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NetApp, Inc. (NTAP)

Q1 2024 Earnings Call

CORPORATE PARTICIPANTS

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

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

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

OTHER PARTICIPANTS

Sidney Ho
Analyst, Deutsche Bank Securities, Inc.

Mehdi Hosseini
Analyst, Susquehanna Financial Group LLLP

Joseph Cardoso
Analyst, JPMorgan Securities LLC

Victor Chiu
Analyst, Raymond James & Associates, Inc.

Asiya Merchant
Analyst, Citigroup Global Markets Canada, Inc.

Krish Sankar
Analyst, TD Cowen

David Vogt
Analyst, UBS Securities LLC

Steven B. Fox
Analyst, Fox Advisors LLC

Wamsi Mohan
Analyst, BofA Securities, Inc.

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

Amit Daryanani
Analyst, Evercore ISI

Shannon Cross
Analyst, Credit Suisse Securities Research

MANAGEMENT DISCUSSION SECTION

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

I would now like to turn the conference over to Kris Newton, Vice President, Investor Relations. Please go ahead.

Kris Newton

Vice President, Investor Relations, NetApp, Inc.

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

During today's call, we will make forward-looking statements and projections with respect to our financial outlook and future prospects, including, without limitation, our guidance for the second quarter and fiscal year 2024; our expectations regarding future revenue, profitability and shareholder returns; and other growth initiatives and strategies. These statements are subject to various risks and uncertainties, which may cause our actual results to differ materially.

For more information, please refer to the documents we file from time to time with the SEC and on our website, including our most recent Form 10-K and Form 10-Q. We disclaim any obligation to update our forward-looking statements and projections.

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

I'll now turn the call over to George.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

Thanks, Kris. Good afternoon, everyone. Thank you for joining us today. Q1 marks a solid start to FY 2024 in what continues to be a challenging macroeconomic environment. We delivered revenue above the midpoint of guidance while our operational discipline yielded operating margin and EPS above our guidance ranges.

As I have outlined on previous calls, we are focused on managing the elements within our control, reinvigorating efforts to drive better performance in our storage business and building a more focused approach to our Public Cloud business. We are seeing positive, early indicators from this plan to sharpen our execution, deliver growth, increase profitability and further strengthen our position for long-term success.

Looking at the results of the quarter, I am especially pleased with the reception to our recent product introductions. The AFF C-Series has been the fastest ramping all-flash product launch in our history with strong demand across all products in the family. Similarly, the AFF A150, our entry-level, high-performance all-flash array, grew quickly in its first full quarter of shipping. Our Storage Lifecycle Program is also seeing good early uptake, driving longer-term commitments to NetApp as we help customers future-proof their environments with a world-class ownership experience.

Building on this momentum, we introduced more storage innovation in Q1. We announced the ASA A-series, a family of SAN-specific all flash arrays, supported by industry-leading data availability and efficiency guarantees. These systems are the only all-SAN storage arrays with virtual machine and application-granular data protection mechanisms. Complementing our unified storage offerings, they enable us to expand on the tens of thousands of customers who already use NetApp for block storage today and drive share gains in the $18 billion SAN market.

In addition to delivering on our innovation agenda, we have implemented the go-to-market changes we outlined on the Q4 call, focusing our enterprise sellers on the flash opportunity and building a dedicated model for cloud.

In May, we held our annual sales kickoff meeting, the first time we've gathered the global team in person since the pandemic. Everyone was energized by the innovation we're bringing to market and the objectives appropriately aligned to each team's strengths. Because many of the products we've introduced open new TAM for us, we are also including training to sharpen our attack on these opportunities. The changes have been well received, are already showing up in pipeline expansion, and should help drive top line growth in the second half.

Q1 Hybrid Cloud segment revenue of $1.3 billion was down 12% year-over-year. Our all-flash array business decreased 7% from Q1 a year ago to an annualized revenue run rate of $2.8 billion. The demand environment is unchanged from the last half of FY 2023, with headwinds from enterprise continuing to weigh on product and AFA revenue. Additionally, as Mike will outline, the first half of fiscal year 2023 benefited from elevated backlog, impacting the year-over-year comparisons.

In the past few quarters, every conversation I've had with customers and investors has touched on artificial intelligence. Generative AI is top of mind for everyone. While still in the early innings of this opportunity, AI is not a new topic for us. We have been a leader in storage for predictive AI and machine learning workloads since we introduced ONTAP AI, a joint NetApp and NVIDIA proven architecture, in 2018. Today, hundreds of customers rely on NetApp storage infrastructure and data management for their AI workloads, including some of the largest pharmaceutical, financial services, and retail companies in the world.

Effective predictive and generative AI projects depend on high quality, well managed, unstructured data. The data pipeline and workflow typically involve data from multiple file and object sources, across cloud and on premises. High performance, highly scalable hybrid cloud storage and data management is a core NetApp advantage and naturally positions us as a leader in this market and will continue to benefit us as the gen AI market evolves.

While early, we are already engaged with customers who are interested in fine tuning large language models with their own data on-premises, as well as those who are leveraging the hyperscalers' gen AI offerings on the public cloud together with the storage and data management capabilities of NetApp Cloud Volumes services.

