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NetApp, Inc. (NTAP)

Q1 2025 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, and welcome to the NetApp First Quarter of Fiscal Year 2025 Earnings Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. Please note this event is being recorded. I would now like to turn the conference over to Kris Newton, Vice President, Investor Relations. Please go ahead.

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

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

During today's call, we will make forward-looking statements and projections with respect to our financial outlook and future prospects, including, without limitation, our guidance for the second quarter and fiscal year 2025; 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.

Thank you, Kris. Welcome everyone. We started FY 2025 strong, building on our momentum exiting last fiscal year. In Q1, we delivered 8% year-over-year revenue growth and set records for first quarter operating margin and EPS. These results are a testament to our strong execution in a continued uncertain macroeconomic environment, our unwavering confidence in the customer benefits of the highly differentiated NetApp Intelligent Data Infrastructure platform, and our disciplined management of the business. As a result, we are raising our FY 2025 outlook for both revenue and profit.

As we said during our recent Investor Day, we are focused on our uniquely differentiated solutions in flash, block, cloud storage, and AI. They address markets which are bolstered by both secular and company-specific tailwinds and represent our biggest opportunities to fuel revenue growth and increase market share. In Q1, we experienced notable momentum across all these areas, evidence that our value proposition is resonating. This focus, coupled with our dedication to innovation, drives my confidence in our continued success.

Customers choose NetApp because we help them address their most important data challenges, leveraging the power of public and hybrid clouds to rapidly deploy new applications, unify their data for AI, simplify cloud integration, and strengthen data protection. We uniquely deliver a comprehensive and integrated storage and data management platform, giving our customers the power to unify all their data for any application, anywhere, and the ability to seamlessly and consistently manage it, while ensuring data remains secure and protected.

We again delivered robust year-over-year performance in our Hybrid Cloud segment, with revenue growth of 8% and product revenue growth of 13%, driven by strength in all-flash storage. Broad-based demand across our all-flash storage portfolio propelled our all-flash array annualized revenue run rate to $3.4 billion, up 21% year-over-year.

At the start of Q1, we introduced the new AFF A-series family of high-performance all-flash arrays capable of powering the most demanding environments, from today's mission critical applications to tomorrow's GenAI workloads. Delivering the advanced data management, industry-leading ransomware protection, and cloud integration that modern workloads require, the new AFF A-series saw positive customer reception and performed ahead of our expectations. Both our capacity flash and block optimized all flash array families exhibited strong growth year-over-year, addressing an expanded TAM and driving share gains. In Q1, we had numerous competitive take-outs across a broad set of workloads and vertical markets as customers leveraged our C-series and ASA products to modernize their legacy infrastructures and deploy new applications like artificial intelligence.

The ASA enabled us to capture a new to NetApp customer, displacing a legacy block storage competitor at a European-based manufacturer. The compelling price performance of the ASA, together with its modern architecture and comprehensive software capabilities, helps the customers realize savings as they refreshed their SAN environment. This is the first step in a larger relationship as the customer plans to purchase additional ASA systems to replace the remaining competitive footprint and evaluate our Public Cloud services.

Keystone, our storage-as-a-service offering was again a highlight this quarter, with revenue growing over 60% from Q1 a year ago. Keystone gives customers the operational agility and reduced financial risk they need to manage in a dynamic environment. A good example of this is a leading automotive supplier that chose Keystone to help address rapidly changing storage demands created by ongoing transformation of the automotive market.

Keystone gives them the flexibility to manage rapid growth but also the ability to shrink based on changing circumstance.

AI is the cornerstone of many of my customer conversations, reinforcing NetApp's position as a proven data infrastructure platform provider and thought leader in this space. Customers are selecting NetApp as their partner at every stage of the AI lifecycle because of our high-performance all-flash storage, unique cloud integration, and extensive data management capabilities. These capabilities support a wide range of needs, from data preparation, model training and tuning, to retrieval-augmented generation, or RAG, and inferencing, and address the requirements for responsible AI, including model and data versioning, as well as data governance and privacy.

While we believe the large opportunity for enterprise AI is still ahead of us, we are seeing good momentum today, with our AI business performing well ahead of our expectations. In Q1, we had over 50 AI and data lake modernization wins. I'll give you just a couple of examples. We were selected by another of the world's largest oil and gas companies for their AI and high-performance compute workloads. Our all-flash storage will power the customer's AI environment, servicing more than 40,000 CPU cores and GPUs, which run simulations and 3D virtualization workloads.

Additionally, we made it practical for a leading financial services institution to consolidate petabytes of data into a single data lake for AI and analytics workloads, including fraud detection, credit scoring and portfolio management, and improving the productivity of their data scientists. Both instances are examples of how our deep understanding of and experience in AI workloads, together with our intelligent data infrastructure platform, help drive customer preference for NetApp infrastructure to service their growing AI requirements.

