

17-Feb-2016

NetApp, Inc. (NTAP)

Q3 2016 Earnings Call

CORPORATE PARTICIPANTS

Kris Newton
Vice President - Investor Relations

George Kurian
Chief Executive Officer & Director

Jeffrey K. Bergmann
Interim Chief Financial Officer

OTHER PARTICIPANTS

Steven Fox
Cross Research LLC

James Kisner
Jefferies LLC

Maynard J. Um
Wells Fargo Securities LLC

Rod B. Hall
JPMorgan Securities LLC

Sherri A. Scribner
Deutsche Bank Securities, Inc.

Brian J. White
Drexel Hamilton LLC

Amit Daryanani
RBC Capital Markets LLC

Mark Moskowitz
Barclays Capital, Inc.

Steven M. Milunovich
UBS Securities LLC

Kulbinder S. Garcha
Credit Suisse Securities (USA) LLC (Broker)

Aaron Rakers
Stifel, Nicolaus & Co., Inc.

James Dickey Suva
Citigroup Global Markets, Inc. (Broker)

Andrew James Nowinski
Piper Jaffray & Co (Broker)

Robert Hahn
Raymond James Financial, Inc. (Broker)

Srini S. Nandury
Summit Research

Brent Bracelin
Pacific Crest Securities

Simona K. Jankowski
Goldman Sachs & Co.

David Ryzhik
Susquehanna Financial Group LLLP

MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the NetApp third quarter fiscal year 2016 results conference call. At this time all participants are in a listen-only mode. Later we will conduct a question-and-answer session and instructions will be given at that time. [Operator Instructions] As a reminder, this call 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

Hello and thank you for joining us on our Q3 fiscal year 2016 earnings call. With me today are CEO George Kurian, and Interim CFO Jeff Bergmann. This call is being webcast live and will be available for reply on our website at netapp.com along with the earnings release, our financial tables and guidance, a historical supplemental data table and the non-GAAP to GAAP reconciliation.

As a reminder, during today's call we will make forward-looking statements and projections with respect to our financial outlook and future prospects, such as our guidance for the fourth quarter of fiscal year 2016 and for fiscal year 2017, our expectations regarding future revenue growth, improved profitability, cash flow, effective tax rate and shareholder returns, our expectations about our ability to drive operational and financial performance, and about the impact of the SolidFire acquisition and business, all of which involve risk and uncertainty.

Such statements reflect our best judgment based on factors currently known to us and are being made as of today. We disclaim any obligation to update our forward-looking statements and projections. Actual results may differ materially from our statements and projections for a variety of reasons, including the macroeconomic environment, the overall growth rate for IT, our ability to successfully pivot to the growth areas of the market, our ability to expand our operating margin, our ability to reduce our cost structure within the planned timeframe, and our ability to continue our capital allocation strategy and investment in strategic opportunities.

Please also refer to the documents we file from time to time with the SEC, specifically our most recent Forms 10-Q, our Form 10-K for fiscal year 2015, and our current reports on Form 8-K, all of which can also be found on our website. During the call all financial measures presented will be non-GAAP unless otherwise indicated.

I'll now turn the call over to George.

George Kurian

Chief Executive Officer & Director

Thanks, Kris. Good afternoon, everyone. Thank you for joining us. Our Q3 performance reflects our strong focus on operational execution as well as continued challenges from a number of headwinds. For the quarter, we achieved our margin and EPS targets. However, we recorded lower than expected revenue.

These mixed results reflect the impact of an uncertain and volatile macroeconomic environment which is causing a slowdown in spending that became more evident in January. Additionally, overall growth rates for enterprise IT remain under pressure as customers shift some of their spending to the cloud.

Despite these headwinds, we had a number of positives in the quarter. Our Data Fabric strategy and pivot toward the growth segments of the market, scale-out, software-defined, flash, converged, and hybrid cloud, continued to yield positive results.

Earlier this month we closed the SolidFire acquisition, positioning us to lead the rapidly growing all-flash array market. Before I go into greater depth on the progress we made in these areas, I want to spend time on the fundamental changes we are undertaking to return NetApp to revenue growth with improved profitability, cash flow, and shareholder returns.

On prior calls, I told you that I was driving a detailed inspection of the business. I have now concluded that formal review. Parts of our business are working well and growing, but we're managing through declines in other parts. We have many exciting, innovative, industry-leading products, strong relationships with customers and partners, and a large growing installed base.

NetApp does not need to completely reinvent itself, but we do need to execute comprehensive and sustained transformation to deliver on our commitment to return to revenue growth and enhance profitability and shareholder returns. We will take significant steps to streamline the business and further advance our pivot to the growth areas of the market in order to capture the full potential of NetApp.

To accomplish this, we've adopted a plan with several key priorities. First, we are focused on the strategic solutions that represent our pivot to the growth segments of the market and are the foundation of how we enable customers' success in the data-powered digital era. Second, we are substantially reducing cost and systematically streamlining the business even while investing for the future.

Third, we will provide greater visibility into the business and our revenue mix to demonstrate why we are so confident in our ability to capitalize on our strategic solutions. And fourth, we remain committed to our capital allocation strategy, which includes the combination of share repurchases, dividends, and investing for the long-term growth of the business.

Let's start with our strategic solutions. As a baseline, our focus remains in enabling our customers' success as they navigate through their own IT transformations which leverage modern architectures and hybrid solutions. Clustered ONTAP, branded E-Series, all-flash arrays, hybrid cloud solutions, and OnCommand Insight are the set of strategic solutions that are the basis of our pivot to the growth segments of the market.

The growth rate of our strategic solutions is strong, but as I've discussed, not yet sufficient to offset the headwinds from the mature areas of our business, OEM, ONTAP 7-Mode and add-on. We expect that these headwinds will lessen as we progress through fiscal year 2017. As we emerge from FY 2017, the transition to clustered ONTAP should be mostly behind us as will the downward pressure that the transition has put on our add-on storage business. As OEM and ONTAP 7-Mode become a smaller part of our mix, we anticipate that our pivot towards the growth areas of the market will return the company to revenue growth, albeit moderated.

