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NetApp, Inc. (NTAP)

Q4 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, ladies and gentlemen. Welcome to the NetApp Q4 and Fiscal Year 2021 Earnings Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session and instructions will be given at that time.

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

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

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

During today's call, we will make forward-looking statements and projections with respect to our financial outlook and future prospects such as our guidance for the first quarter and fiscal year 2022, our expectations regarding future revenue profitability and shareholder returns, and our ability to continue overall growth, gain market share and scale our cloud business, all of which involve risk and uncertainty. We disclaim any obligation to update our forward-looking statements and projections. Actual results may differ materially for a variety of reasons including macroeconomic and market conditions such as the continuing impact and uneven recovery of the COVID-19 pandemic and the IT capital spending environment as well as our ability to gain share in the storage market, grow our cloud business and generate greater cash flow.

Please also refer to the documents we file from time to time with the SEC and available on our website, specifically our most recent Forms 10-Q and 10-K including in the management's discussion and analysis of financial condition and results of operations and Risk Factors sections. During the call, all financial measures presented will be non-GAAP unless otherwise indicated. Reconciliations of GAAP to non-GAAP estimates are posted on our website.

I'll now turn the call over to George.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

Thanks, Kris. Good afternoon, everyone. Thank you for joining us today. Before we get started, I want to take a minute to acknowledge that it's been over a year that we have all been working remotely. I'm encouraged by the public health and economic improvements in many parts of the world, but the recovery is uneven. As you know, we have a large team in India. Our thoughts are with them, as they deal with a distressing surge in COVID cases. Thank you to the entire NetApp team for your dedication, focus and execution throughout this challenging year.

Now, to the results of the quarter. We delivered strong fourth quarter results, capping off a solid year of growth. Our results were all above our Q4 guidance ranges. I am most excited by the return of product revenue to growth, the strength of our public cloud ARR, and an all-time high free cash flow. Our performance was broad-based, as certain verticals, the US, and parts of Europe and Asia are recovering faster than many expected. Cloud and digital transformation initiatives have been accelerated by the pandemic and companies look to NetApp to support these key initiatives.

Going into FY 2021, we had two clear priorities: returning to growth in our storage business powered by share gains from our industry-leading file, block and object software; and scaling our highly differentiated public cloud services business. As I reflect on the past year, I'm proud of what we've achieved during a globally challenging period. We remain focused in executing our strategy and extending our innovation. In Q4, product revenue grew 6% and our all-flash array business grew 11% year-over-year. Based on our growth, I'm confident that we have gained share in the storage and all-flash markets.

We advanced our hybrid cloud portfolio with the introduction of ONTAP 9.9 and Astra. This innovation will support continued product revenue growth and share gains through fiscal year 2022. Additionally, we continue to make good progress with Keystone with many new wins, including our largest ever Keystone deal. We are reaching more customers than ever before with our public cloud business. Over the course of fiscal year 2021, we added approximately 1,500 new-to-NetApp customers with public cloud services and grew our total cloud customer count by 137% from Q4 fiscal year 2020.

In addition to adding new cloud customers, existing cloud customers are expanding their spend with us. Our dollar-based net revenue retention rate increased to 252% in the fourth quarter. Cloud Volumes, Cloud Insights and Spot, all performed well in the quarter, driving our public cloud services ARR to $301 million exiting fiscal year 2021, an increase of 171% year-over-year. As we have said repeatedly, our cloud strategy strongly advantages NetApp. I'll use a customer example to illustrate how cloud helps us to acquire new customers and drive growth in our on-premises solutions.

As a part of its digital transformation strategy, a leading car manufacturer decided to migrate workloads from its on-premises data centers to the Azure cloud. Despite never having used NetApp previously, the customer chose NetApp Cloud Volumes to host its file-based data and NetApp Cloud Sync to rapidly move data from its Dell EMC systems to the cloud. In addition to delivering a high-performance data store in the cloud, Cloud Volumes provides out-of-the box cross-region replication of production data to a secondary cloud environment, high availability to meet the service-level requirements of critical applications, and cost savings through automatic tiering to Azure Blob Storage.

Because of the breadth and depth of the value NetApp delivered, the customer is now looking to deploy a hybrid cloud environment and plans to use NetApp on-premises, as well as increase its NetApp usage in the public cloud. As I noted earlier, the pandemic accelerated and elevated the importance of customers' cloud and digital transformation initiatives. We expect that this trend will be ongoing and that NetApp will continue to benefit from it. Customers appreciate the value we bring as a cloud-led, data-centric software company to simplify and modernize existing data centers, to quickly and confidently deploy applications, and to securely manage data on the public cloud.

We have long been recognized for our industry-leading enterprise data management technology. Our cloud solutions drive further differentiation, expand our addressable market, and enable us to reach new customers. We began our cloud journey seven years ago, with the introduction of Cloud ONTAP, now Cloud Volumes ONTAP. Our initial focus was to leverage the cloud to deliver backup and disaster recovery services to our installed base. We saw that enterprises wanted to move workloads to the cloud. To address that need, we began working with the leading cloud providers to deliver Cloud Volumes Service, a fully managed service with the application certifications required to support mission-critical, production workloads in the cloud.