We continue to advance our strong position with the development of GenAI cloud and on-premises solutions in partnership with industry leaders. In Q1, in partnership with Lenovo, we announced a full-stack OVX system, optimized for GenAI and designed to support RAG. Additionally, we introduced new capabilities designed for cloud AI workloads. We integrated the NetApp GenAI toolkit with Microsoft Azure NetApp files, giving customers the ability to generate unique, high-quality, and ultra-relevant results from GenAI projects by combining their proprietary data with pre-trained, foundational models.

In conjunction with AWS, we released a reference architecture for Amazon Bedrock to help customers implement RAG-enabled workflows that bring proprietary data stored on Amazon FSx for NetApp ONTAP into their GenAI data pipelines. GenAI is a truly hybrid workload, and only NetApp has the breadth of products and services to reduce the complexity, resources, and risks for customers in managing these strategic workloads across increasingly complex, hybrid multi-cloud environments.

Public Cloud segment revenue was $159 million, up 3% year-over-year. Our highly differentiated first party and hyperscaler marketplace storage services remain our focus and top priority. These services continue to grow rapidly, increasing roughly 40% year-over-year and performing ahead of our expectations at each of our hyperscaler partners. As we outlined on previous calls, we expect the headwinds from subscription services to lessen over the course of FY 2025, allowing the strength of our first party and marketplace storage services to shine through.

Our rapid innovation in cloud storage services, broadening workload support, capabilities, price and performance points, continues to solidify our leadership position. In Q1, we again enhanced the capabilities of AWS FSx for NetApp ONTAP, boosting scalability and performance to address evolving business needs. Microsoft recognized the unique value we and Capgemini bring with its 2024 Partner of the Year Award in the Migration to Azure category for our work in moving a large Asian retail customer to Azure, which included Azure NetApp Files.

Our strong Q1 performance continues the momentum from last year, paving a confident path into FY 2025. The robust growth in our revenue, billings, and profitability reflects the increasing alignment of customer needs with our unique solutions. We believe our highly differentiated intelligent data infrastructure platform, designed for the age of data, positions us to capture the growth potential in flash, block, cloud storage and AI, promising continued success for our shareholders and customers.

Looking ahead, our priorities are clear. We are well-positioned to seize a growing market opportunity. As we grow, we will maintain our disciplined operational management to drive leverage throughout our business model.

In closing, I want to thank the NetApp team for their dedication to delivering exceptional results in an uncertain macro environment. I also want to remind you that we are hosting our INSIGHT customer conference in Las Vegas next month, where we will announce advances to our innovation agenda and showcase how we help our customers make their data infrastructure intelligent for the age of AI. I hope to see you there.

Before I turn the call over to Mike, I'm sure you've already seen the news of his upcoming retirement. Mike has been a great partner to me in our focus on delivering profitable growth and shareholder value. Over the course of his tenure, from FY 2021 through FY 2024, he has helped drive revenue growth of 9% and EPS growth of almost 60%. In Mike, I have been blessed to have a wise partner from whom I learn much every day, a world-class human being, whose trusted friendship has helped us navigate disruptions smoothly, and who has entertained us with his encyclopedic knowledge of country music. I appreciate Mike's commitment to stay through the end of the fiscal year to ensure a seamless transition.

Over to you, Mike.

Michael J. Berry

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

Thanks, George, I greatly appreciate the very nice comments. I'll come back to those comments after I run through the numbers. While my family and I are excited about what is to come in our next phase of life, I want to assure everyone that it is business as usual until we name a new CFO. My focus will remain on delivering our [indiscernible] (15:00) and ensuring a smooth, seamless transition.

We executed a solid quarter in an uncertain macro environment, hitting or exceeding all of our guidance ranges. We are delivering on our commitments, as evident in our solid Q1 results. We made progress towards our long-term Investor Day targets of mid-to-upper single digit revenue and double-digit EPS growth on average through fiscal year 2027.

Before I get into the financial details, let me walk you through the key themes for the quarter. As a reminder, all numbers discussed are non-GAAP unless otherwise noted. Our top-line billings and revenue exceeded our expectations, growing 12% and 8% year-over-year respectively in Q1, with product revenue growing 13% year-over-year.

As expected, Q1 consolidated gross margin was strong at 72%, near all-time highs. Gross margin leverage and operating discipline drove operating margin of 26% and EPS of $1.56, both Q1 records. We returned approximately 170% of free cash flow to stockholders through cash dividends and share repurchases, reducing

Q1 diluted share count by 2% year-over-year. As we discussed during last quarter's call, we intend to return up to 100% of free cash flow this year.

Due to solid execution and strong operational management, we outperformed our expectations in the first quarter and expect our continued focus and discipline to deliver year-over-year revenue growth in each quarter of the year. As a result, we are raising our fiscal year 2025 revenue and EPS expectations.

Now, to the details of the quarter. Revenue of $1.54 billion increased 8% year-over-year, above the midpoint of our guidance range. Q1 billings of $1.45 billion increased 12% year-over-year. This marks our third straight quarter of year-over-year revenue and billings growth, even with an uncertain macro environment continuing to pressure IT spending. We are well aligned to customers' priority investments and remain confident that our innovations will drive growth through the rest of fiscal year 2025.

