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NetApp, Inc. (NTAP)

Q1 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, ladies and gentlemen. Welcome to the NetApp First Quarter Fiscal Year 2022 Earnings Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session and instructions will be given at that time.

I would now like to turn the call over to Kris Newton, Vice President, Investor Relations.

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

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

During today's call, we will make forward-looking statements and projections with respect to our financial outlook and future prospects, such as our guidance for second quarter and fiscal year 2022; our expectations regarding future revenue, profitability, and shareholder returns; the value we bring to customers; our ability to execute; and our ability to bring industry-leading capabilities to market, all of which involve risk and uncertainty.

We disclaim any obligation to update our forward-looking statements and projections. Actual results may differ materially for a variety of reasons, including macroeconomic and market conditions such as the continuing impact and uneven recovery of the COVID-19 pandemic; and the IT capital spending environment; as well as our ability to gain share in the storage market, grow our cloud business, and generate greater cash flow.

Please also refer to the documents we file from time-to-time with the SEC, and available on our website specifically our most recent Form 10-K including in the Management's Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors sections.

During the call, all financial measures presented will be non-GAAP unless otherwise indicated. Reconciliations of GAAP to non-GAAP estimates are posted on our website.

I'll now turn the call over to George.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

Thanks, Kris. Good afternoon and thanks to everyone for joining our Q1 fiscal year 2022 earnings call. Building on our accelerating momentum through fiscal year 2021, we delivered a strong start to fiscal year 2022 with results at the high end or above our guidance for Q1.

Broad-based strength drove 12% revenue growth and 16% product revenue growth year-over-year. Public Cloud revenue grew triple-digits again this quarter, up 155% from Q1 a year ago. Our results reflect solid customer demand and strong execution by our team in the quarter.

Cloud and digital transformation initiatives remain top customer priorities, and we continue to benefit from these sizeable, long-term trends. Customers need to simplify and modernize existing data centers and deploy traditional applications quickly and confidently.

At the same time, customers are also accelerating their use of cloud, adopting modern application architectures like Kubernetes and microservices for new workloads, and deploying data-rich applications like machine and deep learning.

With our data fabric strategy, we are uniquely positioned to solve our customers' most significant challenges in both modern and traditional applications, on-premises and in hybrid, multi-cloud environments.

As I've said many times, our Public Cloud services not only allow us to participate in the rapidly growing cloud market, they also make us a more strategic data center partner to our enterprise customers, driving share gains in our Hybrid cloud business.

In Q1, we introduced our new segment reporting disclosures for Hybrid Cloud and Public Cloud, corresponding with how I look at our business. We've provided financial information for both segments in our earnings materials to give you better insight into the dynamics of the two segments. We will maintain our focus on driving growth with our Hybrid Cloud portfolio while scaling our Public Cloud services in fiscal year 2022.

In Q1, Hybrid Cloud revenue grew 8% year-over-year, led by outstanding growth in our all-flash array business, which increased 23% to an annualized net revenue run rate of $2.8 billion. Based on our strong revenue growth, I am confident that we again gained share in the storage and all-flash markets.

In the quarter, we delivered significant innovation that advances our flexible foundation for Hybrid Cloud, unified data management across on-premises and cloud environments, and simplified consumption and operation of Hybrid Cloud services.

We further enhanced the industry's leading and only cloud-ready storage operating system by introducing ONTAP 9.9 with security enhancements, new integrated data protection capabilities, and improved SAN performance.

We also released StorageGRID 11.5 with support for data encryption using external key management, ransomware protection with S3 Object Lock and increased performance with intelligent load balancing. And we announced a broad range of enhancements to Keystone Flex Subscription with new features for service providers, additional cloud support, our partner-delivered FlexPod as-a-service and integration with Equinix colocation services.

Public Cloud revenue grew 155% year-over-year, driven by Cloud Volumes, Cloud Insights and Spot by NetApp. It's been a year since we acquired Spot, and we are excited by the innovation we brought to market under the Spot by NetApp brand and the momentum we have with the Spot offerings.

Public Cloud ARR grew to $337 million, an increase of 89% year-over-year, and Public Cloud dollar-based net retention rate remains healthy at 192%. Our partnerships with the cloud providers are strong and growing. I am honored that we were recognized by Microsoft as the winner of their Global Customer Experience Partner of the Year and of their U.S. SAP on Azure Partner of the Year Awards.

We continue to broaden our Public Cloud services beyond storage and data management services. Today, we help customers extend, migrate, automate and optimize the infrastructure and data management capabilities for enterprise and cloud-native applications.

Customers use NetApp Public Cloud services because we enable them to use more cloud at less cost. In Q1, we announced Spot PC, a fully managed, secure, and cost-effective cloud Desktop as-a-Service for Azure Virtual Desktop and Windows 365. Additionally, we acquired Data Mechanics to accelerate the road map for Spot Wave, an infrastructure and application automation and optimization platform for high-growth big data and machine learning workloads in the cloud.

We also continue to deliver on our vision and strategy around application-aware infrastructure and data management for containers. Spot Ocean automates cloud infrastructure for containers, automatically scaling compute resources to maximize utilization and availability with the optimal blend of Spot, reserved and on-demand compute instances, reducing costs by up to 90%.

In Q1, we evolved Spot Ocean into a suite of DevOps solutions with Ocean Continuous Delivery and Ocean Insights. Ocean Continuous Delivery focuses on the most painful aspects of modern application delivery by automating mission-critical deployment and verification processes. Ocean Insights is an analytical tool that gives users a full view of their application clusters and then previews the potential savings from Ocean.