We then recognized the opportunity to expand beyond storage management and optimization to infrastructure monitoring and compute management and optimization services, which led to the development of Cloud Insights and the acquisition of Spot. These services: Cloud Volumes, Cloud Insights and Spot are now the primary growth engines of our public cloud services business. They are well-established for enterprise applications, and we are taking each of them into the cloud native world, further expanding our market opportunity.

NetApp Astra offers application-aware data management that protects, moves and manages data-rich Kubernetes workloads. Spot Ocean automates cloud infrastructure for containers, automatically scaling compute resources to maximize utilization and availability, while minimizing costs. Cloud Insights for Kubernetes provides simplified infrastructure monitoring to quickly identify performance issues and resource constraints.

Together, our public cloud services give our customers and especially their CloudOps and DevOps teams, a robust suite of multi-cloud infrastructure management services. We plan to press our advantage here by focusing our efforts on enhancing our go-to-market activities, deepening our cloud partnerships, and delivering best-in-class organic and inorganic innovations. We intend to leverage our deep infrastructure expertise and our credibility with the cloud providers to expand our multi-cloud infrastructure management services.

My confidence in our ability to reach our goal of $1 billion in public cloud ARR in fiscal year 2025 is further enhanced by the strength and uniqueness of our cloud services position. Our focused execution last year has set us up well for fiscal year 2022. We have returned to growth, we're gaining share in key storage markets, and our public cloud services are at a scale where they are positively impacting total company billings and revenue growth. Our momentum underscores our value to customers in a hybrid, multi-cloud world. In fiscal year 2022, we plan to accelerate our public cloud services and continue to grow our hybrid cloud business. I am excited about the year ahead and confident in our ability to deliver top line growth by supporting our customers on their cloud and digital transformation journeys.

Before I turn it over to Mike to walk through our financial results, I want to take a moment to thank Brad Anderson, who let us know that he intends to retire at the end of fiscal year 2022. Brad has been instrumental in leading the maturation of our hybrid cloud group and we will continue to leverage his leadership and expertise this year. We are actively engaged in identifying his successor to ensure a smooth transition.

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

Michael J. Berry

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

Thank you, George. Good afternoon, everyone, and thank you for joining us. As a reminder, I'll be referring to non-GAAP numbers unless otherwise noted. As we look back on what was an unprecedented year, I cannot help but be incredibly proud of the focus, execution and commitment of the entire NetApp team. We delivered billings of $5.9 billion, an increase of 9% year-over-year, while revenue of $5.7 billion grew 6%. We delivered free cash flow of $1.2 billion, up 25% year-over-year, while continuing to aggressively invest in our public cloud franchise.

We finished the year strong with Q4 billings of $1.7 billion, up 12% year-over-year, while revenue of $1.6 billion was up 11% year-over-year. Both were solidly ahead of our expectations, driven by accelerating enterprise demand throughout the quarter. Gross margin, operating margin and EPS all came in above the high-end of guidance. Q4 free cash flow of $521 million was an all-time high for NetApp.

As George highlighted, public cloud ARR of $301 million was up 171% year-over-year and an impressive 27% sequentially. In fiscal 2021, the scale of our cloud franchise really started to impact the overall growth profile of NetApp, delivering four of the nine points in billings growth and three of the six points in revenue growth. In addition to the strong cloud ARR performance, we are excited that we exited the year with cloud gross margins near our overall corporate average. Given the growing impact on our total company performance, we anticipate sharing more detail on our public cloud business in fiscal 2022.

When combined, software revenue, recurring support and cloud revenue totaled $1.1 billion and increased 18% year-over-year, representing 72% of total revenue. For the first time in company history, we ended Q4 with over $4 billion in deferred revenue, an increase of 8% year-over-year. Deferred revenue continues to be a leading indicator for future recurring revenue growth.

Product revenue returned to growth in Q4. Importantly, we expect this trend to continue throughout fiscal 2022. Product revenue of $840 million increased 6% year-over-year. Consistent with the trends we have seen throughout fiscal 2021, software product revenue of $480 million increased 18% year-over-year, driven by the continued mix shift towards our all-flash portfolio. Recurring support and cloud revenue of $641 million was also an all-time company high and was up 17% year-over-year, constituting 41% of total revenue.

Gross margin of 67.3% was at the high end of guidance. Product gross margin was 54.3% and benefited from the higher all-flash system mix. Our recurring support, cloud and other services business continues to be a very profitable and growing business for us, with gross margin of 82%. Operating margin of 23% was nicely ahead of our expectations, while EPS of $1.17 came in above the high end of guidance, despite a $0.05 headwind from a higher than forecasted tax rate.

Cash flow from operations was $559 million and free cash flow was $521 million, representing 34% of revenue. Cash flow came in higher than expected in part due to strong collections, as evidenced by the DSO metric of 55 days. Full-year fiscal 2021 free cash flow of $1.2 billion was up 25% year-over-year and represented 20%. We closed Q4 with $4.6 billion in cash and short-term investments.

