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NetApp, Inc. (NTAP)

Q4 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, and welcome to the NetApp Fourth Quarter and Fiscal Year 2023 Earnings Conference Call. All participants will be in a listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. Please note this event is being recorded.

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

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

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

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

For more information, please refer to the documents we file from time to time with the SEC and on our website, including our most recent Form 10-K and Form 10-Q. We disclaim any obligation to update our forward-looking statements and projections. During the call, all financial measures presented will be non-GAAP, unless otherwise indicated. Reconciliations of GAAP to non-GAAP estimates are available on our website.

I'll now turn the call over to George.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

Thanks, Kris. Welcome, everyone, to our fourth quarter FY 2023 call. Our Q4 results reflect solid execution in the face of ongoing macroeconomic challenges. We delivered revenue above the midpoint of our guidance, with disciplined operational management yielding all-time high quarterly operating margin and EPS above expectations. For FY 2023, we delivered record high annual operating margin and EPS, despite the slow demand environment and relatively flat revenue from fiscal year 2022.

Even as customers are tightening their budgets in response to the macro, they are not stopping investments in applications and technologies that drive business productivity and growth. Digital transformation projects involving business analytics, AI, data security and application modernization, both on premises and in the cloud, remain top priorities for IT organizations. This drives our confidence in the health of our markets and future growth opportunity, despite the temporary macro headwinds.

We are participating in the areas of priority spending with a modern approach to hybrid, multi-cloud infrastructure and data management. By providing customers with the ability to leverage data across their entire estate with simplicity, security and sustainability, we increase our relevance and value. And we continue to introduce new innovations to deliver greater customer value, further strengthening our position.

On our last call, I outlined our three areas of focus to sharpen our execution to better deliver results, while at the same time, positioning ourselves for long-term success. As a reminder, the focus areas are; remain prudent stewards of the business, tightly managing the elements within our control, reinvigorate efforts across the company in support of our storage systems business and build a more focused approach to our Public Cloud business.

As you can see from our Q4 and FY 2023 results, we have demonstrated success in managing the elements within our control and staying flexible to adapt to the ever-changing environment. We remain committed to maintaining operational discipline as we move through FY 2024, adjusting as appropriate, to drive operating margin expansion and EPS growth while also continuing to invest for the long term.

Turning to our storage systems business. Q4 Hybrid Cloud segment revenue of $1.4 billion was down 8% year-over-year and up 4% sequentially. Our all-flash array business decreased 4% from Q4 a year ago to an annualized revenue run rate of $3.1 billion. Similar to Q3, headwinds from large enterprises weighed on our product and AFA revenue. As you've seen, we are reinvigorating our storage portfolio, innovating to deliver greater customer value, reach new customers and better address areas of priority spending and market growth.

ONTAP AI and FlexPod AI are proven and tested reference architectures to help speed and simplify AI deployments. These solutions are designed around our all-flash arrays, which are uniquely suited to meet the performance, multiprotocol and data mobility demands of AI workloads. In Q4, we demonstrated industry leading-performance in the GPUDirect benchmark, proof of our ability to enable customers to use the full power of GPU technology for AI.

Our affinity to AI use cases doesn't stop at performance. ONTAP includes native data management tools that streamline workflows for data science teams and integrate multi-platform, multisite and multi-cloud data pipelines. With new performance and data management features planned in upcoming ONTAP releases, we expect to raise the bar again, not just for performance, but for total workflow solutions that help companies realize the benefits of AI faster and with better results.

The new AFF C-series, our comprehensive portfolio of QLC-based all-flash arrays, began shipping late in Q4. We are very pleased with the initial customer response. In addition to lots of quoting activity, we closed a good number of deals in the fourth quarter. One of our early C-series wins was a $15 million deal at a large financial institution for business-critical workloads in its cloud-ready, service-level defined environment. We beat the competition with a solution that was significantly denser and more energy efficient.

Following this highly successful launch, we introduced the NetApp ASA A-series early in Q1. The ASA is a new line of SAN-specific flash storage systems that deliver high levels of performance, scalability, data availability, efficiency and cloud connectivity with up to 50% lower power consumption and associated carbon emissions than competitive offerings. The ASA complements our unified storage offerings to address block-only use cases, while avoiding the operational and data siloes of competitors' products.

We are also innovating to improve the customer experience. In Q4, we introduced NetApp Advance, a portfolio of programs bringing predictability and adaptability, including the Storage Lifecycle Program for nondisruptive storage upgrades.

At the start of Q1, we announced ONTAP One, a simple way to buy and consume all the native software capabilities of ONTAP. We're enhancing the value of these built-in capabilities with our Ransomware Recovery

Guarantee, which leverages ONTAP's unique combination of key built-in security and ransomware protection features to detect, stop and recover from ransomware attacks in real time.

In addition to delivering significant innovation, we have also rebalanced our go-to-market efforts, including focusing our broad sales organization on selling flash through compensation plans and reinstituting a specialist sales team for cloud. We believe these actions will allow the team to better address the large storage TAM. Entering FY 2024, I am confident that these actions will enable us to drive product revenue growth and regain share in the all-flash array market. We are seeing early, positive signs, but the full benefit of these changes will take time to develop and should be a driver for product revenue growth in the second half.

