services and we'll update you at the right point in time when they're available, as well as we're focused on bringing our HCI products that meets the public sector certification requirements to market in time for this buying season. I think those two should contribute to further strengthen our public sector business this year.

In EMEA, we saw a couple of things, some transformations at some of our biggest customers that were exposed to both specific situations as well as the broader economic landscape in EMEA. I think there is also a 500 basis points currency headwind on the EMEA results in quarter. So we've got a couple of things going on in EMEA.

You saw us prioritize our resources to the biggest most attractive customer segments and markets through the course of the last quarter. That was something that we had been planning to do and we exited some of the smaller countries so that we can prioritize NetApp sales resources to leverage our portfolio in the biggest markets. And so we expect to have a good results this coming year in EMEA.

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

Thanks, Steve. Next question?

Operator: Thank you our next question comes from Matt Cabral with Credit Suisse.

Matthew Cabral
Analyst, Credit Suisse Securities (USA) LLC (Broker)
Q

Yeah, thank you. Just wondering if you could talk a little bit about the wider competitive environment and just if you've seen any changes to the pricing behavior as demand has become a little bit more challenging?

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

I think there has been no material change to the overall competitive environment. On any particular transaction, you always see some players sort of resort to irrational pricing, and we have the discipline to walk away from loss-making transactions. I think the overall strength of our portfolio is demonstrated in product gross margins, right? It is the ninth consecutive quarter where we have grown product gross margin. Then it's reflective both of the differentiation in the portfolio, the power of our Data Fabric strategy, which is the long-term differentiator for us in any situation, and the increasing contribution of software to our product mix, all things that we have strategically been working on. And it's paying out for our shareholders and for our customers.

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

Thanks, Matt. Next question?

Operator: Thank you. Our next question comes from Simon Leopold with Raymond James.

Victor Chiu
Analyst, Raymond James & Associates, Inc.
Q

Hi guys, this is Victor Chiu in for Simon Leopold. Regarding the decline in hardware maintenance revenue, can you help us think about the broader implications here? Is this reflective of shifts in customers' plans maybe shifting to the hybrid public cloud or new architecture that you are planning and deploying, maybe competitive issues here, just help us little here with a little more color around the decline this quarter.

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

Yeah, Victor, we told you in FY 2018, it was a headwind but we could tell from the waterfall that in FY 2019 it wouldn't be and through the first three quarters we did execute reasonably well and was not a headwind at all, in fact we grew slightly. We had some execution issues in Q4 which I wouldn't put on our customers I would put that squarely on her shoulders. We know what we need to do. We're making some needed changes in that area and we believe very strongly that since the asset base is growing that FY 2020 will be a growth year for maintenance.

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

I think one thing you should notice is that we really look at the maintenance business in aggregate between both software and hardware. A few years ago, we made a strategic pricing change to reflect the value of our offerings more in software and so when you look at the mix of hardware and software, it would send towards software and I'd ask you to just understand our business in aggregate rather than as piece parts.

Victor Chiu
Analyst, Raymond James & Associates, Inc.
Q

Okay thank you.

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

Thank you Victor. Next question?

Operator: Thank you. Our next question comes from Lou Miscioscia with Daiwa.

Louis Miscioscia
Analyst, Daiwa Capital Markets America, Inc.
Q

Okay, thank you. If you could actually go into the all-flash array area, why do you think you grew lower than your expectations and then obviously if you look at the, let's say, the first quarter in the first half of next year, why do you think it needs to start to get back on track with that, you mentioned that should be something that you think you can do?

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

I think as we noted, some of the issues that we experienced within the quarter, which is the three specific items we talked about, where we had to reprioritize sales resources to offset some of the slower spending in our largest customers, it took longer than we needed to do that.