Given recent developments in the broader technology supply chain, I want to reiterate our confidence in our ability to meet end-demand as we head into Q1. We have an excellent supply chain team and they have been working closely with our partner ecosystem to ensure backlog and customer lead times remain at normal levels throughout fiscal 2022. Towards this goal, we will be investing incremental dollars into inventory and longer-term commitments to help mitigate risk of supply shortages. Given our strong balance sheet and low cost of capital, we feel good about this investment.

Now to guidance. In fiscal 2022, we expect revenues to grow 6% to 7% year-over-year, with billings expected to outpace revenue given the continued strength in recurring support contracts and cloud services. In fiscal 2022, we expect continued momentum and share gains in our cloud-connected all-flash portfolio. We will also continue to grow and invest in our diversified public cloud services portfolio. We are raising the low end our fiscal 2022 guide and now expect to exit fiscal 2022 with public cloud ARR of $425 million to $500 million, driven by enhanced go-to-market activities, deeper cloud partnerships and continued product innovation. Similar to the seasonal pattern we experienced in fiscal 2021, we anticipate Q2 and Q4 to be our strongest quarters for net new public cloud ARR. This seasonal cadence is driven mainly by our semi-annual sales compensation plans. As George noted, we have increased confidence in our ability to eclipse $1 billion in public cloud ARR in fiscal 2025.

In fiscal 2022, we expect gross margin to be roughly flat year-over-year at 67% to 68%, as improving cloud margins are balanced with strong demand for our hybrid cloud products. We anticipate operating margin to range between 21% and 22% as we continue to invest in our growth initiatives while delivering strong operating leverage. Implied in this guidance is our expectation that operating expenses will be between $2.75 billion and $2.8 billion. The year-over-year increase in our expense base is being driven by continued investment in revenue generating activities, including expanding our cloud portfolio, targeted investments in sales resources and continued investment in our customer success sales team.

Moving down the P&L, we expect interest expense to be $65 million to $70 million and our effective tax rate to be approximately 19%. While we get a bit of de-levering below the operating income line as a result of the higher interest expense and tax rate, we are committed to delivering $4.45 to $4.65 in fiscal 2022 EPS, representing 12% year-over-year growth at the mid-point. We expect to again generate over $1.1 billion in free cash flow in fiscal 2022 as our hybrid cloud business continues to fund the growth in our cloud services franchise. Factored into the year-over-year free cash flow generation is a step-up in CapEx to $225 million to $235 million. Our public cloud partners, in particular Azure, are driving us hard to build out additional global capacity for our cloud offerings. Even with this added investment, we expect Cloud gross margins to become accretive to our corporate average as we move through fiscal 2022.

Generating over $1.1 billion in free cash will allow us to continue to deliver on our capital allocation commitments, while also investing in our key strategic areas. The dividend will remain the first call on capital. As you saw today, we raised our quarterly dividend to $0.50 per share. Share repurchases will also continue to play a key role in our capital allocation strategy. Towards this goal our board approved an additional $500 million in buyback authorization. In fiscal 2022, we expect buybacks to offset dilution from our equity plans.

For modeling purposes, we expect share count to remain flat at 229 million shares exiting fiscal 2022. Consistent with NetApp's long history of disciplined M&A, the remaining 30% of free cash generation will go towards our acquisition strategy, which will remain focused on bolstering our strategic cloud services roadmap.

Now on to Q1 guidance. We expect Q1 net revenues to range between $1.37 billion and $1.47 billion which, at the midpoint, implies a 9% increase in revenues year-over-year. We expect consolidated gross margin to be approximately 68% and operating margin to range between 19% and 20%. Assumed in this guidance are Q1 operating expenses of $680 million to $690 million. We anticipate our tax rate to be approximately 19%. And we expect earnings per share for Q1 to range between $0.89 and $0.97 per share. Assumed in our Q1 guidance is interest expense of $15 million to $20 million.

In closing, I want to thank our partners, customers and investors for their unwavering support this past year. And most importantly, a huge shout out to the entire NetApp employee base for redefining what it means to work as a team during what was a challenging year in so many ways. We are more confident than ever in our ability to capitalize on the industry transitions and market opportunity ahead.

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

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from Amit Daryanani with Evercore. Your line is now open.

Amit Daryanani
Analyst, Evercore ISI

Q

Thanks for taking my question. Congrats on the nice strength. I was hoping if you could just talk a little bit more on the Cloud Data Services business. And I guess, A, I would love to understand sort of what really drove the upside in the quarter versus the $260 million to $290 million guide that you really had out there? And then really when I think about the full-year number you've provided of $425 million to $500 million, the low end I think is taken up by $20 million – $25 million. What is driving the confidence in the business as you go into next year? And how important is it for you to scale beyond Azure to achieve the fiscal year targets you laid out?

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

A

Listen, thank you for the question. We have been working on multiple innovation parts of our portfolio, all of which performed extremely strongly. Cloud Volumes for storage, Cloud Insights for monitoring, Spot for compute management, all had really strong Q4s and overall really strong years. We saw good expansion in the number of customers and strong growth in the number of new-to-NetApp customers. We saw customers spending against their digital transformation and their cloud programs throughout the quarter. So it was a smooth trajectory through the quarter. And I think that sets us up well for next year.