Product revenue of $669 million was up 13% year-over-year. Support revenue of $631 million grew 3% year-over-year. Public Cloud revenue of $159 million increased 3% from Q1 a year ago, driven by hyperscaler first party and marketplace storage services, offset by expected declines in subscription services.

Q1 consolidated gross margin came in at 72% and was up 160 basis points from a year ago. Product gross margin was 60%, in line with expectations. As we discussed on the Q4 call and during the subsequent Investor Day, we have an increasing share of total revenue derived from higher margin and recurring revenue sources, which we expect to continue through fiscal year 2025. We have made strategic purchase commitments to lock-in SSD supply and mitigate rising prices in the future, which continues to give us confidence in our product gross margins for fiscal year 2025.

Our recurring support business continues to be highly profitable with gross margins of 92%. Q1 Public Cloud gross margins improved to 71% from 68% in the prior fiscal year 2024 fourth quarter. During fiscal year 2025, we expect to continue to make progress on our Public Cloud gross margins towards our long-term target of 75% to 80%. Operating expenses of $714 million was up 2% year-over-year and declined 1% from Q4 fiscal year 2024. Q1 again highlighted the strength of our business model and disciplined operational execution with operating margin of 26%, ahead of expectations. EPS of $1.56 was also above the high end of our guidance, driven by higher revenues, operating margins, and interest income, and a slightly lower tax rate.

Operating cash flow was $341 million in Q1, a decrease of 25% year-over-year, driven by higher annual incentive compensation payouts and payments for strategic SSD purchases, partially offset by higher customer collections from higher billings. In Q1, DSO decreased to 40 and inventory turns were 8. Free cash flow decreased 28% year-over-year to $300 million due to lower operating cash flow.

During the quarter, we returned $507 million to stockholders through share repurchases and cash dividends, ending the quarter with approximately $600 million in net cash. We have approximately $1 billion remaining on our existing repurchase authorization. Our balance sheet remains healthy. We ended the quarter with approximately $3 billion in cash and short-term investments.

Q1 deferred revenue was $4.2 billion, down less than 0.5% year-over-year, a smaller decline than in each of the past three quarters. We expect continued improvement in our deferred revenue growth during fiscal year 2025 as we drive billings growth.

We are adding RPO as a new disclosure this quarter as it is a leading indicator of future growth in our business. Keystone, our storage-as-a-service offering, continues to gain traction in the market, broadening our relevance to customer use cases and is becoming a more meaningful part of our business. RPO, which includes unbilled commitments, was $4.5 billion in Q1.

Now turning to guidance, starting with the full year. While we continue to believe that macro indicators are uncertain, our continued execution gives us confidence in our business going forward. To that end, we are raising our revenue guidance for the full year to between $6.48 billion and $6.68 billion in revenue, representing 5% year-over-year growth at the midpoint. We expect fiscal year 2025 consolidated gross margin to be 71% to 72% and our operating margin to be 27% to 28%, both unchanged from prior expectations. We are raising our net interest income expectations to $50 million, driven by higher interest income. We now expect our tax rate for the full year to be 20% to 21%. As a result, we expect EPS to be in the range of $7 to $7.20, which at the midpoint, implies 10% year-over-year growth.

Turning now to our second quarter guidance. We expect Q2 revenue to range between $1.565 billion and $1.715 billion, which at the midpoint, implies 5% growth year-over-year. We expect Q2 consolidated gross margin to be 71% to 72%, and operating margin to be approximately 28%. We expect net interest income to be approximately $15 million in the quarter, our tax rate to be between 20% and 21%, and EPS in the range of $1.73 to $1.83.

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

Finally, before we go on to Q&A, I would like to add some personal comments on my announcement. It has been an honor and a privilege to lead such a dynamic and visionary organization over the last 4.5 years. I'm so proud to be part of the NetApp team and being able to play a role in helping NetApp grow and deliver on its promise of profitable growth.

I am committed to ensuring a smooth transition and will continue to lead the finance organization until an appropriate successor is identified. Like all companies, NetApp continues to evolve, and I am excited to welcome a new CFO who will help take NetApp to the next level and execute against the strategic roadmap we laid out at our recent Investor Day. I want to thank all of you for your continued support of NetApp and look forward to the continued success in the business. That being said, I want to reiterate that it is business as usual for now and I look forward to seeing many of you at our upcoming investor events.

Kris, please take it away 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] The first question comes from Krish Sankar with TD Cowen. Please go ahead.

Krish Sankar
Analyst, TD Cowen

Q

Yeah. Hi, thanks for taking my question and congrats on the strong results. And Mike, congrats on the retirement and thanks for all your help towards the sell side and the buy side. We're going to miss you. And my first question is for Mike. On the higher NAND pricing, from a demand or top line standpoint, is that impacting the demand for all-flash? And from a cost standpoint, how to think about its impact on gross margins? Because I understand you made the strategic NAND purchases, but how many quarters do you think that lower NAND price purchase can carry you through? And then I have a follow-up for George.

