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NetApp, Inc. (NTAP)

Q2 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Kris Newton

Vice President-Corporate Communications & Investor Relations

GAAP AND NON-GAAP FINANCIAL MEASURES

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

George Kurian

President, Chief Executive Officer & Director

Q2 HIGHLIGHTS

- Our Q2 FY2020 results reflect the strength of our business model and the value of our innovation
- We delivered gross margin, operating margin, and EPS, all solidly above our guidance ranges
- Despite the ongoing macroeconomic uncertainty and the potential for continuing unpredictability in enterprise purchasing behavior, the fundamentals of our business are strong
- I've just come from two great events, NetApp INSIGHT and Microsoft Ignite, and the many conversations I had with customers, prospects and partners, both underscore the power of our Data Fabric strategy to differentiate our solutions, and highlight our success in reaching new customers and buying centers to expand our market share

Hybrid Multicloud IT

CUSTOMERS

- At this year's INSIGHT user conference, it was clear that we are solving real pain points for customers, as they grapple with the complexity of hybrid multicloud IT.
- I've witnessed the tangible enthusiasm for how we are helping customers address these challenges by building their own data fabric with NetApp
- I'm sure those of you who were able to join us felt that excitement
    - We saw an increase in overall attendance, and for almost half of the customer attendees, this was their first INSIGHT.
- The number of executive-level customers was up 80% from last year, and the number of customers with cloud responsibilities doubled

Innovation Portfolio and NetApp Keystone

- Hybrid multicloud is the reality of customers' IT environment, and NetApp has the strategy, the innovation portfolio, and customer experience to help them succeed
- At INSIGHT, we announced that we are revolutionizing the customer experience and simplifying the business of hybrid multicloud with NetApp Keystone

- NetApp Keystone creates a consistent experience from public cloud to the data center, helping customers transform IT to operate with cloud-like ease and flexibility everywhere

CLOUD SERVICE, SUBSCRIPTION SERVICES AND TECHNOLOGY

- First, for customers who want truly elastic scaling without having to manage infrastructure, they can consume NetApp technology as a cloud service through the world's biggest public cloud
- Second, for customers who want a cloud-like experience on premises, we offer subscription services
- And finally, for customers who want to own and operate technology in their own data centers, we've introduced a radically simplified ownership experience for how our customers buy, optimize, and grow with NetApp
  - Customers and partners choose NetApp, because of our unique ability to offer a full range of capabilities needed to build their data fabric
- NetApp Keystone complements this with a consistent cloud-like customer experience across the public cloud and on premises

New Buyers and Workloads

- Let me be clear, our approach to cloud is giving us access to new buyers and workloads, as well as increasing the relevance of NetApp to companies both large and small
- Cloud gives us both opportunity in the public cloud and makes us more attractive for on-premises deployments
- While I'm heartened by the enthusiasm generated by our hybrid cloud data services, the headwinds we identified on last quarter's call persisted through Q2
- Both macroeconomic and enterprise spending indicators show continued weakness
  - While we cannot predict when conditions will improve, we are planning our business, assuming no change in these external factors for the foreseeable future

Sales, Gross Margins and Growth

- I'm pleased with our sales discipline and the ability to capture value in this tough market
- To that point, our product gross margins demonstrate that we were able to maintain pricing discipline despite the soft environment
- Regardless of what is happening in the broader macro environment, I remain confident that we can return to growth because of our ability to deliver real business value to customers' hybrid multicloud environments
  - This increases our strategic relevance and enables us to reach new buyers through new pathways, address new workloads, and expand our presence with existing customers

Plan

- To better capitalize on our opportunity and replicate our proven areas of success, we laid out a plan for you last quarter
- That includes increasing sales capacity by approximately 200 primary sales resources by the end of Q1 FY2021, without adding to the total operating expenses for the company
- As of the end of Q2, we are well on track to deliver against this goal
- The sales head count will be deployed primarily in our Americas geography

  - They bring capabilities to acquire new accounts, as well as engage new buyers with new sources of funding like cloud architects in existing accounts

Productivity and All-Flash Array Business

- As a reminder, we expect it will take roughly three to four quarters to bring these resources up to full productivity, and the vast majority of the benefit of this additional capacity will be realized next year, in FY2021
- We are also sharpening our attack on the key market transitions of disk to flash, traditional IT architectures to private cloud, and on premises to public cloud
- In Q2, our all-flash array business, inclusive of All Flash FAS, EF, and SolidFire products and services, was up 29% sequentially to an annualized net revenue run rate of $2.2B.