While we are sharpening our attack on the storage market, we are not taking our eye off the Public Cloud opportunity. Public Cloud ARR of $620 million was up 23% year-over-year and ahead of our expectations, driven by strength in Public Cloud storage services. Our Public Cloud business in Q4 was backend-loaded, resulting in softer revenue and lower DBNRR than our ARR results would indicate. Public Cloud revenue for Q4 was $151 million and DBNRR was 114%.

Our Public Cloud services are highly differentiated, with a multiyear advantage over our traditional competitors and they create customer preference for NetApp. The number of total cloud customers, customers using multiple of our Public Cloud services and customers with greater than $500,000 of revenue in the quarter, all continue to grow nicely. While, like our cloud partners, we see continued cloud optimizations, some of the customers whose optimizations created significant headwinds for us in FY 2023 have kicked off new projects that we expect to scale over the next 18 months.

We believe that our first-party storage services, branded and sold by our cloud partners, represent our biggest opportunity. We have aligned our sales specialist resources to our cloud partners' customer segmentation and go-to-market structure to tighten our alignment to and improve our execution against this opportunity. Over the course of FY 2024, we will scale our customer success team to further improve customer retention and expansion, and develop a more focused cloud channel model.

Cloud operations remains an important market for us, and we have dedicated go-to-market resources to address this opportunity. We have not wavered in our conviction that Public Cloud services has the potential to be a multibillion-dollar ARR business for us. While the shift to cloud is experiencing an industry-wide slowdown, the long-term trend in favor of cloud is unchanged.

In conclusion, while FY 2023 was not the year we expected at its outset, our disciplined management enabled us to overcome a number of headwinds to deliver all-time high operating margin and EPS. The fundamentals of our business model are sound, and our confidence in our strategy and the health of long-term opportunity is unchanged.

We are entering fiscal year 2024 with substantially more innovation and a new, more focused operating model to attack the areas of priority spending. In this uncertain environment, we will remain agile and continue to be disciplined stewards of the business. We believe our actions will drive margin expansion and earnings growth while yielding top line growth in the back half of the year.

Thank you to the NetApp team for their dedication and focus. I am pleased with our progress, but we recognize our work is not done. We look forward to building on this momentum and driving long-term value for our shareholders.

I'll now turn the call over to Mike.

Michael J. Berry

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

Thank you, George. And good afternoon, everyone. As George noted, we are laser-focused on managing the elements within our control. Our focus enabled us to deliver strong P&L performance for the full year and Q4.

Before getting into the details, let me quickly highlight the key themes of our results and expectations for fiscal year 2024. As a reminder, all numbers discussed are non-GAAP unless otherwise noted. We delivered record-setting operating margin and EPS above our guidance range in both Q4 and fiscal year 2023. We will continue to prudently manage the business to position ourselves for long-term success while driving further operating margin expansion and EPS growth in fiscal year 2024.

We are confident in the strength of our position and alignment to areas of priority spend. However, macro uncertainties and FX headwinds have pressured IT budgets and lowered spending. We believe these headwinds are temporary, and that the spending environment will rebound in time.

We reached our product gross margin target of mid-50s ahead of expectations. In fiscal year 2024, we expect to maintain product gross margins at this level and drive improvement to Public Cloud gross margin.

In fiscal year 2023, we returned 148% of free cash flow to shareholders and reduced full-year share count by 4% from the prior year. We plan to continue our strong policy of shareholder returns in fiscal year 2024.

Now to the details. Fiscal year 2023 billings of $6.41 billion were down 4% from fiscal year 2022. Revenue of $6.36 billion was up 1% year-over-year. Adjusting for the headwind from FX, billings would have been down 1%, and revenue would have been up 4% year-over-year. Disciplined operational management yielded all-time fiscal year highs for operating margin and EPS. Operating margin was 24.2%, including a 150-basis-point headwind from FX. EPS was $5.59, and included $0.57 of year-over-year FX headwind.

Q4 billings of $1.67 billion were down 17% year-over-year, including roughly 2 points of FX headwind. Revenue came in above the midpoint of our guidance range at $1.58 billion, down 6% from last year or 4% adjusting for FX.

The uncertain macro negatively impacted revenue in both our Hybrid Cloud and Public Cloud segments, as customers continued to exhibit caution in capital expenditures and looked to optimize cloud spend. Hybrid Cloud revenue of $1.43 billion was down 8% year-over-year. Product revenue was $744 million, and down 17% from Q4 last year. Support revenue of $598 million increased 1% year-over-year.

Public Cloud ARR exited the year ahead of expectations at $620 million, up 23% year-over-year. Public Cloud revenue composed 10% of total revenue in Q4, and grew 26% year-over-year to $151 million.

We exited fiscal year 2023 with $4.31 billion in deferred revenue, an increase of 2% year-over-year. Growth of deferred revenue is the best leading indicator for recurring revenue growth; Q4 marks the 21st consecutive quarter of year-over-year deferred revenue growth.

Q4 consolidated gross margin was 69% above our guidance. Total Hybrid Cloud gross margin was also 69%. Product gross margin was 55%, well ahead of guidance, driven by lower premiums, better mix, and lower FX headwinds. As we've described on previous calls, we expect to retain all the benefit from the reduction in premiums, and will be responsive to market pricing of commodity components. Our recurring support business continues to be highly profitable, with gross margin of 92%. Public Cloud gross margin was 66%.