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

A

Sure. Hey, Krish, thanks for the question and thank you for the kind comments. I appreciate it. So let's do the last one first. So as we've talked about, we've purchased a large majority of our NAND forecasted for fiscal 2025. We feel really good about the position that we're in there. How much of it may go into next year really depends on what happens in the rest of 2025-plus. We'll keep our eye on the market. We may decide to do more pre-buys, we'll see how the market goes.

Back to your first question, if I understand it correctly is, hey, I don't – at this point, as we've always talked about customers budget in dollars. And from our standpoint, the market really hasn't changed too much. So we have not seen much of a change in demand. Based on that, we'll see how it goes for the rest of fiscal 2025. But up to this point, no real changes.

Krish Sankar
Analyst, TD Cowen

Q

Got it. Got it. Thanks, Mike. And then George, quick question for you. Earlier this year, you released the ASA A-Series. It's like a great product as it unifies file block and object storage for customers. Can you just update us? How is the product performing? And I understand new products take a while to translate into sales. How is the order flow pipeline looking like and any kind of customer pushback for using a unified product versus their best-of-breed solution? Any feedback on that would be helpful. Thank you, George.

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

A

We have been very pleased with the introduction of the AFF A-Series, which is the unified storage product line like you talked about. We introduced a set of models at the high end of those – of the product family, and the adoption rates have been strong. As you note, they go through a certification process, and in the largest customers that takes a little while. But we are seeing all the right activity in terms of proof of concepts, qualifications, and certifications underway. We've had several wins in customers that are deploying new environments that would be happy to choose a new product.

It complements the C-Series unified storage products. The C-Series is for general-purpose workloads. The A-Series is for high performance-demanding workloads like transactional databases, AI workloads that demand low latency consistently and a lot of IO. And both of those in turn complement the block-optimized ASA family, which serves only block workloads, where we also saw strong uptick. So, I'm very pleased. Overall, our flash business performed really, really well in the quarter, as you saw with 21% year-on-year growth.

Krish Sankar
Analyst, TD Cowen

Q

Thanks, George.

Operator: Our next question comes from Samik Chatterjee with JPMorgan. Please go ahead.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Hi, thanks for taking my questions. And before I ask my question, again, Mike, thanks for working with us so closely. I know this some time, but it was great working with you. Best of luck as well.

I guess, if I can start for the question. George, I had a more of a question on the comments that you had related to uncertain macro and how that's impacting storage demand. Because when I look at the progression of revenue here, which you've been doing a great job on sort of executing to plan, the sequential trends are pretty much in line with seasonality that you've seen historically. It does look customers are back to spending in a more sort of normal fashion.

So, when you think about how the uncertain macro is impacting your customers' appetite to spend, what are you really seeing in terms of what would even concern you? Because you're on track to do record revenue at this point. Trends look pretty sequential in line with seasonality. So, just curious, like, what are you seeing in terms of your customers' appetite to spend in a normal fashion? Is there anything that's giving you some hesitation on that front? And I have a follow-up. Thank you.

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

A

Yeah. Overall, I think there are – while the economy has progressed from this time a year ago, there are still a good amount of geopolitical risks, and we are waiting the interest rate changes that seem to be nearer than they were when we entered the quarter. So I feel like overall, things are progressing in the right way, though there is still a good amount of especially geopolitical uncertainty.

With regard to what we saw in the quarter, we saw a broad-based strength in our product lines and in the Asia-Pac and European markets, where our teams did really well. We saw some slowness in the US public sector, especially the federal part of the public sector business, because of the continued budget challenges with the continuing resolution. US enterprise performed well.

What we see across all these markets is that customers are prioritizing spend on strategic projects, and so that part of our business continues to do really well, and I'm encouraged by the alignment of our solutions to that. What we haven't yet seen is large-scale data center refreshes, which would signal a broader-based economic recovery and confidence in the business.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Got it. Got it. And in terms of when you talk about AI workloads and you talk about sort of AI is truly going to be more of a hybrid sort of environment to play with both public cloud and sort of your hybrid solutions, and you talked about in the prepared remarks ASA driving some of those wins as well, how do you think about fiscal 2025 in the context of what contribution you are expecting from these wins that are more specific to customers, saying these are going to be dedicated towards their AI deployments or AI workloads, both covering sort of Public Cloud and Hybrid, how you're thinking about what that looks like for your fiscal year? Thank you.

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

A

Yeah, let me hit on – you had two points in there. One is, I think broadly speaking, the rate of innovation in the software applications that drive AI is very high, particularly in the Public Cloud, where broader frameworks that combine databases, data warehouses, data lakes, together with AI models are progressing at a really rapid rate.

So what we see within our customers is many of them want to use the tools on the Public Cloud, the application, together with data that might sit in their data center environment, or in the Public Cloud. And we are able to make that entire workflow much, much more secure and easy to manage, which is a part of the reason why we saw strength, both in the data foundation for AI, as well as in the cloud storage portfolio, where we're seeing our ability to create a no-siloed, unified architecture come through for us.