The second, the OEM business, which has a material – a part of it is also solid state storage and then the third is our renewals business which is also overweight on solid-state. I think all of those issues were felt particularly acutely within the ASA segment. I think if you look at what actions we are taking to increase sales coverage and to align those resources against our biggest customer opportunities, we have seen the results this year from moves we made earlier in the year, for example, prioritizing certain segments over others we have seen that pay off through the course of the year and we are really confident that as we continue to do more of that, the first place it should return to growth is actually ASA.

Louis Miscioscia
Analyst, Daiwa Capital Markets America, Inc.
Q

Okay, thank you.

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

Thanks, Lou. Next question?

Operator: Thank you next question comes from Jim Suva with Citi.

James Suva
Analyst, Citigroup Global Markets, Inc.
Q

Thank you very much. George in your opening comments you mentioned some execution issues internally and I know you had mentioned that you're making changes, that's great to hear. What are the changes, what were the challenges so investors can feel more comfortable that they are quickly solvable or maybe they take a long time to solve, if you could help us understand that? Thank you.

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

Absolutely. First of all, I take execution particularly seriously. I think we have demonstrated a strong track record of it. And I'm disappointed at the quality of the execution this quarter. As we said there were three fundamental issues. The first was, we have certain customers that are taking a longer time to make purchasing decisions. I think all of the data center players or a multiple of them are reporting that. We have the opportunity however, given the strength of our portfolio to relocate and make investments in higher growth areas and higher, particularly attractive segments.

For example, we reprioritized some resources within public sector from Fed to SLED or Fed to healthcare and we saw a really strong return on that through the course of the year. We didn't do enough and we didn't do it fast enough to react to what we saw in January and so I am disappointed. But I'm confident that the moves that we made should pay off through the course of fiscal 2020 which is why we have an outlook that is quite good for fiscal year 2020.

The second is in the renewals. We've made organizational changes and process changes to drive much more deeper inspection of our ability to capture the full asset portfolio that we have available for renewals. As Ron mentioned in his remarks, the total asset count is growing in our install base and deferred revenue was up 9% year-over-year. So, it's really a matter of execution on renewals within the quarter and you'll see us drive that with a lot more intensity.

The third was the OEM business, and here we do not forecast a return to where it was. I think what we are doing is really prioritizing a couple of the big OEMs and really staying close to them, and for the rest, we are going to take down our outlook for the go forward. I think it's a lower priority use of NetApp resources. And we have so many other attractive opportunities to focus and execute against. We will give you updates on the progress of our execution plans as we come back to you through the course of next year.

James Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you very much.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thank you very much Jim. Next question?

Operator: Thank you. Our next question comes from Eric Martinuzzi with Lake Street.

Eric Martinuzzi
Analyst, Lake Street Capital Markets LLC

Q

Yeah, my question has to do with the workforce realignment. What was the head count, maybe you gave it, but I missed it, what was the head count ending fiscal year 2019 and then were we, sort of, post realignment?

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

A

Yeah, let me get you the numbers, but this is not a reduction in force in a traditional sense, as we told you after we finished our initial transformation, we will be making adjustments very surgically. We did some last year, we did some in Q4, and we're doing some in Q1. You shouldn't think of it as a reduction as much as a realignment of resources for the right skill set in the right places. Our total head count as of the end of the year was 10,541; it's a slight increase year-over-year, again not significant. In many cases, we added heads in lower cost locations, so it didn't increase our overall cost base.

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

A

I think as Ron mentioned, we continue to see phenomenal opportunity with our portfolio of all-flash arrays, private cloud and public cloud data services. We are entering fiscal year 2020 with that portfolio materially stronger than it was in fiscal 2019. And so what we are doing and what we are going to continue to do through the course of the year is to prioritize coverage and investment against the most attractive market segments and market opportunities, right and to fund that, we are going to stay disciplined and reprioritize investments away from lower value activities and lower value smaller countries, and that's really kind of what we did with the changes we've made.

Eric Martinuzzi
Analyst, Lake Street Capital Markets LLC

Q

Okay so just a recap here, based on your comments about the operating expenses not changing much in fiscal 2020, we would expect the head count to be relatively similar to that 10,541.