During this transition period we will maintain a sharp focus on execution, reduce our cost base, and take additional steps to manage the trends in the storage industry. We will make transformational moves to become more focused, efficient and effective while fundamentally lowering the cost structure of the company even as we invest in strategic opportunities, which brings us to our second priority: cost control.

We will utilize disciplined portfolio management to improve productivity and better align resources with opportunities while simultaneously maximizing returns from the mature portions of our business. We must also streamline the business to increase our effectiveness and flexibility in responding to the rapidly changing markets.

All of this will expand operating margin. We have launched a comprehensive program to reduce the cost base of our business by \$400 million gross annually with run rate savings achieved by the end of fiscal year 2017.

We have already embarked on this initiative. We have made decisions that streamline our business such as consolidating our hardware engineering and manufacturing operations teams, implementing tighter controls on indirect spending, and improving supply chain efficiency. These actions and lower variable compensation enabled us to lower our Q3 operating expenses by 8% sequentially.

Today, we announced a restructuring and reduction in workforce of approximately 12% of total head count. This action will generate annualized run rate savings of approximately \$200 million against our gross target. We expect the majority of this workforce reduction to occur in fiscal Q4. As these cost efficiencies materialize, we are reinvesting some of these savings into strategic solutions like SolidFire and productivity improvements which will allow us to be more effective at a lower cost structure, yielding a net run-rate savings of roughly \$130 million by the end of fiscal year 2017.

We are taking a thoughtful approach to the reductions, employing disciplined portfolio management and fundamentally changing the way we operate. Savings will be achieved through business transformation, including operational process redesign, organizational restructuring and realignment, and further portfolio streamlining. We are also putting into place controls to ensure that these savings are sustained.

These transformational moves will better align our resources against the strategic opportunity and our cost structure to the near-term growth trajectory of the business. While we've been working to make our model more efficient for some time now, this comprehensive and sustained transformation will enable us to realize the benefit of our pivot to the growth areas of the market at a faster pace.

Looking past the streamlining and transformation phase into fiscal year 2018 and beyond, we will continue our focus on productivity and the improvements in efficiency will more substantially materialize. Our non-GAAP operating margins will improve towards the high end of our target range, inclusive of SolidFire.

By coupling the strength of our Data Fabric strategy and the benefits we deliver to customers with a more efficient and agile business, we can increase the value we generate for customers, partners, employees, and shareholders. Over time, we believe that the investments we've made in innovation and streamlining will enable us to grow at an accelerating pace with improved operating margin and cash flow.

Our third priority is transparency. The progress we've already made in our pivot towards the growth areas of the market has not been easy to measure from outside the company. To help provide visibility into this transition, we are providing greater clarity into the dynamics of our product revenue.

In Q3, our strategic solutions, clustered ONTAP, branded E-Series, all-flash arrays, hybrid cloud solutions, and OnCommand Insight, made up almost 55% of product revenue and grew 26% year-over-year. By contrast, product revenue from our mature solutions, OEM, ONTAP 7-Mode, and add-on, declined 40% year-over-year, predominantly from the declines in OEM and ONTAP 7-Mode.

In Q2 FY 2016, we reached a significant milestone when the revenue from strategic solutions exceeded that of the mature ones. In other words, the products with the higher aggregate growth profile are the bigger proportion of our product revenue. We are getting closer to a mix where our strategic solutions can drive a re-acceleration of the business. This shift in the composition of our product revenue is a good indicator of the progress we've made in our pivot to the growth areas of the market. This plus our strong software and hardware maintenance revenues create a solid foundation for NetApp.

The tight alignment between our strategic solutions and our customers' IT imperatives underscores our confidence that we will generate continued growth from this area of the business. As part of their IT modernization efforts, customers want scale-out and software-defined storage functionality for the efficient management of data growth.

Clustered ONTAP enables seamless data management across flash, disk, and cloud footprint, and across public and private clouds for enterprise applications regardless of the underlying hardware. Clustered ONTAP was deployed in almost 80% of FAS systems shipped in Q3, up from roughly 40% a year ago.

Unit shipments of clustered ONTAP systems saw strong continued customer demand, growing roughly 70% year-over-year. The clustered ONTAP transition acceleration program we put in place at the start of the year is feeding the migration of installed base customers who are ready to upgrade both their systems and their software from ONTAP 7-Mode to clustered ONTAP.

Our FAS installed base is growing and clustered ONTAP now represents 24% of installed systems. The installed base mix will continue to ship to clustered ONTAP but you should not expect a linear progression. These migrations are projects that must fit within the overall IT priorities and budgets of our customers, and we anticipate that the transition of the installed base will happen over the course of years. Both the total number of customers and new to NetApp customers who made clustered ONTAP purchases in Q3 grew by approximately 60% from Q3 last year.

Flash is becoming the de facto technology for primary workloads. Our EF all-flash arrays deliver the extreme performance for standalone applications that infrastructure buyers and application owners need. The all-flash FAS arrays have industry-leading data management services with a unified multi-protocol capability that appeals to infrastructure architects driving data center consolidations.

Customer demand for our all-flash arrays continues to grow. Our existing all-flash array business, inclusive of EF and all-flash FAS products and services, has accelerated to an almost \$600 million annual run rate. Through this strong foundation, we are excited to add SolidFire's unique scale-out block storage architecture that is compelling for the cloud architect, masterminding the next-generation data center.

With this acquisition, NetApp is the clear technology leader in the all-flash array market with the broadest portfolio of all-flash arrays in the industry, addressing the diverse needs of enterprises and service providers, which cannot be adequately met by the one-size-fits-all compromise approach of our competitors.

Our Data Fabric solutions are successfully positioning us to help customers with leading-edge cloud deployments. A leading software as a service provider in the Asia-Pacific region created a next-generation service for its customers utilizing NetApp Private Storage for Cloud, AltaVault and OnCommand Insight, connected to multiple hyperscale clouds for compute services. They provide an outstanding customer experience and an enterprise solution built on a single modern platform with a consistent look and feel without the risk of single cloud dependency.