With regard to how we see it play out through the year, listen, on cloud, we have said that we've seen strong results for multiple quarters now with our cloud storage portfolio. Those have been masked by some of the challenges we have noted and that we are seeing lessening as a headwind from the subscription part of our business. So we expect cloud to return to a pattern of consistent growth through the rest of the year.

With regard to the storage portfolio, listen, we are one quarter into the year. We had a really, really strong flash quarter. I'm encouraged. We've raised guidance for the full year. We are very, very confident heading to the rest of the year. And we'll tell you more as the year plays out.

Samik Chatterjee
Analyst, JPMorgan Securities LLC

Q

Okay, great. Thank you. Thanks for the responses. Thank you.

Operator: Next question comes from Simon Leopold with Raymond James. Please go ahead.

Victor Chiu
Analyst, Raymond James & Associates, Inc.

Q

Hi, this is Victor Chiu in for Simon. Can you just provide some color around the sequential improvement in Public Cloud this quarter? Kind of what was the driver behind the strength there? And how should we think about the sustainability and trajectory of the improvement from this point going forward?

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

A

Hey, Victor, it's Mike. Sure, happy to do that. So as George talked about in his remarks, we saw really strong growth in our first party and marketplace cloud storage business. We talked a lot about that at our Investor Day in terms of that growth. So that grew 40% year over year. If you take a look at the rest of the portfolio, as he talked about as well, hey, we are expecting subscription services to still be a little bit of a headwind though, moderating as we go through the year.

So all in all, we do expect cloud revenue to accelerate from a growth perspective as we go through the year, led by the strength in first party and marketplace, and also the subscription services being a little bit less of a headwind as we get through some of those business changes that we are making.

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

Okay, so the strength was kind of largely in line with what you were expecting for the most part.

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

It was a cloud, and first party, marketplace were what we were expecting and even a little bit better, quite frankly. So we've seen some really nice growth in that business. And again, as we look forward, we expect that to continue and actually accelerate because of the strength of those products.

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

Okay, that's helpful. And just one quick follow-up. How should we think about – a follow-up on the last question, how should we think about the mix of the type of customers behind the initial AI contributions? Are you seeing demand from enterprises or is it biased towards kind of a hyperscale, cloud type operators? How do we think about where the demand is coming from initially and how that evolves over time as the type of AI workloads evolve?

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

Most of our demand is from large enterprises, some of which operate as internal service providers, but most of the demand is from very large enterprises. There is a mix of use cases across data lakes and data foundations for AI, fine-tuning and model training, as well as the first phases of inferencing RAG. So we've seen a good blend of all of those use cases.

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

That's helpful. Thank you.

Operator: [Operator Instructions] The next question comes from Steven Fox with Fox Advisors. Please go ahead.

Steven B. Fox
Analyst, Fox Advisors LLC
Q

Hi. Good afternoon. And Mike congrats on your retirement. I guess just in terms of thinking about competitive dynamics, George, it seems like you called out, like you mentioned, a broad set of sort of positives that could be winning market share. Can you sort of give us a sense versus, now versus 90 days ago where you're seeing the most gains and why, and where maybe you're more confident going forward on share gains? Thanks a lot.

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

A

Listen, I think what we've seen is our focus and execution continues to get better and better, and we made good progress on that in the second half of last year, and then that momentum continues. So I feel really, really good about where we are. With regard to the portfolio, our cloud storage portfolio continues to gain traction, right. We've got more workloads, more price points, more customers, and integration into a broader and broader set of the hyperscalers environment.

So, I feel really, really good about the innovation portfolio there. With regard to the flash portfolio, really strong results across the board. We had in the block storage part of that portfolio, which is pure share gain against competition, we are demonstrating the price performance leadership against the high-end product of our competitors, as well as the price performance and feature set leadership against the mid-range products of our competitors. So I feel really good about the wins that we're seeing across the board.

Steven B. Fox
Analyst, Fox Advisors LLC

Q

Thank you.

Operator: Next question comes from Amit Daryanani with Evercore. Please go ahead.

Amit Daryanani
Analyst, Evercore ISI

Q

Good afternoon. Thanks for taking my question. I have two as well. I guess, George, maybe to start with, you folks are seeing some really good growth on the all-flash array side. I think it's up 21% this quarter. Can you just talk about, is this cyclical recovery in demand, or is it share gains, or you're just converting your install base perhaps more towards all-flash? Just trying to understand what's driving the strength here. And then, crucially, what do you think the durability of this 20%-plus growth is on the all-flash side as you go forward?

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

A

This is the third successive quarter of high rates of all-flash growth, double digits, and we feel really good about the portfolio. Which, Just let me hit a couple of the points you raised, which is we are seeing a broad set of new to NetApp customers and new to NetApp Flash customers with the broadened portfolio that we have.