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

A

That's correct, it may change around the world, we may see more heads in lower cost locations, but the overall head count number shouldn't change dramatically.

Eric Martinuzzi
Analyst, Lake Street Capital Markets LLC

Q

Thank you.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thank you, Eric. Next question?

Operator: Our next question comes from Mehdi Hosseini with SIG.

Mehdi Hosseini
Analyst, Susquehanna International Group

Q

Yes, thanks for taking my question, and I apologize I joined the call late, in case the question has already been asked. George, I want to better understand your forecasting, some more details that gives you the confidence that product revenue on a year-over-year basis is going to rebound. What I have seen over the past six months is some of these forecasts have not really materialized, it seems like your enterprise customers have already upgraded what they need to upgrade. The whole cloud migration, hybrid cloud has already reached a plateauing, and in that context what is it out there that you see that gives you the confidence that this time your forecast is actually going to materialize?

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

A

I think first of all we have close relationships with most of the largest customers in the world and for those that we don't, we are going to put direct NetApp resources to cover them and you will see those investments being made within the financial envelope of our long-term operating model. And I think that's prudent and it is a part of our ongoing portfolio management and portfolio optimization.

I think a couple of things give us confidence, right. The first is Cloud Data Services which has been a work in progress for quite a while, is now generally available. I think if you saw the performance of our business this past – the second half of this year in Cloud Data Services, it has been strong, and I would just say that the cloud migrations have not really been completed, right. I think of the low value workloads, yes those might have migrated, but the enterprise workloads have not yet moved and so we are well positioned to capture that because of the capabilities we now bring to the hyperscalers that enable that and that allows us to go after a bigger wallet rather than just a NetApp install base, right. We're seeing a good percentage of our cloud customers being net new customers.

The second is our private cloud portfolio which is as customers make priority decisions within their own data center envelope, albeit that might be diminished relative to last year or a few months ago, they are prioritizing private cloud build-out and I think we are well positioned for that.

I don't dispute the fact that we have to go and prove our execution out. But I do feel that next year's outlook is against for the second half of the year, particularly is against muted compares given this year. And so we are being balanced in terms of how we are trying to run the business, investing against known areas of strength.

Mehdi Hosseini
Analyst, Susquehanna International Group

Q

Thank you.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thank you Mehdi. Next question?

Operator: Thank you. Our next question is from Jason Ader with William Blair.

Jason Ader
Analyst, William Blair & Co. LLC

Q

Thank you. On the NetApp HCI product, I think you gave – I don't think you've ever given numbers for private cloud, and maybe I'm wrong, but I think you said $150 million in the quarter, $600 million run rate. First of all, is that accurate?

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

A

That is accurate. It's for NetApp private cloud which is SolidFire, NetApp HCI and NetApp StorageGRID Object Storage.

Jason Ader
Analyst, William Blair & Co. LLC

Q

Got you. Could you give us some ballpark amount or ballpark percentage at HCI? Is it 10%, 20%, just some ballpark, like, give a wide range is fine?

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

A

I'll just tell you that we are pleased with all of them. All of them performed really well through the course of the year and they are a material contributor to our growth outlook. We will give you more color on that through the course of the year. I'll just say that HCI is growing as a share of the overall business.

Jason Ader
Analyst, William Blair & Co. LLC

Q

Okay. Great. And then just to follow up quickly, do you have an updated data to suggest whether NetApp HCI is cannibalistic at all to the core storage business?

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

A

It's too early for me to comment on that. I feel like it's an opportunity for us to gain net new customers. We'll give you more color on that as we understand customers' buying behaviors through the course of the year. You'll see us provide more clarity on some of these areas through the course of the year, and I'll just tell you that I'm extraordinarily pleased with the progress through the course of this year. For three consecutive quarters, we have done really, really well, reflecting the strength of all the elements of those portfolios and really betting on the hypothesis that enterprise-grade hybrid cloud infrastructure would display its first-generation hyper-converged, we are seeing that happen.