Accelerated by the rise of AI, data continues to grow in both volume and value. A company's data is its most valuable asset. Our robust cyber resilience portfolio helps customers ensure that they have the right enterprise data protection and security on premises and in the cloud. With built-in features that protect and secure data and deliver rapid recovery based on AI and machine learning, our systems can proactively spot and counter malicious or anomalous actions. Our confidence in our industry-leading capabilities is underscored by the ransomware recovery guarantee we announced in Q1 and demonstrated by the fact that NetApp is the only enterprise storage vendor on the NSA's classified program components list.

Now turning to Public Cloud. I want to acknowledge our cloud results have not been where we want them to be and assure you we are taking definitive action to hone our approach and get back on track. At the start of this year, we aligned our cloud sales specialists to our hyperscaler partners' go-to-market structures. Additionally, we are in the process of a strategic review to sharpen the focus of our cloud portfolio, expand on the success of first-party services, and improve subscription performance. We will have more details to share with you on our next call.

That said, Public Cloud segment revenue in Q1 was $154 million, an increase of 17% year-over-year. Public Cloud DBNRR declined to 107%. Within these numbers, strength in first-party and marketplace consumption services was masked by weakness in our subscription services.

Let me emphasize that our strategic focus is on first-party cloud storage services, and we continue to see customer expansion and deepening partnerships, as well as revenue and ARR growth in this part of our portfolio. Our expectations for FY 2024 Public Cloud revenue are reflected in the guidance Mike will walk you through.

First-party storage services, branded and sold by our cloud partners, position us uniquely and represent our biggest opportunity. Our partnerships with the cloud providers are strong and delivering growth. Our close and long-standing relationship with Microsoft Azure continues to deliver solid growth. Likewise, our partnership with Google remains strong. And in the coming weeks, you can expect to hear exciting news about the expansion of our partnership.

Our relationship with AWS is also yielding positive results. As expected, we are starting to win large enterprise deployments with FSx for NetApp ONTAP. We were chosen to be the cloud storage infrastructure for a global sportswear manufacturer's SAP HANA deployment. FSxN was the only storage service that could meet the company's mission-critical service-level availability and recovery requirements. This is a large, long-term SAP project that will continue to develop and grow over the coming years, driving significant consumption of FSxN capacity. Once completed, it will be one of the largest SAP environments on AWS.

In the face of the challenging macro, demand remains muted, and sales cycles remain elongated. Although customers continue to exhibit caution, they are moving forward with strategic initiatives, prioritizing investments in applications and technologies that drive business productivity and growth. Our modern approach to hybrid multicloud infrastructure and data management enables IT organizations to leverage data across their entire estate simply, securely and sustainably. Customers turn to NetApp to help them increase the performance and reliability of their digital and cloud transformational projects.

Looking forward, our priorities are clear. We will continue to tightly manage the elements within our control, reinvigorate efforts to drive better performance in the storage business, and continue to refine our Public Cloud business. Early results indicate we are on track to drive margin expansion and earnings growth year-over-year while yielding top line growth in the back half of fiscal year 2024.

Before turning the call over to Mike, I want to thank the NetApp team for their continued focus. I also want to remind you we'll be hosting our INSIGHT user conference in person in Las Vegas this October. We hope to see you there.

Michael J. Berry

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

Thank you, George. And good afternoon, everyone. We executed a solid quarter in a challenging macro environment, hitting or exceeding all our guidance ranges. We are delivering on our commitments, evident in our solid Q1 results.

Before I get into the financial details, let me walk you through the key themes for the quarter. As a reminder, all numbers discussed are non-GAAP unless otherwise noted. Our disciplined operational management and the strong customer acceptance of our innovation continues to pay off. We expect improved execution and new products will drive growth and operating margin expansion as we move through the second half of the year.

As expected, Q1 consolidated gross margin was strong. Product margin came in at 55%. Given our expectation for competitive dynamics and product mix, we remain confident in our projection that product margin will hold at these levels through the remainder of the fiscal year.

Cash from operations was a first quarter all-time high. Operating cash flow benefited from the reduction of premiums, as well as lower component pricing and incentive compensation payouts. Over the course of fiscal year 2024, cash flow should normalize, with operating cash flow tracking relatively in line with non-GAAP net income.

We returned approximately 120% of free cash flow to stockholders through cash dividends and share repurchases, reducing Q1 fiscal 2024 share count by almost 4% year-over-year. As we discussed during last quarter's call, we intend to return 100% of free cash flow this year.

Now, to the details of the quarter. Q1 billings of $1.3 billion decreased 17% year-over-year. Revenue of $1.4 billion decreased 10% year-over-year. The challenging macro environment continued to pressure IT spending. However, as George pointed out, we are well aligned to customers' priority investments and remain confident our go-to-market changes and product innovations will drive growth in the second half of fiscal year 2024.