By storing data on NetApp Private Storage, they can meet customer preference for a specific cloud provider as well as improve their ability to meet SLA guarantees by failing over to other clouds when the primary cloud is unavailable. The inherent efficiency of NetApp private storage also allows them to improve their profitability by effectively storing less data on tiers of flash, and creating rapid virtual copies for test and development during new customer acquisitions.

Additionally, they can satisfy regulators by proving where data resides at all times for government, financial services, and healthcare customers. This is a great example of what I've discussed in the past. Data is at the heart of the transformation our customers are going through to improve the efficiency of their businesses and better serve their customers.

At the same time, they're reducing IT budgets looking for simpler solutions and rethinking how they consume IT. This evaluation is diverting spend towards transformational projects and architectures, like scale-out, software-defined, flash, converged, and hybrid cloud, where our Data Fabric strategy gives us a compelling advantage. NetApp is the only company able to stand flash to disk to cloud and the only company delivering the ability to manage data across multiple clouds and on-premises today.

Finally, I want to briefly touch on capital allocation, our fourth priority. I'll let Jeff get into the details but, in short, we are fully committed to executing to our capital allocation programs and creating value for shareholders. We expect to complete our current share buyback authorization by the end of May 2018 as planned and remain committed to our dividend program.

I am more confident than ever in NetApp's potential. While we must manage through a dynamic IT market and declines in our mature solutions, we have a clear plan and a lot of positives. We have a large and growing installed base. Our Data Fabric strategy uniquely enables us to assist customers in achieving their strategic IT imperatives. Our strategic solutions are greater than 50% of product revenue and growing. We are making substantial progress in the transition to clustered ONTAP, and we've just expanded our comprehensive all-flash array portfolio.

We are keenly focused on our business model and managing our investments between our strategic and mature solutions. The changes we're making to streamline the business and reduce the cost structure will enable investment in strategic opportunities, while accelerating our ability to deliver shareholder value in the form of profitability and cash flow. We look forward to updating you on our progress next quarter.

I'll now turn it over to Jeff to take you through the numbers. Jeff?

Jeffrey K. Bergmann

Interim Chief Financial Officer

Thank you, and good afternoon to everyone. I'd like to start by thanking George and the NetApp board for the opportunity to step in as Interim CFO. It's an exciting time of transformation for NetApp as we streamline the business to become more focused and efficient and, at the same time, pivot the company toward growth areas of the market and take advantage of the opportunities in front of us.

The team is energized to leverage the strength of our strategic solutions to bolster the company and ultimately drive growth. We have made good progress to date and, as you heard from George, are committed to providing you with greater visibility into the dynamics of our business. With that said, let's move to the financial results for the third quarter of fiscal 2016.

I want to remind you that unless otherwise specified, I will be using non-GAAP metrics to discuss our financial results and guidance. Q3 net revenues of \$1.39 million were down about 4% sequentially and 11% year-over-year. While there were indicators of strength in our results such as clustered ONTAP traction and rapid all-flash array adoption, which drove growth in our strategic solutions, our revenue performance fell short of our expectations.

The shortfall was the result of a combination of the macroeconomic economic uncertainty George talked about that created the lengthening of deal cycles, greater than anticipated rate of decline in our mature business, a mix shift to deferred revenue, and FX headwinds of about three points year-over-year.

When we reiterated guidance in early January, our sales volume was in line with our forecast which assumed a backend-loaded quarter consistent with historical performance and as is typical in the industry. However, after a moderate calendar year budget flush, the macroeconomic environment worsened and we saw an increase in the deferred mix of our business over the course of the last two weeks of the quarter.

Product revenue declined 8% sequentially and 19% year-over-year. We saw higher-than-expected volume of software and hardware maintenance contract renewals, as some customers opted to delay equipment purchases. The combination of software maintenance and hardware maintenance and other services revenues was up 2% year-over-year.

Now, to provide some context and better visibility into our business model, I'd like to walk through how we think about the strategic solutions revenue and software and hardware maintenance revenues coming together to create a foundation from which we can build. Revenue from strategic solutions continues to show strong growth and, as George highlighted, is now more than 50% of our product revenue. The year-over-year decline in our mature solutions revenue is driving overall product revenue declines in the near term but the size and growth of the strategic solutions revenue gives us confidence in our strategy to drive overall product revenue growth in the future.

Looking at software and hardware maintenance revenues, I talked about the strength of our renewal business during the quarter and, as George said, 24% of our installed base is running on clustered ONTAP. While the product revenue declines will ultimately pressure software and hardware maintenance revenues, the lengthening of product life cycles, growth of our installed base, rapidly increasing mix of clustered ONTAP installed base, and high renewal volume creates support for future software and hardware maintenance revenues.

Indirect revenue accounted for 78% of net revenues. Gross margin was 63.1% in the third quarter, above our previous guidance, reflecting favorable mix partially offset by aggressive pricing. Product gross margin of 51.1% was down about 6 points year-over-year, reflecting about 2 points of FX and higher discounting. Software maintenance gross margin was roughly flat while hardware maintenance and other services gross margin was up about 2 points, largely reflecting higher contract revenue, as well as services infrastructure cost efficiencies.

Operating expenses of \$630 million decreased 12% year-over-year reflecting 3 points of FX benefit, lower head count and related compensation costs, and the early work toward driving greater efficiency across the business, as George mentioned in his opening remarks. Operating margin of 17.6% was almost a point above our guidance.

Our effective tax rate was 14.9% and lower than our previous guidance, which reflects a change in the geographic mix of profits and its cumulative year-to-date impact. We expect our effective tax rate for Q4 to be approximately 16%. Our weighted average diluted share count for the third quarter was 296 million shares. Earnings per share was \$0.70 within our guidance range.

Moving on to cash and balance sheet metrics, we ended the quarter with approximately \$5 billion in cash and short-term investments with approximately 12% held by our domestic entities. Deferred and finance unearned services revenue increased \$80 million sequentially and \$16 million year-over-year. Inventory turns increased to 20 and DSO was at 38 days.

We generated \$355 million in cash flow from operations during the quarter, up 29% year-over-year. Free cash flow of \$314 million was about 23% of net revenues, up 217% sequentially and 28% year-over-year. We expect free cash flow as a percentage of revenue for Q4 to be slightly above 20%.