I think if you look at our dollar-based net retention rate, you can see that our organic business grew strongly this year, and we had about $60 million of this year being inorganic from acquisitions of Spot, Talon, and CloudJumper. So, when you back that out, we expect next year's growth rate to also continue the acceleration of our organic portfolio and continued strength of our inorganic portfolio. We have a really good and differentiated portfolio of services. We have deep partnerships and are expanding the range of things we do with the hyperscalers, and we are growing our customer base of people who are doing many business-critical projects on the public clouds with us. So I'm really excited with every confidence. We'll tell you more about our cloud business, as Mike indicated, as we go through the year, giving you more details on it.

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

A

All right. Thanks, Amit. Next question.

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

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Yeah. Thanks, guys. I'm going to do the old question and clarification thing, if I can. The question is on ARR and what the ceiling on that is. Obviously, you've done really well there, and I'm curious if you could, George, maybe just give us some idea of what you think the headroom is there, because clearly there's a lot of growth coming through. And then the clarification just on the EPS calculations for the full-year guide. We're getting a number lower than the range you guys are giving. So I'm not sure if – using all the inputs you're talking about, we get something like $4.41, so I'm not sure if you add all that up, why we would be ending up at a different place than maybe your guide is. So I don't know, Mike, or – if you could clarify that, that would be helpful. Thanks.

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

A

Thanks, Rod. With regard to the cloud portfolio, listen, I think the heavy lift in terms of getting the innovation portfolio to be in really good shape is behind us. I think we have, as I said, three really strong innovation engines, and we are bringing out cloud-native innovations across those lineups as well through the course of the summer. We are making investments, as we indicated last quarter, to accelerate and expand the range of things we're doing in the cloud portfolio.

With regard to what's it going to take to further accelerate the course of the business, it's all the things that we're doing, right? We're expanding the number of sellers and revenue-generating teams facing customers. We've seen really good success with Microsoft in terms of their route to market. We're working with the other hyperscalers to also train and expand the range of ways we take our products to market with them. And we're building out customer service and customer success teams.

I feel even more confident that we have the range of capabilities to achieve the $1 billion target in ARR that we indicated, and the customer use cases that we are deploying on our public cloud portfolios, these are run the business applications, mission-critical, highly differentiated business value-creating applications. So I feel really, really good about where we are at the year.

Mike, do you want to take the other part of the question?

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

A

Sure. Thanks, George. Hey, Rod. So, hey, just want to make sure we can go through it separately with you and the team. I want to make sure that, hey, the gross interest is not the net interest. It could be in the OIE (sic) [OI&E] calculation as well. So – and there's a lot of sensitivity obviously to that calc. So it's probably below operating income than it's a little bit different in your model. We're happy to walk you through that separately. Thanks for the questions.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Hey, Mike, just for the follow-up, could you maybe say what that OI&E number is? Then people can just plug that in.

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

A

Yeah. So we said $65 million to $70 million for the interest. For the OIE (sic) [OI&E]...

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Okay.

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

A

...what we have in there is – yeah, that's the interest. That's what we did in my script.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Great. Thank you very much.

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

A

You bet. And as you know, that number jumps around quite a bit. There's more than just obviously interest in that OIE (sic) [OI&E] number.

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

A

All right. Thanks, Rod.

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

Aaron Rakers
Analyst, Wells Fargo Securities LLC

Q

Yeah. Thanks for taking the question. And congratulations on the quarter. Clearly confident in kind of how the story is progressing. I know you touched on this in your prepared remarks a little bit, but I just wanted to go back to kind of the component environment. There's a lot of discussion out there around SSDs and some controller constraints and pricing moving upward on Flash and SSDs in general. Just help us maybe appreciate the confidence that you have in component supply and how you're reacting to any kind of inflationary pricing dynamic. Thank you.

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

A

Sure. Hey, Aaron, it's Mike. Thanks for the question. So we have certainly contemplated the challenges in the supply chain when providing our gross margin guidance for Q1 and fiscal 2022. Supply chain teams, they've really performed well all year long, working closely with our suppliers. We have confidence we can continue that performance this coming year.

As you know, we're a cloud-led software company. Our product margins we expect to continue to benefit from the higher margin software-rich configurations. And we continue to do a lot of hard work on the services margin as we talked about cloud margins should continue to improve as we go through the year as well as you'll see the benefits of the consumption of the deployed system and more increase in our Software-as-a-Service. There's always unforeseen circumstances that may come into play, but as we sit here today, we feel good about it. And when you talk about total – our total component cost, we expect it to be a little bit of a tailwind in the first half and then based on prices that we have today and you know as well as I, those things change, potentially a little bit of a headwind in the second half, but we've just baked that into our guidance.

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

A

With regard to our technology portfolio, as Mike said, we have a range of configurations that we can support our customers with all the way from 900 gigs to 16 terabytes, and so we have plenty of capability to, given the flexibility in our software operating system, to qualify the right components to meet customer needs and support them. With regard to the demand environment and gross margins, listen, as Mike said, we've operated through a tough year and done a really good job. I think that you'll see us continue to remain prudent balancing end user demand with margin management as we go through the year.