Last year, we introduced Astra Control, a rich set of storage and application-aware data management services for cloud-based Kubernetes workloads. Astra extends the data fabric to the cloud-native world. And in Q1, we extended Astra to be a deployable on-premises software solution, Astra Control Center. Wherever a customer chooses to deploy Kubernetes applications, we can accelerate the deployment, operation, and protection of these critical environments.

Let me share with you a customer story to highlight the value Astra Control Center brings to enterprise customers. As a part of its transformation strategy, a leading telecommunications provider is using a modern IT architecture based on container-native applications. These workloads are mission critical, and the customer turned to NetApp and Astra Control Center to address the challenges of data protection and disaster recovery that don't exist in Kubernetes natively. Additionally, Astra helped them realize their vision of application portability across multiple Kubernetes distributions and data sharing across multiple clusters.

We have long been recognized for our industry-leading enterprise storage and data management technology. Our Public Cloud services drive further differentiation, expand our addressable market, and enable us to reach new customers. We deliver not only industry-leading storage services in the cloud, but also cloud automation and optimization services, and cloud infrastructure monitoring services. You should expect us to capitalize on our advantage by enhancing our go-to-market activities, deepening our cloud partnerships, and delivering best-in-class organic and inorganic innovations.

Our strong customer momentum and the uniqueness of our Public Cloud services position furthers my confidence in our ability to reach our goal of $1 billion in Public Cloud ARR in fiscal year 2025. Our strong first quarter results underscore our value to customers in a hybrid, multi-cloud, data-driven digital world. We are confident that we are well-positioned with the right portfolio and strategy to solve our customers' most pressing challenges. With focused execution and demonstrated leadership in hybrid, multi-cloud, we are reshaping the industry.

We made a number of innovation announcements this quarter, and we will continue to bring industry-leading capabilities to market, further enhancing our differentiated position in cloud and software. I am excited for what this year will bring, and I'm confident in our ability to deliver top line growth as we support our customers on their cloud and digital transformation journeys.

Before I turn the call over to Mike to walk through our financial results and expectations, I want to thank the NetApp team, our customers, and our partners for an outstanding quarter. I also want to remind you that we'll be hosting our fully digital INSIGHT customer event in October. I hope you'll be able to join us.

With that, I'll turn it over to Mike.

Michael J. Berry

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

Thank you, George. Good afternoon, everyone, and thank you for joining us. As a reminder, I'll be referring to non-GAAP numbers unless otherwise noted.

Fiscal 2022 is off to a great start with strong revenue, gross margin, and operating leverage across the entire business. Excellent execution by the whole NetApp team yielded Q1 billings of $1.38 billion, up 20% year-over-year. Revenue came in at $1.46 billion, up 12% year-over-year. Our solid Q1 results were driven by healthy demand across both our Hybrid Cloud and Public Cloud segments. Gross margin, operating margin, and EPS all came in above the high-end of guidance.

As George noted, in our earnings materials today, we introduced our new segment reporting disclosures for both Hybrid Cloud and Public Cloud. Hybrid Cloud captures all the revenue streams from our enterprise data center business, which include product, support, and professional services. Our Public Cloud segment provides incremental visibility into the revenue and gross margin profile of our rapidly growing cloud business.

Total Hybrid Cloud revenue of $1.38 billion was up 8% year-over-year. Within Hybrid Cloud, we delivered product revenue growth for the second consecutive quarter and expect this trend to continue throughout fiscal 2022. Product revenue of $730 million increased 16% year-over-year. Consistent with the trends we saw throughout fiscal 2021, software product revenue of $414 million increased 33% year-over-year, driven by the continued mix shift towards our all-flash portfolio.

Total Q1 recurring support revenue was $578 million, flat year-over-year. Excluding the 14th week from last year's compare, recurring support revenue was up 8% year-over-year.

As George highlighted, Public Cloud ARR exited Q1 at $337 million, up 89% year-over-year and 12% sequentially. Public Cloud revenue recognized in the quarter was $79 million, up 155% year-over-year. The growing scale of our Public Cloud platform continues to positively impact the overall growth profile of NetApp, delivering 4 points of the 12 points in revenue growth. When combined, software revenue, recurring support, and Public Cloud revenue totaled $1.1 billion and increased 17% year-over-year, representing 73% of total revenue versus 71% in Q1 2021.

Recurring support and Public Cloud revenue of $657 million was up 8% year-over-year, constituting 45% of total revenue. Excluding last year's 14th week from the compare, recurring support and Public Cloud revenue was up a healthy 16% year-over-year.

We ended Q1 with over $3.9 billion in deferred revenue, an increase of 8% year-over-year. Q1 marks the 14th consecutive quarter of year-over-year deferred revenue growth, which continues to be the best indicator of the health of our recurring revenue.

Total gross margin of 69% was an all-time company high, reflecting the value of our software portfolio and Public Cloud platform. Total Hybrid Cloud gross margin was also 69% in Q1. Within our Hybrid Cloud segment, product gross margin was 55% and benefited from the continued mix shift towards software-rich all-flash systems. Our recurring support business continues to be very profitable, with gross margin of 92%.

Public Cloud gross margin of 71% was accretive to the overall corporate average. This is a major milestone for the Public Cloud business as we continue to build out a diversified portfolio of cloud-based software offerings. We expect this trend to continue as an increasing percentage of our Public Cloud business is built on software-only solutions.

Q1 highlighted the tremendous leverage in our operating model, with operating margin of 23%, an all-time high for our Q1. EPS of $1.15 came in above the high-end of guidance and was up 58% year-over-year. Cash flow from operations was $242 million and free cash flow was $191 million.