Magic Quadrant

- We have industry-leading guaranteed storage efficiency, the highest performance, and the most complete cloud integration in the market today
- In the quarter, Gartner published its Magic Quadrant for Primary Storage, and NetApp took the highest ranking in the Leaders quadrant for both our ability to execute and for the completeness of our vision

Private Cloud Solutions

- Moving to our private cloud solutions, SolidFire, NetApp HCI, and StorageGRID are the building blocks for private cloud deployment, enabling customers to bring public cloud-like experience and economics into their data centers
  - Our private cloud business, inclusive of products and services, attained an annualized net revenue run rate of over $300mm in Q2, up almost 30% y-over-y

Cloud Data Services

- Now on to cloud data services, based on the last month of Q2, our annualized recurring revenue for cloud data services increased to approximately $72mm, up 167% y-over-y
- We continued to see a healthy mix of customers new to NetApp in our cloud services, and expect that our cloud services will continue to enable us to acquire new customers, reach new buyers, and expand the workloads managed at existing customers

Azure NetApp Files

- Q2 is the first full quarter that Azure NetApp Files has been generally available, and we're making great progress
- At Microsoft Ignite, I spoke to many customers who are planning to move a broad range of enterprise workloads, like Oracle and SAP, into the Azure cloud with Azure NetApp Files
  - Customers love that they get the widest choice of file protocols and on-premises class performance and availability, with an Azure consistent experience, from procurement to support, to billing
- A global energy company that's migrating high-performance workloads into the cloud for flexibility, scalability, global access and collaboration presented at Ignite about their experience with Azure NetApp Files
- The performance improvements they achieved are outstanding

- Simulation run times were reduced from months to days, and in some cases, hours

CUSTOMERS AND CLOUD VOLUMES SERVICE

- To quote the customer, Azure NetApp Files is a lifesaver
- And that's just one example of the excitement we're hearing from customers about what we're doing in the cloud
- Our Cloud Volumes Service is available in all three leading hyperscalers and gives us access to new opportunities, from non-enterprise customers, where our traditional solutions do not economically reach, to new strategic buying centers in the world's largest enterprises, where we are only a small part of their infrastructure, we are expanding our addressable market with our cloud data services

Hybrid Multicloud

HYBRID CLOUD DATA SERVICES

- Our many years of work and deep integration with the leading public cloud give us a sustainable competitive advantage in the hybrid multicloud
- We're delivering an enormous amount of value to a growing number of customers operating and planning to operate in a hybrid multicloud world
- We're adding new customers each day
- We're adding new use cases each week, and we're adding new cloud regions each month to deliver the world's best hybrid cloud data services
  - As I've said before, customers and partners are choosing NetApp because of our Data Fabric strategy and our unique relationship with the hyperscale cloud providers
- Our cloud data services not only give us access to customers and workloads that were heretofore inaccessible with our traditional solutions, they improve our competitive position for on-premises opportunities

INNOVATION PORTFOLIO, DATA FABRIC STRATEGY AND ON-PREMISES SOLUTIONS

- Only NetApp has the strategy, the innovation portfolio, and customer experience to help customers succeed in hybrid multicloud IT.
- We've made a lot of progress in delivering on our Data Fabric strategy
- Our on-premises solutions are highly differentiated, as evidenced by a strong product gross margin
- We are now available in the three leading clouds
- We have delivered both the technology and the customer experience needed for success in the hybrid multicloud, and we are improving our execution and adding demand generation resources to drive new sales motions

GROWTH

- But it is early days, and we have more work to do to communicate the full scope of our capabilities
- As we saw at INSIGHT and Ignite, our story resonates with customers
- Because of this, I am confident in our ability to return to growth
- We will continue to return capital to shareholders, while investing for the long-term health of the business and capitalizing on our unique ability to help customers navigate the complexities of the hybrid multicloud

Management Team

- Before closing, I want to share some news about our organization
- Henri Richard, EVP for Worldwide Customer and Field Operations, has let me know of his intent to retire at the end of the FY.
- Over the past 3.5 years at NetApp, Henri has done much to transform and modernize our sales force to take advantage of the strength of our Data Fabric strategy and our technology leadership, as we pivoted to new buying centers and the growth areas of the market
    - Henri will participate in the search for his replacement and help in a seamless transition, while continuing to lead the field and improving our execution
- At the same time, I'm excited to announce the promotion of James Whitemore to SVP and Chief Marketing Officer
- James came to NetApp in the SolidFire acquisition, where he was CMO, and has since been leading our demand generation and digital strategy in the marketing organization
    - As acting CMO, James has already made a strong impact, and I'm glad to have him as the CMO of NetApp

Ronald J. Pasek

Executive Vice President & Chief Financial Officer

FINANCIAL HIGHLIGHTS

GAAP and Non-GAAP Financial Measures

- As a reminder, I'll be referring to non-GAAP numbers unless otherwise noted
- As George highlighted, in Q2, we delivered strong margins and operating leverage in the face of continued caution from our customers as a result of the macro environment
- Despite the demand uncertainty, we are confident in our product leadership and strategy to reaccelerate growth going forward
- We also remain committed to our capital allocation strategy of returning cash to shareholders through share buybacks and our healthy quarterly dividends

Revenues

- Before discussing our guidance, I'll provide further detail on our Q2 performance
- In Q2, net revenues of $1.371B were down 10% y-over-y, including 1 point of currency headwind
- We had zero ELA revenue in the quarter, compared to roughly $20mm of ELA revenue in Q2 2019
- Product revenue of $771mm decreased approximately 16% y-over-y
- Adjusting for ELAs, Q2 total revenue would have been down approximately 8% and product revenues would have been down approximately 14%

