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OVERVIEW:

Company Summary

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PRESENTATION

Operator

Good day and welcome to the NetApp fourth quarter fiscal year 2024 earnings call. (Operator Instructions) 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 - *NetApp Inc - VP, IR*

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 first quarter and fiscal year 2025, 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 - *NetApp Inc - Independent Director*

Thank you, Kris. Welcome, everyone. We concluded FY24 on a high note, demonstrating robust performance in the fourth quarter and building positive momentum as we step into FY25. Our revenue for both Q4 and FY24 exceeded the midpoint of our guidance, reflecting the strong growth of our expanded All Flash portfolio.

Throughout FY24, we maintained a high level of operational discipline, leading to company records for annual gross margin, operating margin, earnings per share, operating cash flow, and free cash flow. At the start of FY24, we implemented a plan to enhance the performance of our storage business and build a more focused approach to the public cloud business while managing the elements within our control in an uncertain macro environment. This plan has yielded tangible results, and our value proposition is resonating strongly in the marketplace.

Customers are increasingly turning to NetApp to help them build intelligent data infrastructures and leverage the power of public and hybrid clouds for rapidly growing data-intensive workloads like AI, cloud-native, open-source, and enterprise applications, while ensuring their data remains secure and protected from ransomware attacks.

NetApp uniquely delivers a comprehensive and integrated portfolio of unified data storage solutions based on one operating system on tap, supporting any application, any data type, and spanning on-premises and multiple cloud environments. We deliver unparalleled simplicity of data management and infrastructure and application deployment with consistent automation, all unified by common APIs and a single control plane.

In a world of limited IT resources, rapid data growth, and escalating cybersecurity threats, we empower customers with the flexibility to rapidly deploy new applications unify their data for AI, simplify cloud integration, and strengthen data protection.

Now to the results of the quarter. We delivered robust year-over-year performance in our hybrid cloud segment with revenue growth of 6% and product revenue growth of 8%. Strong customer demand for our broad portfolio of modern all-flash arrays, particularly the C-Series Capacity Flash and ASA Block Optimized Flash, was again ahead of our expectations. This demand propelled our all-flash array annualized revenue run rate to an all-time high at $3.6 billion, up 17% year over year.

Early in Q1 of FY25, we unveiled our new All Flash A-Series Unified Data Storage products, offering customers enhanced performance and effective density at a lower cost than the previous A-Series generation. These products set a new standard for enterprise storage, enabling customers to turbocharge workloads ranging from traditional enterprise applications to GenAI. The new AFF A-Series coupled with our highly successful C-Series and TAM expanding ASA products position us to further increase our share in the all-flash market.

Keystone, our storage-as-a-service offering, was also a highlight of the quarter. Keystone provides cloud-like management for hybrid cloud resources in a single subscription with flexible multi-year contracts that align storage costs with business needs, enabling rapid response to changing capacity and performance requirements. We consistently hear from customers that our integrated service-level assurance with performance, availability, ransomware recovery, and sustainability guarantees, is our differentiator. This has enabled us to accelerate growth by displacing competitors' storage-as-a-service subscriptions, winning new Keystone subscriptions, and expanding existing ones.

FY24 total contract value sales of Keystone more than doubled from the prior year to almost $150 million. We expect this momentum to continue and that FY25 will be another significant growth year for Keystone.

A leading semiconductor manufacturer selected Keystone as the vehicle to consolidate its storage needs. Initially aiming to select one vendor for block and another for file, we established ourselves as a single global standard for both environments, displacing the incumbent for block storage. This multi-year, eight-figure deal allowed the customer to reduce the complexity and improve the availability of their storage environment.

AI is a top priority for organizations as they seek to accelerate innovation, revolutionize operations, drive competitive advantage, and deliver superior solutions to their customers. Data management is essential for enterprise AI.

Customers choose NetApp to support them at every phase of the AI lifecycle. Due to our high-performance all-flash storage, complemented by comprehensive data management capabilities that support requirements from data preparation, model training and tuning, retrieval augmented generation or RAG, and inferencing, as well as requirements for responsible AI, including model and data versioning, data governance, and privacy. We continue to strengthen our position in enterprise AI, focusing on making it easier for customers to derive value from their AI investments.

In Q4, we introduced NetApp AIPod with C-series capacity flag system, delivering a new level of cost and performance, rack space utilization, and sustainability. In conjunction with Cisco, we updated FlexPod AI reference architectures to support the NVIDIA AI enterprise software platform, giving customers an end-to-end blueprint to efficiently design, deploy, and operate AI infrastructure. We were one of the first partners to complete the storage validation for NVIDIA OVX system, and at the start of Q1, we were the first to announce a full-stack OVX system.

The NetApp AIPod with Lenovo ThinkSystem servers for NVIDIA OVX is optimized for GenAI and designed to support RAG. We announced much of this innovation at NVIDIA GTC, where we were honored to be recognized during the keynote for our role in storing a significant portion of enterprise's unstructured data, which is the fuel for GenAI. Through our partnership with NVIDIA, we give customers the ability to talk directly to the large amount of existing data stored on NetApp on-premises and in the cloud, demonstrating the value of our install base and the critical role we play in AI.

