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NetApp, Inc. (NTAP)

Q3 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Kris Newton
Vice President-Corporate Communications & Investor Relations

GAAP AND NON-GAAP FINANCIAL MEASURES

- Reconciliations of our previously reported GAAP results to the restated 606 GAAP results as well as our 606 GAAP to non-GAAP results are included in our Q3 earnings release for the applicable period, which is posted on our website, along with our financial tables and guidance, a historical supplemental data table and the non-GAAP to GAAP reconciliation
- Unless otherwise noted, we will refer to non-GAAP and 606 numbers
- During the call, all financial measures presented will be non-GAAP, unless otherwise indicated

George Kurian
President, Chief Executive Officer & Director

BUSINESS HIGHLIGHTS

Opening Remarks

- In the face of an uncertain macroeconomic environment, we focused on the variables within our control and delivered a strong third quarter
- Although, I'm disappointed with revenue being at the low end of expectations, our operational discipline delivered gross margin, operating margin and EPS that were above the high-end of our guidance ranges
- Regardless of the demand headwinds, we remain well positioned for the long term as we address the growth areas of the market and provide efficiency in our business

CY

- I'd like to address the challenges we saw in Q3 head on
- The macroeconomic environment is outside of our control, but I remain exceptionally confident about our strategic position and operational focus to deliver profitable growth and shareholder value
- After a normal close to the CY, we saw a slowdown in purchasing across-the-board in January, driven by deteriorating outlooks for the global economy as well as uncertainty around trade policy

Headwind

- In the face of these headwinds, our largest customers became more cautious in their purchasing behavior and sought more information on the implications for their businesses of slowing economies
- We did not see any real change in the competitive environment
- Our win rates stayed constant and our pipeline remains healthy
- Our customers' purchasing decisions continue to be based on our features, capabilities and future-proved cloud integration strategy

- Even in the face of softening demand, we were able to further expand product margins in Q3 by focusing on the value our solutions bring in addressing customers' largest IT imperatives

Go-to-Market Strategy

- Like any company, we do not have perfect visibility into all the reasons for purchasing slowdowns
- However, we are deeply involved in the strategic planning and purchasing process of our large customers and have good visibility into how they deploy us, and where we fit into their IT strategies
- We remain tightly engaged with them and as such are confident that we have the right product set and the right go-to-market strategy to continue capturing a greater share of our customers' IT wallet

Digital Transformation Initiatives

- Our unique customer value is reinforced by digital transformation initiatives, which are fueling data center modernization projects and cloud-first strategies
- To succeed in the data-driven digital economy and radically improve business performance, customers need to accelerate digital innovation, generate real-time insights and secure access to their data across multiple clouds and on-premises
- This requirement for hybrid multi-cloud capabilities is creating three significant market transitions: disk to flash, traditional IT to private cloud and on-premises infrastructure to hybrid clouds

NetApp Data Fabric and Take Share

- It is in these key strategic battlegrounds that we have substantial opportunity to exploit the advantages created by the NetApp Data Fabric and take share
- We are driving the market transition from disk to flash as we help customers modernize, simplify and improve application performance
- We are displacing competitor's complex equipment, gaining share in new workload deployments and upgrading our installed base with cloud-connected all-flash solutions

All-Flash Array Business

- In Q3, our all-flash array business inclusive of All-Flash FAS, EF and SolidFire products and services grew 19% y-over-y to an annualized net revenue run rate of $2.4B.
- We are over-indexed in the large and growing all-flash market with a significantly higher all-flash arrays share than in the total storage market
- Our advantage here will continue, as the market shifts to flash and we expect that shift to accelerate with ongoing NAND price declines

ASP

- All-flash arrays carry a higher ASP which benefits not only product revenue, but also recurring services revenue
- With only 15% of our installed base currently running all-flash arrays, the runway for this secular transition remains in the early innings
- The second major market transition we're exploiting is the shift from traditional IT to private cloud
- SolidFire and NetApp HCI are the building blocks for private cloud deployments, enabling customers to bring public cloud like experience and economics into their data centers