P&L

Revenues and Gross Margins

- Moving down the P&L, software maintenance and hardware maintenance revenue of $540mm was flat y-over-y
- Deferred revenue increased 8% y-over-y in Q2

- Gross margin of 68.6% was above the high end of our guidance range
  - Product gross margin was 57.3%, which is an increase of 3.2 points y-over-y and above our long-term target of 56% outlined at our Analyst Day
- The improvement was driven by continued sales force discipline, an increase in all-flash product mix and cost reductions, and includes nearly 0.5 point of currency headwinds
- Q2 was the 11th straight quarter we increased product margins y-over-y, when adjusting for the benefit of ELAs
- The combination of software and hardware maintenance and other services gross margin of 83% increased by over 150BPS y-over-y, driven by continued productivity improvements

Operating Expenses, Operating Margins and EPS

- Q2 operating expenses of $631mm were down 3% y-over-y, driven primarily by a reduction in variable compensation
- Operating margin was 22.5%, solidly above the high end of our guidance range
- Despite the revenue headwinds, EPS of $1.09 was up 3% y-over-y and above the high end of our guidance, demonstrating the operating leverage in our business model

Investments, Cash, DSO and DIO

- We closed Q2 with $3B in cash and short-term investments
- Our cash conversion cycle was a negative four days, up 15 days y-over-y
- DSO of 52 days was up six days y-over-y due to linearity in the quarter, and to a lesser extent, customer mix
- DIO was 23 days, a nine-day increase y-over-y
- We continued to expect our cash conversion cycle to remain negative throughout FY2020

Cash Flow and FCF

- Cash flow from operations was a negative $53mm, while FCF was a negative $89mm
- The negative Q2 cash flow metrics are due to timing and do not reflect a change in our underlying business
- The timing issues were primarily the accounts receivable
- Additionally, there is a shift in the linearity of cash tax payments in FY2020
- We are maintaining our expectations for FCF to be in the range of 19% to 21% of revenues in FY2020

Share Repurchasing and Cash Dividend

- During Q2, we repurchased 9.8mm shares at an average price of $51.19, for a total of $500mm
- Weighted average diluted shares outstanding were 236mm, down 28mm shares year-on-year, representing an 11% decrease
- During the quarter, we paid out $111mm in cash dividends
- In total, we returned $611mm to shareholders in the quarter
- Our fiscal Q3 cash dividend will be $0.48 per share

GUIDANCE

Revenues, Gross Margins, Operating Margins and Expenses

- Now on to guidance, we expect revenues for FY2020 to be down approximately 8% y-over-y
- We continued to expect ELAs to represent approximately 2% of total revenue
- For FY2020, we now expect gross margin to be in the range of 67% to 68%, above our previous guidance of 66% to 67%, due primarily to the improvement in product margins
- Operating margin for FY2020 is expected to be in the range of 21% to 22%
- Implied in this guidance is our expectation that operating expenses will be down slightly y-over-y in FY2020, due to lower variable compensation
- As a result of the updated revenue and margin guidance, we expect EPS to be down between 5% and 8% y-over-y, without the benefit of buybacks

Q3

REVENUES, GROSS MARGINS AND EPS

- Now on to Q3 guidance, we expect Q3 net revenues to range between $1.39B and $1.54B, which, at the midpoint, implies a 6% decline in revenues y-over-y, including 0.5 point of currency headwind
- For Q3, we expect consolidated gross margin to be approximately 67%, and the operating margin to be approximately 22%
- We expect EPS for the quarter to range between $1.14 and $1.22 per share

Growth and Leverage

- We are diligently focused on improved execution and addressing the challenges we face
- We are committed to returning the company to growth, and we remain confident our business model leverage will enable us to deliver long-term shareholder returns

QUESTION AND ANSWER SECTION

Wamsi Mohan
Bank of America Merrill Lynch

Q

Your product gross margins, north of 57%, have been very strong. We've not seen that in a while actually since 2015. Can you talk about how much of that product gross margin was product mix-driven vs. commodity price tailwinds or maybe even federal mix? And do you feel that you can sustain or expand these margins as you go into the back half of the year?

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

On a y-over-y basis, most of it was mix, meaning we saw a higher percent this quarter of all-flash than we did, say, last quarter. Some of that was also cost reduction, not just on NAND, on other things as well. That was in the face of having no ELAs in the quarter, so that goes against you. I did contemplate the ability to keep this level of gross margin through the rest of the FY, and you saw that in the increase of the total margin guide.

Wamsi Mohan
Bank of America Merrill Lynch

Q

And if I could really quickly, on CDS, you exited last quarter with $5mm in monthly sales. Seems like you exited this quarter with about $6mm despite Azure GA in quarter. Can you talk about what are some of the challenges not ramping this faster? I know, George, you expressed a lot of enthusiasm in all your discussions both at INSIGHT and Ignite. So, where do you expect CDS annualized revenue run rate could be as you exit FY2020? Thank you.