Aaron Rakers
Analyst, Wells Fargo Securities LLC

Q

Perfect. Thank you, guys.

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

A

Thank you, Aaron.

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

Nikolay Todorov
Analyst, Longbow Research LLC

Q

Yes. Thanks, and congrats from me as well on great results. George, I think we appreciate the full-year guide. I just wonder if we can double click maybe on the revenue outlook, 6% to 7% growth. Can you give us some more color around the assumptions there? Maybe if you can talk how much of that comes from share gains versus the market, or any breakdown between the drivers of product or CDS for software? Thank you.

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

A

Okay. Listen, as we go through the year, we see a continuing improvement in public health and the overall demand environment. We have been benefiting from cloud and digital transformation projects through the course of the year. We have not seen any major – so we don't see some unique snap-back or something like that in government spending or in enterprise spending. We see us benefiting from long-term trends and projects that are strategic to customers.

We see more countries, especially the US and parts of Western Europe, come online in a more significant way through the course of our fiscal year. The US more likely in the first part of the fiscal year, Europe coming online more strongly in the second half of our fiscal year. We have every confidence that our product portfolio is differentiated and will continue to see product revenue grow faster than services revenue and the strength of our cloud portfolio. We have a much bigger base of customers now in the cloud business. We have a much broader range of application certifications than we've entered last year. And so we feel really, really good about the year ahead.

Nikolay Todorov
Analyst, Longbow Research LLC

Q

Great. Thank you.

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

A

Thanks, Nik. Next question.

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

Matthew Cabral
Analyst, Credit Suisse Securities (USA) LLC

Q

Yeah. Thank you. I was wondering if you can give an update on the ramp of the 200 quota-bearing heads that you've added over the past I think it was 18 months or so, just where they are in their ramps relative to full productivity. And as we're heading into fiscal 2022, just how you're thinking about investments in sales capacity for the next fiscal year and beyond?

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

A

So I think, as we said, the typical sales productivity ramp happens over the course of four quarters. We are – the 200 reps that we started adding in fiscal year 2020 are fully productive. They're part of NetApp teams. You saw some of the benefit from their performance and additions to our teams, particularly the Americas business, which was really strong. And it sets us up well for what we think will be a strong American recovery over the course of the next 12 months.

With regard to continued additions, as Mike has said and what we have said before, we continue to be prudent about where we add those teams. We will do so where we see demand and environments being strong. And we'll tell you more about the course of that. We added some head count in our customer success teams and in our cloud teams this past quarter. You should anticipate us continuing to do that to support the growth of the cloud portfolio.

But, Mike, if you want to add any other color?

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

A

Yeah. Thanks, George. So, I would just underline the additions that we talked about in the last quarter and this quarter as well in the specific areas around cloud and then the customer success team which is, as you all know, in a cloud business super important in terms of upsell, cross-sell, renewals. So we do continue to make investments there. And I think you've seen some of the results in the ARR results this quarter.

Matthew Cabral
Analyst, Credit Suisse Securities (USA) LLC

Q

Thank you.

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

A

Thank you, Matt. Next question?

Operator: Thank you. Next question comes from Katy Huberty with Morgan Stanley. Your line is now open.

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

Q

Thank you. Public cloud profitability is ramping faster alongside the better revenue performance. Is that purely due to revenue scale or have you tuned the business model in any way to capture cost efficiencies? And then, Mike, just as a follow-up to that. Can you clarify whether we should expect cloud margins for the full-year 2022 to be dilutive, neutral or accretive to the model? Thank you.

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

A

Sure. Thanks for the question, Katy. Let me do the last one first. So we said, as we go through the year we expected cloud margins to be accretive to the total company average, so – as we get through the year and certainly ending the year. And then, yes, we have seen a much bigger increase in our cloud margins than we had originally expected. Certainly, revenue scale matters.

I would also give a lot of kudos to the team though for being really efficient in terms of how they use not only the hardware, but also all the stuff that goes to support those businesses as it relates to people and processes. So, it's all of the above. But certainly, growth in ARR is the key driver followed next by a really good job by that team in terms of managing the margins.

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

Q

So, for the...

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

A

So if I may add, Katy, I think we have many avenues as we have described, to continue to drive the gross margins in our cloud business. There's a growing portfolio of software-only offerings in the cloud business. Spot, Cloud Insights, several versions of our Cloud Volumes offerings are all software.

Mike mentioned the hardware utilization. We have brought out new versions of our ONTAP operating systems that continued to be more efficient in terms of data management and storage efficiency. And so, we feel very good about our path to continuing to improve cloud gross margins in the direction that Mike articulated.

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

Q

Great. Thank you.

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

A

Thanks, Katy. Next question?

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

Wamsi Mohan
Analyst, Bank of America Merrill Lynch

Q

Yes. Thank you. You noted some seasonality in cloud ARR through the course of the year, where Q2, Q4 are typically higher. I was wondering, would it be accurate to think that the net organic growth sequentially should be at least at a higher level relative to last year even though we look at maybe some seasonality going into Q1? And can you give us any color on these cloud deals, how much of those were NetApp-generated versus partner-generated? Thank you.