Q4 again highlighted the strength of our business model and our operational discipline with operating margin of 26%, an all-time quarterly high. EPS of $1.54 was comfortably above the high-end of guidance, and included $0.08 of year-over-year FX headwind.

In Q4, cash flow from operations was $235 million, and free cash flow was $196 million. Free cash flow for fiscal year 2023 of $868 million came in below expectations due to lower collections and timing of payments. As we noted on our last call, Q4 cash flow included certain onetime restructuring and tax payments, together totaling approximately $85 million. Inventory turns of 12 were steady from last quarter and last year.

During Q4, we repurchased $150 million in stock, and paid out $106 million in cash dividends. For the year, we repurchased a total of $850 million in stock, and paid out $432 million in cash dividends, representing 148% of free cash flow.

Q4 diluted share count of 217 million was down 5% year-over-year. We have approximately $400 million left on our current share repurchase authorization as of the end of fiscal year 2023, and today are announcing an additional authorization of $1 billion. Our balance sheet remains very healthy. We closed the year with $3.07 billion in cash and short-term investments.

Now, to guidance. Let me underscore our confidence in our strategy and the strength of our position in addressing key customer priorities, like business analytics, AI, data security, and application modernization.

However, we expect the macro to remain challenged, with continued pressure on IT budgets and the demand environment. As a result, we expect fiscal year 2024 total revenue to be down in the low- to mid-single digits measured on a percentage basis.

Public Cloud will continue to be a positive contributor with revenue growth expected in the mid-teens. Implied in our fiscal year 2024 revenue guidance is year-over-year growth in the second half driven by sales of recently introduced flash products and benefits from our go-to-market changes.

While we are hopeful that the macro economy will improve in the second half of our fiscal year, our plans for fiscal year 2024 incorporates the environment we are seeing today, and do not assume a material change to the economic or demand backdrop.

We expect fiscal year 2024 consolidated gross margin to be roughly 70%. We believe that product margins will remain at approximately 55%, supported by lower premiums and a rotation to higher margin, all-flash products.

To take advantage of record-low NAND prices, we have made strategic purchase commitments to lock in pricing for a large portion of our expected fiscal year 2024 SSD demand. This will help us maintain product gross margin levels when component prices rise in the future.

We expect to see Public Cloud gross margin improvement in fiscal year 2024, driven by revenue scale and lower depreciation expense. We remain confident in our long-term Public Cloud gross margin target of 75% to 80%.

We anticipate operating margins of approximately 25% and EPS of $5.65 to $5.85. Implied in this guidance is the expectation that we will hold operating expenses roughly flat versus fiscal year 2023.

Fiscal year 2024 OpEx includes benefits from the Q4 reduction in force, offset by annual merit increases, a reset of variable compensation, and incremental expenses to support our first in-person sales kick-off and INSIGHT user conference since 2019. Operating expenses should be spread fairly evenly throughout the year. We expect the tax rate in the range of 21% to 22%. Operating cash flow will move in line with net income, although there will be some quarterly variance based on working capital.

As we've stated before, fiscal year 2023 should be the peak for CapEx with expenditures beginning to come down in fiscal year 2024. Our healthy cash flow generation enables us to continue our strong program of capital returns to shareholders. In fiscal year 2024, we intend to return 100% of free cash flow to shareholders in share buybacks and dividends. We plan to hold our quarterly dividend steady at $0.50 per share throughout fiscal year 2024, with the remainder of free cash going to share buybacks. We expect the timing of buybacks to be roughly similar to fiscal year 2023, and to reduce share count by at least 2% in fiscal year 2024.

Now, on to Q1 guidance. We expect Q1 revenue to range between $1.325 billion and $1.475 billion, which at the midpoint implies a decline of 12% year-over-year. Remember that first half fiscal year 2023 revenue, most notably product revenue, benefited from elevated levels of backlog from supply chain constraints impacting the year-over-year comparisons.

We expect Q1 consolidated gross margin to be roughly 70%, and operating margin to be approximately 20%. EPS should be in the range of $1 to $1.10. Q1 cash flow will be impacted by payments associated with SSD purchase commitments, partially offset by lower incentive compensation payments year-over-year related to our fiscal year 2023 performance.

In closing, I want to echo George's appreciation of the NetApp team and their continued commitment in this uncertain environment. As I look forward into fiscal year 2024, I am confident in our strategy and our ability to continue to improve our execution and increase profitability.

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

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

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

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] And our first question will come from Aaron Rakers of Wells Fargo. Please go ahead.

Q

Hi, guys. Thank you. This is Mike on behalf of Aaron. I just wanted to ask, you mentioned some customers have kicked off new projects following a period of digestion or optimization. I'm just curious, can you give us a sense of how many customers you put in this bucket versus ones that continue to be cautious or maybe are becoming incrementally more cautious? Just trying to get a sense of how the demand environment has changed. Thanks.

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

A

Broadly speaking, the Q4 demand environment was not substantially different from what we saw in Q3, and our plans for next year contemplate continuation of the same environment. We talked about in the cloud segment, some of the larger customers who had significantly optimized their landscapes through the course of the prior quarters began to take on the projects that we anticipated them taking on. These projects take some time to ramp. We also saw strength in new customer additions and the number of customers that were using multiple products from NetApp, so all good signs for future revenue growth. That being said, customers on a broad basis, still cautious about spending and particularly in the large enterprise segment.

