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NetApp, Inc. (NTAP)

Q2 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, and welcome to the NetApp Second Quarter of Fiscal Year 2024 Earnings Call. All participants will be in a 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 third 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 today. Q2 improved on our solid start to FY 2024 in what continues to be a challenging macroeconomic environment. We delivered revenue above the midpoint of guidance, while our operational discipline yielded company all-time highs for gross margin, operating margin, and EPS.

We remain relentlessly focused on managing the elements within our control while driving better performance in our storage business and building a more focused approach to our Public Cloud business. We are seeing positive results from these actions, with increased profitability and a stronger position for delivering long-term growth.

In Q2, we held our INSIGHT user conference where I witnessed the tangible excitement for the silo-free innovation our unified data storage provides. It was invigorating to be with the thousands of attendees and hear stories of the extraordinary outcome NetApp delivers for our customers. NetApp is at the forefront of the evolution of the storage industry, helping our customers turn disruption into opportunity with intelligent data infrastructure. Today's organization need storage infrastructure that harnesses the power of public and hybrid clouds while keeping data secure and protected from ransomware attacks. They need infrastructure that supports dynamic

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workloads like AI, cloud-native, and open-source applications, and they need infrastructure that helps to create more sustainable data centers.

Only NetApp delivers an entire architecture of unified data storage solutions based on one operating system, ONTAP, that supports any application, any data type, and spans on-premises and multiple cloud environments. This comprehensive architecture delivers unparalleled simplicity of management, simplicity of deployment, and consistency of automation, all unified by common APIs and a single control plane. We further elevate the customer experience with our BlueXPs sustainability dashboard and NetApp Advance, a common set of programs and guarantees that include Storage Lifecycle Program which removes the burden of upgrade cycles, as well as storage efficiency, Ransomware Recovery and Data Availability Guarantees. Intelligent data infrastructure combines unified data storage, integrated data services, and intelligent operations, so customers can operate with seamless flexibility to deploy new applications, unify their data for AI, and simplify data protection in a world of limited IT resources, rapid data growth, and increased cybersecurity threats.

Looking at the results of the quarter, momentum from new products and the go-to-market changes we made at the start of the year drove 10% quarter-over-quarter growth in Hybrid Cloud segment revenue to $1.4 billion. Our all-flash array business benefited from the growth of the AFF C-Series increasing 14% from Q1 to an annualized revenue run rate of $3.2 billion. The AFF C-Series all-flash array continues to exceed our expectations, delivering new to NetApp customers and numerous wins over the competition.

In the quarter, we successfully completed against an all-flash competitor with C-Series to win a $16 million deal at an Infrastructure-as-a-Service company. The customer was looking for new storage to host a broad variety of critical applications.

Our ease of management for large storage environments, unique data resilience, common toolkit across all our storage systems, and the right price/performance ratio secured our win, despite the competitor's attempt to use price once they realized their value proposition was insufficient.

ONTAP One, our all-in-one software license that gives customers access to the industry's most comprehensive data management suite, has laid the groundwork with future tech refresh and expansion opportunities.

Building on the success of the C-Series, we introduced blocked-optimized and AI-ready versions. The ASA C-Series family is a solution tailored to deliver high-performance and guaranteed high availability storage for critical applications, databases and VMware infrastructure, coupled with capacity flash to make enterprise-grade block storage more affordable and sustainable than ever. We added the AFF C-Series to the ONTAP AI architecture, lowering the overall cost of entry to scalable AI without sacrificing performance. Keystone, our storage as a service offering, is also growing rapidly.

In Q2, we added Performance and Availability Guarantees to Keystone, expanding on the existing sustainability and storage efficiency guarantees, creating a comprehensive program to keep storage operations running optimally. We also announced NetApp Storage on Equinix Metal, powered by Keystone, providing customers with a single subscription to a full stack of compute, networking and storage infrastructure with low-latency interconnection to all major public clouds.

Turning to Public Cloud. As we said last quarter, our priority is growing first-party cloud storage services. We aligned our cloud sales specialists to our hyperscaler partners' go-to-market structures at the start of the fiscal year and are seeing new customer additions and growth in those services. However, that growth has been masked by weakness in subscription services, which have declined to 23% of Public Cloud ARR. During the

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quarter, we engaged in a strategic review to sharpen the focus of our cloud portfolio. As a result, we will continue to prioritize cloud storage offerings delivered through the hyperscalers while refocusing some services such as Cloud Insights and Instaclustr to complement and extend our Hybrid Cloud storage offerings, creating greater differentiation and additional value for customers. We will integrate other services that are sold as standalone subscriptions today, such as data protection into the core functionality of Cloud Volumes. We will also carefully manage the transition of cloud storage subscription services to align to customer preference for consumption offerings. And we have decided to exit the SaaS backup and virtual desktop services.