George Kurian
President, Chief Executive Officer & Director

A

We aren't going to give you guidance on the CDS business. I think as we said, we've taken longer than we originally expected to get to general availability, given the technical sophistication of what we are offering to customers. The total addressable market is there. We are seeing a lot of demand and interest from customers, and we're adding customers and growing footprints on a daily basis. We are going to just need to keep doing the work necessary to scale and enable all of the pathways associated with being able to take this solution to market, and to replicate the wins that we've got across a broad range of workloads into more customers. So we're focused on execution at this point.

Rod Hall
Goldman Sachs

Q

I wanted to just check and see, Ron, if you could comment on the accounts receivable, and, well, the DSOs, that's the highest we've seen, I think, ever in our model. So just – I heard you say the tailwind – that it was heavily backend-loaded in the quarter, but any more color on that? And then the ELAs, you're holding this 2% guide, yet there are no ELAs so far. So just anything you can say that would help us all have more confidence that you've got visibility into that, or are you still having to run on a treadmill to get those deals? Just kind of help us understand why you still have confidence in that ELA guide. Thanks.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

With respect to AR, it was linearity within the quarter and particularly within the month, and then to a lesser extent, some of the mix of customers we saw that bought in the last two months of the quarter. You saw a similar phenomena in Q4, where we ended pretty backend-loaded, and of course collected all of that AR in Q1, which yielded a bunch of cash flow. It happens sometimes. The other issue with FCF and cash flow, which I mentioned in my script, was larger cash tax payments, but I did reiterate the full-year guide of 19% to 21% for FCF as a percent of revenue.

With respect to ELAs, I'll make a comment, and then let George comment as well. Last year this quarter, we ended up giving you a full-year guide of roughly 2% of revenue, with the understanding that we can't easily contemplate when those ELAs come in within each quarter. But for the full year, we felt comfortable with that. We did that based on extensive conversations with parts of the sales force, making sure they understood the importance of this and the fact that it has a huge impact on earnings, because it's essentially pure profit. So that was a further conversation this quarter, and it led to the continued commitment for H2.

George Kurian
President, Chief Executive Officer & Director

A

With regard to ELAs, Rod, I think the fundamental thing that we are doing with them is to enable streamlined customer purchasing. It doesn't require them to spend the whole amount of the ELA upfront. It's really to make their overall multiyear procurement agreements with us a lot more streamlined and to enable us to get a broader strategic footprint in the account. We know these accounts. Some of them have impending events that this would clearly enable things to get more streamlined. And so we're working it, right? We have visibility into these accounts. We know who these accounts are, and we're working hard to bring these forward.

Karl Ackerman
Cowen and Company, LLC

Q

If I may, going back to your outlook for December, it seems you're implying your non-all-flash array business will decline about 6% sequentially. That seems to be about in line with your seasonal averages of nearline drives, but at the same time, two of your hard drive suppliers have spoken about improved nearline shipments in December and for H1 2020, when you also launched two new midrange hybrid array at INSIGHT. So are there competitive forces impeding your ability to do a bit better in hybrid arrays over the next few quarters? Or is it just conservatism? Thank you

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

I'm not really sure I understand your question. We're guiding total revenue. We're not guiding even specific product revenue, and within that, not all-flash. So I'm not sure I quite understand where you're going with that.

George Kurian
President, Chief Executive Officer & Director

A

We feel good about our position in the hybrid array market. We are, without question, across a range of customer and analyst service, the best hybrid array vendor. We've introduced two new models. I think what we are framing up for the next quarter guide is really an overall product number. We're not forecasting it to the level of specific product components at this point.

Mehdi Hosseini
Susquehanna International Group

Q

I want to go back to the topic of installed base. In the past, you have talked about installed base that is only penetrated in the teens. So how do you see, especially in the context of a strong AFA results, for the October quarter? Thank you.

George Kurian
President, Chief Executive Officer & Director

A

We are up a few percentage points. We're up at 22% of the installed base now being on AFA. As we have said before, our installed base is growing. And so while we ship a lot of new systems each quarter, the size and scope of the installed base and its growth leaves the total AFA penetration at a small number, which allows us to have opportunity to continue to refresh over time the rest of the installed base.

Mehdi Hosseini
Susquehanna International Group

Q

Just one clarification, if I may. Would the end-of-life support for ONTAP 7 actually help expedite or increase the penetration rate?

George Kurian
President, Chief Executive Officer & Director

A

Some of those customers that have not upgraded so far, there's a small number. But certainly some of those, if they look at the economics today, of a platform like our C190, they would choose to go all-flash than go to a 10-K disk-based system, because the economics are already better with our solutions to replace 10-K drives.

Aaron Rakers
Wells Fargo Securities LLC

Q

I just kind of want to understand a little bit on the guidance side. It would appear, based on the gross margin guidance in the current quarter, that you're not obviously factoring in an ELA. I think last time, it was like a 400-basis-point benefit that you saw on product gross margin. So if that's true, and we kind of think about the setup going into the April quarter to kind of hit the full-year guidance level, number one, are you factoring in a revenue contribution to kind of hit an absolute increase in revenue in the April quarter that includes an ELA, and therefore we should also be thinking that the gross margin into the April quarter is significantly higher, just because that ELA contribution would fall into that, if you kind of hit that 2% of total revenue for the full year, or is that just not factored into your guidance at all? I'm just – I'm trying to understand how you kind of think about the mechanics of the implied guidance for the April quarter.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

So remember, as we go through the FY, for Q3 and Q4, product revenue becomes a larger part of the total, which overall is dilutive to overall margin, right? So, you can't just look at the number and say you're holding total margin flat to Q3, therefore you don't have an ELA in it because the mix of product vs. services is higher in Q3, obviously. So, there is some ELA in Q3 and there, absolutely, is some in Q4.