We are the AI infrastructure of choice for one of the world's leading oil and gas companies. The company is developing its own large language model using a high-performance AI cluster with NetApp all-flash storage. They are now also building an AI center of excellence to support various departmental AI initiatives and have again selected NetApp storage for this part of their AI infrastructure, leveraging CCVs to optimize price and performance.

They are rapidly ramping up their AI infrastructure, building new models and onboarding AI resources. They awarded us the deal over their AI server vendor because of our ability to remove roadblocks in their AI workflows and accelerate the time-to-value from their AI investments.

Public cloud segment revenue was $152 million, up 1% year over year. First-party and hyperscaler marketplace storage services remain our priority and are growing rapidly, increasing more than 30% year over year and driving cloud storage services to two-thirds of total public cloud ARR. These offerings are highly differentiated and closely aligned with customers' purchase preferences. In Q4, we had a good number of takeouts of competitors' on-premises infrastructure with cloud storage services based on NetApp ONTAP technology, which helped drive our best quarter for cloud storage services with each of our hyperscaler partners.

We are well ahead of the competition in cloud storage services and we are innovating to further extend our leadership position. In Q4, we further increased the performance of Amazon FSx for NetApp ONTAP, addressing an even broader set of performance-intensive workloads. We also introduced a new service level for Google Cloud NetApp Volumes, giving customers more granular control to match the capacity and performance needs of their cloud workloads. We were proud to receive Google Cloud's Technology Partner of the Year for Infrastructure — Storage for the second consecutive year.

Reflecting on FY24, I want to thank the NetApp team for their work to strengthen our position. We have a stronger, more complete all-flash portfolio after addressing a wider set of cloud storage workloads and have a robust go-to-market plan, better positioning us to win across the board and in new markets like AI. Without question, our modern approach to unified data storage, spanning data types, price points, and hybrid multicloud environments is resonating in the market, giving us solid momentum as we enter the new fiscal year.

Looking ahead to FY25, we are cautiously optimistic on the macro environment; the backdrop is better now than it was at the start of FY24. We will remain laser-focused on our top priorities while continuing to raise the bar on execution and maintaining our operational discipline. NetApp is leading the evolution of the storage industry, helping our customers make their data infrastructure intelligent for the age of AI. I am confident that this leadership, coupled with the strong momentum we've built through FY24, positions us for continued growth and share gain.

I encourage you to attend or tune into our June 11 Investor Day to learn more about our long-term strategy. Visit our investor relations website for more information. I'll now turn the call over to Mike.

Michael Berry - *NetApp Inc - Chief Financial Officer, Executive Vice President, Interim Chief Accounting Officer*

Thank you, George, and good afternoon, everyone. As George noted, we are laser-focused on managing the elements within our control. This focus enables us to deliver strong P&L performance for Q4 and the full year.

Before getting into the details, let me quickly highlight the key themes. As a reminder, all numbers discussed are non-GAAP unless otherwise noted. We delivered solid revenue growth in Q4, driven by our all-flash and cloud storage portfolio, which have strong momentum as we head into fiscal year '25. For Q4, our all-flash array revenue achieved a $3.6 billion annualized run rate, growing 17% year on year. Flash now accounts for approximately 60% of hybrid cloud revenue.

Keystone, our storage-as-a-service offering, delivered another strong quarter and a strong year, with revenue growth up triple digits year over year in fiscal year '24. And first party and marketplace cloud storage, the largest part of our cloud business, grew double digits quarter over quarter and over 30% year over year in Q4. Our operating profit margin was a record for a Q4, and operating cash flow was an all-time record.

For the full year of fiscal '24, product gross margins reached a record high of 60%, representing around 1,000 basis points of year-over-year improvement, driven by product mix, lower SSD costs, and a normalizing supply chain environment. We have an increasing share of total revenue derived from higher margin and recurring revenue sources, which we expect to continue into fiscal '25.

In fiscal '24, we generated $1.53 billion in free cash flow, a 76% year-over-year increase compared to fiscal year 23, and an all-time high. And we returned 86% of fiscal '24 free cash flow to shareholders, through $900 million of share repurchases and around $400 million of dividends.

Our share repurchases resulted in a reduction of full-year diluted share count by approximately 3% from the prior year. We plan to continue a strong policy of shareholder returns in fiscal '25 and are announcing today an increase in our quarterly dividend from $0.50 to $0.52. Furthermore, today, we are announcing an increase to our share repurchase authorization by another $1 billion.

Now to the details of Q4. Revenue came in slightly above the midpoint of our guidance range at $1.67 billion, up 6% year over year, and up 4% quarter over quarter. Q4 billings of $1.81 billion were up 8% year over year. This marks our second straight quarter of year-over-year revenue and billings growth.