Q

Got it. Thank you.

Operator: The next question comes from Samik Chatterjee of JPMorgan. Please go ahead.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Yeah. Thanks for taking my questions. I guess for the first one, if I sort of – you reiterated a few times you're really not baking in any macro improvement to the guide, but you did highlight the opportunity to get back to revenue growth in the second half. Just wondering if you can help us think through both of those pieces, particularly when I sort of put them against each other, it does look like you're calling for more of a share gain than revenue rebound in the second half of the year, what sort of drives confidence in this sort of a sequential ramp in revenue through the year, and is there more to it than sort of share gain. And I have a quick follow-up. Thank you.

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

A

I think broadly speaking, we are super-excited about the recent portfolio introductions we've made. We've seen the benefits of improved focus in our field organizations. It takes a few quarters to build. And I think if you look at the pattern of sequential linearity through next fiscal year, it is similar to what we have seen in more traditional years.

I think FY 2023 was a bit anomalous. And so, we feel good about the progress through the year. I think with regard to the macro, we are not – we've built our plan assuming the macro stays the same. Clearly, if there's upside to the macro, that should be a benefit to us over the course of the year.

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

A

Hey, Samik, it's Mike. If I could just add on to that, and want to underline the one point George made. When we talked about our guide for 2024, when we talk about linearity, that's – and we define that as total revenue we expect in the first half versus the second half. That's much more at where we've been historically, which is about 48% and 52% in those halves. So, when you take a look at the year-over-year growth rates in 2024, just keep in mind that those were heavily influenced by the backlog last year. So, when you normalize for that, it looks like a much more normal linearity in 2024.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Okay. Got it. On the cloud business, the growth expectations that you have for fiscal 2024, can you just outline how you're thinking about sort of retention business versus new business wins? And also curious if you – obviously highlighted the AI opportunity, but do you see that opportunity on the cloud revenue side as well? Thank you.

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

A

Yeah. Listen, I think, first of all, we are very pleased with new customer acquisition, the broadening of our workloads, clearly the performance, and the efficiency and multiprotocol capability of our storage is an advantage whether for AI workloads, whether they are on-premises or in Public Cloud.

What we have seen in Public Cloud for AI is a lot of data science teams using the prebuilt tools that are available on the Public Cloud to calibrate and get their learning models up the curve quickly. And that's uniquely available with NetApp.

I think with regard to our perspective for the full year, listen, cloud storage, especially the storage that's sold alongside the hyperscalers, will be the primary driver of our business next year. I think if you look at the total dollars, in any given year, the opportunity to expand existing customers is substantially larger than the amount that new customers contribute because they are just small, but we feel good about the pace of new customer acquisition. And now, our installed base of cloud customers is very substantial. So, there's a good opportunity to cross-sell and upsell them more capabilities.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Got it. Got it. Great. Thank you. Thanks for the color.

Operator: The next question comes from Meta Marshall of Morgan Stanley. Please go ahead.

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

Q

Great. Thanks. Maybe first question, you noted starting to kind of – noted seeing customers coming out of optimization periods and starting to add workloads. Just wanted to gain a sense of, are you seeing that more with larger or smaller customers or any particular types of workloads that they're starting to kind of add back?

And then maybe second question, the series-C customer that you noted winning in the quarter, just any commentary on whether that was an existing customer? And just you noted efficiency and kind of energy efficiency being the reason for the sale, but just kind of how long that sales cycle was, just any details there would be helpful. Thanks.

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

A

Yeah. So, let me get the two questions. The first one is what we've seen in the cloud environment is that customers are still progressing new workload deployment, meaning new applications, analytics environment, the AI/ML environment and so on, right, and that has not slowed down.

I think there was a period of time where customers were monitoring their environments and optimizing the infrastructure, but the new deployments continue. I think where we have seen people being more cautious is about migration of on-premises environments, for example, to Public Cloud, where they are benchmarking the total cost of each of those landscapes.

We have a large and growing opportunity in public cloud on new workloads because of the capabilities and the certifications that we continue to bring. And so, we're excited about that opportunity.

I think with regard to the customer we mentioned, they were not using NetApp for the landscape that we won. We won – we replaced a competitive environment, and we did so based on the new C-series products that had a significant advantage over all the competitive products, both in terms of our traditional advantages around multiprotocol and all of the data management features, but we're also substantially more efficient from a power consumption and density standpoint.

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

Q

Great. Thanks so much.

Operator: The next question comes from Steven Fox of Fox Advisors. Please go ahead.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Hi. Good afternoon. Just one question for me. I don't think I'm alone in this, but the product gross margin surprised substantially the upside of 7, 8 points of upside by my account. Can you just kind of break down how that happened? And whether any of that is transitional? How much carries through the rest of the year in your full fiscal year plan? Thanks.

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

A

Sure. Hey, Steven, it's Mike. So, let's do the walk from Q3 to Q4, what we guided and where we ended up. So, Q3 product margins were about 46%. We guided approximately 50% largely with the full expectation that we would continue to get relief from premiums that we've talked a lot about. And my goal is to never mention the word premiums on another call going forward. That was about 500-basis-point benefit to the quarter, and we expected that to be.

The two things that were incremental is mix came in better than we expected. And by that, we mean the capacity per system came in a little bit better. If you remember, in Q3, we talked about that that caused a little bit of a reduction in gross margins as well as a little bit better all-flash margin. And then, FX helped a little bit quarter-on-quarter as well. So, that's the walk from 46% to 55%.