Roughly 50-50 mix of completely new to NetApp, have never had NetApp, as well as a broad set of customers who are buying our flash products for the first time. So I feel that's a good leading indicator of continued momentum in the portfolio. With regard to the install base getting upgraded, we have said that a part of the cycle of QLC Flash is the refresh or the migration of a very, very large 10K install base of hard drives, both ours as well as our competitors to that Flash product portfolio. And so it's a mix of new accounts, new to NetApp Flash accounts, as well as some of the install base getting refreshed.

And I think if you just look at it, right, the total install base of 10K drives is enormous. It was roughly from a volume perspective, somewhere around 35% to 40% of the total storage market for a very long period of time. And so there's a huge install base to go refresh. So if you ask me, we are in the second inning of a nine inning ball game.

Amit Daryanani
Analyst, Evercore ISI
Q

Perfect.

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

And you know what, in terms of our, one final comment, the strength of our customer addition says that even with all of the growth of our flash, the overall install base grew. So that the penetration of flash into our install base stayed steady quarter on quarter.

Amit Daryanani
Analyst, Evercore ISI
Q

That's really helpful, George. And then Mike, I'll extend my Mike, congrats as well on your retirement. Could you just maybe just touch on how should we think about product gross margins from the 60% ZIP code that you had in Q1, really for the rest of the fiscal year? Just maybe any parameters on how to think about product gross margins as we go through the year would be helpful. Thank you.

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

Sure. Amit and everybody, hey, thanks for the comments. I appreciate it. We got a lot of work to do. You're going to see me for a little while, so I do appreciate it. Hey, on product gross margins, as we said last quarter, we do expect it to come down a little bit as we go through the quarter, as we work down the pre-buys. So we were right about at 60% this quarter. Again, we said for the full year that as we sit here today, we're still comfortable with that upper 50s to 60% for the full year basis. So no real change, Amit, in the trajectory of what we expect through the rest of the year. That we, anything different than we talked about last quarter.

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

If I were to just add, during the course of the quarter, we saw as we see in the history of the storage industry, some of our competitors did take pricing up. And so that's a leading indicator of actions that the broader industry would take in an inflationary commodity environment.

Amit Daryanani
Analyst, Evercore ISI
Q

Great. Thank you very much.

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

Thank you.

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

Mehdi Hosseini
Analyst, Susquehanna International Group
Q

Thanks for taking the question. I want to go back to George's commentary. You talked about the all-flash array record [ph] 3,400. (44:01) Actually, year-over-year growth of 21%, another record. But, George, consistent with the prior question, every time we get to this kind of 20%-plus growth, the concern is, okay, when is it going to deaccelerate? And I understand that you laid out your targets for FY 2027, but could we see a de-acceleration in FY 2026, especially if overall spending environment were to remain constrained? And then a more broader upgrade cycle would come in, in FY 2027, could we see that kind of cycle materializing? Because given what we have seen over the past 20 years, every time you had this kind of strong growth, it's followed by de-acceleration. I want to understand what gives you the confidence, and I have a follow-up.

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

I think two or three things, right? I think one is our portfolio is a lot broader than what we've had in the past. And I would point that out by the fact that we now have flash products across all the price points in the market, as well as custom offerings for block storage, where we previously would only sell unified storage.

And so, I feel really good about having a much fuller product portfolio, as well as the pace of innovation and leadership that we have in areas like data security is pretty clearly underwritten in the market. The second is, where we are today is in a market where the pure play storage players are outperforming the integrated system vendors. And so you look at a broad range of the integrated system vendors, they have struggled now for many quarters in their storage business. And it remains to be seen whether that is a strategic focus for them going forward.

And so, when I look at our position relative to other players in the market, I feel really good. I would not call the current environment a rosy spending environment, right? And we have done well for multiple quarters now in a fairly choppy macroeconomic environment. I'm hopeful that if the macro stabilizes, especially the geopolitical environment stabilizes, we should see some more spending come through, which would be benefit to our business.

Mehdi Hosseini
Analyst, Susquehanna International Group
Q

Thank you. Thanks for additional insight to a repeat question. And just one quick follow-up for me. How should I think about the mix of NAND that are used in terms of QLC versus other technology, and how the QLC mix would trend over the next couple of quarters?

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

QLC should grow as a percentage of our total mix. It's roughly half right now as a percentage of the flash business. And so you should see that grow as a percentage of the total flash business.

Mehdi Hosseini
Analyst, Susquehanna International Group
Q

Great. Thank you. And, Mike, best of luck in your next endeavor.

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

Thank you, Mehdi.

Operator: Our next question comes from Aaron Rakers with Wells Fargo. Please go ahead.

Q

Hi. This is [ph] Jake (47:19) on for Aaron. Congrats on the quarter, and thanks for the question. I was just hoping you could double-click a little bit on the enterprise demand you're seeing for AI products. It sounds like it's still pretty early days for AI inference. I'm wondering what inning of adoption you think we're in, and what's the competitive landscape like there?

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

A

Yeah, I think we are in the early innings of the AI landscape from a storage perspective. I think you are seeing the fact that AI so far, the AI applications require specific computing architecture, which is why you're seeing the compute build-out happening. But from a storage and data standpoint people are using their proprietary data with these AI models, and so as we said consistently, we're in the early inning. It is when that inferencing trend, as well as large-scale generation of data, come into play that you really see the inflection in data storage.