Hybrid Cloud revenue of $1.3 billion was down 12% year-over-year. Product revenue of $590 million was down 25%. Remember that first half fiscal year 2023 revenue, most notably product revenue, benefited from elevated levels of backlog, which impacts the year-over-year comparisons. Support revenue of $611 million grew 2% year-over-year.

Public Cloud ARR grew 6% year-over-year to $619 million. Public Cloud revenue of $154 million increased 17% from Q1 a year ago. First party and marketplace services grew as customers continue to choose solutions based on NetApp technology for mission critical and cloud native workloads. This growth was offset by underperformance in subscription services.

As George noted earlier, Public Cloud did not meet our expectations for the quarter, and we are taking action to hone our approach and reaccelerate growth.

Q1 consolidated gross margin of 71% came in above our guidance, up 400 basis points from a year ago, and again reaching an all-time company high. Product gross margin was 55%, in line with expectations.

As we discussed on the Q4 call, we made strategic purchase commitments to lock-in record low NAND pricing and mitigate rising prices in the future. NAND prices continued to decline in Q1, and we are still positioned favorably versus the market.

The potential for increased price competition is factored into our expectations and we remain confident in our ability to hold product gross margin consistent at this level through the year.

Our recurring support business continues to be highly profitable with gross margin of 92%. Public Cloud gross margin improved to 67% from 66% last quarter.

As expected, operating expenses of $703 million were flat year-over-year and grew 4% from Q4 2023. The sequential increase was driven by annual merit increases and a reset of incentive compensation, as well as expenses related to our in-person sales kickoff meeting.

Q1 again highlighted the strength of our business model and disciplined operational execution with operating margin of 22%, ahead of expectations. EPS of $1.15 was also above the high end of our guidance.

Operating cash flow was $453 million in Q1, an increase of 61% year-over-year, driven by lower supply chain payments and variable compensation, partially offset by lower collections. In Q1, DSO decreased to 41 and inventory turns improved to 13. Free cash flow increased 94% year-over-year to $418 million, helped by strong operating cash flow and lower CapEx.

During the quarter, we returned $506 million to stockholders through shares repurchased and cash dividends, ending the quarter with approximately $600 million in net cash. We have approximately $1 billion remaining on our existing repurchase authorization.

Our balance sheet remains healthy. Total deferred revenue as of the end of Q1 was $4.2 billion, up slightly from a year ago. We ended the quarter with approximately $3 billion in cash and short-term investments.

Now turning to guidance. We are reiterating our guidance for the full year. Our total revenue guide is unchanged, with revenue down low-to-mid single digits year-over-year, measured on a percentage basis.

Based on our Q1 results and updated projections, we expect Public Cloud revenue growth to come in lower than initially expected primarily due to softness in our subscription services. This minor weakness is expected to be at least offset by strength in our Hybrid Cloud revenue.

We continue to expect fiscal year 2024 consolidated gross margin to be roughly 70%, operating margin to be approximately 25%, and EPS to be in the range of $5.65 to $5.85. We expect Q2 revenue to range between $1.455 billion and $1.605 billion, which at the midpoint implies a decline of 8% year-over-year. If FX rates stay at the end of July levels, we would see nearly 2 points of FX tailwinds to revenue.

As I called out earlier, first half fiscal year 2023 revenue benefited from elevated levels of backlog due to last year's supply chain constraints, which impacts the year-over-year comparisons. We expect Q2 consolidated gross margin to be roughly 70%, and operating margin to be approximately 24%. EPS should be in the range of $1.35 to $1.45.

In closing, I want to thank our employees, customers and investors for their commitment and investment in NetApp. I am confident in our ability to help our customers successfully achieve their digital and cloud transformation goals. We are well aligned to priority IT investments and are committed to deliver sustainable, long-term value for our stockholders.

I'll now turn the call over to Kris to open the Q&A. Kris?

Kris Newton

Vice President, Investor Relations, NetApp, Inc.

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

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] Our first question is from Sidney Ho with Deutsche Bank. Please go ahead.

Sidney Ho
Analyst, Deutsche Bank Securities, Inc.

Q

Great. Thanks for doing the call. So last quarter, you guys talked about spending for large enterprises were cautious where, obviously, you guys are overexposed. That doesn't seem like that has changed that much. From your conversation with the customers, do you have a sense when demand could start picking up maybe based on utilization data or whatnot? First, just give us some historical context at what utilization rate level do you start seeing demand pickup? And do you think that will be quite – any different this cycle? And then, while you're at it talk about the trends in small and medium businesses as well. Thanks.

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

A

Thank you for the question. Overall, the spending environment this past quarter was unchanged from what we saw in the second half of the prior fiscal year. Our mid-sized enterprise business across the globe and public sector did better than large enterprise. Within large enterprise, as we noted, the same verticals remained cautious in spending, service provider, high tech and to a lesser extent, financial services.

With regard to their spending criterion, they are spending on strategic projects, but are running infrastructure, broadly speaking, hotter than, meaning at higher levels of utilization than they typically do and what we typically tell them is best practice. That is common in such macro environment, but it's not a long-term trend. I think we expect them as we progress through the fiscal year for them to start to expand investment because they cannot run systems that hot.