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

A

Yeah. So on the organic growth, Wamsi, what I – this is Mike, by the way. I would point you to the dollar-based net retention number. And as you saw in the quarter, it actually accelerated quarter-over-quarter. So you can assume if you take a look at that that the organic business is doing – call it, the organic business is doing very, very well. And as George talked about, a lot of those offerings are – is that organic business.

And we don't break out the contribution from the hyperscalers versus the core business or the NetApp business. What I would say is, a lot of the seasonal pickup that you see in Q2 and Q4 is driven by our sales teams in addition obviously with the hyperscalers. And I just want to underline that, please, with just, hey, when you guys do your models for next year, please make sure that you take that seasonality into account. Don't just take the increase in ARR and divide by four. There is absolutely seasonality in that business, and you've seen it the last two years.

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

A

All right. Thanks, Wamsi. Next question?

Operator: Our next question comes from Steven Fox with Fox Advisors. Your line is now open.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Hi. Good afternoon. George, I was just wondering, when I listen to everything that you said, you talked about improving market share, it sounds like a better mix as you go through the year. You had accelerating digital transformation engagements during the quarter and into this quarter. And then when I look at the full-year guidance, it seems to imply when I look at the markets, you're expecting some sort of deceleration as you go throughout the year, even when I take into account some of the tougher comparisons. Am I thinking about that conservatism right? Or is there anything else that you would say on the markets? Thanks.

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

A

Listen, I think when we look at the full-year guidance for next year, we've guided 6% to 7% in terms of revenue growth. I think that what you'll see from us is real confidence in the business. The second half of the year is on a compare basis compared to a stronger second half this year, as enterprise spending came back online through COVID, right. So, it isn't an expectation of us having a deceleration in terms of our ability to grow cloud or gain share. It's just kind of a realization that the second half of this year is a stronger compare than the first half of this year.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Okay. Thank you very much.

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

A

Thanks, Steve. Next question?

Operator: The next question comes from Jim Suva with Citigroup. Your line is now open.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you. My question, and it's kind of a clarification, but also related forward-looking is, can you clarify for this quarter how much of the revenues were organic versus acquisition? And then the outlook, George, I know you mentioned the $1 billion run rate, is that based upon all organic? I assume that's the case. But I just wanted to clarify, because I think Mike mentioned about 30% of cash flow could be used for M&A. But I just kind of want to clarify organic versus M&A, as you sit today reported and as you look out. And again, congratulations on the great results and outlook.

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

A

Hey, Jim. It's Mike. On the first one from the organic contribution of revenue, it was very small. It was less than 0.5 percentage point of growth. It was really not much at all in terms of – keep in mind that that is related to the cloud acquisitions earlier in the year. Not much of an impact at all. And in the quarter, it was very little.

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

A

Hey, I think, Jim, when we look at the business, we feel very good about our portfolio capabilities that we have today getting us to that $1 billion ARR number in fiscal year 2025. We're not going to break out organic versus inorganic. I think we feel that we've achieved a full year of integration of our core acquisitions: Spot, CloudJumper, and Talon. So we feel that the core bets are in place for this year. We will continue to look at inorganic acquisitions to fill out our portfolio, right?

So, we think that we have a strong path to a differentiated position in the cloud market. We feel really strong about the capabilities that we have. We will tell you more about it through the course of the business, through the course of – as we expand the cloud business. And I'll just hit on three things, right? We are growing our cloud business, while growing our core business. We are acquiring a lot of net new customers. We are accelerating our organic business growth and our inorganic acquisitions. And so, I feel really, really good about our business overall.

Cloud gross margins, as Mike said, are near the corporate average; and as we go through next year, will be accretive to company gross margins. So, I'm just – feel very, very good about our opportunity in the cloud and the work that our team has been doing with the cloud providers and we're going to double down on it.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Congratulations.

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

A

Thanks, Jim. Next question?

Operator: The next question comes from Shannon Cross with Cross Research. Your line is now open.

Shannon Cross
Analyst, Cross Research

Q

Thank you very much. I had a question on cash flow. I understand that you guided to over $1.1 billion in this fiscal 2022 is going to have pressure from inventory and higher CapEx. But as you think about the model on a longer-term basis, should we expect that when you don't have to buy excess inventory, we'll start to see cash flow growth that maybe more closely mirrors what you're able to do in terms of earnings? Or will the increased CapEx be a drag for a longer period of time? Thank you.

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

A

Hey, Shannon. It's Mike. So, thanks for the question on cash flow. Happy to do that. So, a couple of things. If you look over the last four years, the operating cash flow results of NetApp have really mirrored the non-GAAP operating income. It's like 107% of that number. So, we do expect over time that we'll see operating cash flow mirror operating income growth. Now, it's going to bump around a little bit and I'm going to do operating and then I'll take you to free cash flow.

Next year, for instance, in fiscal 2022 we would expect to see operating cash flow growth be a little bit lower than earnings just because of the working capital impact of some of the expenses in 2021; and we've put that in the script. From a free cash flow perspective, we really look at next year CapEx as, hopefully, the high watermark. A couple of pieces there. One is the – we're certainly continuing to install hardware in some of the data centers to support the cloud business, as George talked about. We're super excited about some of the software options there as well. And as we have more software defined, that will help.