As we look into next year, we're assuming that we can retain that 55%. There is a little bit of premium benefit left, but we're also going to make sure that we are flexible as the component pricing rolls through that we can be competitive in the market. And then in addition, we also talked about, hey, we've done some strategic purchase commitments to lock in a large portion of the NAND supply for fiscal 2024 at today's prices. So, we're excited about that being able to not have to deal with that when in the likely event it starts to go up. As we all know, NAND pricing is at an all-time fall. So, that's the walk from Q3 to Q4, how we did a little bit better, and our outlook into fiscal 2024.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Great. That's super-helpful. Thank you.

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

A

Thank you.

Operator: The next question comes from Amit Daryanani of Evercore ISI. Please go ahead.

Irvin Liu
Analyst, Evercore Group LLC

Q

Hi. Thank you. This is Irvin Liu on for Amit. I wanted to double-click on the drivers of Public Cloud ARR outperformance during the quarter. I think you referenced cloud storage services strength. But can you talk about what you saw in data management and cloud optimization? Is there anything to call out for Spot just given the increased focus on optimizing cloud spend? And I also have a follow-up.

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

A

The CloudOps business was relatively flat sequentially. There were new customer additions and some optimizations within existing customers. The majority of the growth rate sequentially from Q3 to Q4 was driven by cloud storage, especially the consumption business with our cloud provider partners.

Irvin Liu
Analyst, Evercore Group LLC

Q

Got it. Thank you. And then, about 11% of your revenue is public sector. From a debt ceiling perspective, I wanted to ask, are there direct impacts we should be thinking about as it relates to your federal government exposure? Is there a potential for a delay in your accounts payable, or any potential changes in how you view the budget flush environment looking through the back half of calendar 2023?

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

Yeah. So, thanks for the question. At this point, we don't expect any meaningful change in that business from an ARR perspective or from a bookings perspective. We'll certainly watch it. We would expect this thing to have – to resolve itself in the relatively near term. At this point, we don't expect any material impact from all those discussions.

Irvin Liu
Analyst, Evercore Group LLC
Q

Got it. Thank you.

Operator: The next question comes from Shannon Cross of Credit Suisse. Please go ahead.

Shannon Cross
Analyst, Credit Suisse Securities Research
Q

Thank you very much. George, can you take a step back and maybe talk a bit from a higher level on how conversations with customers are going with regard to AI. And I'm thinking not just like near term, but I'm trying to understand or figure out because I think we all are, what the various roles IT hardware will play in the AI proliferation that we're seeing. So, I'm wondering, well, you've got trainees, so do you need [indiscernible] (00:40:57) storage, and then you move to inferencing, so it could be more traditional storage or is that not correct? I'm just – I'm wondering, because I know you're having probably a lot of conversations with customers that could be beneficial to us. Thank you.

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

Yeah. We have done exceptionally well in the analytics, AI, deep learning environments. We have both technology leadership across multiprotocol, high-performance, scale-out storage and multicloud, which are super-important buckets of what customers need to drive these analytic applications. And we have done – we've doubled our business this past year to a very significant amount.

I think the key use cases are business problems around, for example, in financial services, sentiment analysis, recommendation engines, advanced recommendations engines and e-commerce, precision medicine, cross-department clinical AI solutions. And then even last quarter, we had a substantial win in a new form of metaverse around autonomous driving, right. So, these are advanced analytics engines that are being deployed on very large-scale data sets. They typically require file and object and cloud integration.

And today's environments are not the advanced LLM models. The majority of the business we see today are really around replatforming from Hadoop to more modern environments as well as the use of advanced neural networks. We see the impending onslaught of ChatGPT and tools like that, where customers will take the OpenAI or open-source generative AI model, but then build it on top of their own data sets, which require the storage that we have. So, we're excited about the future, and we have real strong performance in our AI and analytics business today.

Shannon Cross
Analyst, Credit Suisse Securities Research
Q

Thank you. That was helpful. Mike, can you talk a bit about – I know OpEx is supposed to be – or you're planning on it being flat this year. But I'm wondering, you delayed some investments and you've had some cost cutting in that. I'm wondering, given the gross margin outperformance and the relative strength you're seeing or improvement you're seeing, is there room to maybe reaccelerate some of those investments, or is it just too early to make that call?

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

A

Yeah, Shannon. So, I'd say we actually have accelerated some of those investments. We've talked about doing CONVERGE, which is our sales conference in person as well as INSIGHT. That's the first time in three years. We do a very good job, I give the team a lot of credit, for reallocating dollars internally to reallocate to growth initiatives.

You've seen us react very quickly from a product perspective in the last couple of months, C-series and other things. So, I think at this point, we feel good about where we are from an OpEx perspective. We'll see how we get through the year.

And when we talk about prudently managing the business for us, it is make sure we spend the money in the right areas, but we always want to make sure we're investing in growth. And that's what you have, and that's what we put in the guide for the year.

Shannon Cross
Analyst, Credit Suisse Securities Research

Q

Great. Thank you very much.

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

A

Thank you.

Operator: The next question comes from Ananda Baruah of Loop Capital. Please go ahead.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Hey. Good afternoon, guys. Thanks for taking the question. Just picking up on Shannon's AI question, George, do you see an opportunity over time to have the product growth rate altered by AI on-prem? And actually, we just love maybe even a similar question for cloud software as well as this time? Thanks.