As we noted in our prepared remarks and in prior calls, we do not expect the macro to change substantially to support our guidance for the year. Our guidance for the year reflects our confidence both in the changes that we made in go-to-market as well as in our product portfolio that we recently introduced.

Sidney Ho
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. Thank you.

Operator: The next question is from Mehdi Hosseini with SIG. Please go ahead.

Mehdi Hosseini
Analyst, Susquehanna Financial Group LLLP

Q

Yes, thanks for taking my question. I have two quick follow-ups. George, I want to go back to the big picture and revisit the topic of repatriation. How do you see generative AI strengthening this argument that there will be repatriation enterprises have better ownership of the data that, that would actually help with a faster adoption?

Is there any update? Is there any feedback from your conversation from your enterprise customers that you can share? And a quick follow-up. Can you provide the mix of a QLC NAND that you're procuring? And how do you see that changing towards the end of the calendar year?

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

A

With regard to gen AI projects, which we are already engaged in in a number of customers, we see a mix of use cases. I would say there are three common patterns. One is unstructured data. The second is the need for consistent data management, both security and privacy are hot topics as well as the lineage of data so that they can keep track of which version of gen AI model is the best and most accurate.

And then the third is from a deployment architecture, we are seeing them engage in both on-prem discussions as well as public cloud discussions. In Public Cloud, the advantages are much faster feature velocity as well as prepackaged models available on the Public Cloud. With the on-prem environments, the major sensitivity is the data being kept in a restricted location. So, we intend to benefit from both. I don't think that it is a meaningful driver of repatriation at this point in the discussion Mehdi. We're seeing a mix of public cloud and on-prem environments.

Michael J. Berry

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

A

Hey Mehdi, it's Mike. On the QLC, we're not going to break out specific numbers, but we would say we are procuring more of that. We've started to see the pickup. We'll see how the rest of the year goes, but we do expect that to continue as a percentage as we go through fiscal 2024.

Mehdi Hosseini

Analyst, Susquehanna Financial Group LLLP

Q

Great. Thank you.

Operator: The next question is from Samik Chatterjee with JPMorgan. Please go ahead.

Joseph Cardoso

Analyst, JPMorgan Securities LLC

Q

Hey. Thanks for the question. This is Joe Cardoso on for Samik. Just one question for me. You reported a strong gross margin performance in the quarter, and I was just curious if you could quantify how much of the improvement was related to premium, the premium benefits, strategic purchases, et cetera, that you've highlighted and how we should think about that tailwind as we progress through this year, including and excluding the expected price competition that you have embedded into the guide. And then just real quickly, a clarification on that last part. Like are you guys actually seeing price competition currently from your competitors? Thanks.

Michael J. Berry

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

A

Hey, Joe, it's Mike. So, hey, on your question, we've talked a lot about premiums and as we talked about last time, we're super excited to not have to talk about them anymore. So largely in Q1, all of those premiums have, I would say, gone away not only from a P&L perspective but cash. We talked about that number was anywhere typically between, call it, $30 million and $40 million a quarter. Sometimes it bumped up to $50 million, so call it an average of about $40 million. A good bit of that, we did not have to accrue in Q4 and then the rest rolled to Q1.

So you saw 55% last quarter, 55% this quarter and now premiums are fully out of the number. So, as you look forward, it's one of the reasons why we feel confident in the 55% guide.

Hey, there's always been price competition. We see it in certain geographies or certain customers. We haven't seen any material change to that. In our guide, we do expect that we will need to be, call it, marginally more aggressive in certain situations, but certainly nothing significantly different than we are today.

Joseph Cardoso
Analyst, JPMorgan Securities LLC

Q

Thanks for the color.

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

A

Yeah.

Operator: The next question is from Aaron Rakers with Wells Fargo. Please go ahead.

Q

Yeah. Thank you, guys. This is [ph] Michael (00:30:01) on behalf of Aaron. I wanted to ask, your ARR growth in the quarter slowed quite a bit. And I know you guys have pushed out your $2 billion sort of target. But I just want to take a step back and then think about like to your first $1 billion, how would you describe the trajectory to getting there and maybe timing, if you can kind of just help us think about where we go from here? Thank you.

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

A

Yeah. I think, first of all, we have two models in which we serve customers: the consumption model, which is essentially a pay-as-you-go utility model and then a subscription model, which is where the customer pays for a certain amount of capacity or managed units or capability and then renews that on an annual basis or a term basis. The consumption part of our business has grown to about three-quarters of our total business, roughly speaking. Of our cloud business, subscription is a quarter.

And if you look at the last quarter's performance, the cloud storage and consumption businesses continued to perform well. They grew year-on-year. Their dollar-based net retention rate was at the industry average, industry norms. Subscription is where we saw a challenge both a small part of cloud storage subscription as well as CloudOps, and we are conducting a review, and we'll get you an update at the next quarterly call about our plans for that part of our business.

Q

Okay. Thank you. That's helpful. And if I can just add one more. I just want to understand your all-flash business was down about 7%, and I can appreciate the macro backdrop there. But I'm wondering if you can just help me understand the share kind of trends and maybe your best estimate where that's been this quarter? How it's changing and kind of what your expectations are moving through the year? Thank you.