Q4 hybrid cloud revenue of $1.52 billion was up 6% year over year. Product revenue was $806 million and up 8% year over year. Support revenue of $623 million increased 4% year over year. Public cloud ARR exited the year at $630 million, up 2% year over year, and up $22 million from Q3. Public cloud revenue composed 9% of total revenue in Q4 and grew 1% year over year to $152 million.

We exited fiscal '24 with $4.23 billion in deferred revenue, a decrease of 2% year over year, consistent with the year-over-year decrease in Q3.

Q4 consolidated gross margin was approximately 71.5%. Total hybrid cloud gross margin was 72%. Product gross margin was 61%, 130 basis points ahead of our prior guidance, driven by better mix and continued growth in our C-series products. Our recurring support business continues to be highly profitable, with gross margin of 92%. Public cloud gross margin increased 290 basis points both quarter over quarter and year over year to 68%.

Q4 again highlighted the strength of our business model and our operational discipline with operating margin of 28%, the highest for a Q4 in the history of NetApp, and the second only to last quarter's 30% operating margin. EPS of $1.80 was $0.02 ahead of guidance of $1.78, predominantly driven by better gross margins. As a reminder, we had a one-time improvement in our tax rate in Q3 that normalized towards our usual low 20% range in Q4, which was contemplated in our prior guidance.

In Q4, cash flow from operations was $613 million, and free cash flow was $567 million. These cash flow metrics came in above our expectations in Q4 due to higher customer collections, lower tax payments, and lower supply chain payments.

During Q4, we repurchased $100 million in stock and paid out $104 million in dividends. Q4 diluted share count of $212 million, was down 2% year over year. We had approximately $500 million left on our current share repurchase authorization as of the end of fiscal '24, and today, we are announcing an increase in that authorization by another $1 billion.

Before moving to guidance, let's review the results for the full year of fiscal '24. Revenue of $6.27 billion was down 1% year over year, and billings of $6.25 billion were down 2% year over year. Discipline operational management yielded all-time fiscal year highs for operating margin and EPS. For fiscal '24, operating margin was 27%, up 260 basis points year over year, driven predominantly by 450 basis points of year-over-year improvement in gross margins, slightly offset by the small year-over-year revenue decline and targeted operating expense growth.

For fiscal '24, operating cash flow was $1.69 billion, and free cash flow was $1.53 billion, both all-time company highs.

Our balance sheet remains very healthy. We closed the year with $3.25 billion in cash and short-term investments against $2.4 billion in total debt.

Now to guidance, starting with fiscal '25. Let me underscore our confidence in our strategy and the strength of our position in addressing key customer priorities, such as business analytics, AI, cloud transitions, data security, and application modernization.

Macro indicators today are better than a year ago. However, while there has been some improvement, in our view, the macro environment remains unsettled. As a result, we expect fiscal '25 total revenue to be in the range of $6.45 billion to $6.65 billion, which at the midpoint reflects 4.5% year-over-year growth. Implied in our fiscal '25 revenue guidance is year-over-year revenue growth in each quarter of fiscal '25.

While we are not providing specific cloud revenue guidance, we do expect public cloud revenue to return to consistent growth in fiscal '25. We expect fiscal '25 consolidated gross margin to be roughly 71% to 72% consistent with fiscal '24 gross margins, despite the pressure coming from rising NAND component costs. We expect growth in supporting cloud gross profit to help maintain our overall gross margins. Implied in this guidance is growth year over year in gross profit dollars, which is our focus.

We have secured a large majority of our forecasted SSD demand for fiscal '25, albeit at higher prices than fiscal '24. Given our existing inventory levels and the forecasted use of our pre-buy supply, product gross margins are expected to be higher in the first half of fiscal '25, as we utilize our inventory, compared to the second half of fiscal '25. We remain confident in our long-term public cloud gross margin target of 75% to 80% and expect to make progress in fiscal '25 towards this target.

We anticipate operating margins of 27% to 28% and EPS of $6.80 to $7. For the year, we expect a tax rate in the range of 21% to 22%.

We expect operating cash flow will move in line with net income, although there will be some quarterly variance based on working capital, especially in Q1 when we will pay our annual incentive compensation plans. Our anticipated healthy cash generation enables us to continue our strong return of capital to shareholders.

In fiscal '25, we intend to return up to 100% of free cash flow to shareholders in share buybacks and dividends. Our conviction in future cash flow generation is driving the increase in our quarterly dividend to $0.52 per share in fiscal '25, with the remainder of free cash flow going to share buybacks. We expect to reduce share count by approximately 1% to 2% in fiscal '25.

Now on to Q1 guidance. We expect Q1 revenue to range between $1.455 billion and $1.605 billion, which at the midpoint implies growth of 7% year over year. We expect Q1 consolidated gross margin to be roughly 72% and operating margin to be approximately '25%. EPS should be in the range between $1.40 and $1.50.