We anticipate ARR headwinds of approximately $55 million from exited services and unrenewed subscriptions in the second half of fiscal year 2024. Growth in first-party and marketplace services are expected to partially offset this decline, positioning us to enter FY 2025 with a more focused and much healthier business from which to grow.

Now to the results of the quarter. Public Cloud segment revenue in Q2 was $154 million, flat from Q1 and up 8% year-over-year. Our first-party and marketplace offerings are highly differentiated and are tightly aligned with customers' buying preferences. These services grew over 30% from Q2 a year ago. We continue to see customer expansion and deepening partnerships, as well as increases in customer count, capacity, revenue and ARR in this part of the portfolio.

In Q2, we extended our partnership with Google with the introduction of Google Cloud NetApp volumes. Now we are not only the only vendor to have a natively integrated storage service in the Public Cloud, but we are natively integrated into all three of the leading hyperscale vendors, and we are not standing still with this advantage. Just two months after introducing the GCNV service, we announced the availability of a new lower-cost tier of Google Cloud NetApp Volumes, expanding the offering to address a greater range of workloads.

These partnerships uniquely position and enable us to participate in the innovation and adoption of AI services in the Public Cloud. As examples, during Q2, we announced support for Google Cloud's Vertex AI with Google Cloud NetApp Volumes, as well as cross-protocol, Hybrid Cloud AI pipeline on Amazon FSx for NetApp ONTAP with support for SageMaker Studio notebooks.

Our position with the hyperscalers also enables us to displace legacy on-premises competitors as customers migrate workloads to the cloud. A US-based medical equipment company chose FSx for NetApp ONTAP to replace a competitor's SAN systems when they move their database workloads to the cloud. This is the customer's first engagement with NetApp. Following a successful initial deployment, they are evaluating FSxN for workload consolidation and disaster recovery.

Looking forward, our focus is clear and is delivering results. We expect the momentum we saw in Q2 to continue through FY 2024, despite continued softness in the demand environment due to the challenging macro. Customers value our modern approach to hybrid, multicloud infrastructure and data management, which enables IT organizations to leverage data across their entire estate simply, securely, and sustainably.

With recent innovations that enable us to address a broader set of markets more efficiently, I am confident that we are well positioned to deliver positive outcomes for customers and stockholders.

I'll now turn the call over to Mike.

Michael J. Berry

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

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Thank you, George, and good afternoon, everyone. Q2 was a very solid quarter in what continues to be a challenging macro environment with soft IT spend. Our relentless focus and consistent execution delivered results that met and exceeded our guidance ranges and drove record-setting non-GAAP profitability measures across consolidated gross margin, product gross margin, operating margin and EPS.

Before I get into the financial details, let me walk you through the key themes for the quarter. As a reminder, all numbers discussed are non-GAAP unless otherwise noted. Our modern innovative solutions are resonating with customers and our disciplined operational management drove profitability margins to a record high. As we look ahead, we expect our industry-leading solutions and unwavering focus to drive revenue growth and profitability in the second half of the fiscal year.

Q2 consolidated gross margins of 72% were at an all-time high driven by product gross margins of 61%, also at an all-time high. Gross margin leverage and the returns on our strategic investments drove record operating margins of 27% and record EPS of $1.58. During the quarter, we returned approximately $403 million to stockholders through cash dividends and share repurchases, reducing share count by 4% versus Q2 2023. Over the course of the year, we expect to return at least 100% of free cash flow to stockholders.

Given our growth, profitability and working capital improvements, we expect operating cash flow for the full year to normalize and track relatively in line with net income for the full year.

Due to our solid execution and operational efficiencies, we outperformed the second quarter and expect our continued focus and discipline to deliver year-over-year revenue growth in the second half of the year. As a result, we are raising all our guidance measures for fiscal year 2024.

Now, to the details of the quarter. Q2 billings of $1.5 billion decreased 9% year-over-year and revenue of $1.6 billion decreased 6% year-over-year as IT budgets remain constrained in a challenging macro environment. Adjusting for the FX tailwind of 160 basis points, billings and revenue would have decreased 11% and 8% year-over-year, respectively. Hybrid Cloud revenue of $1.4 billion decreased 7% year-over-year, and product revenue of $706 million decreased 16% year-over-year.

As discussed last quarter, the first half of fiscal year 2023 revenue and most notably product revenue, benefited from elevated levels of backlog entering fiscal year 2023. For the second half of fiscal year 2024, year-over-year comparisons should be more apples-to-apples.

Support revenue, an attach to our install base and indicative of the value of our products, grew 3% year-over-year to $623 million. We are pleased with the momentum of our product portfolio and our go-to-market initiatives implemented at the start of fiscal year 2024.