During Q1, we repurchased $100 million in stock and paid out $112 million in cash dividends. In total, we returned $212 million to shareholders, representing 111% of free cash flow. We closed Q1 with $4.5 billion in cash and short-term investments (sic) [cash, cash equivalents and investments].

As you all know, the supply chain situation remains fluid. Our excellent supply chain and procurement team continues to work closely with our partner ecosystem with the goal of keeping backlog and customer lead-times at normal levels. Towards this goal, we will continue to invest incremental dollars into inventory and longer-term commitment to help mitigate any potential supply risks.

Aiding this effort is the fact that we have a singular software platform that powers all of our key storage products, which provides us added flexibility to work with our contract manufacturers and customers to meet end demand.

With our strong execution in Q1 and our expectation of continued growth for the remainder of the year, we are raising our fiscal 2022 guidance across the board. We now expect revenues to grow 8% to 9% year-over-year, with billings growth expected to outpace revenue growth given the continued strength in recurring support contracts and our Public Cloud platform.

We also have growing confidence in our public cloud opportunity and are raising the low end of our fiscal 2022 guide. We now expect to exit fiscal 2022 with Public Cloud ARR of $450 million to $500 million driven by enhanced go-to-market activities, deeper cloud partnerships, and continued product innovation.

As George noted, we are solidly on track to deliver on our commitment to eclipse $1 billion in Public Cloud ARR in fiscal 2025. In fiscal 2022, we expect total gross margin to be approximately 68% with product margin of approximately 55% for the full year. We anticipate operating margin to range between 23% to 24%.

Operating expense expectations remain unchanged at $2.75 billion to $2.8 billion, driven by continued investment in revenue generating activities, including expanding our Public Cloud portfolio, targeted investments in go-to-market resources, and continued investment in our customer success sales team.

As we discussed at our Investor Day last September, we continue to grow revenue faster than operating expenses. We are committed to delivering $4.85 to $5.05 in fiscal 2022 EPS, representing 22% year-over-year growth at the midpoint. Implied in this guidance is our expectation that other income and expense will be a negative $60 million to $65 million and our effective tax rate will remain at 19%.

We now expect to generate more than $1.2 billion in free cash flow in fiscal 2022 as our Hybrid Cloud business continues to fund the growth in our Public Cloud platform. We are committed to the capital allocation framework we outlined during our Q4 call. The dividend will remain the first call on capital, while share repurchases will continue to play a key role in our capital allocation strategy.

In fiscal 2022, we expect buybacks to offset dilution from our equity plans. For modeling purposes, we expect share count to remain flat at 229 million shares exiting fiscal 2022. Consistent with NetApp's long history of disciplined M&A, the remaining free cash flow generation will go towards our acquisition strategy, which will remain focused on bolstering our strategic public cloud road map.

Now on to Q2 guidance. We expect Q2 net revenues to range between $1.49 billion and $1.59 billion, which, at the midpoint, implies a 9% increase year-over-year. We expect consolidated gross margin to be approximately 68% and operating margin to be approximately 23%. Assumed in this guidance, our Q2 operating expenses of $690 million to $700 million. We anticipate our tax rate to be approximately 19%. And we expect earnings per share for Q2 to range between $1.14 and $1.24 per share.

Assumed in our Q2 guidance is our expectation that other income and expense will be a negative $15 million to $20 million. As a reminder, Q2 tends to be our seasonal trough for free cash flow. This is further compounded by the one-time tax payment associated with the sale of our Sunnyvale campus.

In closing, I want to thank the entire NetApp team for working tirelessly throughout Q1 to maintain the momentum we had exiting last year. We are at a unique inflection point in the company's history as we continue to build out a truly differentiated Public Cloud platform while maintaining an unwavering focus on the Hybrid Cloud business. As a result, we are more confident than ever in our ability to deliver long-term value to our shareholders, customers, and partners as we execute against both opportunities.

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

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

Thanks, Mike. Let's open the call for Q&A. Please keep to just one question so we can get to as many people as possible. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of Katy Huberty with Morgan Stanley. Your line is open.

Katy L. Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Yes. Thank you. Good afternoon and congrats on the quarter, especially the cloud profitability milestone. I have a question on the cloud business. Last quarter, you emphasized the seasonality that you expect in this business, weaker 1Q, 3Q, and stronger 2Q, 4Q seasonality. So, I just want to confirm that, that would imply in your second quarter that you would expect an ARR sequential increase that's greater than what you just posted for the July quarter.

And then just to add color to that, any shift in the sources of cloud ARR and revenue in terms of your different cloud offerings or the different public cloud platforms that are driving the growth? Thank you.

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

A

Hey, Katy. It's Mike. Thanks for the question. I'll take the first one, and George will jump in on the second one. So, we would expect the same seasonality we discussed last time, a little bit more in Q2 and in Q4 on a sequential basis. That's really driven by our, as you know, our biannual sales plans that we have now. So, yes, correct, we would expect sequential to be a little bit higher in Q2.

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

A

I think with regard to the second question you had, Katy, with the mix of offerings, we feel really good about Spot by NetApp and the work that we're doing with the hyperscalers, both especially Microsoft and Google were strong in the quarter. I think the seasonality reflected in – as we had said, reflected in the offerings that were sold by NetApp. They grew nicely, but not as much as the hyperscalers and Spot did.

Katy L. Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Thank you.

Operator: Thank you. Our next question comes from the line of Jason Ader with William Blair. Your line is open.

Jason Ader
Analyst, William Blair & Co. LLC

Q

Yeah. Thank you. First question on the Public Cloud growth revenue or ARR, how much of that was organic?