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

I think, first of all, the year-on-year compare for our flash product business is impacted by last year benefiting from elevated levels of backlog that we shipped in the comparable quarter last year. If you remove that backlog, flash actually grew year-on-year this quarter, and we saw strong growth from our capacity flash products. We expect the overall flash portfolio to grow as a percentage of our business through the course of the year. The first quarter customers are still qualifying our capacity flash products, the C-Series. And so we weren't able to move all of our intended customer environments over to all-flash yet, but they are headed that way. And so we feel really good about both the go-to-market changes that are starting to reflect in pipeline expansion as well as in the flash product portfolio that we have. And you should see that reflected in growth in the second half of the year. With regard to share gains, our expectation based on what the others have guided is that we have picked up the second position in share in the market behind Dell.

Operator: The next question is from Simon Leopold with Raymond James. Please go ahead.

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

Hi. This is Victor Chiu in for Simon Leopold. You guys noted that the product gross margin is expected to hold for the remainder of the year. But I think the latest industry forecast and commentary from NAND manufacturers implies that the market experience has a sharp overcorrection next year. Can you help us understand how this impacts your expectations for the next fiscal year and whether you've secured any pricing agreements for flash media beyond this fiscal year?

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

Yes. Hey, Victor, it's Mike. So, hey, we haven't guided for fiscal 2025, but let us walk you to that. As we talked about between pre-buys and price locks, we have secured a large portion of our NAND purchases for fiscal 2024. Not all of it, you never want to hedge the whole bucket, but we feel really good about that.

In addition, some of those agreements do flow into fiscal 2025. It's not a majority at this point. So where we stand today is we feel really good about where we are in 2024. We have some of that rolling into 2025, and we're certainly looking forward about, hey, what should we do? We'll do a lot more work on that, call it, in the next 90 days and update you on the next call.

As you know, it's a very changing market. We want to make sure it be prudent and think through that. But it is something that we are looking hard at.

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

Okay. That's helpful. And just on the other side of the legacy part of the business, the last several quarters have seen pretty sharp declines in shipments of legacy spinning drives. And I know historically, there's not very much correlation between storage media trends and storage systems. But more recently, one of your competitors have asserted that there won't be any new spinning disk drives manufactured in five years. Do you have any view on this commentary? Do you agree with this perspective? And how do you see this impacting NetApp, I guess, over the long run?

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

A

Listen, I think we have the best spinning media and the best flash technologies in the market. I think that's reflected by the richness of our feature set, the flexibility of our operating system and increasingly, the data security functionality that natively integrated into our offerings. I think that the outlines of what our competitors have talked about is a long time. And so we give our customers choice, and we'll continue to invest in a broad range of technologies that meet the right price performance points. When you cannot support a type of technology like our competitors cannot, then you have to throw grenades and say that, that technology doesn't exist because you frankly can't support it.

Victor Chiu
Analyst, Raymond James & Associates, Inc.

Q

Okay. So you think that that's an extreme view that legacy, that spinning drives will be gone in five years, that's extreme in your opinion?

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

A

Five years is a long time in technology, as we've all learned.

Victor Chiu
Analyst, Raymond James & Associates, Inc.

Q

Yes. Okay. Okay. Thank you.

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

Asiya Merchant
Analyst, Citigroup Global Markets Canada, Inc.

Q

Great. Thank you for taking my question. In the past I think you guided for some linearity on first half versus second half. So I just wanted to clarify if that still holds for the remainder of this year?

And just back on the Public Cloud side of things, I know it's guiding to a little bit lower relative to prior expectations due to the subscription weakness. How should we think about just the linearity, I mean, are we expecting these run rates to kind of continue? Do you have any more insight into how we should think about the growth rates for the rest of the year? Are we still looking at something – are we still expecting from a year-on-year basis as the comps get easier in the back half of fiscal 2024 to have cloud revenues accelerate from this point? Thank you.

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

A

Yes. Thank you for the question. So on the first question on linearity, based on the midpoint of guidance, we are still assuming about 48% revenue in the first half and 52% in the second, pretty close to rounding, which is very consistent with what we did last quarter. So no big change there, and that's very consistent with the linearity that we've shown historically, also our Q2 guide is up about 7% quarter-on-quarter, which is well within our historical linearity as well.

On the cloud revenue number, so we're not going to update the guidance. We had originally thought and forecasted somewhere around, call it, mid-teens growth in that cloud revenue business. Even if as you look at the historical numbers, that cloud revenue, and we're not forecasting it will, if it stays where it's at today, there would still be growth year-over-year because of the growth last year.

So we have baked all of that into our full year number. So we feel good about where we are on that guide. We'll see how the rest of the year goes. But at this point, we've reflected that in our full year number.

Asiya Merchant
Analyst, Citigroup Global Markets Canada, Inc.

Q

Great. Thank you.

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

A

Thank you.