Private Cloud Business

- In Q3, we announced new validated and proven architectures that simplify the design, deployment and support of on-demand services and applications as well as support hybrid cloud workflows with an on-premises S3-compatible object storage
- Customers are embracing our unique value that couples extreme ease of use with enterprise scalability and quality of service
- And as a result, the momentum in our private cloud business that began in the October quarter accelerated in Q3

Cloud Data Services

- The shift from on-premises infrastructure to hybrid clouds is the third key market transition that we are taking advantage of to expand our business
- Only NetApp is building a comprehensive set of cloud data services available across multiple clouds
- We help customers extend on-premises environments to the cloud, deploy enterprise workloads in the cloud, and build and re-factor primary workloads for the cloud, with tools to optimize hybrid cloud workloads and cost
- Based on the last month of Q3, our cloud data services annualized recurring revenue is approximately $33mm, up 22% from Q2

Cloud Volumes Service

- As we've said before, this is a foundational year for our cloud data services, during which we are focusing on operational readiness and deployment with the hyperscalers
- We are excited by the feedback that we are receiving from the growing number of customers, who are in controlled production with us
    - While still in early phases, we are well positioned for when these services soon become broadly available
- Roughly two-thirds of early Cloud Volumes Service customers are new to NetApp
- This coupled with the strong customer interest we are experiencing, gives us tremendous confidence in the potential of this part of our business

Private Cloud Solutions

- In closing, we are confident in our position for long-term success
- We are a leader in the large all-flash array market
- We are seeing accelerating momentum with our private cloud solutions and our public cloud solutions are positioned to deliver strong growth in FY2020

Core ONTAP Business

- We are playing into the big market transitions from a position of strength
- Flash and cloud integration enables us to protect and expand the installed base of our core ONTAP business
- Our private and public cloud solutions enable us to reach new buyers

- Our flash, hybrid cloud infrastructure, and AI solutions are serving as pillars of customers' new architectures and we are seeing adoption of our cloud offerings as part of our customers' foundation for moving applications and data to the cloud
  - These factors combined, give us confidence in our ability to re-accelerate growth as customers become more comfortable with the external environment

Gross Margin and Profitability

- We have demonstrated discipline in managing the business and will continue with a keen focus on the factors within our control
- We are paying close attention to execution to maximize our opportunity in an uncertain macro
  - We again expanded gross margin and increased profitability in the quarter, despite the slight moderation in customer buying behavior
- I would like to thank the NetApp team for their commitment to a high level of discipline, execution and customer focus

Ronald J. Pasek

Executive Vice President & Chief Financial Officer

FINANCIAL HIGHLIGHTS

Margin and Operating Leverage

- As a reminder, I'll be referring to non-GAAP numbers, unless otherwise noted
- As George highlighted, in Q3, we delivered strong margins and operating leverage in the face of caution from our customers around the macro environment
  - This is a solid testament to the strength of our underlying business model
- Despite the market uncertainty, we are confident in our product leadership and strategy to reaccelerate growth going forward, and we remain sharply focused on execution and managing the variables within our control

Product Revenue

- Consistent with our commitment to shareholders, we again improved gross margin, operating margin and delivered outstanding FCF
- In Q3, despite a slower demand environment experienced in January, net revenues of $1.56B were within our guided range and grew 2% y-over-y, including about a one-point of currency headwind
- Product revenue of $967mm, increased 2% y-over-y, reflecting our shift to all-flash arrays and growing traction in our private cloud solutions, offset by about 150BPS of currency headwinds
  - There were no ELAs in the quarter

P&L

Cloud Data Services Business

- Moving down the P&L, software maintenance and hardware maintenance revenue of $531mm increased 2% y-over-y, driven by our continued growth in our installed base and to a lesser extent our cloud data services business

Gross Margin

- Gross margin of 63.7% was above the high end of our guided range
- As expected, we saw the normal seasonal sequential decline in product margin from Q2 to Q3
- Product gross margin came in at 52.6%, which is an increase of about 100BPS year-on-year, reflecting continued sales force discipline in the face of macroeconomic uncertainty and about 50BPS of currency headwinds
    - This was the eighth straight quarter, we increased product margins y-over-y
- The combination of software and hardware maintenance and other services gross margin of 81.7% increased about 50BPS y-over-y