In closing, I want to echo George's appreciation of the NetApp team and their continued focus and execution in this uncertain environment. As I look forward into fiscal '25, I am confident in our strategy and our ability to capture our growing set of opportunities and increase profitability.

I'll now turn the call over to Khris for Q&A.

Kris Newton - *NetApp Inc - VP, IR*

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) David Vogt, UBS.

David Vogt - *UBS Equities - Analyst*

Maybe, George, to start, you spent some time talking about the competitive successes that you had in the quarter and the strength of both the A-Series and the C-Series. Can you maybe expand upon that relative to sort of what you're seeing in the macro? I mean, there's a lot of discussion in the market, not just for storage, but in IT for general, macro headwinds, and it doesn't appear to be a big factor for you this quarter.

And then with regards to Keystone, you talked about some displacements because of a whole host of factors with the offering. Can you maybe expand upon what were some of the more important factors? You mentioned performance. Was price a consideration, or is it really the suite of solutions, the suite of offerings that really drives sort of that Keystone success? And can you maybe talk about the average length of these agreements or these two- to three-year agreements? Any color there would be helpful. Thank you.

George Kurian - *NetApp Inc - Independent Director*

Thanks for the question. Listen, we are cautiously optimistic on the macro. As you noted, it's better than we started the prior year, but there's still a good amount of uncertainty and caution in customer spending.

They are prioritizing the applications like analytics, unifying their data for AI, modernizing their environment, and dealing with disruptions from changes like VMware. And we have had really good success across all of those landscapes. We've had strong wins across multiple elements of the AI opportunity, from data lakes to model training to rag on our customers' installed data, and we see that across multiple verticals. We've had strong success with our offerings displacing VxRail and other hyper-converged platforms that customers look to optimize their VMware landscapes.

And in the case of Keystone, which has had a really strong year, every quarter of the year has been strong, and we had a really, really strong Q4. What we are seeing is customers like the idea of a unified integrated data platform for all of their data and a cloud-like experience. What we are able to offer uniquely in the market is the same experience in your data center as in a co-location environment as in all the leading public clouds. And so the value of the flexibility that we offer and the operational consistency and simplicity is what's allowing us to win all these deals. And they're not on price. These are long-term architectural commitments that customers are making. They are multi-year agreements. I'll leave it there.

David Vogt - *UBS Equities - Analyst*

Perfect. Thank you very much.

Operator

Matt Sheerin, Stifel.

Matt Sheerin - *Stifel Nicolaus and Company, Incorporated - Analyst*

George, regarding your outlook for growth for fiscal '25, 4.5% growth, which, as you say, reflects macro concerns, we are hearing another reason is that vendors focusing on AI investments, which are leading to push-outs of other projects, including both hardware and software. We heard from a number of big companies just this week. Are you seeing signs of that as well in your business, or are you just seeing continued cautiousness concerning all budgets?

George Kurian - *NetApp Inc - Independent Director*

I think more of the latter. There's just generally continued scrutiny of spending. I think with regard to our outlook, we are very confident entering the year. We finished really strong. Our flash portfolio has even got stronger in Q1 with the refresh of our A-series flash products. We feel really good with a really up-to-date A-series, a CAM expanding ASA product, which had a really strong quarter, and, of course, the C-series, which has been setting records for performance in our business. So we feel really good.

I think on the AI side, listen, we are the installed incumbent for the world's largest unstructured data set, and we are helping customers unify those data sets, building data lakes. We saw that, for example, in one of the world's largest genomics companies where, together with NVIDIA, we built a supercomputing environment that allows them to accelerate drug discovery.

And then we talked about the success we had at one of the world's largest oil and gas companies where we not only built their supercomputer for a trillion-parameter large language model, but we are also the backbone for all of their RAG at their AI center of excellence. So I feel really good about our ability to tap into the AI opportunity as well as continue the leadership we've shown in traditional enterprise applications.

Matt Sheerin - *Stifel Nicolaus and Company, Incorporated - Analyst*

Okay. Thank you very much.

Operator

Meta Marshall, Morgan Stanley.

Meta Marshall - *Morgan Stanley - Analyst*

Maybe the first question, just on the first party and marketplace cloud storage strength, is there any trends that you're seeing with the type of customer? Is that somebody who is an existing NetApp customer or those largely new customers? Just any trends of who are those customers where you're seeing that strength?

Maybe just as a second question for Mike, it would seem Q1 is starting seasonally strong, at least in comparison with last year, which maybe was seasonally weak. Is some of that A-series launch, just how to think about how A-series launch impacts the seasonality of the year? Thanks.

George Kurian - *NetApp Inc - Independent Director*

I'll take the first question, Meta. On the cloud storage side, the first party and marketplace storage services, which are our focus, have had strong results throughout the year. In Q4, we continue to see a really good balance of new customers that are new to NetApp, including competitive displacement, bringing competitor footprints to cloud on our platform, as well as a mix of existing NetApp customers who were deploying and migrating workloads to the cloud, and expansions, where a customer might have not had a first-party service like in Google, now expanding on our first-party Google Cloud service. So good balance across the board sets us up to have a continued strong outlook for cloud storage this coming year. Mike?