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

A

So if you – Jason, it's Mike. If you look at the revenue growth, it was 155% year-over-year growth. If you exclude the acquisitions, it was still very strong at about 138%. So, super strong.

Jason Ader
Analyst, William Blair & Co. LLC Q

Great. And you had Spot in the numbers last year, correct? Last [ph] Q-on-Q (00:27:19).

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

Great question. We only had Spot for less than a month. We closed...

Jason Ader
Analyst, William Blair & Co. LLC Q

Oh, less than a month.

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

...that early...

Jason Ader
Analyst, William Blair & Co. LLC Q

Okay.

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

...early July. So, it was very little in Q1 last year.

Jason Ader
Analyst, William Blair & Co. LLC Q

Okay. All right. So, Q2 will be kind of apples-to-apples though with Spot.

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

Yeah. You're going to get a full quarter in Q2...

Jason Ader
Analyst, William Blair & Co. LLC Q

Okay.

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

...this year.

Jason Ader
Analyst, William Blair & Co. LLC Q

All right. And then, George, on the growth on the product side, how much do you think is coming from pent-up demand as the economy started to reopen here over the last several months, six months or so? And then, what type of sustainable revenue growth you think is reasonable beyond this year where there's some, I guess, easier comps?

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

A

Listen, I think that we have never signaled a V-shaped snapback or anything like that. Our belief has been that other than a small number of customers who were directly impacted by COVID, the vast majority of the customers that we work with had a steady demand pattern for several quarters now.

Certainly, we are seeing strengthening in demand as the economies reopen. But this is a reflection of more long-term trends, transformational work that customers are doing to digitize or hybridize their business, the work that they're doing to build cloud environments, and so on. So, I don't think that we see this as a pent-up demand kind of model.

I think with regard to the sustainability of our business, we feel really good about product revenue. As we said, we think that we can sustain product revenue growth each of the quarters of this year and particularly, our flash segment is very, very strong. And so, we see really good momentum there, and no reason to feel anything but real good confidence about where we are.

Listen, we just finished a phenomenal quarter. In Q1, we grew our all-flash business by 23%, overall product revenue by 16% and Cloud by 155% year-on-year. We raised our fiscal year to 8% to 9% growth and anticipate delivering close to $5 in earnings per share. These are all record numbers, right, operating margins, full year and earnings per share for the company. So, I feel very, very, very good about where we are.

Jason Ader
Analyst, William Blair & Co. LLC

Q

Thanks very much.

Operator: Thank you. Our next question comes from the line of Aaron Rakers with Wells Fargo. Your line is open.

Aaron Rakers
Analyst, Wells Fargo Securities LLC

Q

Yeah. Thanks. Thanks for taking the question. I guess kind of two related questions, if I can. First of all, as the kind of industry, we've seen a lot of evidence of component constraints and inflationary component pricing dynamics.

As you've seen that, how do you believe your customers have behaved as far as putting orders in place? How has your lead times maybe changed with relation to that? Or has that not been a factor and you don't believe that will be a risk factor as we move forward?

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

A

Listen, I think that components being constrained and the supply base being dynamic and fluid is something that everybody in the industry faces. Our team has done an excellent job. And the fact that we have a single operating system and a single architecture for the vast majority of our revenue gives us flexibility to adapt and react in real time to potential supply constraints. Both the gross margin guide and the revenue guide that we've given anticipate puts and takes across the supply chain.

With regard to our ability to manage pricing in an inflationary environment, I think the product gross margin strength in Q1 and the outlook for Q2 remains strong and is a reflection of the discipline in our field organization. With regard to do I see customers buying up product ahead of schedule to deal with supply constraints? I don't see that. Maybe there are occasional anecdote situations. But the vast majority, as we've said, is a pretty steady and strong demand pattern across a broad range of deals. You see that in our results this quarter.

Mike, do you want to add anything?

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

A

No. As George talked about, it's obviously very fluid. I would just give another shout-out to not only our team, but obviously, our partners as well for all the work that goes on. They had a really good quarter, and we expect them to continue to perform and help us get through this as everybody in the industry faces this.

Aaron Rakers
Analyst, Wells Fargo Securities LLC

Q

That's perfect, guys. Congrats. Thanks again.

Operator: Thank you. Our next question comes from the line of Amit Daryanani with Evercore. Your line is open.

Amit Daryanani
Analyst, Evercore ISI

Q

Thanks a lot and thanks for taking my question. I just have one, I guess. George, really impressive set of numbers across the board and you took up your ARR estimates for the year by $25 million at the low end. I'd love to just understand, what is giving you the confidence to raise the guide this early in the year? Is it better sales execution, go-to-market? Are you just seeing better adoption at the cloud company? Just help me understand what's driving the confidence to uplift the guide for fiscal 2022 on cloud services.

And then, Mike, related to that, you achieved that in the gross margin numbers and cloud services a lot quicker than you may have thought. So, how does the rest of the year look like from a cloud gross margin perspective?

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

A

With regard to our confidence in the cloud business, I think we feel very, very good about the portfolio that we have. It serves a broader and broader range of use cases, both traditional applications as well as net new applications.

Second, we are adding a lot of customers, both through NetApp pathway and particularly the hyperscaler pathways. Third, once a customer joins our platform, as you can see from our dollar-based net retention rate, they expand quite substantially with NetApp. They like the portfolio and they do a lot more with us. I think those three key sort of fundamentals of the business drives my confidence in being able to take up the bottom of the range to this early in the year.

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

A

And then on the gross margin question, so great question. If you remember back in September, Amit, we talked about, hey, there's really four things that we think will drive increased gross margins in the Public Cloud business. And it was revenue scale, and we've certainly exceeded our expectations there; increased hardware utilization. The team is doing a wonderful job making sure as we deploy that hardware that we drive utilization.