Aaron Rakers
Wells Fargo Securities LLC

Q

And on an absolute basis, April quarter vs. what you've done over the past few years, I think early 2018, the storage market was fairly healthy. So, I'm just trying to – do you have a line of sight that says, look, on an absolute sequential basis, you can kind of see that kind of jump that you saw back in 2018, or is there something else that I'm just not thinking about in the model?

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

Again, you've got the benefit of ELAs in Q3 and Q4, which you didn't have essentially last year Q3, Q4, to a great extent. So, that helps things, all things being equal.

Kathryn L. Huberty
Morgan Stanley & Co. LLC

Q

EMEA was stronger than other segments. Can you talk about whether that was your own execution, or did you see some improvement in the market? And then, just generally speaking, can you comment on the spending environment relative to the caution that you highlighted in Q1 in the major segment? Thanks.

George Kurian
President, Chief Executive Officer & Director

A

We saw Q2 relatively unchanged from Q1. And as we said at the start of the year, Q1 was a step down from calendar Q1, which was our fiscal Q4 of last year, but Q2 was not – there were no major changes overall in terms of the trajectory from Q1 in terms of spending. Customers continue to be cautious. They are scrutinizing transactions. They're buying for what they need today. And the differentiation of our offerings is clearly visible in the fact that our gross margins were really, really strong. With regard to EMEA, our teams have done a really good job, and I want to salute our sales teams. There's a lot of execution that has been a big part of our strength in EMEA.

Matthew Cabral
Credit Suisse Securities (USA) LLC

Q

The services business was down a touch if you put together both hardware and software. Just wondering if you could talk a little bit about where you are in addressing some of the renewal issues that you've highlighted on prior calls, and just how we should think about a return to growth for services going forward.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

We've made some progress on that. You can see that we're essentially flat when you adjust for FX. We still have some work to do. There's some organizational work we're doing. There's some process work we're doing. You can't see that yet manifest itself in growth. But as George indicated, the installed base is growing, and we believe that, eventually, that will get back to growth as well, and you can see that in the deferred revenue number. So, it's not going backwards, which is good, as it did Q4 of last year, but we still have some work to do.

Alex Kurtz
KeyBanc Capital Markets, Inc.

Q

On the last call, it seemed like the sales force productivity issue was really the main driver to the reset. And I'm sure – I mean, we touched on macro on that call, but it just seemed like that was really the focus from the team. So then fast forward 90 days and you seem very optimistic about the hiring of the new reps. And I just wonder, what gives you the confidence 90 days later? Because it seemed like it was a pretty big setback internally as far as how the team was working, but maybe we were overestimating that and maybe things weren't as difficult to kind of fix as far as hiring productive reps and ramping them.

George Kurian
President, Chief Executive Officer & Director

A

What we said on Q1 call was that the quarterly results reflected two-thirds macro, one-third sales execution. And so, it was a reflection of the macro in the purchasing behavior of our largest customers that drove the majority of the impact in Q1. We've always believed that our portfolio is really strong. And given our position in the market, we have ample room to capture more accounts and to invest some of the really strong gross margin leverage that we're seeing into investment in field sales coverage. We've always believed our story is differentiated in the market. We are doing exciting things, and we are an attractive place to work. So, we've been pleasantly surprised with our ability to hire good quality salespeople and we're focused on getting them productive and ramping them.

I think I would just say, we are heads down and focused on execution. Q2 saw an improvement relative to Q1 in terms of our ability to execute and capture the deals in front of us. We got to keep doing that, and I expect us to continue to do that through the course of the year.

Amit Daryanani
Evercore Group LLC

Q

You're taking up gross margins fairly notably for FY2020. Structurally, I'm wondering, do you think 67%-plus gross margin as something that's sustainable long term? Or was there some specific benefits that were maybe more one-time in nature in FY2020 vs. longer term? So how do we just think about the levers that are enabling this upside? And then, George, how do you think about Dell's upcoming midrange solution and what that could do from a pricing or competitive basis to you guys?

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

If you look at where we are in the quarter and then implied in some of the guide for the rest of the year, we are at the model we articulated at our Analyst Day for product margins a year and a half ago. So, we said 55% at that point. After the ASC 606 change, I said 56% to 57%. And so, yeah, I believe it's completely sustainable. It's a good 10 points below one of our competitors who's an all-flash competitor. It's 10 points above where we were two years ago. So, it's a really good place to be, and it gives us a lot of flexibility to still be aggressive, but not under-earn.