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

Krish Sankar
Analyst, TD Cowen

Q

Hi. Thanks for taking my question. I have two high-level questions on AI for George. Our understanding is that most of the benefits of storage as we put all-flash unified file and object solution. A, is that assessment accurate? Or are you seeing hybrid HDD solutions being used in AI workloads today? And second, for unified cloud and object, can you speak about your product portfolio there and your competitive position compared to other solutions like flash array from Pure Storage and PowerScale from Dell? And also if unified cloud and object solutions are most expected to benefit from AI, is your market share there similar to your market share in other storage solutions like block and file? Thank you.

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

A

Listen, I think that the first comment that I would make is AI primarily operates today on unstructured data, whether it's predictive AI using unstructured data to analyze images or audio files or generative AI that analyzes text in various types of document format, unstructured data is the priority.

Second, I think with regard to unified file and object, listen, we created unified storage, and we have a really strong track record in unified across file block, object and cloud. And I think that is the new definition of unified rather than little systems that try to say that they've got one protocol or the other.

I think the third is when you talk about AI, it's a broad topic and therefore, what customers typically have is versions of data that they use to train different models. At the time that they are running the training workload, they typically store it on a high-performance landscape like on all flag system, but they keep those models available so that they can go back and look at when they make changes to models and data sets and what the implications are for accuracy. And so the archival life cycle of that data is usually on disk or on cloud.

And then I think the last point I would make is, listen, we are seeing clients use hybrid workflows. Public Cloud is a strong place where a lot of the developers and data science teams are beginning their workflows, either Vertex in Google or SageMaker in Amazon and our solutions on Public Cloud give us a strong position to start with the data science team at the start of these AI projects.

Krish Sankar
Analyst, TD Cowen

Q

Thanks, George.

Operator: The next question is from David Vogt with UBS. Please go ahead.

David Vogt
Analyst, UBS Securities LLC

Q

Great. Thanks. Hey, George, hey Mike. I had some phone difficulties. So I apologize if you addressed this. On the AI strategy going forward versus like mass capacity storage, what are you hearing from your customers from the enterprise side in terms of what the priority looks like from an investment perspective? I know your mass capacity product has seen some really strong traction out of the gate. But over the longer term, how do you think the mix between high end, high-performance storage and mass capacity trends?

And then maybe just on Public Cloud real quickly, I know this has been a fits and starts business for you. When you think about how much of maybe an impact that has on your management bandwidth, how are you thinking about that business longer term now? I know you're talking about giving out updated outlook maybe next quarter. But do you still think it has the same opportunity to be a key driver for the business? Or is it maybe a little bit less of a longer term opportunity today than you might have thought 90 days ago or even a year ago at this point? Thanks.

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

A

Let me hit on those two points. I think the first is with regard to AI, again, as I mentioned, it's a broad life cycle of tasks. There are light portions of the life cycle that run on extremely high-performance systems. And then there are portions of the life cycle where the data sits on more fine-tuned capacity-oriented systems, because you want to keep versions of your models available.

And so I look at it like any type of workload, there's a portion of time where the workload has data that's hot and then there's a portion of its life cycle where you want to keep a copy of the data.

With regard to the overall all-flash array outlook, listen, I think we are one quarter in. We are really pleased with the adoption of our capacity flash products. Overall, what I see is all-flash will grow at higher speed than our total storage business and will be a bigger part of our mix.

Within all-flash, the capacity flash products will grow more quickly than the performance flash products because one is attacking the next tranche of upgrades and refreshes, which is the 10K drive market while the high-performance products have already been in market for a long period of time. So, I think that's how they break that out.

With regard to cloud, I think that, listen, the opportunity is strong. We are excited about the growth of our cloud storage services all of the capabilities and the pace of customer adoption of those services. We have more exciting news to come with Google around the work we're doing with them, both with regard to the expansion of our offerings as well as new use cases in the Google Cloud that you'll hear more about in the next couple of weeks.

And I think that our approach right now is to focus on the best parts of our cloud portfolio, have a dedicated go-to-market model that has been well received by the hyperscalers. We're one quarter in. The cloud storage and consumption offerings performed well. We have work to do on the subscription side. We'll give you an update next quarter. Our overall view of cloud has not changed.

David Vogt
Analyst, UBS Securities LLC

Q

Great. Thanks guys.

Operator: The next question is from Steven Fox with Fox Advisors. Please go ahead.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Hi, thanks. Good afternoon. I just wanted to follow-up on some of those last comments, George, especially on subscription. I guess I'm wondering, obviously, you want to grow faster in Public Cloud. And the subscription business being down, it seems like it's consistent with the type of macro we're in.

So, I guess I'm trying to understand more specifically, given all the other stuff that's going on in terms of Public Cloud in terms of refining the business, why the subscription business is especially disappointing here as opposed to maybe riding it out until you start to see an upcycle? Thanks.

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

A

Yes. Listen, I think that we are not the only company in the world that had a subscription cloud software business that got impacted. When we saw the trends for optimization, you generally see the consumption part of the business get optimized quickly because you are on a pay-as-you-go contract. I think the subscription part usually gets affected at the time of a renewal of a subscription or a decision to expand or not expand a subscription.