Now I'd like to discuss share repurchases for a moment. In Q3, we repurchased approximately \$85 million of our stock. This was less than we would have liked, due to the events such as the SolidFire transaction which reduced the number of days we could be on the market. However, as George noted, we remain fully committed to completing our \$2.5 billion share repurchase program by the end of May 2018, with 262 million as remaining by the end of May 2016.

Additionally, we paid \$52 million in cash dividends in the third quarter. Today, we also announced next cash dividend of \$0.18 per share of the company's common stock, which will be paid on April 27, 2016. Overall, we are confident in our allocation of capital between growth initiatives and shareholder returns as we continue to execute on our transformation strategy.

Looking forward to guidance, giving the increasingly uncertain macroeconomic environment, continued shifts in enterprise IT spending, and our own work in transforming the company, we are tempering our forecast. For the fourth quarter, we are forecasting a revenue range of \$1.35 billion to \$1.5 billion. Given the aggressive pricing environment, we expect gross margins to decline to approximately 61.5% driven by higher discounting, which will be partially offset by cost-saving initiatives.

Looking at operating margin, we are transforming the company in order to streamline the business, improve efficiency, become more focused, and enhance our ability to rapidly address the changing market. Our initiatives will fundamentally change the way we do business by centralizing similar activities across functions, optimizing geographic location resources, and consolidating suppliers. We are better positioning NetApp for near and long-term success while reducing our cost structure across both cost of revenues and OpEx and ensuring that the changes we make are sustainable.

To minimize disruption, the pace of these changes will be dictated by the company's preparedness for each transformative initiative. As George mentioned, we're driving to achieve a gross run rate savings of \$400 million by the end of fiscal 2017, which will include the previously announced discontinuance of our flash array product line.

We plan to use these cost savings to minimize erosion of margins in a price competitive environment. We will reinvest some of the gross savings into strategic opportunities, such as SolidFire and productivity improvements, yielding a net run rate savings of roughly \$130 million by the end of fiscal 2017. While George touched upon several of the initiatives that are already underway, we will provide more specifics around additional initiatives as they are executed.

As a step towards lowering our cost and rewiring the company, we will initiate a head count reduction of approximately 12% during the fourth quarter. We expect to realize Q4 savings of just over \$30 million, resulting in a Q4 operating margin of approximately 15% and an earnings per share target range of \$0.55 to \$0.60 for the fourth quarter, including the impact of the SolidFire acquisition. We expect a GAAP restructuring charge of approximately \$60 million to \$70 million in Q4 relating to this action.

Finally, to help with your models, I'd like to provide some color around the impact of SolidFire on our outlook. As you know, the acquisition closed on February 2. We funded the transaction through a short-term loan of \$870 million. We intend to integrate SolidFire into our global operating structure and expect to retire the acquisition

debt with our global earnings by the beginning of Q3 FY 2017. In Q4, we expect SolidFire to reduce operating margin by about 3 points, resulting in an operating margin of approximately 15%.

Looking forward to FY 2017, we expect our strategic plans for SolidFire to contribute about two points of revenue growth and be dilutive to operating profit by about two points into earnings per share by \$0.28 to \$0.30. This is at the high end of the guidance range that we gave you on the acquisition call, as that range included the benefit of the flash array discontinuance, which we are now reporting as part of the overall cost reduction plan. We anticipate that SolidFire will be accretive in FY 2018.

The IT environment is changing rapidly and we've provided a lot of additional content to give you more insight into how it's impacting us and the actions we're taking to adapt. Let me summarize the four themes around this transformation that I want to ensure that you take away from this call.

First, underlining our top line results, there is a strategic business that is material and growing. Second, we are significantly reducing the cost structure of our core NetApp business aligning our resources to market opportunities, which will expand operating margin.

Third, we are committed to providing greater transparency and visibility into our business. And fourth, we're committed to our capital allocation strategy of providing a meaningful dividend that grows over time and executing a robust share repurchase program while investing in the long-term growth of the business.

With that, I'd like to hand it back to Kris to open the call for Q&A. Kris?

Kris Newton

Vice President - Investor Relations

We'll now open up the call for Q&A. Please be respectful of your peers and limit yourself to one question so we can get to as many people as possible. Thank you for your cooperation. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question comes from the line of Steven Fox of Cross Research. Your line is now open.

Steven Fox

Cross Research LLC

Q

Thanks, good afternoon. George, just on the cost savings initiatives and the \$400 million total, can you sort of flip that versus what you just announced? In other words, how much of the 400 million was realized to date? I assume that's a gross number so if you net that out, what were the savings? And then specifically where were you getting them from? And along those lines, I guess, there's some product mix issues that are helping you as well. Can you address that in terms of just how your margins are benefiting? Thanks very much.

George Kurian

Chief Executive Officer & Director

A

Okay, the total program is a comprehensive program that encompasses across-the-board business process redesign, organizational restructuring and realignment and further streamlining of the portfolio. The total dollar savings that we are going after, the gross savings between the end of Q3 fiscal 2016 and the end of fiscal 2017 is a gross number of \$400 million in cost savings. The first step in that program is the restructuring action that we are announcing today and which will be complete in Q4. Within Q4, we will be recording about \$30 million of savings from the action itself which, over a full year annualized run rate, is about \$200 million.

Kris Newton

Vice President - Investor Relations

A

Thanks, Steve. Next...

Steven Fox

Cross Research LLC

Q

Just to be clear, that's without any kind of mix benefits, that's just the whole cost going forward, and then the mix is separate.

George Kurian

Chief Executive Officer & Director

A

That's correct. That's right.

Steven Fox

Cross Research LLC

Q

Okay. Great.

Kris Newton

Vice President - Investor Relations

A

All right, thanks again, Steve. Next question.

Operator: Our next question comes from the line of James Kisner of Jefferies LLC. Your line is now open.

James Kisner

Jefferies LLC

Q

All right, thanks very much. You said that 55% of your product revenue I think in Q3 was strategic solutions. I'm just wondering what you – could you share some rough thoughts on what you think the composition might be as you exit fiscal 2017 that gives you confidence that you'll be set up to return to revenue growth in FY 2018? Thanks.