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

A

I think the AI applications that drive business productivity are a topic of discussion in every CEO room around the globe because it is a key way to bring speed and operating efficiency to companies.

And so, many of the applications that we talked about help transform a company's business model. And so, they will get prioritized in spending envelopes, and we are really excited about our opportunity to capitalize on that.

We have done the work not only to build high-performance storage, but in addition, build the integrations into all of the AI and data science tool chains that are common in the world, and to enable a really flexible data pipeline that can start in the cloud where the tools are available, but then can be operated at scale on the data in your data center.

So, we're really excited about what the future holds, and we're going to keep pushing forward. I see cloud and I see AI as two big opportunities for NetApp. We are super-well-positioned in both, and we look to take advantage of both of them going forward.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

That's great. And I guess as the follow-up, could you just talk a little bit about the ability and I guess maybe even over what timeframe that the newer NAND technologies could have on share gains on-premise relative to HDD? Just how should we think about that dynamic and over what period of time? Thanks so much.

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

A

I think the lower cost NAND technology that we've introduced in our products will become a bigger part of our business through the course of fiscal year 2024 and will be the biggest part of the flash storage growth rate in the industry over the next two or three years. These HDD replacement cycles are multiyear, right? I think if you saw the high-performance 15K HDD segment, it took multiple years to transition that footprint. And so, 10K, which is an even bigger part of the market, will take many years to transition. But we're excited about our offerings, the start that we've had and the opportunity over the next many years.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Thanks a lot. Really appreciate it.

Operator: The next question comes from Krish Sankar of Cowen. Please go ahead.

Robert Mertens
Analyst, Cowen & Co. LLC

Q

Hello. This is Robert Mertens, on for Krish. Thank you for taking my questions. Congrats on the strong execution and guide, with a targeted 2024 product margins of around 55%. Could you give a little bit more color on how the strategic purchases of SSDs plays into the target? And on the flip side, if there's any risk to competitors doing the same, or headwinds if pricing declines, if there's any sort of elasticity there? And then, I have one follow-up.

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

A

Sure. It's Mike. So, let's take both of those. So, the guide of 55% assumes, that's what we came out of Q4 with, there are some nice continued tailwinds going into next year. One is, of course, the continued shift to all-flash, which has higher margins. In addition to that, we do have a little bit of benefit from premium. So, we feel good about the 55% number. The strategic purchases really help, I'll call it, hedge that number to lock the prices in that we have today. I would certainly assume, given the lower price of NAND, that other folks are doing similar exercises. And why we're at 55%, Robert, is we want to make sure that we have some flexibility around pricing to your very point. So, to the extent that there are changes in the market pricing, we feel like we have that flexibility to stay within 55%, but still be able to get to our product revenue goals for the year.

Robert Mertens
Analyst, Cowen & Co. LLC

Q

Got it. Thank you. That's helpful. And then, just one more on the public cloud. Do you think the negative impact from cloud optimization efforts is behind us for the year? And would you mind sharing just sort of which areas within your cloud portfolio are seeing the strongest growth? Thank you.

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

A

I think it's premature to signal that cloud optimization is behind us. As we commented in our prepared remarks, I think that this – customers will continue to manage their spend, whether that is on data center infrastructure or on public cloud. I think what we continue to see is the projects and applications that drive business performance, especially core business growth, are getting prioritized and invested. Those could be analytics, those could be AI, those could be digital manufacturing projects and on and on, right?

I think where we have seen optimization and some amount of caution is in migration of enterprise workloads from data centers, the old lift and shift, I think people are taking a hard look at benchmarking both environments, whether it's public cloud or on-premises. So, I think that's where we continue to see some optimization.

In the plan for 2024, the real focus is on accelerating our hyperscaler storage, the storage that is sold alongside our cloud providers, it had a good quarter this quarter. We are uniquely positioned in the market, and we are serving a wider and wider range of applications with the strength of our technology. So, we're excited about that.

Robert Mertens
Analyst, Cowen & Co. LLC

Q

Got it. Thank you for letting me ask the questions.

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

A

Welcome.

Operator: The next question comes from Tim Long of Barclays. Please go ahead.

Tim Long
Analyst, Barclays Capital, Inc.

Q

Thank you. Two, if I could as well. First, I was hoping you could talk a little bit – I think last quarter you talked about kind of increased focus given the large enterprises were a little bit more macro impacted, a little bit more focused on small and midsize businesses. Can you give us an update there and how that push into that customer class is going?

And then, second, if I could just come back to the QLC-based products. George, talking about it taking more share, I'm just curious how you think it's going to further proliferate your portfolio? So, are you going to start it moving into different workloads, different use cases? How should we think about kind of progression of new products to help gain more share of all-flash and grow as a percent of your business? Thank you.

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

A

Yeah. So, maybe I can start with the portfolio. We've introduced three major expansions of our portfolio in the all-flash segment over the last four months to five months. We have capacity flash, the broadest, most feature-rich, most competitive capacity flash products in the industry. We've announced a set of entry flash products that are shipping, which brings our industry-leading software in an all-flash configuration at a price point that is perfect for midsized enterprises. And we introduced early this quarter an all-SAN array, which is a block-only storage configuration for customers that have large block storage environments and don't want to use unified storage for those offerings. So, major expansion to our product portfolio, the most significant expansion since we introduced our flash portfolio many years ago. So, I'm excited about that.