Public Cloud revenue increased 8% year-over-year to $154 million and was relatively flat from Q1 2024. As George noted, year-over-year growth was driven by hyperscaler first-party and marketplace services, partially offset by continued declines in subscription services.

Now for our operating results. Q2 consolidated gross margin increased 580 basis points year-over-year to 72%, and product gross margin increased 1,080 basis points year-over-year to 61%. Product gross margin benefited from three main factors: number one, a mix shift to higher margin and higher capacity products. Number two, favorable COGS stemming from lower component costs and our strategic purchase agreements for NAND. Number three, price discipline in a cost-sensitive, competitive pricing environment. I want to be very clear on this point. There were no unusual or one-time transactions that drove the higher product gross margin results.

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As we discussed in prior calls, we continue to make strategic purchase commitments to lock in NAND pricing and mitigate margin pressure from rising prices in the future as NAND prices largely bottomed out in Q2.

Operating expenses of $706 million were flat year-over-year and grew $3 million quarter-over-quarter. Within a relatively consistent OpEx envelope, we will continue to reallocate investments to areas of higher opportunity to drive long-term growth.

In Q2, operating margin increased 320 basis points year-over-year to 27%, which includes 80 basis points of FX tailwind. EPS grew 7% year-over-year to $1.58, which includes a $0.07 FX tailwind. These record results demonstrate the strength of our business model, product relevance and unwavering focus and execution.

As expected, Q2 operating cash flow of $135 million was impacted by seasonally lower collections and repatriation tax payments. DSO was 46 and inventory turns were 15. More importantly, year-to-date operating cash flow of $588 million grew 19% year-over-year compared to a decline of 8% the same period a year ago. Free cash flow came in at $97 million, bringing the year-to-date amount to $515 million, up 46% year-over-year.

During the quarter, we returned $403 million to stockholders through share repurchases and cash dividends, ending the quarter with approximately $230 million in net cash.

Our balance sheet remains healthy. Total deferred revenue as of the end of Q2 was $4 billion. The slight decline year-over-year is driven by lower multiyear support and Public Cloud subscription billings. We ended the quarter with approximately $2.6 billion in cash and short-term investments.

Now turning to guidance. Given the success of our product portfolio and consistent execution on operational improvements, we are raising our fiscal 2024 guidance in still a soft IT spending environment. We now expect fiscal year 2024 revenue to be down approximately 2% year-over-year, an improvement from our previous guidance. We expect to see continued strength in product and hyperscaler first-party and marketplace services as we work through minor headwinds from Public Cloud subscription services.

Consolidated gross margins are expected to be approximately 71%. For the second half, we expect product gross margins to range between 58% to 60% driven by continued mix shift to all-flash products and taking into account the current pricing environment and our commitment to maintain pricing flexibility.

Operating margin is expected to be approximately 26% and EPS to be in the range of $6.05 to $6.25 with the assumption of net interest income of approximately $30 million and share count of 212 million.

Operating cash flow is expected to move in line with net income, although there will be some quarterly variance based on working capital. In Q3, we expect revenue to range between $1.51 billion and $1.67 billion, which at the midpoint implies an increase of 4% year-over-year. We expect Q3 consolidated gross margins to be roughly 71% and operating margin to be approximately 28%. EPS is expected to be in the range of $1.64 to $1.74.

In closing, I want to thank our customers, employees and investors once again for their steadfast commitment and investment in NetApp. I remain confident in our ability to manage the elements in our control and focus our key priorities to help customers successfully achieve their digital and cloud journeys. Our portfolio is well aligned to priority IT investments, and we are 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?

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

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Today's first question comes from Mehdi Hosseini with SIG. Please go ahead.

Mehdi Hosseini
Analyst, Susquehanna Financial Group LLLP

Q

Excuse me, thanks for taking my question. Two quick follow-up. Given the updated fiscal year 2024 revenue guide, should we assume that the July product revenue of $590 million was essentially the bottom and you would continue to see a sequential improvement in the second half?

And the second question has to do with momentum with some of these higher margin, higher capacity to product. To what extent should we assume these market share has enabled you to ride out a tough IT spend environment?

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

A

I'll take the second one, and then Michael take the first, Mehdi. Good afternoon. We feel very good about the momentum with our C-Series portfolio. We are able to serve customer workloads and use cases, particularly at the time of soft IT spending, where we are aligned to the value that we bring. And the software value of ONTAP is particularly useful in these all-flash configurations. We are also expanding the total addressable market with the all SAN Array configuration of the C-Series and of the high-performance flash products. So I'm excited about what the future holds for our flash business, and it is because of that momentum and the focus of our go-to-market that we've taken up our guidance for the full year.