George Kurian

Chief Executive Officer & Director

A

I think as we indicated, we are providing greater visibility into the product mix between our mature products and our strategic products. I think we've also given you the size and relative growth rates of each of those categories. We're not going to provide guidance beyond that in terms of the specific buckets.

Add-on storage, just to be clear, is not going to go to zero from the mature bucket. From the mature bucket, the declines are primarily from 7-Mode and OEM. The Add-on piece of the mature bucket is essentially going through a transition from 7-Mode to clustered ONTAP and so will be the majority of the mature bucket going forward.

Kris Newton

Vice President - Investor Relations

A

All right, thanks, James. Next question.

Operator: And our next question comes from the line of Maynard Um of Wells Fargo. Your line is now open.

Maynard J. Um

Wells Fargo Securities LLC

Q

Hi. I just wanted to make sure I understood the use of cash. I understand that you're still committed to the capital allocation program, but should we anticipate that you'll pause the share repurchase as you focus on paying down the debt? And it also feels like you have a broad portfolio to address the growth areas of the market. So should we read into those comments that a use of cash wouldn't be to do further M&A? Thanks.

Jeffrey K. Bergmann

Interim Chief Financial Officer

A

So we do plan to resume our stock repurchase activity in the quarter. Our stock price obviously is attractive at these levels and we will look forward to be opportunistic. I would say that in terms of M&A, we are really focused on integrating SolidFire and so our focus will be to invest in that area rather than focus a M&A at this point.

Kris Newton

Vice President - Investor Relations

A

All right, thanks, Maynard. Next question.

Operator: Our next question comes from the line of Rod Hall of JPMorgan. Your line is now open.

Rod B. Hall

JPMorgan Securities LLC

Q

Yeah, hi, guys, thanks for taking my question. I just wanted to circle back to these percentages of strategic and mature revenue that you guys talk about in the growth rates. I guess if I assume that the balance of the revenue,

the 55%, is mature and I just multiply by growth rates, I get the wrong number. So I'm wondering if you could help us kind of reconcile the percentages in growth rates back to the reported product revenue growth rate so that we understand, is there another segment in there you're not talking about and what is the growth rate in that segment? And then I have one follow-up as well.

George Kurian

Chief Executive Officer & Director

A

The product revenue numbers essentially are broken out in 100% between the mature pieces and the strategic pieces. I will tell you that in the mature pieces, you should be cognizant of the fact that the declines are primarily in the 7-Mode and the OEM pieces of the bucket. The add-on storage numbers are essentially a large percentage of the mature bucket and they are not deteriorating at the rate of 7-Mode or OEM.

They're essentially going through the transition from 7 to clustered ONTAP and so will be a relatively stable business, will also be affected by the trends of disk to flash, but I would just tell you that 100% of our product revenues are either categorized as mature or strategic.

Rod B. Hall

JPMorgan Securities LLC

Q

Okay, George, just on my follow-up, if you multiply the thing out, so 55% product revenue by 26% growth and then the remaining 45% by a 40% decline you get like a 4% decline, which isn't the same thing that you guys reported. So maybe offline you guys could elaborate or later in the call. And then it would also be helpful if you could give those growth rates that you called out for this quarter last quarter so we can see the trajectory, like are we seeing stabilization of the decline in the mature stuff? Thanks.

Jeffrey K. Bergmann

Interim Chief Financial Officer

A

Yeah, Rod, this is Jeff, real quickly, I think the reason why the math may not work is the percentages that we're calculating are based upon our gross revenue for those product lines that fit within mature and strategic.

Rod B. Hall

JPMorgan Securities LLC

Q

Great, thanks.

Kris Newton

Vice President - Investor Relations

A

All right, thanks, Rod. Next question.

Operator: Our next question comes from the line of Sherri Scribner of Deutsche Bank. Your line is now open.

Sherri A. Scribner

Deutsche Bank Securities, Inc.

Q

Hi, thank you. I just want to clarify, I think you said that the all-flash array business was now for you \$600 million run rate, which I assume does not include SolidFire, and how much SolidFire revenue are you expecting or including in the guidance for fiscal 4Q? Thanks.

Jeffrey K. Bergmann
Interim Chief Financial Officer

A

So the \$600 million-dollar run rate on the flash business is just EF and our AFF product lines. That doesn't include SolidFire. We just have minimal revenue planned in Q4 for SolidFire in our plan.

Sherri A. Scribner
Deutsche Bank Securities, Inc.

Q

Thank you.

Kris Newton
Vice President - Investor Relations

A

Thanks, Sherri. Next question.

Operator: Our next question comes from the line of Brian White of Drexel Hamilton. Your line is now open.

Brian J. White
Drexel Hamilton LLC

Q

Yeah, you talked about business slowing a bit at the end of January. Maybe you can just walk us around the world and give us a view of what you're seeing by geography and also by vertical. Thank you.

George Kurian
Chief Executive Officer & Director

A

Okay. So our business reflected the general commentary in the market about the macro. Asia-Pacific, particularly the economies dependent on China as well as Japan saw pretty choppy business in January. Certainly sectors like oil and gas and countries that are dependent on oil and gas were also affected. The service provider business in the U.S. is down as many telcos are divesting of their cloud businesses and reevaluating their approach to the data center business. And as we noted before, 2015 has been a year where the U.S. Fed has lowered IT spending as well as shifted priorities within their spending envelope to initiatives such as cyber security and some on the cloud.

Kris Newton
Vice President - Investor Relations

A

Thanks, Brian. Next question?

Operator: Our next question comes from the line of Amit Daryanani of RBC Capital Markets. Your line is now open.

Amit Daryanani
RBC Capital Markets LLC

Q

Thanks, good afternoon, guys. Just on the strategic piece of the revenue, growing 20% plus based on the gross numbers, can you just talk about – do you have a sense of how much of this is potentially just cannibalizing your own legacy or mature piece of business versus what's net new? And then the strategic bucket itself, do you think it's margin and free cash flow accretive versus the overall business or is that dilutive to your model?