That gives us opportunity to both expand wallet share in enterprise customers, going after parts of the wallet that we used to not serve, but importantly, address the expanding opportunity within commercial customers. Our commercial segment has outperformed the enterprise segment throughout this fiscal year and again did so in Q4, representing the resilience of those customers to the macro spending environment. So, we feel good about that. We moved some resources within our spending envelope. We reprioritized some more resources to cover the commercial market for fiscal year 2024.

Tim Long
Analyst, Barclays Capital, Inc.

Q

Okay. Thank you very much.

Operator: The next question comes from Nehal Chokshi of Northland Capital Markets. Please go ahead.

Nehal Chokshi
Analyst, Northland Securities, Inc.

Q

Yeah. Thank you. Congrats on nice results. Your billings did decelerate quite a bit, the 15% year-over-year decline versus 7% year-over-year in the Q3. So, given your guidance for analysts, it sounds like you do expect the billings to represent a low point in terms of the billings trends. Is that correct? And if so, why is that?

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

A

Yeah. Hey, Nehal, it's Mike. So, if you take a look at Q4, so total revenue was down year-over-year by about 6%, total billings were down by about 17%. When you take a look at the difference between billings and revenue, product revenue and product billings are basically the same because there is no change in deferred. What we saw in the second half, especially in Q4, is lower product bookings, then correlated with less support bookings, specifically the multiyear bookings that come with new sales. So, we do expect to see that come back as we go through next year. That's going to be the difference that you see in billings and revenue.

So, based on the guidance for the year, which is revenue down low- to mid-single-digit percent, we do expect billings to be more flat to somewhere around plus or minus a couple of percentage points to do a little bit better than revenue, again, because of the contribution from support.

Nehal Chokshi
Analyst, Northland Securities, Inc.

Q

Okay. Thank you very much.

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

A

Thank you.

Operator: The next question comes from Simon Leopold of Raymond James. Please go ahead.

Simon Leopold
Analyst, Raymond James & Associates, Inc.

Q

Thanks for taking the question. I wanted to see if we could maybe unpack the Public Cloud business a little bit, in that last quarter it seemed apparent that some of it was very much a recurring revenue stream and some of it was more sensitive and consumption-based. And I'd just like to get level set as to how to think of the composition of PCS as to what you would consider consumption based and what you would consider truly recurring? Thank you.

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

A

Hey, Simon, it's Mike. So, we'll do this two ways. We've given this detail in the past. So, cloud storage represents approximately 60% of the total cloud ARR. CloudOps represents about 40%. It stayed amazingly consistent through fiscal 2023.

If you then look at what is consumption versus subscription, consumption is going to more than half of the business, and it's growing faster than subscription because the two products that are growing the fastest that George referenced, ANF and FSx, which are our first-party cloud storage products, are consumption based.

So, you should expect to see that percentage of consumption continue to climb as we go through 2024. And then, it doesn't mean that subscription is declining. It means that the consumption business is growing faster. And by consumption, we mean there – hey, there is no start or end date, it's not an annual or a multiyear subscription, it is a pay-go relationship.

Simon Leopold
Analyst, Raymond James & Associates, Inc.

Q

Thank you very much for that.

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

A

Thank you.

Operator: The next question comes from David Vogt of UBS. Please go ahead.

David Vogt
Analyst, UBS Securities LLC

Q

Great. Thanks, guys, for squeezing me in. So, maybe this is a question for both George and Mike. When you think about sort of the product innovation engine and the new all-flash offerings versus sort of keeping your OpEx flat going forward, how should we think about sort of what you need to invest in the business as, theoretically, there should be sort of a pretty steep growth rate in storage demand by some of your customers over the next couple of years?

And then, maybe as a quick follow-up. When you think about AI and what it means maybe for your business, how do you think about productivity gains and the uses of those productivity gains within NetApp? So, does that flow through, or is that reinvested into the business, whether it's go-to-market channels? I'm just trying to get a sense for how you think about what the benefit for AI would look like for you over the next couple of years as well? Thanks.

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

A

Okay. Let me hit the sort of the broad picture, right, which is, listen, I think that we are disciplined managers of the business. We are balancing a uncertain macro with the strength of our product portfolio and the long-term opportunity. And I think what you'll see us is we continue to invest in the areas where we see the best returns so that we don't forgo the long-term health of the business. If we see the year outperform, we will certainly look at investing to further accelerate the business. But I think, at this point in time, we want to be prudent in terms of managing the business just given the macro landscape.

I think the second is, with regard to AI uses at NetApp, we have a broad range of users. We already use AI in our customer support and our product portfolio to help customers be able to have much reduced management requirements, right? So, we automate how data is managed in the system and automate self-healing of a system, as well as give customers intelligent chatbots, for example, so that they don't have to wait in queues for all of their basic questions.

I think with regard to the big areas that we see opportunity is really in software development productivity. We have some exciting work already underway using some of these large language models and this profound opportunity for innovation there that we are leaning into. And you'll see the benefit of that in the ability to deliver more software to customers in a faster period of time. And I think those are some of the key areas of focus for us.