Michael Berry - *NetApp Inc - Chief Financial Officer, Executive Vice President, Interim Chief Accounting Officer*

Thank you, George. Thanks for the question, Meta. So, yes, we do expect Q1 to be seasonally strong. As you mentioned, Q1 of last year was seasonally weak, so it is one of the easier compares, I'll say, for the year.

In reference to the A-series launch, we're super excited about it. That is something that's just gotten started, though, so it won't have a big impact on Q1. We do expect that, though, to start driving some nice trajectory as we move through fiscal '25.

Meta Marshall - *Morgan Stanley - Analyst*

Great. Thank you.

Operator

Samik Chatterjee, JPMorgan.

Samik Chatterjee - *JPMorgan - Analyst*

I guess, George, you talked about the support and sort of the infrastructure you're providing your customers as they go through their AI deployments and the wins you have. I was just curious if you can give us a bit more sense about how to then translate that into revenue, particularly when I think about sort of fiscal '25 guide here, how much of that is incorporated in terms of those deployments in your revenue and how to think about that ramping in the out year.

And a quick follow-up from Mike. Mike, if you can just help me with the puts and takes in terms of gross margin variance between Q3 and Q4, that will be helpful in terms of what the headwinds and tailwinds were. Thank you.

George Kurian - *NetApp Inc - Independent Director*

Listen, broadly speaking, we had about more than 50 AI wins in Q4 across all elements of the AI landscape I talked about, both in data foundations like data lakes as well as model training and inferencing across all of the geographies. I would tell you that in the AI market, the ramp on AI servers will be much ahead of storage because what clients are doing is they're building new computing stacks but using their existing data. And so we expect that over time, there will be a lot more data created and unified to continue to feed the model. But at this stage, we are in proof of concepts We think that there's a strong opportunity over time for us and all of the AI growth is factored into our guidance for next year.

Michael Berry - *NetApp Inc - Chief Financial Officer, Executive Vice President, Interim Chief Accounting Officer*

On your follow-up, Samik, on gross margins from Q3 to Q4, so as we talked about in the prepared remarks, we did come in about 130 basis points higher on product margins. We had guided around 60%. That was largely due to better mix. As we had talked about, we did expect that to come down from Q3 just because it was our Q4 and that's largely what happened. We support gross margin very consistent and importantly, we started to see a nice increase in our cloud gross margins and we expect that to continue in the next year. So pretty consistent performance Q3 to Q4 in our gross margin line.

Samik Chatterjee - *JPMorgan - Analyst*

Thank you. Thanks for taking the questions.

Operator

Mehdi Hosseini, SIG.

Mehdi Hosseini - *Susquehanna Financial Group LLLP - Analyst*

Mike, when I look at your Q1 operating margin guide and put it in context of fiscal year, it seems like you're going to exit FY25 in the high 20% operating margin, 29% to be exact. Does that 29% operating margin exiting FY25 include all the OpEx leverage given the resizing that you went through last year?

Michael Berry - *NetApp Inc - Chief Financial Officer, Executive Vice President, Interim Chief Accounting Officer*

Yeah, so we got in full year 27% to 28% operating margin and yes, operating margin is always a little bit lower on a percentage in Q1 just given the seasonality. So I think what you're referring to, Mehdi, is we did do the restructuring last year in Q4. As we enter fiscal '25, we do have some leverage continuing in OpEx. We do expect OpEx to grow, I'm going to say, about 2% for the full-year basis on a revenue guide of about 4.5%. We are doing targeted hiring in sales and in engineering to drive key product initiatives. Outside of that, as we've always said, our goal is to always drive operating leverage in the business and have OpEx grow at a rate less than revenue growth.

Mehdi Hosseini - *Susquehanna Financial Group LLLP - Analyst*

But you did 30% operating margin in January at a lower revenue run rate. Why shouldn't we be able to meet or exceed 30% operating margin given your reduced footprint?

Michael Berry - *NetApp Inc - Chief Financial Officer, Executive Vice President, Interim Chief Accounting Officer*

Yeah, so the 30%, keep in mind, that was the highest that we saw in our gross margin numbers. And we have talked about, Mehdi, those starting higher in fiscal '25 and then coming down as we go through the year as we go through the pre-buys that we have for SSD. So it is significantly influenced by that gross margin number. We'd love to get back to the 30%. At this point, a lot of that depends on where the gross margin line goes.

Mehdi Hosseini - *Susquehanna Financial Group LLLP - Analyst*

Okay, thank you.

Operator

Steven Fox, Fox Advisors.

Steven Fox - *Fox Advisors LLC - Analyst*

Hi. Mike, just to follow up on his points on pre-buys, can you just maybe further outline your strategy in terms of pre-buys? Would you continue to do that 6 months out, 12 months out, et cetera? Or is it more depending on how you view the market? And along those lines, can you give us a better sense of sort of the gross margin headwinds as you get into the second half from the higher NAM costs?