George Kurian
Chief Executive Officer & Director

A

Let me just, first of all, in terms of clustered ONTAP, the net new to NetApp customers and total customers on clustered ONTAP grew strongly, 60% year-on-year. So we are winning more than our fair share of both new customers as well as transformational activity within our existing customers using our strategic solutions. I would say the EF-Series, the all-flash arrays are also primarily growing in parts of the market that we historically did not serve, the high-performance fiber channel segment of the market. So we feel good about the new solutions allowing us to get wallet share in both existing customers as well as net new to NetApp customers.

Jeffrey K. Bergmann
Interim Chief Financial Officer

A

So, and this is Jeff, just to add on the margin, we think that the shift between the mature and the strategic is pretty much neutral in terms of gross margin.

Kris Newton
Vice President - Investor Relations

A

All right, thanks, Amit. Next question.

Operator: Our next question comes from the line of Mark Moskowitz of Barclays. Your line is now open.

Mark Moskowitz
Barclays Capital, Inc.

Q

Yes, thank you. I want to talk maybe bigger picture. Just given this kind of perennial cost cutting, and kind of almost a morale busting job force reduction announcement today, are you signaling, despite your optimism around some of these strategic imperatives, that longer-term, the storage market is going to decrease and compress for other reasons outside of your control, whether it's from cloud displacement or just because of data reduction technologies? Because I'm just trying to reconcile some of your optimism around why you're going to cut more muscle from the bone.

George Kurian
Chief Executive Officer & Director

A

We are going through, as I indicated on the call, we are going through a transition in our business from the traditional to the strategic segments of our business. We feel very good about the strategic portions of our business growing double digits. At the same time, we want to manage the business responsibly as we go through the transition, and set up the company to be able to generate margins and shareholder returns in a moderated growth environment.

We are not sacrificing investments in growth areas. For example, we will continue to invest in our all-flash arrays. We continue to invest in clustered ONTAP acceleration. We continue to invest in strategic solutions like SolidFire, and our hybrid cloud solutions. We're just getting much more focused on the company as a company on the parts of the market that are really growing.

Jeffrey K. Bergmann
Interim Chief Financial Officer

A

Yeah, Mark, I would just add real briefly on that that we've done a pretty extensive analysis on our operating model and compared ourselves to top-performing companies. And this is really about aligning ourselves with the profile that we need to address the market going forward and feel confident in where we're ending up.

Kris Newton

Vice President - Investor Relations

All right. Thanks, Mark. Next question.

A

Operator: Our next question comes from the line of Steve Milunovich of UBS. Your line is now open.

Steven M. Milunovich

UBS Securities LLC

Thank you. George, you kind of positioned the recovery beginning in 2018, so I know it's premature perhaps, but when you think about 2017, it sounds like you might be kind of in a mid teens operating margin, you're going to have some SolidFire revenue, so I don't know, revenue maybe flattish to slightly down. Just curious if you're prepared to make any broad comments about what 2017 look like before things accelerate into 2018.

Q

George Kurian

Chief Executive Officer & Director

We're not going to provide any comments and guidance on 2017. We'll give you that when we're ready to do so. Right now, we're focused on streamlining the business and doing so in a responsible fashion so that we can manage the risk, but also make sure that we can take the strategic actions that set us up for a better productivity model going forward.

A

Steven M. Milunovich

UBS Securities LLC

Do you view it as a transition year?

Q

George Kurian

Chief Executive Officer & Director

2017, as I said, if you do the evaluation of our strategic solutions and our mature parts of the portfolio, we still have some transition ahead of us.

A

Kris Newton

Vice President - Investor Relations

Thanks, Steve. Next question, please.

A

Operator: Our next question comes from the line of Kulbinder Garcha of Credit Suisse. Your line is now open.

Kulbinder S. Garcha

Credit Suisse Securities (USA) LLC (Broker)

Thanks. I just had a clarification, please. On the \$400 million of cost savings, is it right to think \$200 million OpEx and \$200 million of cost of goods sold? Just a round clarification. And then, my deeper question is...

Q

Kris Newton

Vice President - Investor Relations

Kulbinder, we can barely hear you.

A

Kulbinder S. Garcha

Credit Suisse Securities (USA) LLC (Broker)

Sorry, can you hear me now?

Q

Kris Newton

Vice President - Investor Relations

Yes.

A

Kulbinder S. Garcha

Credit Suisse Securities (USA) LLC (Broker)

Okay. My question is on the \$400 million of cost savings, how does that split between OpEx and COGS?

Q

George Kurian

Chief Executive Officer & Director

We'll tell you once we get through the cost savings approach. As I said, we've got programs in flight, some of which are already in flight. Some of which have been part of the Q4 restructuring action. We'll give you more detailed updates as we execute the transformation program.

A

Jeffrey K. Bergmann

Interim Chief Financial Officer

Yeah, just to add a little color to that, the \$400 million is really – we expect to accomplish that during FY 2017, and part of Q4, so that's really a run rate exit level for FY 2017.

A

Kris Newton

Vice President - Investor Relations

Thanks, Kulbinder.

A

Operator: And our next question comes from the line of Aaron Rakers of Stifel. Your line is open.

Aaron Rakers

Stifel, Nicolaus & Co., Inc.

Yeah, thanks for taking the question. I want to go into the revenue a little bit. As you guys go through this transformation, it looks like you still have about a high 30%, kind of 40% contribution of your revenue coming off the balance sheet, software entitlement maintenance as well as the maintenance service revenue. So as you see the declines in your traditional or mature businesses, how are we to think about the progression of that revenue as we look into fiscal 2017? Thank you.

Q

George Kurian

Chief Executive Officer & Director

First of all, I'll let Jeff provide some more details, but our installed base is growing. The installed base of systems that are under maintenance contracts with NetApp is growing, both reflecting a longer lifespan of utilization of existing systems and their strategic values serving high performance, data rich applications in our customers, but also the fact that our strategic solutions are growing. So our overall installed base of systems is growing, which is supportive of the fact that our maintenance revenues are strong.