Operating Expenses

- Operating expenses of $629mm were down 2% y-over-y coming in lighter than anticipated, largely due to lower variable compensation
- We remain committed to strong OpEx discipline and continue to expect operating expenses for FY2019 to be roughly flat y-over-y
- Operating margin of 23.5% came in solidly above the high end of guidance and represented a new company record

EPS, Cash and Short-Term Investments

- EPS of $1.20 was above the high end of our guided range and increased 14% y-over-y
- We closed Q3 with $4B in cash and short-term investments
- Similar to Q2, we again saw healthy growth in deferred and financed unearned services revenue, which increased 7% y-over-y and was up $151mm sequentially
- Deferred revenue growth continues to be a strong leading indicator of the health of our installed base

FCF

- Our cash conversion cycle remained extremely healthy at a negative 11 days, which was roughly flat y-over-y
- Cash flow from operations was $451mm
- FCF of $420mm represented 27% of revenues, while YTD FCFs of $804mm represents 18% of revenues
- Q4 has historically proven to be a strong seasonal period for FCF conversion
- As such, we remain committed to driving FCF of 19% to 21% of revenues for the full FY

Capital Allocation Strategy

- Our confidence in our long-term vision and execution is reflected in our capital allocation strategy
- During Q3, we repurchased 8.1mm shares at an average price of $67.84 per share for a total of $550mm
- Weighted average diluted shares outstanding were 255mm, down 21mm year-on-year, representing an 8% decline
- We have $2.4B remaining on our current share repurchase authorization, and we'll continue to be aggressive given NetApp's FCF yield and return on invested capital profile
- During the quarter, we paid out $99mm in cash dividends
- In total, we returned $649mm to shareholders, representing 155% of FCF generated in the quarter

GUIDANCE

Net Revenue

- Now on to guidance, customer caution around the macro backdrop has heightened as we entered the new CY
- As a result, we expect Q4 net revenues to range between $1.59B and $1.69B, which at the midpoint implies flat revenues y-over-y
- It is worth noting that our Q4 revenue guidance includes 200BPS of currency headwind, and is off a very challenging Q4 2018 compare where we grew total revenue by 11% y-over-y

Gross Margin and EPS

- Consistent with the normal seasonal sequential decline in gross margin from Q3 to Q4, associated with product revenue being a larger portion of the overall revenue mix, we expect Q4 consolidated gross margins to range between 62% and 63%
- We expect Q4 operating margin to be between 23% and 23.5%
    - We expect EPS for Q4 to range between $1.22 and $1.28 per share
- The midpoint of our Q4 revenue guidance implies total FY2019 revenue growth of 4.6%
- Our Q4 guidance also implies FY2019 gross margin of 64.3%, operating margin of 22.7% and EPS growth of 28%

Long-Term Profitability Targets

- As we look out to FY2020 and beyond, I'm confident in our ability to reaccelerate growth and deliver on our long-term profitability targets
- We remain diligently focused on both disciplined execution and continued innovation
- In the face of a slower demand environment, our business model leverage and the secular tailwinds created by the three key market transitions, flash, private cloud and cloud data services, will enable us to continue to deliver on the commitments we've made to shareholders, partners and customers

QUESTION AND ANSWER SECTION

Andrew James Nowinski
Piper Jaffray & Co.
Q

Maybe I'll just ask a question as it relates to your guidance that you gave at Analyst Day regarding FY2020 and 2021. I'm curious just given the results that we saw today and your guidance for Q4, would you say you're still expecting to deliver at least 15% earnings growth over the next two years? And then also on the revenue, is that mid-single digit still valid?

Ronald J. Pasek
Executive Vice President & Chief Financial Officer
A

Hi, Andy. Yes, that is our plan and you're seeing in FY2019, we're going to do well above that. And, yes, our long-term guidance still is mid-single digits on the top line, absolutely.

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

Just relative to the weakness that you're seeing from your large enterprise customers, it looked like your direct business was down 12% year-on-year. That was the first time in I think six quarters that you were down, but your channel business was actually up mid-single digits. What do you think the difference is in terms of the tone of smaller customers vs. large customers? Because if you look at all the channel partners that have reported, they all talked about fairly strong growth and still good outlook for this year.