Also next year in that number, there is about $50 million in CapEx related to two facilities projects related to our Wichita site and to a lesser extent our new building in San José. We always had a little bit of facilities CapEx, but that's a big number next year. That's why we feel comfortable going forward that we can have CapEx below the $200 million that I discussed in the script. So I just want to walk you through those puts and takes. But over time, yes, I do expect operating cash flow to pretty much mirror operating income with some bumping around every year, largely due to working capital.

Shannon Cross
Analyst, Cross Research

Q

Great. Thank you.

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

A

Thank you.

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

A

Thank you, Shannon. Next question?

Operator: The next question comes from Ananda Baruah with Loop Capital. Your line is now open.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Hey, guys. Yeah, congrats on the strong results. Thanks for taking the question. I guess, just going back, so George and Mike, to new sales force adds, is there any – I guess, is sort of the go-forward on that, the incremental, is there anything meaningfully incremental that collectively those add initiatives can contribute?

And not just with regard – I mean, I know the $200 million were sort of across the portfolio. So I'm really thinking in totality, not just on the cloud side, but also on the new customer side and with regards to how you are repositioning the go-to customer from a solution perspective. And that's it. Thanks.

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

A

I think we'll continue to be careful about where we add sales teams. I think we constantly rebalance to areas of opportunity both in terms of the composition of the sales force and the locations where we put the head count. I think, as I've said before, the recovery will be at different rates in different geographies. And I think as the public data indicates, the Americas is the place where we expect the recovery to be more pronounced this coming year; Europe lagging six to nine months thereafter; and the rest of the developing economies maybe six to nine months after that. So we'll prioritize any additions in accordance with how we see the end user demand.

With cloud, we have been adding step-wise. I think one of the important things that we're focused on this year is to get our frontline sales teams to be balanced with selling cloud and our systems in customers' data centers. And so, I feel like, listen, we're not going to have a step-wise addition in our investment. We'll do it as the business comes. And we feel very good about the disciplined approach we've taken and the payoffs for those investments in fairly short order.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

And George, are the current adds, the adds so far, are they fully optimized at this point?

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

A

I think on the 200 heads, as we've said, they are fully productive, fully part of the NetApp sales teams. We added some cloud head count in last quarter. We anticipate to add some more this year. Alongside the course of the business, they will take some time to get productive, but those are in the same range of productivity ramps as our traditional sales head count.

I think what you see from this coming year – from our guidance to the coming year is that revenue outpaces the growth in operating expense, leading to additional leverage in our business model. That reflects our disciplined approach to investing where we see the opportunities.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Okay. That's great. Thank you.

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

A

Thanks, Ananda. Next question?

Operator: Thank you. Our next question comes from Mehdi Hosseini with SIG. Your line is now open.

Mehdi Hosseini
Analyst, Susquehanna Financial Group LLLP

Q

Yes. Thanks for taking my question. I joined the call late, so I apologize if I'm repeating the question. I notice your inventories are at a two-year low and I want to see what's your strategy and how aggressively you're going to be out there buying key components, especially storage. And I have a quick follow-up.

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

A

Sure. Hey, Mehdi. It's Mike. So yes, we had very good inventory turns at the end of Q4. As I mentioned in the script, it was already started and we will expect to continue a couple of the different programs. One is to double down on some of the key components related to our storage products to make sure that we had enough inventory. We've already done that, and then we will continue to do that. We will also add some safety stocks so that if there are issues throughout the world then hopefully we're able to respond to that.

In addition, we also will have longer, I'll call it, purchase orders that we will extend through the year. So we're doing everything that we can to make sure that we have enough inventory. I would expect in Q1 you should see those turns probably go back to the 12 to 14 number. And again, given the low cost of capital, our goal to make sure that we always have product and we can meet customer requirements, we think that's a very good investment. So, thanks for the question. Yes, you should see those inventories increase and the inventory turns go down in Q1 and likely through the rest of fiscal 2022.

Mehdi Hosseini
Analyst, Susquehanna Financial Group LLLP

Q

Great. And just a quick follow-up. Your cloud services margins is becoming accretive. But is it higher cost of component that is capping the gross margin?

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

A

Listen, I think with regard to component costs, as Mike said, as we look out the next year we see that the component costs in aggregate for the full year is going to be relatively flat to this year, with some puts and takes in terms of the mix. I think that with regard to cloud gross margins, it's really reflecting the balance of certain regions getting more heavily utilized and seeing customer consumption of the installed footprint, while we make investments in other regions to continue to expand our business. And that trade-off between investing to continue to expand the business with the growth in ARR, is the balance we walk.

I think as I also mentioned, we have several other avenues to continue to drive gross margins in cloud. The software mix in the portfolio is growing with solutions like Spot and Cloud Insights and some versions of our Cloud Volumes products being software only. The second is, we continue to drive efficiency in the software in ONTAP operating systems software. So there are lots of avenues to continue to accelerate cloud gross margin. Team's done a good job this year, and we expect it to be accretive to company gross margins as we go through next fiscal year.