I think what we are seeing right now is everybody is getting their data ready for AI. And so they're all trying to unify their data, figure out what data they need for particular types of application, getting their hybrid cloud pipelines working so that they have AI applications in the cloud, they can connect their data to it. And so we're seeing a lot of getting data ready, which is often in the form of a data lake or some kind of data infrastructure that brings together all of their data, and we're very well-positioned for that.

We hold a huge amount of the unstructured data in the world, and so we are naturally a part of any generative AI use case requires data that often sits on us. And the two examples we gave you on the earnings call are classic examples. One is a large financial services institution that is trying to summarize all of the unstructured data that they have in their various application, and so they work with us and a set of AI application vendors to feed all of that into their data – into their LLMs.

We are expecting – inferencing is expected to be the preponderant majority of the storage market for AI and the enterprise AI landscapes. It's about 80%, maybe 90% of the total market. And RAG is expected to generate about 8x more data than the data that is fed into the RAG pipeline. So there's a lot of new generation going to happen, when and if these applications become mainstream.

Q

Great. Thank you.

Operator: Thank you. Our next question comes from Ananda Baruah with Loop Capital. Please go ahead.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Hey. Yeah. Good afternoon, guys. Thanks for taking the question. Yeah. And, Mike, congratulations. We'll miss working with you, but job well done, obviously. I guess, George, sticking right there, I just had one. Sticking right there, piggybacking off the [ph] LSA (50:34), so inferencing is 80% to 90% of the storage market opportunity over time. The comments you made about RAG a moment ago and the growth there, the data getting thrown out there, like, how does that – I guess, is that, like, in the other 10% of the opportunity, or does that actually, in some way, feed and amplify the inferencing opportunity?

And then, can you just remind us – you guys, you just mentioned access to data installed base that you guys have. But can you also remind us, from a capability perspective, how you stack up to the other companies that could be – sort of have a play in, say, inferencing and RAG? And then also, could you include your thoughts on how you stack up relative to, say, VAST and WEKA and DDN, just to level set that for us, thanks.

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

A

Yeah. So let me just – there's three questions in there. On the first one, the comment about where do we see the large multiplicative effect of RAG and vectorization of data, it is actually part of the inferencing data growth, right. And so, we see that when you create structure on top of unstructured data for inferencing, it actually grows the amount of data that you store quite significantly. And so, that fits into that opportunity set that we say, hey, 80% of it is probably inferencing.

With regard to our capability set, listen, we feel really, really good about our capability set. I think what we see is, first of all, a lot of – we have a lot of experience in AI. We've been in the market since 2018 with NVIDIA, we have hundreds of customers that do AI with us.

The second is, to do this kind of large-scale AI workloads, you need to have scale-out file systems and integrated object. And so, the fact that we have in ONTAP a scaled-out file system with parallel NFS and integrated S3 capabilities gives us a lot of strength in the market. We've got wins in training. We've got wins in data lakes. We've got wins in fine tuning and inferencing, right, so pretty much across the board.

We are also unique in the market with the hybrid cloud pipelines, right. There is no one else in the market that can do what we do, literally no one else because of the native integration that we have. And I would just close by saying come to NetApp INSIGHT. We have an awesome set of innovations that will showcase how real customers are using our technology to solve real AI problems today. And over the next 12 months, we got an awesome set of capabilities that build on all the hard work we've done so far.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

That's super helpful. I'm going to just do a quick follow-up. Does this mean – like, just given all the capabilities you spoke about, George, does that suggest that you believe the company could have an amplified share position in GenAI storage going – like when that kicks in?

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

A

With GenAI, the two market players that have the installed base, Dell and us, are super well-positioned. We feel extraordinarily good about our capability set. Come to INSIGHT, you'll hear more.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Thanks a lot, appreciate it.

Operator: Our next question comes from Wamsi Mohan with Bank of America. Please go ahead.

Wamsi Mohan
Analyst, Bank of America Merrill Lynch

Q

Yes, thank you so much for taking the question. George, you just said that you had in all-flash new to NetApp and new to all-flash. Can you just elaborate a little bit what parts of the all-flash market are you seeing the most traction between hybrid capacity and performance flash? And who do you think you're taking the most share from? And I have a follow-up.

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

A

I think if you look at the overall market, the capacity flash market is the fastest growing. It is because the technology is new. You're seeing the displacement of 10K drives and it's all year-on-year compares the capacity flash market as tailwinds, right. And I think that's where we see the strongest growth. The performance flash market continues to be a growing part of the business. We have done well there. And I feel good about the prospects for our performance flash block products, which are, a TAM expanding opportunity for us. We compete in that part of the market against frame arrays, right. It could be the Dell, PowerMax or a large frame array from Hitachi or HPE.