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

A

Thank you, George. Good afternoon, Mehdi. On your question on product revenue, certainly for fiscal 2024 implied in the guidance is continued growth in the second half for the product line. Total revenue growth averages about 4% for the second half. We have not guided for fiscal 2025 yet, but we certainly would – we feel good about going into 2025 as it relates to our product portfolio and our operational improvements.

Mehdi Hosseini
Analyst, Susquehanna Financial Group LLLP

Q

Thank you.

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

A

Thanks, Mehdi. Next question.

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Operator: Thank you. Yes, ma'am. And our next question comes from Meta Marshall with Morgan Stanley. Please go ahead.

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

Q

Great. Thanks. A couple of questions. Just one, realizing that you're saying there's no major contributor to the gross margin upside. But just how do you see NAND prices increasing, just an outlook on how you see gross margins developing throughout the year and whether these are sustainable?

And then just as a second question, do you attribute the more confident in the year to the early success that you're having with C-Series? Do you attribute it to signs you're seeing coming out of INSIGHT? Just what gives you more confidence on the year just given the dampened environment? Thanks.

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

A

Hey, Meta. This is Mike. I'll take the first one, and then George will take the second one. So, the comment in the script was specifically related to no one-time transactions that drove the overachievement in product margins.

As we look forward through the rest of fiscal 2024 and 2025. And let's start with the second half of 2024, we're currently guiding product gross margins between 58% and 60%. As we all know, we continue to benefit from the lowest component costs we've seen in many years. We have included some room in our guidance to be flexible in pricing as well as mix and capacity. And as we've all seen from the industry analyst reports, we do expect that component pricing has bottomed out in our Q2 and will rise as we go throughout the rest of 2024. We do feel very good about our position for the rest of the fiscal year as it relates to purchase agreements that we have struck as well as prebuy.

Similar to 2024, we are looking to extend that into 2025, and we'll continue to work with our suppliers as we go through the rest of the year. I'd also note that, hey, historically, we all know storage industry pricing evolves as component pricing changes, and we expect that trend to continue.

So, all that being said, we feel good about the second half of 2024, as we've included in our outlook. As we head into 2025, we'll see how things progress as it relates to mix, pricing and component costs and we'll guide 2025 when we get to our Q4 call. With that, I'll hand it to George.

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

A

With regard to your question on the underlying factors that support our optimism in the guide. First of all, from a macro perspective, it's still a challenged macro with the soft demand environment. We saw incremental improvement in North America, but equally a deceleration in certain parts of Europe, mirroring the economic landscape in the public domain. I think within the large enterprise, we see a case-by-case situation in terms of demand and we continue to see a more robust product business in this commercial or mid-market customer base. So, no real fundamental change in the demand environment.

With regard to the two underlying factors for confidence. One is, we are a much more focused go-to-market organization, and we are seeing the second consecutive quarter of pipeline and performance from the changes we made at the start of the fiscal year. And so I want to credit our go-to-market teams for their focus and the results that they have delivered this quarter, and that is one of the key contributors.

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The second is the really strong performance of our all-flash portfolio. We talked in the prepared remarks about a large competitive win against a purely flash competitor. And we see that across multiple segments where we are seeing competitive wins with our portfolio. So those are the two fundamental reasons: go-to-market focus and execution and confidence in our portfolio.

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

Q

Great. Thank you.

Operator: And our next question today comes from Krish Sankar with TD Cowen. Please go ahead.

Krish Sankar
Analyst, TD Cowen

Q

Yeah. Hi. Thanks for taking my question. Actually I have two questions for George. George, first one, kind of like what are the lead times for the storage products today? And what does that imply for your visibility when you look into calendar 2024?

And the second question is, curious whether on a storage content per customer, does it – have you seen any increase in it because of AI? Or do you think that will happen maybe at some point in the future? Or is there any way to put some timelines around it?

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

A

With regard to lead times, we are at normal lead times for our portfolio, and we reached those normal lead times a few quarters ago. With regard to the question on storage demand for AI, listen, I think we have been in the AI business for predictive AI or industrial AI for five years. And there are large datasets that are built out to support training of those models and the implementation of those models across the enterprise. So we have a good and robust business there.

We are starting to see early signs of trials and use cases with generative AI. Generative AI is particularly well suited for NetApp's capabilities because it operates on unstructured data, files, documents, video, audio and so on. And so we have large repositories of those in customers, and we are able to use that dataset and add to that dataset to support AI use cases. This quarter, we won a large AI implementation at a very large US bank that was really focused on generative AI document summarization analysis and so on, and we are the infrastructure foundation for that. So it will take time for generative AI to become a demand driver. We are seeing early positive signs there.