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

A

And David, it's Mike. If I could add one more from a go-to-market. We've talked a lot about building the customer success team, which adds productivity, because we're able to shift renewals and cross-sells and upsells and then create capacity for our core sellers. So, that's another big initiative over the next couple of years.

David Vogt
Analyst, UBS Securities LLC

Q

Great. Thanks, George. Thanks, Mike.

Operator: The next question comes from Sidney Ho of Deutsche Bank. Please go ahead.

Sidney Ho
Analyst, Deutsche Bank Securities, Inc.

Q

Great. Thank you. I have a cash flow question. So, I know Q1 is going to be impacted by all these strategic buys. But, Mike, how are you thinking about free cash flow for the fiscal year, maybe the linearity of that? It sounds like you're expecting to return 100% of free cash flow to shareholders this year. At what point, do you think M&A will come back to be a priority? Thanks.

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

A

Yeah. Hey. Thanks, Sidney. So, let's start at the top. So, we ended the year fiscal 2023 with $1.1 billion of operating cash flow. We talked about the onetime items, which was the restructuring and the Danish tax case. So, we paid out about $85 million for those two items in the quarter. So, if you add those back, you get about $1.2 billion. We would expect going into next year, I would call that kind of the floor for cash flow going into next year. Working capital then will drive whether we can do a little bit better or not. We will have some lower cash outflows in Q1 because of the incentive compensation payments. So, that will help Q1. The strategic buys will start a little bit in Q1 and then they'll build in Q2 and Q3, and then largely by the end of the year it's not a big number. So, it's more of an intra-year impact. And again, we do expect cash flow plus or minus a couple of percent, Sidney, to be pretty close to non-GAAP net income than it has been historically.

As it relates to our capital allocation policy, hey, it's the continuation of what we talked about last March – two Marches ago, with a little bit of a tweak going into the year. We've always said that we'd spent about 70% of our free cash flow on return to shareholders and reserve, call it, 30% for acquisitions. Going into fiscal 2024, we'll over-index on share buybacks, especially in the first half. It doesn't mean that we won't do any acquisitions. There's still a pipeline, we're still looking at them. But given where we are from an execution perspective and our focus on the business, we would rather reallocate that to share repurchases, especially in the first half, and we'll see where it goes in the second half of the year.

Sidney Ho
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. Great. Thanks.

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

A

Thank you.

Operator: Our last question will come from Louis Miscioscia of Daiwa Capital Markets. Please go ahead.

Louis Miscioscia
Analyst, Daiwa Capital Markets America, Inc.

Q

Okay. Thank you. George, I think you had said earlier in your script that you're going to regain some all-flash array share. Maybe you could go into that in any more detail. Do you think that you did lose some share, but obviously, now with the new products coming out now in the second half that you're going to start to regain, maybe if you could mention how much you think you might have lost and what you think you might be able to gain back? And then just a quick follow-up after that.

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

A

First of all, if you look at the recent print from our competitors, I think we took share already in the current quarter. So, that's a good start to that dynamic. I think with regard to our overall kind of focus areas, we talked about expanding innovation to support our storage business. And so, we've done a lot of product-led innovation into the market as well as brought innovations in storage life cycle management programs, the simplified licensing, the industry's most advanced and complete ransomware protection and recovery guarantees. So, a lots of service innovations as well for our customers.

We have aligned our go-to-market teams, starting fiscal year 2024, to be laser focused on our flash portfolio. We think we've got a strong opportunity there. Last year, as I mentioned in our Q3 call, we had a compensation plan that was complex, having our frontline sales team sell a broad array of products, and that impacted execution. We have sharpened that starting FY 2024 per our commitments, and we have brought a much more focused approach to our cloud portfolio.

So, I expect us to – we have the strongest hybrid flash portfolio in the industry. We now have the broadest capacity flash portfolio in the industry and truly the only unified storage portfolio in the industry. Unified now includes block, file, object and cloud. And so, we've redefined the landscape for unified to take it to the next level. So, we're excited about the portfolio. We've got to execute, and we're focused on it.

Louis Miscioscia
Analyst, Daiwa Capital Markets America, Inc.

Q

Okay. Then a very quick follow-up. On the guidance of down mid- to low-single, what is the FX expectation for next year? I assume that you're giving guidance an actual what you expect revenues to perform, but didn't know if you had an FX expectation in there.

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

A

Yeah. Hey, Louis, it's Mike. Our expectation is it's not going to be a big impact at all, less than 1% based on where we sit today from a revenue perspective. So, we don't think FX is going to be a big hit. And that's a small benefit from where we are. Who knows where FX rates go after all of the fun that we've had with the debt ceiling and other things. So, we don't think it's going to be a big driver next year.

Louis Miscioscia
Analyst, Daiwa Capital Markets America, Inc.

Q

Okay. Best of luck on the new year.

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

A

All right...

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, Louis. I'm going to pass it over to George for some closing remarks.

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

Thanks, Kris. Our focused execution yielded solid Q4 results, capping off fiscal year 2023 with record high annual operating margin and EPS, despite the slow demand environment. The fundamentals of our business model are sound and our confidence in our strategy and the health of long-term opportunity is unchanged. We will continue to prudently manage the elements within our control to drive margin expansion and improve profitability.

I'm excited to enter FY 2024 with substantial new innovations and a more focused operating model to better address areas of priority spending within our customers. I look forward to updating you on our progress on next quarter's call.

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