Michael Berry - *NetApp Inc - Chief Financial Officer, Executive Vice President, Interim Chief Accounting Officer*

Thanks. Sure. So as we talked about, we were very active in pre-buys for fiscal '24. As we talked about in the prepared remarks, we have locked in a large majority of our forecasted SSDs for '25, albeit at prices higher than '24, as you would expect, Steve. And really, when we look at that, we look at where the market is. We look at, obviously, our demand and where we think the prices are going to go. The supply chain team has been very active in this market, and we think it's an important part of protecting our margins.

At this point, we are still comfortable with the full year 58% to 60% range that we talked about in product gross margins for fiscal '25. The variables there are potential further increases or decreases in NAM costs over the rest of the year, and then, of course, storage market pricing plays into it.

I do want to reiterate, hey, we are focused on driving the topline growth and driving additional gross margin dollars at EPS while being disciplined in pricing. We certainly continue to look at product gross margin percentages, but at the end of the day, we will focus on driving profitable revenue growth and margin dollars. Again, 58% to 60% for the full year, starting higher in the first half, and then scaling down as we go through the year.

Steven Fox - *Fox Advisors LLC - Analyst*

Great. That's helpful. Thank you.

Operator

Simon Leopold, Raymond James.

Simon Leopold - *Raymond James - Analyst*

I did catch the comment that you expect public cloud services to grow through the year. I just want to see if we can maybe get a refresh on what's changing in that business that's getting us back to growth, and maybe if you could quantify what you mean in terms of your contributions with some more numbers. I'd appreciate it. Thank you.

George Kurian - *NetApp Inc - Independent Director*

Yeah, listen, a couple of quarters ago, we said that we were taking action to sharpen the focus of our public cloud business. Those are along two dimensions. The first was to continue to drive the execution of a growth strategy around our first-party and hyperscaler storage services. As we said, storage is now about two-thirds of the total cloud business, and first-party and marketplace cloud storage services are the preponderant majority of our cloud storage, and that has performed really, really well and is the foundation for long-term success and growth in cloud.

Second, we said that the subscription business had headwinds related to cloud optimization, and we took several actions to improve the health of our subscription business. As a reminder, we said that subscription was about a fifth of the total cloud business, so a small part, and we took actions to both stop selling certain products and services that were no longer a part of our go-forward plan, to migrate some customers from our subscription offerings to our first-party cloud consumption offerings, to integrate some of the subscription products as big features of our cloud storage offerings, and to be able to sharpen the value proposition of our subscription offerings and work with our customer success team to improve the value of the client.

What this has resulted in is a decrease in subscription revenue in the second half of this year, as we forecast, but the headwinds from that decrease are getting smaller and smaller, and over the course of the first half of next year, we feel that a large part of those headwinds will be mitigated. We expect that cloud first-party and marketplace cloud storage should continue to ramp strongly, which will deliver overall growth in cloud, consistent revenue growth in cloud in fiscal year '25, stronger in the second half than in the first half.

Simon Leopold - *Raymond James - Analyst*

Thank you.

Operator

Wamsi Mohan, Bank of America.

Wamsi Mohan - *BofA Global Research - Analyst*

I was wondering, Mike, did I hear correctly? You say that the range of product gross margin could be between 50% to 60%, starting at sort of the high end of that range and maybe closing out somewhere towards the lower end of that range. Could you clarify that?

Michael Berry - *NetApp Inc - Chief Financial Officer, Executive Vice President, Interim Chief Accounting Officer*

Yeah, so Wamsi, sorry if I said it correctly. What we talked about is we're still comfortable with the 58% to 60% range in product gross margins for the full year, starting out higher in the first half and then sliding down as we go through the second half and use the inventory of pre-buys.

Wamsi Mohan - *BofA Global Research - Analyst*

Okay. I mean, historically, when you looked at the swing in product gross margins, given change in commodity pricing, you've had two impacts. First one is just sort of your ability to pass some of that through on your top line. And secondarily, the swing on product gross margin has been a little bit larger. So could you just maybe talk through maybe 400 or 500 basis points? Maybe historically, Mike, and correct me if I'm wrong there. Can you just talk through sort of what is the upside on revenue that you're thinking could come from pass-through of the increased NAND cost in the second half and why is it not quite as wide this time around when presumably you've done pre-buys in the past too? Thank you.

George Kurian - *NetApp Inc - Independent Director*

Listen, I'll take that question in two parts, one on the revenue side and the second on the gross margin side. On the revenue side, we continue to believe that customers budget in dollars, not in systems. And so while we expect that the industry will follow the normal course of behavior, which is to raise prices to customers as commodity prices go up, we don't expect that to translate into directly increasing revenue. Customers will buy smaller amounts of storage if they have to pay more for it, but they will spend the dollars budgeted for it. And that's what's reflected in our top line.