That doesn't excuse the fact that we wanted to do better in the subscription part of our business. I think we've got work to do to refine our portfolio, sharpen the value proposition, optimize pricing in certain cases to meet customers' expectations, and we'll give you an update on that. We're already working on those. We'll give you an update on that on the next call.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Great. That's helpful. Thank you.

Operator: The next question is from Wamsi Mohan with Bank of America. Please go ahead.

Wamsi Mohan
Analyst, BofA Securities, Inc.

Q

Yes. Thank you. It sounds from your comments like you had at least 7 to 8 points of backlog-related headwind from last year in AFA. Can you help us think through? Is the magnitude sort of similar in fiscal 2Q? And for fiscal second half on the Hybrid Cloud side, is it fair to think that there's going to be a 4- to 5-point acceleration in growth? And as you look at the estimates that the Street's modeling is kind of – that's kind of what is implied. And

I'm wondering if you could talk about what is the upside that you're seeing in hybrid that's offsetting the weakness in public, given your relative overall guidance didn't change? Thank you so much.

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

A

Hey, Wamsi, it's Mike. Thanks for the question. So let's go through the numbers. So, yes, you're pretty close on the impact. It was about – so last quarter, we talked about, if you adjust for the backlog benefit in the first half of fiscal 2023 and you compared our growth this first half with the second half of last year when we declined about 5% or 6% that we expect the growth to be better than that, still slightly negative. That is about the same in Q1 and Q2. So Q2 has about the same impact that based on the midpoint of guidance, we do expect Hybrid Cloud then to have growth in the second half, the low single-digit growth based on the guidance that we gave.

And we're still comfortable with that based on the progress that we saw in Q1, especially related to C-Series. The focus that we have on the new products as well as the go-to-market changes, we do expect those to bear more fruit as we go into the second half, and that's based on what we've seen not only in pipelines and then also sales activity. So overall, yes, that would be accurate, and that's what gives us confidence as we go into the second half of the year.

Wamsi Mohan
Analyst, BofA Securities, Inc.

Q

Okay. Great. Thank you so much.

Operator: The next question is from Meta Marshall with Morgan Stanley. Please go ahead.

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

Q

Great. Thanks. Maybe as a first question, you noted that the storage and consumption piece of the business you expected that, that was growing about market rate this quarter. I guess just is kind of the assumption there that essentially optimization has stabilized, and we are starting to see growth again? I just kind of want to get a sense of where you guys are in terms of what you – if we're at kind of the bottom of optimization and seeing growth again or if we're still kind of in this bottomed out period? And then as a second question, just if there's any kind of surprises in terms of customer types or workload types that have been more interested in C-Series than kind of initially expected? Thanks.

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

A

On the first question, Meta, I think that what we saw was continued good pace of customer additions, which means that there are cloud projects and ongoing deployment of workloads on the cloud. We saw the pace of optimization slowdown as customers have basically done the easy stuff. And so now they probably are more cautious about what further to optimize. Within the latter bucket, the customers that have been optimizing, there are early signs of them starting to do new projects on our technology, but they haven't ramped those projects yet. So the benefit we saw within the quarter was new customers and new workloads as opposed to the ones that optimize reaccelerating spending.

With regard to the second question, capacity flash, we were selling high-performance flash into use cases where capacity flash was a better product. Those were in two flavors. One would be more of a general purpose private cloud environment, where customers don't care about the performance of a particular application, but generally want good performance. And so that was one and then smaller environments where we had the A150 product that was also introduced at a lower price point than any other flash product. Both of them saw strength. And I think we saw strength in the mid-market segment, broadly speaking, across all of our products.

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

Q

Great. Thank you.

Operator: The next question is from Amit Daryanani with Evercore. Please go ahead.

Amit Daryanani
Analyst, Evercore ISI

Q

Thanks for taking my questions. I got cut off in the middle, so I apologize if this was addressed. But on the Public Cloud, can you just talk about what are the reasons that led to the miss over here? Was it macro or was there any micro impact as well? And then when you talk about the initiatives you're taking, is it more around just aligning your specialists to the hyperscalers? Or are you taking any more incremental initiatives? Just love to understand macro versus micro impact? And then what are the initiatives you're specifically taking to address them?

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

A

I think broadly speaking, if you look at our cloud business, roughly three quarters is consumption and a quarter is subscription. That mix has shifted in favor of consumption a meaningful amount over the last year as customers have preferred more of the marketplace and first-party offerings over some of our more traditional subscription type, bring your own license offerings. I think so the impact that we saw was more pronounced in subscription rather than consumption. Consumption performed quite well. And so I would point out that it's in the quarter of the business in subscription.

Then second, with regard to whether it was macro or micro, it was a mix of things. I think it was – in some customers, clearly, it was related to budget constraints where upon renewal, they said, listen, I want to use less of the product and only use it for the most mission-critical environment, some of our monitoring tools. In other cases, it was the customer not being ready to deploy the product and so we've taken a couple of actions. One action is to, as we said, conduct a review of our products, make sure we have the right products tailored to the right use cases that pricing is set up right, that the value share between us and the customer is set up right, that is already underway. We've implemented some of those changes. We'll give you a more fulsome update.