Remember as well, ONTAP drives everything here at NetApp on-prem as well as in the cloud, and we continue to see great improvements there. And the one that I think is underappreciated is more software. Keep in mind that of the four major products in that portfolio, Cloud Volumes Services, Cloud Volumes ONTAP, Cloud Insights and Spot, only Services is "hardware-dependent". The other three are all software cloud offerings, and they've grown all very nicely, which has helped us get to where we are from a margin perspective. So, thanks for that.

And then, hey, Jason, just so I can sleep at night. So I gave you 138%. It was 135%, still a very good number on the organic revenue growth if you exclude all acquisitions. So, thank you for that question.

Amit Daryanani
Analyst, Evercore ISI

Q

Thank you [indiscernible] (00:35:16).

Operator: Thank you. Our next question comes from the line of Rod Hall with Goldman Sachs. Your line is open.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Yeah. Hi, guys. Thanks for the question. I guess I want to come back to these product gross margins and just try to check. I mean, you beat your guide substantially, beat our expectations substantially, yeah, for total gross margin, I should say, but also product is over two points better than what we anticipated. I wonder if you could talk a little bit about what the surprise was there. I mean, what was different and what – maybe what you were thinking last quarter? And then, I've got a follow-up on that.

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

A

Sure, Rod. Hey, it's Mike. So I think there are two things that really drove that outperformance. And the first one was the large majority, which was the growth in all-flash. And that going from, I believe, it was 11% year-over-year growth last year to 23%, as you know, that comes with much better margins, more software-rich, mix matters as well in that business as we've talked about in the past. The other thing that helps the percentage as well is, hey, as you know, we deprioritized things like HCI last year. Those come in at lower margin percentages. So you add those two together, and that's really what drove the higher product gross margin number.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Okay. That's great, Mike. That helps a lot. I wanted to also ask about cash flow seasonality. I know you – I think I heard you call out that next quarter should be a low point for cash flow. And then you've given us full year guide on cash flow. I'm just curious, like, what is pushing all that cash flow to the back end of the year? Is it – I mean, I see quite a bit of compensation accrual, but I'm just curious kind of why the flow of cash looks the way that it does this particular year? Thanks.

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

A

Sure. So, I love cash flow questions. Happy to answer those anytime. So, in Q1, if you look at the balance sheet, you see the accrued expenses were down significantly, and that's when a lot of variable pay gets paid in Q1. In Q2, cash flow is largely going to follow billings growth from an aggregate perspective. Q1, from a total dollars perspective, is our lowest billings. That then flows into lower collections in Q2 as well. The other big mover there is cash taxes. And I highlighted that. Keep in mind, we'll pay about $40 million in state and federal taxes on the Sunnyvale campus.

Then in the second half, as we build billings, that's when collections go up. Everything else is largely relatively similar. The big movers are seasonality of collections, variable pay, timing, and then cash taxes.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Great. Okay. And like you said, the big thing on the year-to-year is just that sale of the headquarters last year, which positively impacted cash flow quite a bit, right?

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

A

So that – yeah. And keep in mind that it helped cash balances that didn't go into operating cash flow, though.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Right.

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

A

[indiscernible] (00:38:22) right.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Yes. Okay. Great. Thanks very much, Mike. Helpful.

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

A

Absolutely. Thank you.

Operator: Thank you. Our next question comes from the line of Matt Cabral with Credit Suisse. Your line is open.

Matthew Cabral
Analyst, Credit Suisse Securities (USA) LLC

Q

Yes. Thank you very much. It sounds like the demand environment continues to pick up. Curious what you're seeing from a competitive standpoint. As that demand has improved whether it's discounting your pricing and just what you're seeing in terms of the broader environment at this point.

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

A

I think we see, as I said in my prepared remarks, solid steady demand across all the geos. I think all of our geographies have executed extremely well to capture that demand. I feel very good about the differentiation in our offerings, both on-premises as well as in public cloud. That gives us a chance to drive value conversations with customers.

Our public cloud services clearly help our on-premises Hybrid Cloud business because customers see us as the only storage vendor with a cloud-ready operating system and a path for them to get to public cloud. And the combination of those two is allowing us to bring on new customers and to be able to maintain a differentiated value proposition in the market. So, very good execution by the team against steady, solid demand across all geographies.

Operator: Thank you. Our next question comes from the line of Samik Chatterjee with JPMorgan. Your line is open.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Hi. Good afternoon. Thanks for taking my question. I just had one on operating margins. You're guiding to 23% to 24% for the full year. That's about a 300-basis-points expansion. But if we start to look beyond this fiscal year, how should we think about headroom on margins? I know you referred to OpEx leverage a couple of times in your prepared remarks, but just trying to think about kind of the magnitude of margin expansion beyond this fiscal year and the drivers between like gross margin and OpEx leverage. How should we think about the balance of that?

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

A

Listen, I think overall, as we've said, we continue to be a disciplined management team in the way we run the business. You should expect, as you see in the numbers this year, that we should grow top line ahead of expenses, and that should create leverage in the model.

I think as Mike outlined, we wanted to get to 55 points of product gross margins in the Hybrid Cloud business. We have achieved that and we want to maintain that for the rest of this year. And then, in terms of Public Cloud, we said that we wanted to get it to be accretive to the margin structure of the core business, which it is, and we want – we have expectations to continue to improve that over time towards a more SaaS-like gross margin model. Both of those elements, top line as well as gross margin, should allow us to be kind of create leverage in the operating margin model of the company.