George Kurian
President, Chief Executive Officer & Director

A

With regard to your comment about Dell EMC, we feel very good about our solution set. We are seen by Gartner and customers as the leader for primary storage, and we are the only vendor in the market with a comprehensive cloud strategy. And so we feel good about our position in the market and we're going to capitalize on it, which is why we're investing in sales capacity to go capture net new accounts and expand wallet share within existing accounts.

Andrew Vadheim
Wolfe Research LLC

Q

Wanted to follow up on a prior question and how it relates to guidance. So you mentioned the weakness you're seeing and sort of deteriorating macroeconomic environment, but just wondering why you decided then, tighten the full-year guide, especially on revenue, kind of taking it from a 5-point range to 1 point estimate.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

When you think about the guide, we had two quarters of actuals. I'm guiding Q3 discretely. So you essentially have three of the four quarters, I think it would be strange to keep the same 5% to 10% down, when, in fact, we kind of know where we think we'll be in Q4. Remember, Q4 last year is a relatively easy compare. We were down 3%. So getting to that number should not be that difficult, whereas H1 this year was much more difficult compare, couple that with the fact that we have ELAs in H2, we didn't have them in H1, just felt like it was a better thing to do.

Andrew Vadheim
Wolfe Research LLC

Q

And then separately, public sector was kind of down sequentially. Just was wondering to what extent that was expected, and should we think of public sector sort of being in line with the rest of the company on a y-over-y growth basis in sort of Q3 and Q4?

George Kurian
President, Chief Executive Officer & Director

A

Over the last year or two, we started to shift the mix of our public sector business to be more program-related and broaden the book of business beyond just the fed to state, local, and higher education and other parts of the market. As a result, you will see the business trend towards more of a standard pattern as opposed to a big step-up in Q2.

Simon Leopold
Raymond James & Associates, Inc.

Q

I wanted to see if we could touch a little bit on what you're seeing in the macro environment, given what we've heard from others reporting tonight. It sounds to me that maybe you saw some of the deterioration of enterprise demand a little bit earlier. And so this is more of an issue of timing. And what I'm really looking for from you is how the demand has maybe evolved or changed over the course of the quarter vs. what you talked about in August, is the weakness shifting among verticals, steady, how has it changed? Thank you.

George Kurian
President, Chief Executive Officer & Director

A

In aggregate, we did not see a material change in Q2 from what we saw in Q1. With regard to the exposure of specific verticals and so on, we have a broad book of business. We wouldn't say that we are exposed to any particular vertical to be able to comment specifically about it. I would say it's reflective of the news that you see in the market, right? And there are teams in countries like Germany, where the spending pattern is tight, who are executing really, really well for us. And we did see some slowdowns in other parts of the world, but nothing that's unique to NetApp.

And our view is, Q2 is reflective of a more stable long-term pattern that we see in the market, and it doesn't materially change from Q1. And that's what we're planning our business around, to capture the value from our differentiated offerings by being disciplined on price and extracting the value that we feel we deserve, and then investing some of that benefit from gross margin and operating margin leverage into the quota-bearing sales capacity that we talked about last time. And we feel that the combination of the two should allow us to get our business back to growth over time and continue to deliver the earnings model and returns to shareholders that we've committed to.

Simon Leopold
Raymond James & Associates, Inc.

Q

Just to clarify one thing, did you see a seasonal strength in the federal vertical in the most recent quarter that sets up a tougher sequential comp in the January quarter? Is that material for you? Thanks.

George Kurian
President, Chief Executive Officer & Director

A

Our book of business in the public sector market is increasingly broad. We have diversified our book of business to be deployable in program spending, which is not driven by any specific seasonality pattern. We are growing our footprint in state and local governments, so the public sector business had its normal year-end pattern, but it's a smaller component of our – the fed business is a smaller component of our overall public sector business.

George Iwanyc
Oppenheimer & Co., Inc.

Q

You continue to be pretty bullish on adding new customers, especially with your cloud offerings. Can you give us a sense of whether that's just share displacement there, primarily new workloads, and is that transitioning over to some traditional storage sales as well?

George Kurian
President, Chief Executive Officer & Director

A

We are certainly seeing a broad range of workloads being deployed on our cloud solutions, e-commerce, databases like Oracle and SAP HANA, which are high-performance transactional workloads, we see generics and bioscience applications, vertical applications for oil and gas and healthcare, so really broad set of application that require consistent performance and high availability. And I think that's what we are uniquely positioned in the cloud for.

There are customers and many that are saying that, listen, we're going to – if we're going to use you in the cloud, we want to harmonize our on-premises environment so that we can move workloads between the two landscapes. And with our announcement of Keystone, a subscription service for on-premises environments, they can now have not only the technology that allows them to standardize workload models between on-prem and public cloud, but the customer experience and the consumption offering that allows them to do that.

George Iwanyc
Oppenheimer & Co., Inc.

Q

And just expanding on your Keystone comments, how long do you think the selling motion will take to get that up and running?

George Kurian
President, Chief Executive Officer & Director

A

We don't believe that Keystone subscription services will replace CapEx purchasing, right? We think it will be a part of what customers want for their IT landscape. We are doing the work to enable our sales teams to be able to position that offering in the right way into customers, and we think it will take time. We'll give you updates as we go. With regard to our business model, we hold the assets on our books. You'll see depreciation similar to what – where in the P&L, we report cloud data services depreciation, right? So it's not going to be material this year.