Jason Ader
Analyst, William Blair & Co. LLC

Q

Thank you.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thank you, Jason. Next question?

Operator: Thank you. Our next question comes from Nehal Chokshi with Maxim Group.

Nehal Sushil Chokshi
Analyst, Maxim Group LLC

Q

Yeah, thank you. For the July quarter operating margin guidance, that's down 450 basis points year-over-year. Could you parse that between OpEx and gross margin?

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

A

Yeah, so most of it, if you remember in Q1 2019, we had $90 million of ELAs, which was very beneficial to gross margin and op margin. So most of that is actually gross margin.

Nehal Sushil Chokshi
Analyst, Maxim Group LLC

Q

Got it. Okay. And if I may, the renewal execution issue, is that concentrated to a particular protocol or type of array or is it broad-based?

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

No, it's broad-based.

Nehal Sushil Chokshi
Analyst, Maxim Group LLC
Q

Okay, great, thank you.

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

Thanks, Nehal. Next question?

Operator: Thank you. Our next question comes from Nikolay Todorov with Longbow.

Nik Todorov
Analyst, Longbow Research LLC
Q

Hey, guys, good afternoon. Recent industry announcements for cloud services kind of validate you're approach to the market and you guys have a first mover advantage. Can you talk about how you see the market evolving from over here? And also, can you share if you have a cloud services ARR target for edge within fiscal year 2020?

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

We don't have one broken out for fiscal year 2020. I want to say that we are confident in our target for fiscal year 2021. And we expect that the general availability of Azure NetApp Files should be a step function increase in our opportunity with Cloud Data Services. And so we have a room to really accelerate that business this year.

I would say we are differentiated on multiple fronts, right. We are differentiated in the number of offerings we have on the way they're integrated with cloud providers, on the ability for us to build truly hybrid cloud workflows given the uniqueness of some of our data movers like SnapMirror and others. And we are expanding beyond just data services to include services like NetApp Kubernetes Service, which gives customers the ability to move apps and data in a portable way across cloud.

So we have first leader – first mover advantage. We have world-class technology. We are really excited at the work we're doing with hyperscalers, and this is an area of material improvement to our business this coming year.

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

Thanks, Nikolay. Next question?

Operator: Thank you. Our next question comes from Matt Sheerin with Stifel.

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

Thank you. George, you talked earlier about the issues you're seeing with large enterprise customers taking longer to pull the trigger on deals and certainly some of your competitors are saying the same thing. Are there any particular reasons that you can point to those issues and as you look toward the rest of the fiscal year and expecting a return to growth? Is that lumpiness still factored into your guidance and your outlook?

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

A

Yeah, we continue to be cautious. I think that's reflected in our outlook. I think that we see two particular reasons for that, the lumpiness or the slow approvals of data center spending. One is in some parts of the world, there are economic considerations that are affecting specific customers who are undergoing their own transformation. And when they undergo a transformation, they put spending on hold until the shape of that transformation comes into play. We did see that in some parts of our European business.

The second is in other parts of the world, they are going through the evaluation of their hybrid cloud journey. I think that's both an opportunity for us because of the unique positioning to our offerings, but we may also have seen more of it, given that we are one of the few players who can offer solutions on either side and so maybe what customers are starting to do is take that journey first with our platform.

So, I think that's both an opportunity plus an area that we are following keenly. We have seen that when we make investments to cover the market more broadly more given the strength of our portfolio, that they do pay off. We've seen that through the course of this year. As I said, we stepped out of China in the early part of the year and struck a joint venture there which is off to a good start. We stepped out of certain countries in Europe this past quarter and refocused our resources within the public sector markets, we made targeted moves to places where we saw healthier spending patterns. And you'll see us continue to do that through the course of this coming year.