George Kurian
President, Chief Executive Officer & Director
A

Our largest customers are the ones that we serve through a direct pathway. The broad range of customers are served through a channel model. The largest customers are the ones that are most affected by some of the uncertainty, both economic and political uncertainty around the globe. And we saw incremental caution in their buying behavior in January.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer
A

Matt, the other thing that's a little misleading just to factor in is, in Q1 and Q2, we did have ELAs, which show up in direct revenue. So, they skewed the direct number a little bit higher. If you adjust for that, we're always within the last say eight quarters 20/80. And again, that's where the demand is fulfilled not necessarily where it's created.

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

Okay. And in terms of the ELAs, you didn't have any revenue. You've had some good revenue there in the last few quarters. Is that more of a timing issue and related to the weakness that you're seeing from your large customers?

Ronald J. Pasek
Executive Vice President & Chief Financial Officer
A

No. It has nothing to do with that. Nothing at all. It's just – as we said, when we first started talking about ELAs, they tend to be difficult to predict and lumpy. And there weren't any we had in the quarter or anticipated to have.

Wamsi Mohan
Bank of America Merrill Lynch

Q

Ron, can you talk about the gross profit at a product level? If you could bridge that sequentially from last quarter to this quarter, the 150BPS sequentially, and given the revenue decelerations that you have seen, do you think that you can hold the 50% product gross margin over the next year or so, especially when the competitive environment becomes a little tougher around the mid range storage product launches that are anticipated to happen later in the year?

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

Yeah. Thanks, Wamsi. Yeah, I mean, if you look at the last eight quarters, we've grown product margins each of the last eight quarters y-over-y. And our intent is still to do that. The target we gave you was 55% to 56% and we still plan to do that. The bridge from Q2 to Q3 on the product side, remember this is always a seasonal thing that happens with the public sector quarter being Q2. And then typically we have a fall-off in that business. So that's very traditionally we saw that each of the last five years, so we had some of that seasonality affects over the headwind and then we had no ELAs in the quarter. We had in the last quarter, and then that's offset with some benefit from NAND pricing.

Wamsi Mohan
Bank of America Merrill Lynch

Q

Okay, great. And George just a quick clarification for you. I think you noted that elasticity of the NAND controller kick in, given these NAND prices. Is there typically a three to six-month lag that you expect to see this elasticity of demand and this macro environment sort of clouding maybe that elasticity of demand from kicking in faster?

George Kurian
President, Chief Executive Officer & Director

A

We think that over time as NAND prices continue to decline that customers will shift the mix of their business from disk-based systems to flash-based systems. We saw good acceleration in our flash system counts through the course of the quarter. We saw some incremental caution in terms of how much capacity customers were buying, which could be correlated to buying for today's needs as opposed to building out for their entire future requirement. So we saw a little bit of that. It's reflective of a bit to the macro environment.

We believe that as NAND prices continue to move favorably, it gives us an opportunity. We are well-positioned in the flash market. We have strong differentiation with software, which has allowed us to preserve and even grow gross margins. And if you look at the ASPs of a flash-based system as opposed to a disk-based system, they are actually higher. So we think that's a good trend for us to capitalize on.

Aaron Rakers
Wells Fargo Securities LLC

Q

First of all, could you just help us understand, I mean, the rate of deceleration that you saw during the month of January? And as you thought about the guidance for this current quarter, your assumptions how maybe February played out? And what assumptions you're making relative to what you saw in January as far as any kind of improvement? And I have a quick follow-up.

George Kurian
President, Chief Executive Officer & Director

A

I would say that we felt very good about where we were within the quarter, sort of, heading into the Christmas holiday. And things changed materially through the last week of December and really January.

I think that we did not see any change in the competitive dynamic, win rates or any of those aspects. We just saw an increased amount of scrutiny in terms of spending within our customers. Them requiring more approvals, and just buying for today as opposed to buying the full scope of what they plan to buy with us.

I think that with regard to some of our largest customers, the global customers that are exposed to geographies around the world, as well as to public sector, there will be time before they come back to their normal course of spending, right? Some of that is related to sort of clarity on how their businesses are impacted and some of that like in public sector is it takes time to get the workforce back and into normal operating cadence, which is reflective of our caution in Q4.