Krish Sankar
Analyst, TD Cowen

Q

Thanks, George.

Operator: Thank you. And our next question comes from Steven Fox with Fox Advisors. Please go ahead.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

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Hi. Good afternoon. I had two questions on the product business. So first of all, I'm not fully understanding what you're saying about the pricing environment. At one point you said, you maintained disciplined pricing and then at another point you said you would be flexible going forward with pricing. So, can you sort of give us a sense for how challenging or not challenging it is to hold pricing in these gross margins? And the second one is related to the product gross margins. I'm just still trying to get a sense for how sustainable this last quarter and the guidance for the next quarter is in terms of product gross margins, even if we adjust for the changes in NAND pricing? Thanks.

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

A

Listen, on pricing, we've been in this industry for a very long period of time. And while there will be people who are vendors who are aggressive in any particular transaction or other, depending on their own strategic reasons. Overall, we don't see fundamental changes in the pricing environment. Clearly, the room with lower component costs gives you an opportunity to do more in terms of pricing flexibility. But I think that our past quarter's gross margin results, our demonstration of the fact that we've been able to maintain pricing discipline at a time where demand is soft, [ph] and it talks (00:34:22) to both the differentiation of our product portfolio and the execution in our field teams. I'll have Mike talk a bit about your second question.

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

A

Thanks, George. And I'll refer to George's comments, Steve, when I talk about the sustainability. So as -- so we finished at 61% product margins in Q2. We guided a range of 58% to 60% in the back half. We feel very good about our component costs and the view of that for the rest of our fiscal 2024. The reason why we guided slightly lower than Q2 from a margin perspective, that's exactly what George talked about, which is, we feel really good about our pricing discipline in our products, but we want to make sure and leave room to be flexible should we need that in the second half. That's the one part of the equation that we don't control as much as the cost. So, hopefully, that helps. We would not have guided that range if we didn't feel good about it for the second half, Steve.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Yeah. That's very helpful. Thank you.

Operator: Thank you. And our next question today comes from Asiya Merchant with Citi. Please go ahead.

Asiya Merchant
Analyst, Citigroup Global Markets Canada, Inc.

Q

Great. Thank you. Maybe just a little bit on the macro. Clearly, you're executing really well. And should we -- should we expect slightly better than seasonal growth for you guys in the second half just given the fact that you guys are ramping on a new product?

And then just broadly on the macro, are we starting to see more adoption of flash across the customer base, in general, as people start to appreciate maybe more pricing being more attractive? Or is this something that was specific to NetApp just given the success that you're seeing in your C-Series? Thank you.

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

I'll take the second, and Michael cover the first, Asiya. Thank you for the question. Listen, I think that with regard to customer adoption of flash-based technologies, they are -- we saw the high-performance landscape moved to flash several years ago and there's been a steady movement of that footprint to flash. That is about 15% to 20% of the overall storage market, maybe 20%.

The next tranche of use cases are more in the general purpose application footprint. These are in the process of migrating over multiple years. We are in the early innings of that migration. And so we feel very good about the position of our flash portfolio to attack that part of the market. It is essentially the 10,000 hard drive market that is about 30% to 40% of the hard drive market. So, you'll see that move over time. And so I'll let Mike talk to the first question you had.

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

Sure. On your question, Asiya, as it relates to linearity, we did see a nice quarter-on-quarter pickup in Q2, which was really driven by the factors that George discussed. And if you look at the midpoint of guidance for the year, we do expect it to be relatively consistent with the numbers we like to talk about, which is the 48% in the first half and 52% in the second.

Again, keep in mind that the good bit of our revenue, thankfully comes from support, very predictable. Hopefully, we can do a little better, but that is -- the midpoint of guidance is pretty much right on linearity.

Asiya Merchant
Analyst, Citigroup Global Markets Canada, Inc.
Q

Great. Thank you.

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

Thank you.

Operator: Thank you. And our next question today comes from Wamsi Mohan with Bank of America. Please go ahead.

Wamsi Mohan
Analyst, BofA Securities, Inc.
Q

Yes, thank you so much. I was wondering, George, if you could comment a little bit on the Public Cloud revenue trajectory in fiscal 2024, given some of the changes that you noted? And given those changes in CloudOps, how does that change your long-term revenue outlook for that business on a relative basis, I think before you were thinking 40% of total Public Cloud. Wondering where you're thinking that, that might shake out now in the long-term?

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

So, let me provide some baseline before I jump into the strategy review takeaways and the implications. First, cloud is roughly 10% of total revenue. Subscription is 23% of cloud revenue, down from about 35% a year ago.

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So, it's a small percentage of the total cloud revenue and an even smaller percentage of the total company revenue.