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

Q

Thank you.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thank you, Matt. Next question?

Operator: Thank you. Our next question comes from George Iwanyc with Oppenheimer.

George Iwanyc
Analyst, Oppenheimer & Co., Inc.

Q

Thank you for taking my questions. Ron, when you look at seasonality, I think you mentioned that you expected relatively normal contributions for the full year. What are the puts and, takes given the way that you've started, do you expect maybe a little bit higher peak at the end of the calendar year or is this being made up a little bit more at the end of the fiscal year?

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

A

It's hard to say, I think the wildcard as I noted was ELAs which tend to come customer based on customer demand. So, as you noticed last year, almost half of the ELAs came in Q1. That could happen in any given quarter through the year so, I think the base business is going to be a fairly traditional seasonal pattern, with each quarter as essentially bigger than the prior one, and then the thing that you'll lay on top is some amount of ELAs which right now I can't see anything in Q1. And quite frankly I'm not – I don't have any specific targets through the other quarters as well. But we do believe those will still be at roughly 2% of revenue as they were this year.

George Iwanyc
Analyst, Oppenheimer & Co., Inc.

Q

Thank you.

A

Thanks George. Next question?

Operator: Thank you. Our next question comes from Wamsi Mohan with Bank of America.

Wamsi Mohan
Analyst, Bank of America Merrill Lynch

Q

Yes, thank you. For Cloud Data Services, there was some hesitancy here to guide fiscal 2020, whether you spoke about very strong exit for the last month sounded like you did about $17 million in this year. Is there a way that you could benchmark? And why is there a hesitancy just given that you have significant amount of confidence looking at fiscal 2021 to exit within the range, so it'll be helpful for a modeling perspective to understand where that trajectory is even if you could give us some guideposts, if not exact numbers very specifically, some ranges that we can think about would be helpful. And secondarily the half over half growth in Cloud Data Services and private cloud, how does that look? I mean it seems like there is a lot of it hinging on that based on second half versus first half. So any quantification there also would be helpful. Thank you.

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

A

Listen I don't think you should have any indication that we don't have confidence in these offerings, right. We don't guide below the one single revenue number. We've never done that and we are not going to do that going forward.

But that has zero, let me repeat, zero correlation with our confidence in these platforms. I think that we continue, as I've said at the start, we continue to believe that these offerings will grow through the course of the year as we expand our coverage as we bring more and more customers on board, you'll see us providing you updates through the course of the quarter. But I would not – I don't want to set a precedent by guiding below the revenue line.

I think you should just take the fact that we have demonstrated really strong results through the course of the year. We have a track record when we say we're going to do something to be disciplined about going and doing that, and I think that we are being cautious about the outlook for next year. And all of those has factored into the guidance that we are giving.

Kris Newton
Vice President-Corporate Communications & Investor Relations, NetApp, Inc.

A

Thank you, Wamsi.

Operator: Thank you. That concludes our question-and-answer session for today. I would now like to turn the call back over to Mr. George Kurian for any closing remarks.

George Kurian

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

In closing, I'd like to leave you with a few thoughts. We have met our commitments on financial results and shareholder returns each year that I've been CEO, a track record that I intend to keep going forward. Customers and partners choose NetApp because of our Data Fabric strategy which is aligned with their IT roadmap. This creates the opportunity for strong market share gains on-premises and in the cloud.

What we're doing in the cloud also drives wallet share gain on-premises. We have three strong and differentiated growth engines where we see the biggest opportunity, flash, private cloud and public cloud data services. We expect our flash business to reaccelerate and private and public cloud revenue to grow substantially in fiscal year 2020.

We are moving quickly to improve our execution and to capitalize on this opportunity, while staying within the boundaries of our financial model and continue to deliver strong shareholder returns. We started these investments in fiscal 2019. We'll continue them in fiscal year 2020. And I'm confident that they will pay off in fiscal year 2020 and beyond. Thank you again and I'll speak with you next quarter.

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