With regard to cost of goods sold, I think, first of all, as Mike said, we have completed a large percentage of our forecasted demand for NAND through the course of next year. And as we have said before, NAND is less than 50% of our total cost of goods, the rest of which stays flat.

The outlook we are providing is based on current market pricing. If the overall market raises prices as they have done in the past, we expect to follow the market, and that should be accreted to the outlook that we have provided.

Michael Berry - *NetApp Inc - Chief Financial Officer, Executive Vice President, Interim Chief Accounting Officer*

And if I could just add one thing, Wamsi, and you asked about the volatility of the margins. Keep in mind that in fiscal '23 we had to deal with the premium issue. That then went away. So that's caused a lot of it. Fiscal '24 was really 55 to 61. So just keep that in mind as you look at fiscal '23, please.

Wamsi Mohan - *BofA Global Research - Analyst*

Okay. Thank you so much.

Operator

Tim Long, Barclays.

Tim Long - *Barclays - Analyst*

(technical difficulty) Can you hear me?

Kris Newton - *NetApp Inc - VP, IR*

No, you are off the static. You might need to dial back into the queue. Next question, please.

Operator

(Operator Instructions) Nehal Chokshi, Northland Capital Markets.

Nehal Chokshi - *Northland Securities - Analyst*

Given the discussion around the driver of the 10% cubic increase in first-party marketplace cloud storage, it sounds like this is a sustainable driver. So is it fair to expect that the public, the cloud storage and first-party marketplace year-over-year growth will accelerate as we go through fiscal year '25 here?

George Kurian - *NetApp Inc - Independent Director*

Listen, we expect public cloud storage, particularly first-party and marketplace, which are the focus of our cloud efforts, to continue to grow nicely through the course of the year. I'm not going to comment about sequential growth rates each quarter. We had a really nice quarter this quarter, and we had a good year all year.

I think that we see that first-party cloud storage and marketplace is a much bigger part of our overall cloud business entering fiscal year '25 than it was entering fiscal year '24. And the rest of the offerings, as I said, we continue to sharpen the focus and be more targeted in terms of our subscription offerings. They will have a little bit more headwinds in the first half of the year. But we expect cloud to grow consistently in FY25, stronger in the second half than in the first.

Nehal Chokshi - *Northland Securities - Analyst*

Thank you.

Operator

Tim Long, Barclays.

Tim Long - *Barclays - Analyst*

Just wanted to touch on the QLC C-Series business. It seems like there's been some competitors trying to get into that piece of the market as well. So two-parter, number one, what do you think the increased competition would mean for that business, for NetApp? And then secondly, if you could just remind us, that business has been very successful for you. Can you talk a little bit about how that business has been going, meaning has there been a lot of success with new customers or keeping your own base that's upgrading from hybrid systems? Any help there would be great. Thank you.

George Kurian - *NetApp Inc - Independent Director*

Yeah, thanks for the question. With regard to upgrading an existing hybrid flash customer to our C-Series, there are enormous advantages for a customer of NetApp to stay in place because we have the same operating system, the same management console, the same telemetry system, and we can do that virtually seamlessly for customers. And so we've seen a good chunk of upgrades from 10-K drive environments to our all-flash, and we expect that to continue over time. Those will come up as customers upgrade their fleet in a periodic and steady fashion.

We also saw a lot of new to NetApp environments in our customers where we were able to either displace competitive footprints and/or bring new footprints to NetApp as customers deployed new applications. We talked about the example with Keystone in a large customer that was considering two different approaches, one for file and one for block, and decided to unify on NetApp. We have seen several environments where hyper-converged VMware landscapes are now moving to optimize the cost of their VMware licenses and are using C-Series. And over time, we just introduced the C-Series AI part that gives clients a cost-effective capacity flash-based AI model training and inferencing environment. So we're excited about the prospects with C-Series.

Listen, everybody will have their alternatives in the market. We feel really good about the fact that we have the industry's most comprehensive data management, the only real hybrid cloud solution, and the track record of having really large-scale data management capabilities on our flash products. And we feel very, very confident getting into next year.

Tim Long - *Barclays - Analyst*

Okay. Thank you.

Operator

Ananda Baruah, Loop Capital.

Ananda Baruah - *Loop Capital - Analyst*

George, maybe just actually picking up right there. Is there a useful way to think about which of these kind of opportunities you've been stepping into are sort of the most accretive through the fiscal year? And I believe you were talking, I think, like the last few quarters, I'm saying few loosely. It's kind of been ASA SAN opportunity and the 10-K drive opportunity. Is there any way to, I don't know, like sort of anecdotally, not force range, but give us context around which opportunities are going to be the biggest catalyst as you go through the year? Thanks a lot.

George Kurian - *NetApp Inc - Independent Director*

We have four growth opportunities that we are focused on, all-flash storage, block storage, cloud storage, and AI. And let me give each of those in turn. In all-flash storage, we have seen strong success with high-performance flash replacing legacy frame array and sort of traditional mainframe-class storage with much more modern, high-performance landscapes. We have seen the C-series both replace hyperconverged as well as traditional hybrid flash architectures, upgrading both our install base and competitor install bases.