The mix of cloud storage and CloudOps is still relatively consistent, approximately 60/40. We focused our strategy review on all elements of our cloud portfolio and had five key takeaways that I outlined in my prepared comments.

Sharpening the focus on first-party and hyperscaler marketplace storage services, these performed very well in the second quarter and continue to be uniquely differentiated both to end customers of our on-premises solution and a vehicle to acquire net new customers alongside our cloud partners. We would carefully manage the transition of some of the storage subscriptions to our consumption offering as we roll out 1P services, customers that used to buy storage subscriptions prefer to now go towards the 1P offering, and we'll manage that carefully. We will integrate some standalone services like data protection and privacy into our cloud storage offering so that they bring more value to the base offering. And we'll refocus other services like Cloud Insights, which are subscription services and Instaclustr to differentiate NetApp in the cloud storage workload motions that we are focused on.

We've decided to exit some standalone services like Virtual Desktop and SaaS Backup services. And all of this will lead to about a $55 million ARR headwind from these actions in the second half of fiscal year 2024. The reduction in Public Cloud subscription services will be partially offset by the good growth of our consumption cloud storage services in particular. And so our plans for the second half of the year assumes that we will have a modest decline in cloud revenue. We're not going to guide it, but we assume that. And we have built that into the guidance for the fiscal year 2024, which we took up by approximately $100 million. We're not going to comment today on the outlook for the overall cloud business. We will talk to you when we update our long-term models to that effect.

Wamsi Mohan
Analyst, BofA Securities, Inc.

Q

Okay. Thanks, George. And if I could, Mike, your margins were really, really strong, both sequentially and on an absolute basis. Wondering, as we think about free cash flow margins, would all this EBIT margin improvement flow through into free cash flow margins?

And secondarily, just on the EBIT margins, is there a way to dimension out of the three things that you noted, maybe rank order or order of magnitude so that we can get some sense around the confidence of sustainability, especially as it relates to commodity pricing, which you seem to indicate won't really matter too much sequentially. But just wondering what was the biggest sequential driver of that margin improvement? Thank you.

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

A

Sure. So, Wamsi, two questions there. First of all, on cash flow, and I'll do operating cash flow. We do expect for the year, I talked about it in the prepared remarks, operating cash flow to move relatively consistently with non-GAAP net income. So to your question, yes, as the income increases so should operating cash flow, short of any quarterly fluctuations in working capital. So all good there in terms of free cash flow margins largely moving with operating cash flow.

And then on the second question, and I'll answer this on a sequential basis, not a year-over-year basis. As we look from Q1 to Q2, certainly, the mix shift was a significant impact. We did receive some benefit on costs as those older inventories are now completely gone. And then, of course, pricing discipline is in there as well. So I

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would rank from a sequential perspective, the order that I did in my prepared remarks in terms of mix shift, which is both product and capacity, then favorable COGS and then pricing discipline. So, hopefully, that helps.

Wamsi Mohan
Analyst, BofA Securities, Inc.

Q

Yeah, thanks a lot, Mike. Thanks, George.

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

Nehal Chokshi
Analyst, Northland Securities, Inc.

Q

Great. Thanks for taking my question. You guys mentioned 30% growth in first-party storage services. What's the NRR underlying that?

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

A

We don't break those out. I think we feel very good about -- we have brought in the number of workloads that we serve. We have brought in the number of hyperscalers now with Google coming online. We have brought lower price points for Azure and Google, and we have brought higher price points for Amazon. So I feel really, really good about the momentum in our first-party cloud storage services.

Nehal Chokshi
Analyst, Northland Securities, Inc.

Q

Maybe phrasing in a different way, the driver of that growth is expansion or lands?

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

A

The combination of both new customer adds and new workload use cases within existing customers as well as expansions.

Nehal Chokshi
Analyst, Northland Securities, Inc.

Q

Okay, great. And then a quick follow-up question. George, you talked about how you had a $16 million win with the C-Series. And you mentioned four drivers behind that. Which of those four drivers was really probably the biggest element of that win?

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

A

Listen, I think we have a really strong operating system capability for performance and simplification at scale. Many of the other vendors that start simple run into real trouble when you try to build a large enterprise environment. And we have a really good portfolio to do that. I think that was probably the number one reason. And the number two reason is now that we have the C-Series, we have a price point to deliver to customers that used to not have it.

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Nehal Chokshi
Analyst, Northland Securities, Inc.
Q

Awesome. Thank you.

Operator: Thank you. And our next question comes from Simon Leopold with Raymond James. Please go ahead.