Mike, do you want to add anything?

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

A

No. Well put. Those are the puts and takes.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Great. Thank you.

Operator: Thank you. Our next question comes from the line of Karl Ackerman with Cowen. Your line is open.

Karl Ackerman
Analyst, Cowen and Company, LLC

Q

Yes. Thank you. Your all-flash array portfolio grew 23% off a difficult compare and that only gets better in the second half from a comparison standpoint. So, it seems that, that's driving the bulk of your upwardly revised fiscal 2022 outlook for hardware. But I'd love to hear what you are seeing from hybrid arrays across both commercial and even SMB environments because component providers would also suggest that area is also doing well, too. Thank you.

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

A

I think hybrid arrays, as we have consistently said, have a place in customer environments. There are a set of use cases. We have consistently maintained that a hybrid array has a better solution to offer than an all-flash array. And so, we continue to see an opportunity for hybrid arrays to have a go-forward enduring place in customers' environments. Our hybrid array business is a strong business. We have a differentiated value proposition in hybrid just like we do in all-flash.

Karl Ackerman
Analyst, Cowen and Company, LLC

Q

Thank you.

Operator: Thank you. Our next question comes from the line of Steven Fox with Fox Advisors. Your line is open.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Hi. Thanks. Good afternoon. George, you threw a lot at us on the Public Cloud side in your prepared remarks about the types of services you have today and where they're going. If we sort of step back – and you mentioned with how the near-term trends are going, but if we step back and thought about the two to three-year plan around what will be the dominant services then versus now and what maybe isn't in the revenue base today, can you just sort of put all of that in perspective for us, how it drives towards that $1 billion ARR target? Thank you.

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

A

Yeah. I think we are in the early innings of enterprise use of cloud for big mission-critical, business-critical applications. I think we see that over the next few years, as businesses deploy more of their core operations on public clouds, the opportunities we have around compute automation management through Spot, storage and data protection and management through Cloud Volumes and monitoring through Cloud Insights will be a very, very strong business. And all of the hyperscaler partners that we work with see it much the same way, which is why they're building more and more capabilities with us.

We also see a new growth engine in the Public Cloud segment with all of the cloud native work we are doing around containers and serverless. So, Spot Ocean, we mentioned, is the same value proposition that Spot brings for enterprise applications to containerized applications that has seen very strong adoption. We've worked with some of the hyperscalers around Astra Control, and we are starting to see that get to ramp especially with new cloud-native Kubernetes applications. And then we started work on Cloud Insights for Kubernetes to bring monitoring and management. So I feel very good about the portfolio. There's a lot of organic innovation, and Spot has proven to be a really stellar acquisition for the company.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Thanks very much. Appreciate that color.

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

A

Thank you.

Operator: Thank you. Our next question comes from the line of Nik Todorov with Longbow Research. Your line is open.

Nikolay Todorov
Analyst, Longbow Research LLC

Q

Yeah. Thanks, and congrats on great results, guys. George, maybe can you give us more color on your on-prem share gains? Can you talk in which segments of the market you see the strongest momentum there? And also, if you can comment on – your direct sales grew faster than your indirect for a fifth quarter in a row. Is there any particular reason for that? Thanks.

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

A

I think with regard to where we see strength, I mean, this was a really balanced quarter across all the geographies. You can look at our results in the Americas, you look at the results in Europe and in Asia Pacific, we grew in all the major geographies very, very nicely. So I feel very good about that. With regard to the direct versus indirect, I think it's a reflection of some of our largest customers who continue to buy direct being a strong contributor to some of our all-flash array growth, right? So I think that's the sort of the puts and takes. I wouldn't read anything into the specific quarter-on-quarter trends in the channel. I continue to see good opportunities to grow our business across both direct and indirect channels.

Nikolay Todorov
Analyst, Longbow Research LLC

Q

Got it. Thanks.

Operator: Thank you. Our next question comes from the line of Shannon Cross with Cross Research. Your line is open.

Shannon Cross
Analyst, Cross Research

Q

Thank you very much. I just wanted to dig a little bit more into the longer term impact from, obviously, the shift to cloud now that you're breaking it out. And I understand on the gross margin side. But I'm curious if there are SG&A and R&D differentials like in terms of how you would allocate or how we think about it from an OpEx perspective. And then the same on cash flow. I know it will be lumpy depending on the investments you need to support cloud. But longer term, how should we think about sort of the mix shift impacting the model? Thank you.

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

A

Hey, Shannon. It's Mike. So a couple of things as it relates to OpEx. Keep in mind that the two largest operating expense line, sales and marketing and R&D, there's a lot of shared resources across there. Let's do R&D first.

We've talked about it. We get a lot of efficiencies from the ONTAP group in terms of the work they do both on-prem and in the cloud. We would expect to continue that where they're focused on both of those, and we get a lot of efficiencies there.

Clearly, most of the growth in that line has been focused around cloud and it probably still will be. That doesn't – and that excludes any acquisitions. It could certainly play into that as well.

And then from a sales and marketing perspective, we now have it where our core sales team is selling both. And so that will continue to be a focus. But we will also add like our customer success team that we've talked about, that's largely focused on the cloud business in terms of expansion and upsell and cross-sell to that team. So I think over time, you'll continue to see that investment there.

From a cash flow perspective, I think that probably largely follows where operating income would. If you're down to free cash flow, you get a little bit of difference in terms of the hardware. But we've also talked about in the next couple of years, we'll continue to see a good bit of hardware especially as it relates to Azure.