James Suva
Citigroup Global Markets, Inc.

Q

You've been very vocal about hiring the more sales, and can you just remind us of the cadence? Is it kind of hire during six months, train, get relationships with growing six months after, so we're kind of looking at fiscal kind of 2021 or kind of summer of next year and all of a sudden the fruit really starts to bear from these efforts? Is that the right timeline or I might be off on that?

George Kurian
President, Chief Executive Officer & Director

A

We said that – just to go back to what we said, we said that we were going to hire 200 incremental demand generation head count over four quarters, with the last quarter being Q1 of FY2021. And we're on track. It takes three to four quarters to train a rep and to get them to full productivity. So we think that the predominant benefit of this additional capacity will be in FY2021.

Louis Miscioscia
Daiwa Capital Markets America, Inc.

Q

Two questions sort of combined together, one of the things about the sales force, you said that a good portion of the sales force wasn't selling the entire product line. Given obviously the relationships they have there, I assume this is just more of a reeducation and maybe some adjusting to the sales plan. So I'm just wondering how is that actually happening, how is it going. And then combined with that, and maybe this is a part of it, obviously flash improved significantly on a quarter-to-quarter basis. Just you went through some of the impacts last quarter, but how did you get flash bouncing back so quickly this quarter?

George Kurian
President, Chief Executive Officer & Director

A

I want to credit the field organization for focus and execution, right? I think we said that what we were going to do was to focus on the big market transitions, disk to flash, traditional IT to public/private cloud, and the deployment of enterprise workloads in public clouds, as sort of the key areas where we would attack the market. And I think credit to the sales leadership and the sales force for the progress in all-flash.

With regard to the comments you made earlier about our ability to sell the full portfolio, what we observe is that there are different buyers for some of our portfolio than the traditional storage buyer – cloud architects, DevOps staff, and workload owners, like application owners. We have been focused on reaching them and bringing them to our user conference. We saw a substantial uplift in the number of people from those pedigrees coming to our user conference, reflecting both the success of our field and marketing teams and reaching them over time, as well as the interest that they have in our portfolio, right?

So we need specific competency to go after those types of sales motions, and we're bringing that into the company as part of our 200 head count. And of course we are focused on training the storage-focused sales force on expanding their relevance to some of these new audiences. So work's underway, as I said, we're head start in executing against these three imperatives. We saw the benefit of that focus in Q2, and we're going to continue to stay laser-focused on that through the rest of the year.

Ananda Baruah
Loop Capital Markets LLC

Q

At your last Analyst Day, you guys talked about mid-single-digit revenue growth. Now that you're getting the sales force sort of, call it, re-optimized, I mean, maybe even re-optimized sort of distinct from the adding. Does the optimization process put you in the position longer term to do stronger revenue growth if your marketplace optimized? And just real quick, Ron, I believe you had some ELA expectation in the results for the quarter. So did you – and you basically did in line revenue, so did you outperform your internal product revenue targets for the quarter? Thanks, guys. Appreciate it.

George Kurian
President, Chief Executive Officer & Director

A

That we have many avenues to grow our business. We have a leading position in primary storage on premises. We have a growing private cloud business, and we are the only storage vendor who can support enterprise workloads in all of the major public clouds. And so, I feel like we have plenty of total addressable market. We're focused on getting the company back on track to growth, right? And we'll tell you more about our long-term earnings model the next time we hold an Analyst Day. I will just tell you that we have delivered on all of the elements of commitments we made in terms of gross margins and operating margins and so on. And barring the slowdown in enterprise spending this year, we were on track to meet even the top line numbers that we had committed.

So, we feel strongly about delivering on our commitments. Right now, we are entirely focused on executing against the opportunities in front of us, and getting the company back to growth. Additional sales head count, funded by the strong margin profile of our business, is the first step, getting them on board, productive, and all of that's the focus of the company right now. Ron?

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

I did mention in Q2 guide, we had factored in some amount of ELA, which, of course, did not come through. And it was essentially the entire miss to the midpoint. It simply flops into Q3. So, yeah, we basically came in exactly where we thought, with the exception of that one ELA.

Nehal Sushil Chokshi
Maxim Group LLC

Q

Really nice net new cloud ARR within a quarter of $11mm, which compares to $7mm in the year-ago quarter, so that's a very strong net new ARR growth. Is that all as Azure Files driven or sales capacity driven or something else?

George Kurian
President, Chief Executive Officer & Director

A

The majority of our growth in cloud data services is from Microsoft Azure NetApp Files. And the majority of that revenue is from net new customers, right? So, we don't have a single large customer that's a big percentage of the total number. We are seeing good momentum across a broad range of use cases and a broad range of customers trying things out and deploying their first workload. So as we go forward, we are focused both on continuing to acquire new customers, but additionally, to expand our footprint now that we've got success in some of these customers to broader sets of workloads. So, thank you for that.