Simon Leopold
Analyst, Raymond James & Associates, Inc.
Q

Great. Thanks for taking the question. First, just a quick clarification. On the strategic review update, I just want to confirm, it sounds like you've concluded that review apart from sort of regular business kind of reviews. I just want to confirm that, that's the case. And then really, the element I'm trying to sort of tease out here is you've taken out $55 million of ARR, so roughly $15 million of revenue, yet your outlook is higher. What is informing the higher outlook? What's been the biggest surprise and the biggest delta contributing to the higher outlook? Thank you.

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

So, first of all, let me hit that in three parts, right? First, we have concluded the strategic review. We have a set of good decisions we've made that we need to now go implement that will result in a more focused cloud business and a healthier subscription base, albeit a smaller one to build off. We believe that these actions should allow us to get back to growth in fiscal year 2025 off a healthier business mix in cloud. We always will do reviews of various aspects of our portfolio as ongoing parts of our business. But the focused strategic review, I would say, is mostly complete.

I think the second is, with regard to the confidence we have. Listen, we said that when we guided the second half of the year, we took up the overall guide by close to $100 million. That is mostly based on the momentum of our all-flash Hybrid Cloud storage portfolio. We've raised the second half guide by substantially more than we beat in the second quarter. And it also accounts for the fact that we will have some headwinds through the rest of fiscal year 2024 in our cloud subscription business, which will only be partially offset by growth in our cloud consumption business.

Simon Leopold
Analyst, Raymond James & Associates, Inc.
Q

Thank you.

Operator: Thank you. And our next question then comes from Aaron Rakers with Wells Fargo. Please go ahead.

Aaron Rakers
Analyst, Wells Fargo Securities LLC
Q

Yeah. Thanks for taking the question. A lot of those have been asked and answered. But I wanted to go back to some prior discussion around this notion of AI. And we hear a lot about like AI, large language models becoming smaller and implemented more maybe pervasively over time in traditional enterprise environments. We've even heard more about inferencing and how that might evolve in enterprises. I'm just curious, are you seeing at all any signs of that pulling either discussions or early signs of demand? And if so, is it a prerequisite that, that has to pull all-flash storage with that kind of footprint? And the reason I ask is there's a lot of discussion about a lot of this

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existing infrastructure that's going to have to be upgraded to support these acceleration of AI infrastructure. Sorry for the long-winded question.

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

A

Yeah. No problem. I'll address that in three steps. I think first is the use of smaller models as opposed to the very, very large model. Yes, that term is distillation. We do see that going on in customers, whereas they kind of run these different models, they begin to realize that you can get as effective an outcome with much faster results and a smaller number of parameters. For example, the demonstration – the live demonstration that we showed at NetApp INSIGHT actually was a distillation. We started with a much larger LLM and we brought it to a much smaller range of parameters because you get the same benefit. So that's going on.

The second is with regard to training environment, which is the part of the data lifecycle in AI where you aggregate a dataset and you train the algorithm or the language model for better answers to be able to either predict a good outcome or generate a relevant outcome. You do need very high-performance storage because the GPUs that drive those algorithms need very, very fast parallel access to data. And with our unstructured data scale-out file system, we feel very well positioned for that.

And then the third is, with regard to inferencing, inferencing is the part of the data lifecycle where you've taken a model and now you want to put it into production on a dataset, could be on a factory floor, could be in a distributed office. There it really depends on the dataset and the use case, what type of storage you need. You may need it for larger environments like shop floors, but you may not need super high-performance storage and compute for a very small office, like a claim's office, for example, in insurance.

Aaron Rakers
Analyst, Wells Fargo Securities LLC

Q

That's very helpful. And as a quick follow-up, maybe real quickly, who is your predominant competitor that you see on the block optimized C-level all-flash arrays or C-Series arrays?

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

A

It's all the – the block market is a crowded market. We feel very good about our offerings in the mid-range, especially, and the ability to offer a single solution with common automation, common administration, common lifecycle management for both file and block. And no other vendor in the market can do that. And so we feel very good. I think the large competitors are clearly Dell and HPE in the mid-range and then you occasionally see some [ph] cure (00:51:53).

Aaron Rakers
Analyst, Wells Fargo Securities LLC

Q

Yes. Thank you.

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

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

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Hi. Thanks for taking my questions. I guess if I start with the Public Cloud strategic review that you discussed, just wanted to clarify, based on the changes you're making there, are there any cost implications, other changes? I'm assuming that allows you to focus your go-to-market a bit more, but is there any sort of cost implication where you're enabling some cost take out there?

And secondly, Mike, you mentioned sort of the 58% to 60% gross margin on the product revenue in the second half. When we think about, sort of, prebuys that you might do going into fiscal 2025, how should we think about the trajectory of the gross margin into fiscal 2025. Any levers that you have to offset sort of the flow-through of that to the operating margin that you're sort of really reporting at a very strong level right now? Thank you.