Mehdi Hosseini
Analyst, Susquehanna Financial Group LLLP

Q

Got it. Very clear. Thank you.

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

A

Thank you, Mehdi. Next question?

Operator: Our next question comes from Sidney Ho with Deutsche Bank. Your line is now open.

Sidney Ho
Analyst, Deutsche Bank Securities, Inc.

Q

Thanks for taking my question. Maybe one more question on gross margin. In the past you talked about a target to get product gross margin back to the mid-50s. You are at 54% and change already this quarter. Should we expect this gross margin to continue to improve over the next few quarters, given the mix shift towards the software-heavy side products? Or should we think about hardware and software margins both still have room to grow? And it sounds like higher component cost may not have an impact in the near term. I just want to confirm that. Thanks.

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

A

Yeah. So, hey, Sidney, it's Mike. We have guided in our fiscal 2021 in our Q1 numbers, product gross margins to be relatively consistent with how we exited Q4. Again, component costs over the full year, at this point as we sit here today, relatively flat. It will move around a little bit by quarter, but keep in mind as well mix matters a lot in that as well. Also in Q1, we talked about 68% gross margins. Keep in mind that there's a much bigger component of revenue in Q1 than services versus products. So you also get that bump in margin. You saw that the last couple Q1s as well.

So as we sit here today, we don't see a lot of movement in the gross margin numbers. Again, that's based on the component costs that we see today. Mix does matter in the quarter, but we've largely stayed relatively consistent with how we're exiting Q4.

Sidney Ho
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. Thank you.

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

A

Thank you, Sidney.

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

A

Thank you.

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

Next question?

Operator: The next question comes from Nehal Chokshi with Northland Capital Markets. Your line is now open.

Nehal Chokshi
Analyst, Northland Securities, Inc.
Q

Thank you, and congrats on a great quarter. Great guidance. And also, thank you for providing the extra visibility on PCS in terms of the profitability with the gross margin comment, which was actually quite impressive at scale. But I always want more. So my question here is, what about the operating income profitability of the PCS division? And/or maybe you can comment on where on the Rule of 40 is PCS operating at right now?

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

So, I want to make sure I understand the question. You're not talking about gross margins; you're talking about operating margins, Nehal?

Nehal Chokshi
Analyst, Northland Securities, Inc.
Q

Correct. Correct. And then maybe if you want to put that into context of the Rule of 40?

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

Yeah. So at this point, as you said, you always want more. We feel good about talking about our gross margins. We're not going to go down to operating margins in that business. That gets into a lot of allocations and things. So what we're going to do is, we're going to focus the business on gross margin. Do we certainly look at OpEx and where we spend the money? Yes, we do. So in terms of the Rule of 40, again we'd have to go down the operating income. We won't do that. We will keep it at the gross margin discussion.

Nehal Chokshi
Analyst, Northland Securities, Inc.
Q

In the future, do you expect to be able to break this out? Or do you expect that there's just too much cross-selling going on that would prevent that kind of breakout to happen?

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

What I would say is that, hey, tune in after the Q1 call and we'll talk about what we're going to disclose going into 2022.

Nehal Chokshi
Analyst, Northland Securities, Inc.
Q

Okay. Great. Thank you. Congratulations.

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

A

Thank you.

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

A

Thanks, Nehal.

Operator: Thank you. Our last question comes from Karl Ackerman with Cowen. Your line is now open.

Karl Ackerman
Analyst, Cowen & Co. LLC

Q

Yes. Thank you. Your latest run rate all-flash array revenues are near a record of $2.9 billion and your year-over-year growth exceeded most peers. And so, I was hoping you could provide some parameters at least qualitatively around your fiscal 2022 expectations for all-flash array growth? And maybe how the mix of your installed base plays into those expectations? Thank you.

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

A

Listen, I feel really good about our flash business. We are focused, differentiated and executing in the market. I think our strong position in the sweet spot of the storage industry, which is the mid-range part of the market, is clearly evident. And it is affecting the growth rates of our competitors. We have taken share for the last several quarters, and we see every confidence that we will continue to do that going forward.

What we said at the Analyst Day was that, over the next few years the all-flash array market will grow at about 7.5% CAGR, and we expect to outpace that this coming year. We expect that the storage industry will grow around 4% and our revenue picture expects us to outpace the growth of the storage industry overall. So, we feel really good and ONTAP 9.9 coming out gives us even more confidence in our differentiation.

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

All right. Well, thank you, Karl. That's our final question, so I'll hand it over to George for some closing remarks.

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

Thanks, Kris. In closing, we delivered a great end to a strong year, and we are well positioned as we move into fiscal year 2022. I want to reiterate that our public cloud business is at a scale where it is contributing meaningfully to revenue and billings growth, and the innovations we delivered to our hybrid cloud business will support continued product revenue growth.

In fiscal year 2022, we expect to grow the top line, deliver operating leverage and generate significant free cash flow, all while investing in growth initiatives. I am excited by and confident in our ability to capitalize on the industry transition and the market opportunities ahead. I look forward to speaking with you again next quarter. Thank you for joining us, and a special thank you to our NetApp team.

Operator: This concludes today's conference call. Thank you for participating. You may now disconnect.