Aaron Rakers
Wells Fargo Securities LLC

Q

Okay. That's very helpful. And then on the NAND pricing front, can you just help us understand what rate of declines are you currently seeing on the flash side? And how you would characterize your ability to hold flash pricing in the market?

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

The price declines we're seeing are not perfectly linear. They continue to go down. I think what we've – you got to remember in the storage industry and our company's history is predicated on decreasing commodity pricing. So in many ways, as George said earlier, it catalyzes demand for new use cases and drives the never ending appetite for increasing data consumption. So, it's something we're predicting. It's why we have a over rotation on flash. We know that that's the growth area. The price reductions help that growth. As George said, you see the elasticity between the different types of media and so as NAND prices come down more workloads move to all-flash.

George Kurian
President, Chief Executive Officer & Director

A

And we're seeing that. If you look at system counts and capacity counts through the course of this FY, they have been both up quite substantially. I think what we noted this quarter especially in January was a little bit of a step back in caution around capacity. System counts continue to be really good.

Ananda Baruah
Loop Capital Markets LLC

Q

I appreciate. Hey, George or Ron, any greater context you can provide on what your large customers are using as signpost? I mean you mentioned, George, I think in the prepared remarks that they're looking at their end business. And then just quick a follow-up to that, do you have any sense if they're pausing on how broad – are they pausing on new implementations? Or are they milking – not milking, but are they sort of raising capacity on existing projects? You mentioned that they might be adding less capacity on new projects like that. Would just love any more context around those two things. Thanks.

George Kurian
President, Chief Executive Officer & Director

A

I think it's too early to draw broad conclusions. I would say that January represents a new budget cycle for a lot of our customers. And as they get their planning in place, I think they took a little bit longer this year than typical because of the uncertainty. I think we saw the transformational projects that have multi-quarter implementations continue at pace. I think in the net new projects, I think people were probably a little bit more cautious waiting for clarity in terms of how their business rolled out. I would say in terms of our book-of-business, all of the strategic areas of focus for us; all-flash arrays, private cloud, and our cloud data services we feel good about our progress across all of those dimensions. They really reflect the strategic aspect of our discussion with customers, and we feel good about the progress on all of those dimensions.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

You should keep in mind even if you isolate Q3, it's really – we were off 2% from the midpoint. And if you look at the full year based on the midpoint in Q4 guide, we're off maybe a little over – almost two points in the full year. So in the scope of the greater scheme of things we're still pretty much on exactly what we thought from mid-single digits.

Kathryn Lynn Huberty
Morgan Stanley & Co. LLC

Q

Ron, for you on gross margin guidance, if I look back at the last two fourth quarters, total company gross margins were actually up a little bit sequentially despite the fact that the lower margin product business was growing very fast. And you didn't have as much help from NAND. So can you just talk through, why this year you think total company gross margins are down sequentially?

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

So, Katy, I think, the better compare is really y-over-y. And I think that's a more meaningful compare. And then remember, what we typically see sequentially is – and you see this from Q1 to Q2, Q2 to Q3 generally, and Q3 to Q4, the higher weight of product margin and product revenue, which grows carry – this is slightly lower margin than the services margin, so that always puts pressure. That's a mix issue that we see all the time.

Kathryn Lynn Huberty
Morgan Stanley & Co. LLC

Q

Okay. I see. And then George just as a follow-up, I think, a year ago you talked about exiting this FY with perhaps...

Kris Newton
Vice President-Corporate Communications & Investor Relations

A

I think we lost, Katy.

Kathryn Lynn Huberty
Morgan Stanley & Co. LLC

Q

Sorry, sorry. Just a follow-up for George at – about a year ago you talked about exiting this year with $6mm of cloud services revenue. And it looks like you're tracking a little bit below that. Why do you think that is? Or is that not the right way to think about it? Thanks.