A

Jeffrey K. Bergmann
Interim Chief Financial Officer

A

Yeah, I would just add to that we just think that that provides us a strong foundation for that revenue stream. We clearly have an installed base that's growing. And with cDOT at 24% and growing, we think that gives us confidence in that as we move forward.

Kris Newton
Vice President - Investor Relations

A

Thanks, Aaron. Next question.

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

James Dickey Suva
Citigroup Global Markets, Inc. (Broker)

Q

Thank you very much. Can you help us understand how we should quantify or measure the milestones of the SourceFire (sic) [SolidFire] (47:15) acquisition, whether that be profitability or breakeven of earnings or revenues? How can we measure the integration? And do you actually have a timeline for breakeven.

George Kurian
Chief Executive Officer & Director

A

SolidFire will be accretive in fiscal year 2018. We'll provide more insight into the program as we integrate them, and as we lay out our plans for fiscal year 2017. But at the moment, we see that SolidFire will be accretive in fiscal year 2018.

James Dickey Suva
Citigroup Global Markets, Inc. (Broker)

Q

Great. Thank you very much.

Kris Newton
Vice President - Investor Relations

A

Thank you. Next question, please.

Operator: Our next question comes from the line of Andrew Nowinski of Piper Jaffray. Your line is now open.

Andrew James Nowinski
Piper Jaffray & Co (Broker)

Q

All right. Thanks. So sorry if I missed it, but can you give us any color on your new customer growth relative to prior quarters? Because that may give us a better sense of how compelling clustered ONTAP is relative to some of the other next-gen vendors like Nutanix and Tintri and others. Thanks.

George Kurian
Chief Executive Officer & Director

A

We've got good growth quarter-on-quarter as well as year-on-year. As I said, year-on-year, net new to NetApp as well as cDOT customers in aggregate grew 60% year-on-year. And so we feel good about both expanding footprint in existing customers as well as access to net-new customers. SolidFire, for example, allows us to be able to be

competitive in customer environments that have historically valued the extreme simplicity as well as the efficiency of hyper conversion environments. We've seen good success with SolidFire's base of customers that are able to meet that design point so we think that both clustered ONTAP and SolidFire give us good footprints in both traditional as well as emerging categories.

Andrew James Nowinski
Piper Jaffray & Co (Broker)

Q

Thanks.

Kris Newton
Vice President - Investor Relations

A

Thanks, Andrew. Next question.

Operator: And our next question comes from the line of Brian Alexander of Raymond James. Your line is now open.

Robert Hahn
Raymond James Financial, Inc. (Broker)

Q

Hi, this is actually Bob Hahn calling in for Brian. Just wanted to ask a quick question regarding your 7-Mode installed base. I know last quarter, you mentioned that Q2 marked the first time that you did not experience growth in the 7-Mode installed base. And I was wondering if that installed base is now declining, and do you think you'll be able to convert over a lot of these customers or how confident are you that you can convert over these customers over time? Thanks.

George Kurian
Chief Executive Officer & Director

A

The aggregate installed base of 7-Mode and clustered ONTAP FAS systems is actually growing. So we feel good not only about the overall installed base, but if you think about the percentage of the installed base that is clustered ONTAP, it's at 24%, up from 17% a quarter ago. So strong growth in terms of the installed base and execution. I will tell you that the pace of those transitions are IT projects in our customer environments, right? And so to the extent that enterprise IT spending overall is pressured, there will be some practical moves that customers might make to just stay on 7 for a period of time before they cut over.

The programs that we initiated at the start of the year, clustered ONTAP, acceleration program, have seen strong growth. We've already exceeded our expectations for the year with that program in terms of customers, the total volume of transactions, as well as the number of resellers engaged in moving customers. So we feel good.

Kris Newton
Vice President - Investor Relations

A

Thanks, Bob. Next question.

Operator: Our next question comes from the line of Srinu Nandury of Summit Research. Your line is now open.

Srinu S. Nandury
Summit Research

Q

All right. Thank you for taking my call. Can you talk about the competitive environment, who is being aggressive and what's your outlook for the startups who are competing in the space?

George Kurian

Chief Executive Officer & Director

A

I would say that the competitive environment, we've seen some more price discounting from select players in the market. We think that the dynamic of them discounting is relatively unchanged. HP, HDS, they are the key players that lack the innovation value so they are being aggressive on price to compete. We don't see much change from the startups. I think Nimble has continued to retrench mostly into the SMB market. Pure is unchanged in terms of its competitive stance, and EMC is challenged with the transaction that they are about to undertake. So we do see some opportunities where we have been able to take footprint from EMC, given the lack of clarity in terms of their roadmap going forward.

Kris Newton

Vice President - Investor Relations

A

Thanks, Srimi.

Srini S. Nandury

Summit Research

Q

Thanks, guys.

George Kurian

Chief Executive Officer & Director

A

Thank you.

Operator: Our next question comes from the line of Brent Bracelin of Pacific Crest Securities. Your line is now open.

Brent Bracelin

Pacific Crest Securities

Q

Thanks. George, I had a follow-up on the mature product segment. As you think about that 44% decline that you saw this quarter, how much would you attribute to a pause, macro-related concern versus a more accelerated shift towards this industry transitioning to flash and cloud? If you could help us parse out that decline and how much of it is kind of a change in the environment in the demand environment versus more of an acceleration to these transitions?

George Kurian

Chief Executive Officer & Director

A

I would say there was certainly a percentage of it that was, rather than doing technology refresh, it was basically moved towards a maintenance contract or a service agreement that said, hey, I'm going to wait until I see what happens in the macro before undertaking the big project. I don't think that represents a shift to the cloud. It's just, I'm not ready to take on a major capital project at this point in time, is much more of the discussion thread there.

I think in terms of the migrations from our existing platforms to solid state, I would say the strength of our solid state portfolio is not just a transition from our existing footprint, right? We are actually getting a lot of new

customers because the majority of our footprint is essentially, with solid state arrays, is in high-performance fiber channel environments that we historically did not have a big landscape in.

So I would say that some of the declines are from pauses. Some of them are from our natural migrations to clustered ONTAP. And some of it is essentially going through a period of, I've got enough things going on in my business where I've acquired new platforms and I'm waiting to consume them.