Nehal Sushil Chokshi
Maxim Group LLC

Q

And if I may, my understanding is that you do have some specialists trying to sell cloud data services, although I'd believe also the broader sales force is also capable of selling the cloud data services. What's the sourcing of this new cloud ARR between these two sales forces?

George Kurian
President, Chief Executive Officer & Director

A

It's hard for me to comment on that. I think we've got multiple pathways into the market. We've got both specialists and generalists within our field who are focused on selling cloud data services as part of their remits, and we have the Microsoft pathway into market, which we are continuing to work to enable around the use cases and the expanding number of use cases of our technology. So, it will take time, but we're heads down and focused on it. And we're really excited about how successful the technology is in serving the customers that have come on board, right? For things like databases and e-commerce and content management and media and life sciences and an incredibly wide range of applications, frankly, more than I had expected, we have compelling business advantage that we offer customers.

Nik Todorov
Longbow Research LLC

Q

Service margins continue to tick up despite, I think, you guys are still investing a lot in the CDS business, which is a headwind which should abate at some point. So, Ron, can you comment about the runway or how do you see the opportunity to continue to grow services margins over time?

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

It's something that we are focused on in the sense that we're trying to get more efficient. Having said that, I don't want to be too much more higher than where we are today. It's not something I contemplated in our long-term guide at our Analyst Day, much about what you saw this quarter. So, I think there's good work being done. There's some more work we can do, but we don't think that there's a ton of upside to that number.

Nik Todorov
Longbow Research LLC

Q

And if I can just follow up, at some point, in order to hit the FY2021 guide for CDS, there needs to be a step function increase, I guess, on a q-over-q basis. I guess, what work needs to be done? Do you guys need Google also to go general availability to kind of start seeing really that inflection, so investors can get more confident around that target exiting FY2021? Thanks.

George Kurian
President, Chief Executive Officer & Director

A

We got to general availability later than we expected, given the complexity of integrating a really high-performance service so deeply into these hyperscaler clouds. We are at GA with Microsoft. We have clear line of sight into GA with Google, and we think that there is a broad – the total addressable market's there. As I said earlier, the number of use cases that are being deployed on our platform is broader than we originally anticipated. And so, we've got work to do to execute, to train the sales force, to train the Microsoft channel, get our message out to market, and bring in the customers to be able to deploy them on our platform.

We saw a good start to that with the attendance at Microsoft Ignite and at NetApp INSIGHT, where the number of people coming to talk to us and starts to do proof-of-concepts with us were really good. So, we've got our heads down. We've got to deliver on getting these customers successful, but we feel like we got a really, really good platform, and the early results have been really good.

Steven Fox
Cross Research LLC

Q

Just one question for me, George, obviously, you're not making any grand ambitions about the macro. So when you mentioned the return of growth, I assume for next FY, is it mainly driven by the sales force execution? Or how would you sort of rank and characterize what's most important in terms of getting back to top line growth? Thank you.

George Kurian
President, Chief Executive Officer & Director

A

It's really making sure that we can capture the full range of opportunities that are available in front of us. As I said, we have leadership positions in a broad range of categories of primary storage. We are the only vendor with a cloud strategy and really compelling technology available in the big public clouds, all of the big public clouds, and we need to be able to go and access the customers that are making those decisions, which is where the sales head count focus is really a critical part of the go-forward plan.

The differentiation of our technology is evident in product gross margins, right? And the leverage of our business model is evident in the results we just showed and the guidance we gave. And I think for us, the macro is going to be the macro. We're going to go take share and to go after the addressable market. We're doing that prudently within the guidance of – that we gave you and by prioritizing our resources against the biggest opportunities.

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

Q

Could you talk about the contribution you saw in the quarter from your big distribution channel partners? Several distributors and resellers have called out relative strength in storage following a very weak June quarter. Is that a reflection of the middle markets being a little bit more stable or bouncing, or any changes in your channel partner programs? Thank you.

George Kurian
President, Chief Executive Officer & Director

A

The contribution of indirect channels to our business was relatively unchanged in terms of the overall mix of our business. It's approximately 80% each quarter. And we feel that that's reflective of our overall book of business, nothing unusual there. You are correct that the mid-market is relatively less concerned about the impact of the global economic slowdown and some of the uncertainty there. And we have more opportunities to capture share, because our share in the mid-market is a bit smaller than it is in the enterprise. Our channel partners were focused on enabling a focused set of channel partners, so that they get the full impact of NetApp's enablement resources. And so we've got a narrow group that we work with, and we're pleased with the progress so far.

George Kurian
President, Chief Executive Officer & Director

SUMMARY

- Before we close, I want to underscore a few key points

- NetApp is helping customers deliver enormous business value in both traditional IT leg, and increasingly, in cloud leg use cases
- Only NetApp has the strategy, the broad innovation portfolio, and customer experience to help customer succeed in hybrid multicloud IT
- We believe we can return to growth over time by selling the value of our differentiated portfolio and investing in additional sales capacity to reach new buyers
- As I saw at INSIGHT and Ignite, we are making real progress here
- We continue to be disciplined in our spending and have a strong financial model, with growing gross margins and operating margins that enable us to return cash to shareholders and invest in the long-term health of our business