George Kurian
President, Chief Executive Officer & Director

A

We are in the foundational year of our cloud data services business. I would say we're a bit behind where we expected to be in terms of the operational readiness of our service offerings with our cloud providers. We are, as we said, generally available with AWS. We are in controlled pilot production projects with both Azure and Google, and we expect them to be available eminently. I would say that, we are probably a half basis point towards – below where we guided for the full year revenue. But we are excited that the results that we're seeing, it confirms all of our expectations in terms of differentiation. We have broadened the range of use cases and workloads that we serve. And so as soon as we get to generally available with these cloud providers, we feel very good about our ability to inflect the business and return and accelerate that.

Kathryn Lynn Huberty
Morgan Stanley & Co. LLC

Q

[indiscernible] (35:37).

George Kurian
President, Chief Executive Officer & Director

A

In terms of our long-term model for cloud data services, we're not backing off the projections we had. As Ron mentioned, we feel confident about our long-term model for the whole business as well as for our cloud data services.

Steven Fox
Cross Research LLC

Q

Just one other question on the slowdown you saw in January. Is there – could you isolate it to what verticals maybe were more – where you saw it more in terms of the slowdown, or geographic regions? And given we're talking about longer term start-up projects, like, what would you say would be the extended decision timeline vs. what you previously thought for these things closing or starting to ramp at pace you originally anticipated?

George Kurian
President, Chief Executive Officer & Director

A

I would say that one of the areas that we talked about as having some decisions pushed out was in U.S. public sector, where we said in Q2 some decisions pushed out. We saw the recapture of a preponderant majority of those decisions in Q3 and we were able to move those projects forward.

With regard to the broader macro, I don't think there were any specific industry trends that we noticed. I think that clearly those industries with specific exposure to China and public sector were incrementally more cautious. But I think there weren't any other specific trends that we could draw out.

With regard to the U.S. public sector, as we said earlier on the call, we think that it will take some time for the government to get back to full-fledged operations. And so, we don't have perfect visibility into how projects shape out through the course of the coming quarters, so we're being incrementally cautious there.

Mehdi Hosseini
Susquehanna International Group

Q

One question for George. How do you see the replacement cycle for 10-K RPM playing out for the remainder of 2019? Is it going to be more of late in the year, or we should think of this cycle kicking in next year? And for Ron, how – I know, this is a little bit far out, but as we look into FY2020, how aggressive are you going to be in managing your OpEx?

George Kurian
President, Chief Executive Officer & Director

A

Let me take the 10-K RPM drive question. I think there's still work to be done to get a viable solution to replace some of the capacity points that 10-K drives were focused on. If you notice, the majority of the 10-K drives that are still being deployed are actually lower capacity points than some of the TLC NAND solutions that are available in the market at comparable effective dollar per gigabyte price points.

So you can see some customers that'd say, listen, I want to strategically move to all-flash for its benefits that increasingly start to look at that as an option. But I think for the full transformation to happen, you will need quad-layer cell or the next sort of capacity price point in the NAND cycle. And we're working on that, but it will take some time.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

So Mehdi, on your OpEx question, it's a little early for that. But I'll remind you what we said at Analyst Day last April. So I guided this year to be roughly flat in OpEx and actually next year as well. But remember we're still actively doing a ton of transformation, so we're still doing a lot of investments and a lot of disinvestments. So, it's not as if we're just staying flat and not doing anything. We're really working and getting a lot more efficient.

George Kurian
President, Chief Executive Officer & Director

A

In terms of just to underscore that point we have made all of these bets into the new parts of the market private cloud, all-flash arrays, cloud data services and new pathways to market, while simultaneously improving operating margins to a record. This quarter operating margins are the highest – been the highest in the company's history, right?

So we will continue to stay disciplined on the operating expense side of the business, but we're not going to forego strategic opportunities for short-term gain. I think, we have maintained discipline and you'll see us continue to invest into the future opportunities, while being prudent about overall spend.

Alex Kurtz
KeyBanc Capital Markets, Inc.

Q

George, just on hyper-converged, I know this has been a big area of investment for the company over the last couple of years. I know, it's still kind of working its way through the channel and with the sales organization [ph] if we're (41:01) looking to FY2020. Are you prepared at this point to provide kind of a run rate that you think is reasonable? Or a percentage of product revenue? Or just serve a contribution to the overall product side of the business? That'd be helpful to understand.