Kris Newton

Vice President - Investor Relations

A

All right, thanks, Brent. Next question.

Operator: Our next question comes from the line of Simona Jankowski of Goldman Sachs. Your line is now open.

Simona K. Jankowski

Goldman Sachs & Co.

Q

Hi, thank you very much. I think you've said that you had a \$600 million run rate in the flash product, and on the call in December I think you cited \$370 million, which would imply about 60% quarter-on-quarter growth. I just wanted to clarify that I've got that correctly. And then in terms of my question, I wanted to ask about your strategy for addressing the hyper-converged segment of the market, thank you.

George Kurian

Chief Executive Officer & Director

A

Yeah, first of all, your analysis is correct, Simona, on the sequential growth rate. The second is in terms of the hyper-converged market, we see what customers really want is essentially simplified provisioning and operational management, a relatively simple pay as you go building block architecture, and you will see us address those customer needs with both the SolidFire architecture, which is built with a scale-out, simplified design right out of the get-go as well as some exciting new innovations in the FlexPod lineup.

Kris Newton

Vice President - Investor Relations

A

Thanks, Simona, next question.

Simona K. Jankowski

Goldman Sachs & Co.

Q

Thank you.

Operator: And our final question comes from the line of Mehdi Hosseini of Susquehanna Financial. Your line is now open.

David Ryzhik

Susquehanna Financial Group LLLP

Q

Hi. Thanks for taking the question. This is David Ryzhik for Mehdi Hosseini. Just going through April guidance – April quarter guidance for gross margins, it looks like it's down 200 basis points quarter over quarter and it seems like higher discounting is the reason, but earlier on the call you mentioned the dynamics of discounting is unchanged. So just wanted to clarify, does this mean that pricing pressure has basically accelerated in the April

quarter and did we anticipate that in both the strategic and mature or mostly on the mature segment of the business? Thanks.

George Kurian

Chief Executive Officer & Director

A

These are year-on-year numbers. I think we're being cautious about the mix. We're being cautious about the macroeconomic environment and typically the discounting behavior in our year-end quarter.

Jeffrey K. Bergmann

Interim Chief Financial Officer

A

And just there's also just an unfavorable product mix involved in that as well.

Kris Newton

Vice President - Investor Relations

Thanks, Mehdi. I'm going to pass it over to George for some final comments.

George Kurian

Chief Executive Officer & Director

In closing, let me reiterate my confidence in NetApp's potential. We have a lot of positives with our strategic solutions that are the foundation of how we enable customer success in the data-powered digital era. We have a large and growing installed base. Our Data Fabric strategy uniquely enables us to assist customers in achieving their strategic IT imperatives. Our strategic solutions are greater than 50% of product revenue and growing. We are making substantial progress in the transition to clustered ONTAP, and we've just expanded our comprehensive all-flash array portfolio.

While we must manage through a dynamic IT market and declines in our mature solutions, we have a clear plan to drive long-term growth and profitability. We are focused on driving continued growth of the strategic solutions. We are substantially reducing cost and systematically streamlining the business. We are providing greater transparency to give you better visibility into the basis of our confidence and, finally, we remain committed to our capital allocation strategy.

Thank you. I look forward to giving you further updates next quarter.

Operator: Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program. You may all disconnect. Everyone, have a great day.

Disclaimer

The information herein is based on sources we believe to be reliable but is not guaranteed by us and does not purport to be a complete or error-free statement or summary of the available data. As such, we do not warrant, endorse or guarantee the completeness, accuracy, integrity, or timeliness of the information. You must evaluate, and bear all risks associated with, the use of any information provided hereunder, including any reliance on the accuracy, completeness, safety or usefulness of such information. This information is not intended to be used as the primary basis of investment decisions. It should not be construed as advice designed to meet the particular investment needs of any investor. This report is published solely for information purposes, and is not to be construed as financial or other advice or as an offer to sell or the solicitation of an offer to buy any security in any state where such an offer or solicitation would be illegal. Any information expressed herein on this date is subject to change without notice. Any opinions or assertions contained in this information do not represent the opinions or beliefs of FactSet CallStreet, LLC. FactSet CallStreet, LLC, or one or more of its employees, including the writer of this report, may have a position in any of the securities discussed herein.

THE INFORMATION PROVIDED TO YOU HEREUNDER IS PROVIDED "AS IS," AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, FactSet CallStreet, LLC AND ITS LICENSORS, BUSINESS ASSOCIATES AND SUPPLIERS DISCLAIM ALL WARRANTIES WITH RESPECT TO THE SAME, EXPRESS, IMPLIED AND STATUTORY, INCLUDING WITHOUT LIMITATION ANY IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, ACCURACY, COMPLETENESS, AND NON-INFRINGEMENT. TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, NEITHER FACTSET CALLSTREET, LLC NOR ITS OFFICERS, MEMBERS, DIRECTORS, PARTNERS, AFFILIATES, BUSINESS ASSOCIATES, LICENSORS OR SUPPLIERS WILL BE LIABLE FOR ANY INDIRECT, INCIDENTAL, SPECIAL, CONSEQUENTIAL OR PUNITIVE DAMAGES, INCLUDING WITHOUT LIMITATION DAMAGES FOR LOST PROFITS OR REVENUES, GOODWILL, WORK STOPPAGE, SECURITY BREACHES, VIRUSES, COMPUTER FAILURE OR MALFUNCTION, USE, DATA OR OTHER INTANGIBLE LOSSES OR COMMERCIAL DAMAGES, EVEN IF ANY OF SUCH PARTIES IS ADVISED OF THE POSSIBILITY OF SUCH LOSSES, ARISING UNDER OR IN CONNECTION WITH THE INFORMATION PROVIDED HEREIN OR ANY OTHER SUBJECT MATTER HEREOF.

The contents and appearance of this report are Copyrighted FactSet CallStreet, LLC 2016 CallStreet and FactSet CallStreet, LLC are trademarks and service marks of FactSet CallStreet, LLC. All other trademarks mentioned are trademarks of their respective companies. All rights reserved.