And essentially this capability that we have is exceptional price performance, consistent latency, which makes it easy to run databases, and other workloads on our infrastructure, plus a great set of features that allow you to unify your data landscape, and take these environments and plug them into the AI workflows that you want. And so, I feel good about that on the high end. We've also seen good progress in the mid-range with QLC against a broad range, upgrading our installed base of 10K drives, upgrading other installed bases of 10K drives. And so same suspects we compete with, our results are strong. And so, I feel good about the fact that we've taken share in the market.

Wamsi Mohan
Analyst, Bank of America Merrill Lynch

Q

Okay, thanks, George. I want from Mike, Mike, congrats as well. Can you talk about the drivers for the lower tax rate? And if you look at the higher interest income, and lower tax rate, it does not show much increase of the operational level for operating dollars despite the higher, slightly higher revenue. So just wondering what some of the puts and takes there, if there are anything that you'd like to call out? And are you still expecting gross margins to step down a little in the second half versus first half or does that change now, because you have these pre buys that you've made during the quarter? Thank you.

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

A

So, thank you Wamsi. Thanks for the question. So I'm going to answer the last one first and then just give me the chance to walk through the puts, and takes of guidance. The answer is no, no change to what we said last time in terms of the trajectory of gross margin. So hey, let's back up for a second. So, we beat the first quarter by $11 million in revenue and $11 million in EPS. Because of the strength in the business, and our confidence in it, we then raised it by $30 million in revenue, and then $0.20 in EPS.

Let's go left-to-right first and then we're going to go down because I think this is important. So based on those results, and the demand that we see, and the visibility in the Q2, we did raise Q2 by about another $10 million. We also raised the second half in revenue as well. EPS largely follows that as you go through the year. However, we did underspend in OpEx in the first quarter. Therefore, we pushed some of that spend to the second half. That answers your question about why you don't see the operational, the throughput as much.

And then let's hit your other questions. On the tax rate, it is simply a forecast of projection of income by geo. Our tax rate in the last two years has been 20.9%, 20.3%. We thought it would go up based on the mix of profitability. We now expect it to be consistent with last year.

And then on the interest income, the team has done a lot of great work, making sure that we can invest all of our cash balances. And candidly, they didn't lower rates as fast as we thought they might, hence, we've bumped that number up as well. So those are the big movers in guidance.

And then for the year, we've left, importantly, the full year gross margin percentage and operating income percentage is consistent. We're only one quarter in. We feel really good about the year, but let us get through the next quarter and then we'll take a look at that as we go through the year, so hopefully that helps. That's the outline for guidance for the year, Wamsi.

Wamsi Mohan
Analyst, Bank of America Merrill Lynch

Q

Yeah. Thank you so much, Mike.

Operator: Our final question today comes from David Vogt with UBS. Please go ahead.

Q

Hi, thanks for taking the question. This is [ph] Brian (59:42) on for David. I'm just wondering on GenAI, is flash at a TCO today to drive adoption of storage or do we need the cost curve to come down further over the next year or so? And then what percentage of shipments and installed base are flash today? Thank you.

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

A

With regard to shipments, flash is, if you look at it, roughly 60% of the Hybrid Cloud revenue. And so, it's a little bit higher than that on product revenue, so I would just leave it there. I think with regard to the install base, it's still a small part of the total install base. The majority is, it's about 40%. The majority is still hard drives, right. And we've been selling flash for how many years? So, it shows the size and the fact that our overall install base is growing.

Let me get to your question about AI. With regard to AI, it depends on what part of the lifecycle you're operating in. If you're building a large repository of data, like a data lake, where you're unifying all the different data types that you want to be able to process in a large language model, the portion of that data that is actively being used with the model is going to be on flash. The sort of a practical customer that doesn't want to gold plate their environment will keep the archived data sets for models that they have run for either regulatory reasons or for business trajectory reasons. They will keep that on disk based solutions, is what we've seen so far, large scale object repositories that are typically on kind of disk based solutions.

If you then move into active model training and fine tuning, that happens in an all-flash configuration where the active data set is being crunched with an LLM. And then when you move to an inferencing model, inferencing happens wherever you have your business process, right. So, you could have it in a data center environment where you could run it on flash. You could have it in a small manufacturing facility where you could probably use disk or flash. And then you could also have it in the cloud. We are seeing many instances of cloud based inferencing that our tools are being used, so it's a broad mix. I hope that gave you – and there is no one answer. I hope that gave you a good sense of where the business is at.

Q

Got it. That's helpful. Thank you.

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

A

All right. Thank you, [ph] Brian. (01:02:29) I'm going to pass it back to George for some closing remarks.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

Thank you, Kris. And thanks, everyone. We have got FY 2025 off to a strong start, because of the strong alignment of our solutions with customers' most important data challenges coupled with our focused execution. We are delivering innovation at a fast pace, and are well positioned to capture the growth potential in the key markets of flash, block, cloud storage, and AI. Our relentless focus on these significant opportunities combined with disciplined operational management continues to yield positive outcomes. I hope to see you at NetApp INSIGHT and look forward to updating you on our continued progress on next quarter's call. Thank you.

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