George Kurian
President, Chief Executive Officer & Director

A

Our overall private cloud business, meaning SolidFire deployed standalone or as part of a hyper-converged model. For large customers they deployed standalone. For smaller and mid-market customers, they deployed as hyper-converged. As well as object storage, which are deployed for cloud native applications in a private cloud form were a substantial contributor to NetApp's revenue this quarter.

I'm not prepared at this point to break it out, but I can tell you that they performed in a really good pattern across customer accounts, revenue contribution, units, strategic wins; you name it, we got it. And we think that as we look forward to FY2020, it gives us a really strong second leg foundation to our growth, right?

So we're already a leader in the all-flash array market. We are seeing accelerating and materially accelerating momentum in the private cloud game. So stay tuned, we'll tell you more as we head into FY2020.

Timothy Patrick Long
BMO Capital Markets (United States)

Q

Ron, you talked a little bit about the install base when referring to the software, hardware, maintenance and services. Just give us – if you could just give us a little more color there? It was up a little bit y-over-y. It looks like it was down a little bit sequentially, so is there a seasonal pattern there as well? And when do you think we could expect to see that line with a little bit more sustainable growth? Is it dependent on just all-flash array being a bigger piece of the overall base? Or cloud data services? Or what do you think will help move that line higher more sustainably? Thank you.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

Yeah. So, as we talked about we continue to grow system counts in the install base. And remember up until two years ago we had 13 quarters of sequential decline in a row on the product side. So we've really got to get back to 13 quarters of y-over-y increase in the install base to really get back to where that you'll see that grow again. So we're probably several quarters away from that. We don't – as you know we don't guide that discretely, Tim, so even though we'll give guidance on the next call for FY2020, I won't guide specifically I'll give some general color though.

Simon M. Leopold
Raymond James & Associates, Inc.

Q

I wanted to see if you could talk a little bit about what's happening in your competitive environment? And to what degree your growth is driven by your customer base upgrading their base of NetApp platforms vs. to what degree are you dependent on basically taking footprint from others in the marketplace? Thank you.

George Kurian
President, Chief Executive Officer & Director

A

We did not see any change in the competitive dynamic through the quarter. I would say that when you look at our all-flash array business it is expanding wallet that we used to not have within our traditional enterprise customers as well as through our cloud solutions both private cloud and certainly public cloud solutions, we are expanding to net new customers.

I'll simply give you some data which says that of all of our cloud customers that we are engaged with either through the hyperscalers or through our own cloud software offerings, two-thirds of them are net new to NetApp. So they are opening up new relationships and new logos for us to acquire. So we do not see any fundamental change within the comparative landscape. We think that as the market transitions from disk based to flash based systems given that we are a leader in all flash with a substantially higher market share percentage than we are in disk, there are a lot of weak large players in disk based systems that we will take share from – IBM, Hitachi, Fujitsu, Oracle, HP – there's a lot of them and even Dell has a challenged midrange portfolio and high-end portfolio. So we feel good about our opportunities. We've got to execute to capture them.

Jason Ader
William Blair & Co. LLC

Q

George, Cisco just reported and they didn't see the macro issues that you guys apparently did. So I'm just wondering how do you explain that, number one. And number two, do you think there might be something else going on in terms of maybe NAND pricing causing some customers to delay just because they want to see where prices go in the market?

George Kurian
President, Chief Executive Officer & Director

A

You know we did not – I can't comment on what Cisco saw or not, so I would leave that to Chuck to comment. I think with regard to our business what I can tell you is we maintain discounting through the end of the quarter, so it's not a matter of, hey if you offered a lower price customers would step forward and transact. I would tell you based on being involved deeply in many of these transactions, we saw an increased level of scrutiny on transactions where you would have to get more purchasing approvals or provide for greater explanation of ROI or business case or things like that. And so, I would just tell you that, if it were as easy as providing a discount to deal with forward price NAND contracts, we have the vehicles to do that and we would have applied those.

Jason Ader
William Blair & Co. LLC

Q

Okay. And then one quick follow-up for you George. Just on – at AWS re:Invent this year, Andy Jassy spent like a half an hour talking about Amazon's new file-based storage offerings. And I was just wondering what impact you think that might have on your offering through AWS?