But over the next couple of years, that will flatten out. It's much more of a – hey, we're adding in a certain location versus seating it. Once we get to almost 100% that it's more of a replacement motion. So those are the puts and takes around OpEx and cash flow, I think, for those two segments.

Shannon Cross
Analyst, Cross Research

Q

Thank you.

Operator: Thank you. Our next question comes from the line of Jim Suva with Citigroup. Your line is open.

James Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you. And the additional colors in detail was greatly appreciated. The upside for this quarter, was it due to mostly volumes or better pricing? And if the answer is both, can you kind of help us to say it was a little bit more of one versus the other? Thank you.

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

A

Well, hey, Jim. It's Mike. It was largely related to volumes. We haven't seen much of a change in external pricing for -- as we've talked about, competitive environment has always been competitive but relatively similar.

So it's largely going to move with volumes. We saw – we didn't see much of a mix shift. We've talked about that in previous quarters. So it was all relatively consistent mostly driven by volumes.

James Suva
Analyst, Citigroup Global Markets, Inc. Q

Thank you so much and congratulations. And we appreciate the details.

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

Thank you.

Operator: Thank you. Our next question comes from the line of Lou Miscioscia with Daiwa. Your line is open.

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

Okay. Thank you. Hey, George. When we look back to 2018, it was a very strong year. So when we get to 2022 – and I'm referring to spending broadly on capital equipment for data centers. When we get to 2022, we'll be at the four-year anniversary, not necessarily looking at guidance, and maybe it's obviously a little bit early to ask that question. But given the macro and the last cycle and that we had a couple of down years in 2019 and 2020, can you see that enterprise and commercial customers are, hopefully, coming strongly back to the market in 2022?

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

Listen, we have seen steady, consistent demand for our offerings and our capabilities for several quarters now. I wanted to just remind us that we had a strong year last year, particularly the second half of last year. And so we continue to see that the overall demand environment is brightening steadily.

We have said from – for many quarters, we saw the US and China leading the recovery. Europe, a few months, 6 to 12 months behind that. And then the developing economies, maybe another 6 to 12 months behind that. We continue to hold that perspective with the benefit of several quarters of experience. And so I feel very, very good. I think that we have customers who are seeing a better economic environment starting to build confidence in spending in technology. I think within that segment, Hybrid Cloud, digital transformation initiatives are well-positioned, and NetApp is well-positioned to go after that.

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

Okay. Good. That's helpful. Thank you. Any comment on component availability and pricing? Obviously, your margin structure has improved so congratulations on that. But what should we think about for the next six months there? Thank you.

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

Listen, I think as Mike and I said in prepared remarks, the component supply chain is a dynamic and fluid supply chain. It is well-understood in the industry. Our team has done an excellent job managing through that. We have good, deep relationships with suppliers and long-term commitments with many of them.

I think as Mike and I have suggested, we will continue to use cash to buy ahead of what we need so that we can maintain supply availability. We think that's a good use of cash in the current environment. And I think that having a single operating system that drives the vast majority of our business allows us to qualify and adapt to the environment that we're in.

So I want to thank our supply chain team for continued execution and our engineering team and our partners for working with us. And I think our sales teams have done a really good job of managing through the environment to capture the value that we should for our products.

Louis Miscioscia
Analyst, Daiwa Capital Markets America, Inc.

Q

Okay. Guys, good luck on the rest of the year.

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

A

Thank you.

Operator: Thank you. Our next question comes from the line of Wamsi Mohan with Bank of America. Your line is open.

Wamsi Mohan
Analyst, BofA Securities, Inc.

Q

Yes. Thank you. George, on the AFA side, can you give us an update on where you stand with respect to penetration of the installed base? And are you seeing any changes on the competitive side? And I have one clarification for Mike, too.

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

A

It's 29%. So it's up another percent. As we have said consistently, our installed base continues to grow as we acquire new customers and new workloads, and flash is penetrating that installed base an incremental 1% to 2% at a time, right? So a long runway ahead on that installed base.

With regard to the competitive environment, again, we don't see any sort of substantive changes. I think we have a really good offering in the market. I think we believe we have taken share in the environment. And we're going to continue to stay focused on winning not only traditional workloads, but also new types of workloads like deep learning, machine learning, data lakes and others with our all-flash portfolio.

Wamsi Mohan
Analyst, BofA Securities, Inc.

Q

Okay. Thanks, George. And, Mike, just a clarification on these product gross margins. I heard your commentary on sort of better software mix, also discipline in the field. But was there any contribution from either new ELAs or renewal of prior ELAs that had any impact on margins in the quarter?

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

A

Yeah. So thanks for the question, Wamsi. So as we've talked about, look, it's such a small piece of the business. We're not going to talk about ELAs. Here's what I would point you to, and I've said it every quarter. If you look at the financial results, specifically the amount of software and hardware revenue, you can see that in Q1 software increased but so did hardware. They've basically moved in lockstep the last four quarters. And if anything, if there's any large transactions that are different than our current mix, you will see it in the numbers.

Wamsi Mohan
Analyst, BofA Securities, Inc.
Q

Okay. Thank you.

Operator: Thank you. Our next question comes from the line of Simon Leopold with Raymond James. Your line is open.

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

Thank you. I wanted to see if you could talk a little bit about your methodology for forecasting the business of your Public Cloud compared to your Hybrid Cloud. They're different animals, they're different maturity. And I just want to understand how you're doing it. And if you have some advice for the analyst community of what we can do to better enable our ability to forecast your Public Cloud trends. Thank you.