And then with regard to go-to-market, we've, as we noted, implemented both a dedicated cloud specialist organization aligned with the hyperscalers and also implemented customer success so that customers can get expertise from NetApp on how to use the product. It's early. We've seen some good evidence of progress, but there's more work to be done.

Amit Daryanani
Analyst, Evercore ISI

Q

Got it. That's really helpful. And Mike, if I could just have you clarify, Q1 free cash flow, I think, was much better than what I had expected and what you typically be in Q1, I think, as well. Can you just touch on maybe what drove that, if there was a bit of a pull-in or something with some of the stuff? And any view on fiscal year free cash flow, given the strong performance here?

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

A

Yes. Awesome. Thanks for the question on cash. Yes, there was – it was quite a bit better than we thought. There was three moving parts. Amit, I would say you've seen billings commence lower in the last two quarters. So collections were down year-over-year. But what really drove the operating and free cash flow was the reduction in our supply chain spending. And that's not only premiums. It's the quantity of components that came down significantly.

And then, of course, pricing came down as well. So if you think about the rest of the year, we should expect to continue to see some of that benefit not as big as in Q1 because that compares to Q1 of last year when we were still, I'll call it, bulking up on inventory because we expected growth before things slowed down in the middle of the year.

There was a one-time benefit year-over-year, which unfortunately is we paid a good bit less in incentive compensation. So that helped drive it as well. And then lower CapEx helped drive free cash flow as well. And we did say, hey, the $239 million we spent last year, we expect to be the high and we expect that to continue to come down.

As you look at the rest of the year, we do expect on a full year basis it to track pretty close to non-GAAP net income, which guidance is somewhere around $1.2 billion. I do want to note, though, hey, folks in Q2, and this happens every year, keep in mind, it's the quarter we pay most of our taxes. So we pay almost $88 million in repatriation taxes and then we make our US federal tax payment as well. So expect Q2 to be down from Q1, and it's been like that every year. And then in the back half, following more typical trends. So thanks for the question.

Amit Daryanani
Analyst, Evercore ISI

Q

Thank you.

Operator: And the final question today comes from Shannon Cross with Credit Suisse. Please go ahead.

Shannon Cross
Analyst, Credit Suisse Securities Research

Q

Thank you very much. I guess my first question, George, can you talk about ONTAP AI from a competitive standpoint? Are you seeing this as an ability basically to sell into your existing customer base you are using ONTAP and comfortable with it in that? Or is this something that, from a competitive differentiation standpoint, can actually drive switchers to NetApp's product set? And then I have a follow-up. Thank you.

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

A

We sell ONTAP AI into data science teams and AI teams, whether they are in our installed base or net new accounts. It's a very verticalized selling model. So for example, in pharmaceuticals, we work with teams on rapid drug discovery, clinical data analysis so that they can apply really high-performance GPUs from NVIDIA together with large-scale data storage from NetApp.

We could also do the same thing, For example, in manufacturing, we are selling into advanced digital twin prototypes where they are optimizing manufacturing yield and sort of accelerating development. So I think those are the key areas that we have sort of net new budget, net new customer landscape. Our advantages are high performance, large scale advanced data management, the best in the industry, and it's highly integrated into the data science toolkit of our customers. And then increasingly, we also now have the same versions of two chains running on all the leading public clouds, and you'll hear more about that in the next couple of weeks at the Google conference.

Shannon Cross
Analyst, Credit Suisse Securities Research

Q

Okay. Thank you. And then I guess we've asked you about AI from an opportunity standpoint. But how are you thinking about utilizing generative AI internally within NetApp to increase productivity, save costs and maybe, I don't know, improve customer experience? Thanks.

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

A

We already use AI tools in three ways. One is to accelerate software development; and two, increase the pace at which we can deliver more innovation to customers. The second, to integrate AI into our products and services so that we can automatically detect, for example, ransomware attacks or impending risks from running systems harder than they should be or various other things and give customers proactive advice rather than reactive response. And then the third is across the range of our businesses, everything from marketing collateral, documentation, multilingual support as well as chatbots. In customer service, we have AI capabilities already being integrated. And gen AI is the next version of that. So there are lots of exciting projects underway on that. Thank you, Shannon.

Shannon Cross
Analyst, Credit Suisse Securities Research

Q

Thank you.

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

Let me close with a few comments. The strong customer reception to the substantial innovation we have brought to market has got in FY 2024 to a solid start despite the choppy macro backdrop. We are laser-focused on our FY 2024 priorities to be prudent stewards of the business, tightly managing the elements within our control to reinvigorate efforts to drive better performance in our storage systems business and to build a more focused approach to our Public Cloud business.

Early results of this focus indicate we are on track to drive margin expansion and earnings growth, while yielding top line growth in the back half of the year. I am absolutely delighted by the positive reception to our new products, the differentiation and continued growth of our first-party Public Cloud storage services and our exciting innovation road map.

I hope to see you at INSIGHT and look forward to updating on our continued progress on next quarter's call. Thank you.

Operator: The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.