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

A

On the cost side, listen, I think we will, for the most part, just repurpose those resources to drive growth in our first-party cloud storage, we feel good about the demand environment there, and we want to continue to accelerate that. Whatever cost opportunities they are, it's been factored into the second half guidance that we gave you.

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

A

Okay. And then thanks for the question, Samik. On the question, especially going into fiscal 2025 from the product margin, I'll go over a little bit my answer to Meta when she asked the same question. So as we've all seen from the analyst reports, we have -- we do expect that NAND is largely bottomed. We're at the loss component pricing we've been at in a while. We did a really nice job, again, kudos to the supply chain team for doing the prebuys and purchase agreements for 2024. We will certainly look at those and continue to look at those in 2025, but it has to make sense for both NetApp and our suppliers.

So as we go into end of 2025, there are certainly some levers. The big question there, Samik, that I don't have an answer to is what does the market do and pricing do over the next six months. That's why we're going to wait. We'll guide the margin number when we guide for the full year because we really want to get through the next couple of quarters to see how component pricing goes, what we expect the mix to be. And then what happens from a pricing environment perspective.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Okay. Thank you.

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

A

Thank you.

Operator: Thank you. And our next question comes from Ananda Baruah with Loop Capital. Please go ahead.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Yeah. Good afternoon. Thanks for taking the questions. I guess, George, an inference-related question, maybe two quick parts. Are you hearing any of your customers talk about legislation around inferencing, having an

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impact on their plans? And I guess, just generally speaking, any opinion you have on sort of what that ramp over what time period kind of looks like even if just anecdotally would be helpful. I appreciate it. Thanks.

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

A

Yeah. I think, first of all, we are in the early stages of generative AI. Predictive AI is quite mature and has very strong use cases. We have done really well in healthcare and life sciences, in manufacturing, in parts of financial services, lots of use cases, right? And so I think that's mature. It requires good datasets and good data management to make it have the right outcome.

With generative AI, there is obviously a lot of discussion on both regulation as well as judicious use of the technology, everything from fairness to ethics to privacy to all kind, cybersecurity, all of those things. And I think it will take time. Where we are with most clients today is proof of concepts, right? They are trying to put their datasets together. They are trying to learn of what these models will help them do. And there are some use cases which are really easy to see the benefits from software development. It's very easy to see the benefits from the more advanced ones where some of these concerns exist that we're seeing customers move cautiously. So it will take time. These are multiyear use case developments. And so we feel good about where we are at the moment and we're just realistic that it'll take time to build momentum.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Yes. Thanks for the context. That's helpful.

Operator: Thank you. And our final question today comes from Sidney Ho with Deutsche Bank. Please go ahead.

Sidney Ho
Analyst, Deutsche Bank Securities, Inc.

Q

Great. Thanks for the questions. I apologize if you have already addressed this. On the macro level, are you seeing any major differences between demand from large enterprises, small dealing businesses in federal. Any particular verticals you would point out that shows particularly strength of weakness both on the Hybrid Cloud and the Public Cloud businesses? Thanks.

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

A

The demand picture is still soft and mixed. Overall, we saw some improvements in the US offset by some weakness in Europe. Nothing that is not in the public domain. With regard to the customer time, large enterprise is still soft. Tech – for example, tech and service provider spending has not really come back. It is really a customer-by-customer situation versus a broad industry situation. With regard to the demand picture in midsized enterprise, our midsized enterprise business performed more robustly and secularly better than our large enterprise business. Public sector continues to be a work in progress. We saw some of the impacts of the budget negotiations result in softer budgets for certain agencies. Our business performed well, particularly in the civilian agencies.

Sidney Ho
Analyst, Deutsche Bank Securities, Inc.

Q

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Great. Thank you.

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

Thank you, Sidney. I'm going to hand it back to George for some final comments.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

In closing, I want to thank the entire NetApp team for their strong execution and operational discipline in Q2, which drove revenue above the midpoint of our guidance and record gross margin, operating margin and EPS. Only NetApp delivers an entire architecture of unified data storage solutions, helping customers operate with seamless flexibility to deploy new applications, unifying their data for AI and simplify data protection in a world of limited IT sources, rapid data growth and increased cybersecurity threats.

Innovation in our all-flash storage portfolio enables us to address a broader TAM and we continue to innovate and lead in Public Cloud storage services. Our go-to-market team is laser-focused on these positions of strength, enabling us to deliver strong results in the challenged macro landscape.

Looking ahead, I'm confident that the momentum we saw in Q2 will continue through the remainder of fiscal year 2024. Thank you.

Operator: Thank you. And ladies and gentlemen, this concludes today's conference call. We thank you all for attending today's presentation. You may now disconnect your lines, and have a wonderful day.

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