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

Yes. So, hey, Simon. It's Mike. So I'll take that one. When we look at the Public Cloud business, certainly, it is much – it is similar to some of the Hybrid Cloud dynamics. I'll talk about that in a second. There are certainly new transactions that we forecast not only coming in from the hyperscalers but from our sales team as well. We get pipeline reports. We see what that looks like. So we're able to forecast that. More and more, it's also renewal rates, being able to forecast renewals. And then really the big driver of all cloud software business is upsell, cross-sell. That's obviously difficult for you folks to see those details, but we look at all of those. Certainly, sales capacity is part of that.

On the Hybrid Cloud business, keep in mind, I think it's now $2.3 billion of support revenue every year. So that's much more of a renewal rate. We do look at cross-sell, upsell, and we also look at where we are in terms of pipelines and conversion rates. And a big piece for us is, obviously, do we have enough sales capacity.

So I know we get a lot of questions about, hey, NetApp should go quarter-on-quarter sequentially. I would just encourage you when you look at that sequential. Keep in mind, hey, the last couple of years have been very different than the last 10. And it makes it – I understand it makes it a little bit difficult. But hopefully, when we get through this COVID environment and it gets back to normal, those are more relevant. I think now it's very difficult to use those sequential growth to try to forecast the business.

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

Thank you.

Operator: Thank you. Our next question comes from the line of Sidney Ho with Deutsche Bank. Your line is open.

Sidney Ho
Analyst, Deutsche Bank Securities, Inc.
Q

Thanks for taking my question. Just a quick follow-up on the Public Cloud business. Obviously, you raised your target exit rate for this year. Gross margin is already above the corporate average. It sounds like it's going to go higher given the software mix. I know you haven't talked too much about operating margins. But should we think about this revenue stream will eventually get to above corporate average levels? Is there a certain revenue target we should be thinking about when that happens? Or is there a time element? Maybe what are some of the things that we should consider when we think about this business grows.

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

A

So, Sidney, it's Mike. Just to make sure I get the – you're talking about operating profits for the Public Cloud segment. That's your question?

Sidney Ho
Analyst, Deutsche Bank Securities, Inc.

Q

Correct. Correct.

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

A

Okay. Yeah. I think the best way that I would encourage you to look at that is here's the great thing about the cloud businesses, there's a lot of good comps out there that we look at all the time. And as we look at businesses that are, call it, $250 million in ARR, as they grow to $1 billion, there you see not only a slight uptick in gross margin but then, obviously, you see the dynamics of operating income.

So I would encourage you to take a look at some of those compares. We look at that a lot in terms of benchmarking our business. Largely what ends up happening as they turn cash flow positive before they turn operating income because of, again, the way they recognize revenue ratable. So I would encourage you to take a look at those. And there's really no reason to believe, as we said today, that we wouldn't follow that comparable group as we march to $1 billion in ARR.

Sidney Ho
Analyst, Deutsche Bank Securities, Inc.

Q

Great. Thank you.

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

A

Thank you.

Operator: Thank you. Our next question comes from the line of Ananda Baruah with Loop Capital. Your line is open.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Hi. Good afternoon, guys. Really appreciate you taking the question. I'd love to get your thoughts on as you see sort of more workload shift to the cloud, to what extent, if any, are you guys also seeing a hardware benefit particularly – and sort of like an on-prem hardware benefit [indiscernible] (01:00:55) just to move workloads to the cloud particularly given your software positioning. Thanks a lot.

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

A

I think with regard to the work that we're doing in Public Cloud, as Mike has mentioned and I've said before, the vast majority of our solutions are software-based, and we scale that software out using clustering so that it can go faster by going wider to serve more computing demand.

With regard to certain traditional applications that are more sort of scale-up applications like an SAP HANA or something like that that requires a scale-up platform to support it, that's where we use hardware. And I think the software that we have can be run on generic hardware for the broad range of use cases, or on proprietary, our own hardware, for the narrow really specific application use cases.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Okay. Got it. Yeah. Thanks, George. That's helpful. Thanks a lot.

Operator: Thank you. Our final question comes from the line of Nehal Chokshi with Northland Capital Market (sic) [Markets]. Your line is open.

Nehal Chokshi
Analyst, Northland Securities, Inc.

Q

Yeah. Thank you. And congrats on the strong results, and nice to see the increasing rate of capital return to shareholders as well. My question here is that sounds like the acceleration in all-flash array is what is behind the acceleration of software product revenue of 33% year-over-year growth. So is that correct? And then what do you see as a sustainable growth rate in product software?

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

A

Yeah. So 33% increase in the software portion of product revenue is driven, per the earlier question, really by two things. One is the really nice growth in all-flash, but also less growth in HCI and some of the products that have less software and more hardware. And I would expect if – going forward, if we're talking about growth in product revenue, given the continued mix shift towards all-flash, you should expect to see software – the software portion grow faster than the total product portion.

Nehal Chokshi
Analyst, Northland Securities, Inc.

Q

Okay. Would a 20-plus percent growth in product software be viable?

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

A

So we're not going to guide to that other than to say it should grow faster than the total product number.

Nehal Chokshi
Analyst, Northland Securities, Inc.

Q

Understood. Thank you.

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

Thank you, Nehal. I'm going to pass it back to George for some closing remarks.

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

Thanks, Kris. In closing, we delivered a great start to FY 2022 and are very well-positioned for continued growth throughout the year. Cloud and digital transformation initiatives remain top customer priorities, and we continue to benefit from these sizable, long-term trends. Our Hybrid Cloud and Public Cloud offerings put NetApp in a unique position to address our customers' most pressing challenges. Our cloud and software intellectual property truly differentiates us. As a result, I am more confident than ever in our ability to deliver long-term value to our shareholders, customers, and partners. Thanks for joining us.

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

Thank you.

Operator: Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.