With the ASA platform, which is block, the second part of the growth opportunity, that is TAM expanding for NetApp. And we are excited at the wins that we've seen and the momentum that we have. It will be a smaller business this coming year relative to the C-series and the AFF, A-series, but it will be all TAM expanding for NetApp. And I'm excited at where we are today.

With cloud storage, listen, the cloud market is an enormous market. It's a multi-billion dollar opportunity. And our cloud storage is a part of that opportunity. As the cloud providers have seen a re-acceleration in their business, we are well-positioned to grow our business. And our focus is to grow it at a rate higher than the infrastructure as a service growth rate of the big hyperscalers.

And then finally, AI. This is the opportunity that will become much more meaningful over time. We are well-positioned with the huge install base of unstructured data, which is the fuel for GenAI. And we are focused on helping customers do in-place RAG and inferencing of that data.

Second, our unified data storage systems with integrated data services provide an ideal foundation for customers looking to build a data lake or model training landscapes. And then our hybrid cloud architecture gives us a unique place in the environment, allowing customers to use public cloud AI platforms such as Vertex from Google or Bedrock from AWS with their on-premises data and be able to scale inferencing to where every piece of customer's data and IT landscape exists.

So those are the four. We're excited about the year ahead. We will tell you more about the specific puts and takes of each opportunity at our Financial Analyst Day on June 11.

Ananda Baruah - *Loop Capital - Analyst*

That's great, George. Thanks so much.

Operator

Krish Sankar, TD Cowen.

Unidentified_1

This is Eddie for Chris. When it comes to RAG applications, have you seen any increase in storage density for units requirements? And I wonder if you can update us on your efforts of adopting 30-terabyte SSDs in your system. Thank you.

George Kurian - *NetApp Inc - Independent Director*

Listen, I think with -- I didn't hear the question entirely clearly, but what we see with RAG is customers wanting to use a large amount of unstructured data alongside a model that has already been trained to get it even more aware of the context in which it's operating. Our C-series and A-series are both well-suited for that. For customers that want really large landscapes, we are really excited about the opportunity with the C-series where we already have 30-terabyte drives and are adding higher-density drives as customers need. And then for large-scale data lakes, we are able to build highly dense object storage or mixed object and file storage landscapes that we have done for many, many clients over the last quarter.

Unidentified_1

Okay. Yeah, my question, George -- thank you. My question was about 30-terabyte SSDs. So it seems like that's already shipping in your systems as of today. Is that right?

George Kurian - *NetApp Inc - Independent Director*

We have 30-terabyte SSDs, and they're growing quickly as a percentage of the total capacity. The way our systems are built, we can pack a lot more density into a single system than many of our competitors.

Unidentified_1

Got it. Thank you, George.

Operator

Asiya Merchant, Citigroup.

Asiya Merchant - *Citi - Analyst*

I apologize if this question's been asked, but maybe if I can just focus on the free cash flow for next year. I don't know if this is a guide that was provided for that and how you can think about how we should think about that and the shareholder returns for the fiscal year.

Michael Berry - *NetApp Inc - Chief Financial Officer, Executive Vice President, Interim Chief Accounting Officer*

Sure. Thanks for asking the cash flow question. So maybe we'll have a couple more minutes. As I talked about in the prepared remarks, we expect cash flow to continue to track with net income. So if you take the midpoint of the guide, that says that net income does go up year over year.

A couple things. So we would expect cash flow to move with it. During the year, there will be some working capital changes, and I just want to make sure and highlight these. Keep in mind that in Q1, we will pay our annual incentive compensation payments and incrementally year over year. Thankfully, it's a relatively large number. It's about $150 million. We expect then collections to increase year over year.

And then as long as we continue to purchase, do pre-buys, we expect that to even out over the year as well. So all of that says we would expect operating cash flow to continue to track with net income. And from a CapEx perspective, we did about $155 in fiscal '24. You should expect something relatively consistent with that in fiscal '25. And then that caps it off with capital allocation.

We did increase the dividend from $0.50 a share to $0.52 a share. So that will use probably $425 million of cash about for the year. The remainder of free cash flow is slated to go against share repurchases.

Asiya Merchant - *Citi - Analyst*

Great. Thank you.

Kris Newton - *NetApp Inc - VP, IR*

Thank you. I'll now pass it over to George for some final comments.

George Kurian - *NetApp Inc - Independent Director*

Thanks, Kris. We ended FY24 strong with robust performance in Q4 and building positive momentum entering FY25. Capacity flash, block storage, cloud storage services, and AI all represent enormous growth opportunities for us. We are performing well and expect continued growth in these areas.

NetApp is leading the evolution of the storage industry, helping our customers make their data infrastructure intelligent for the age of AI. We are capitalizing on our share gain opportunities and will maintain the operating discipline that has yielded record profitability.

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

Operator

The conference is now concluded. Thank you for your participation. You may now disconnect your lines.