George Kurian
President, Chief Executive Officer & Director

A

We continue to see really good uptake of our cloud volume software through AWS. And so I'm sure, he has his own offerings, but that hasn't had any impact on NetApp.

George Iwanyc
Oppenheimer & Co., Inc.

Q

George, Europe looked to behave a little bit differently, it looked relatively strong. Can you give us an idea of what's happening there? And then just a quick follow-up as well.

George Kurian
President, Chief Executive Officer & Director

A

It was really good execution by European team. We are the leader in all-flash arrays in many parts of the European market. We have deep strategic relationship with customers. There is volatility in the European political landscape. We did see some GDP changes. We're being cautious about the overall environment, but I just want to say that our team executed well and stayed in control of the business until the end.

George Iwanyc
Oppenheimer & Co., Inc.

Q

Okay. And can you give us an update on your Lenovo partnership and if that's helping in China.

George Kurian
President, Chief Executive Officer & Director

A

It's too early to comment about the success of the partnership. We are in the market. We are seeing wins that are additive to the NetApp footprint. It's too early for me to characterize them in terms of size or color except that, listen this is additive to NetApp.

I think with regard to China, it gives us a pathway into that market that is isolated from some of the trade tensions. The NetApp team finished the NetApp quarter well and executed well and I want to thank them for that. And we're looking forward to the joint venture getting off the ground soon enough and we'll keep you posted as the news of that and the operational readiness comes online. So we feel like the China approach that we have is positioned well to endure all of the challenges that might exist between the geopolitical – in the geopolitical relationship and it allows us to focus from a branded channel perspective on the rest of the world, while Lenovo helps us with their enormous resources in China. Stay tuned.

Paul Coster
JPMorgan Securities LLC

Q

The macro uncertainty that you saw in January that was manifested in the slight change in behavior of your large customers, was that also true of the cloud service providers either as partners or even as customers?

George Kurian
President, Chief Executive Officer & Director

A

We don't – the three major hyperscalers, meaning; Amazon, Google and Microsoft do not buy hardware from us. They work with us where we deliver a service through their data centers to customers. So they're more like a partner. We saw no evidence of them backing off. In fact, the range of use cases and the deployments that we have with them are widening rather than narrowing.

There are other cloud service providers who we sell to, sort of not the super jumbo hyperscalers. And across them there was a variety of puts and takes. I think many of them are being careful to prioritize the investments around their best opportunities. For example, 5G wireless, right? So I would just say, they're going through one of these evaluation of priorities process, and so we did see some changes in that mix.

Paul Coster
JPMorgan Securities LLC

Q

Okay. And then the other sort of big secular theme that's happening of course is more and more workloads and data is being pushed to the edge. Are you seeing any manifestation of that to your business?

George Kurian
President, Chief Executive Officer & Director

A

Yeah. We are pleased by the growth of the use cases that we are deploying in the edge, so we have software-defined solution that are part of ruggedized environments that are deployed at the edge in industrial and public sector use cases, we saw good traction with our object storage portfolio, providing a private cloud for certain advanced telemetry use cases. In autonomous driving, we saw good adoption early, but still good adoption of some of our AI solutions to crunch the data that is generated at the edge and brought back to the core.

So we remain optimistic that our solution portfolio is good and differentiated and the number of growth engines we have as the macro stabilizes is certainly broadening from even a year ago.

Jim Suva
Citigroup Global Markets, Inc.

Q

George I think you've been very clear about the demand environment and a lot of questions on that. So maybe I'll switch a question over to Ron. Ron, in the past few quarters there were several ELAs that came up and then NAND this quarter. I think some people were thinking that ELAs might just kind of be a normal course of doing business. So with none this quarter is the normal course of doing business with one or two a quarter kind of not really how it's going to turn out or were there a couple of customers who signed ELAs and just other people don't want that? Or any type of behavior change on kind of the topic of ELAs? Or just simply is it lumpy and we shouldn't expect it to be one per quarter or something like that?

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

Yeah. It's a good question. Last quarter I mentioned, it's hard to anticipate when they're going to land, so I gave a full year view this year and the next year, as you should expect roughly 2% of revenues as ELAs.

It is lumpy. They're hard to predict. There will be quarters when they're zero. There will be quarters when they are quite a bit more than that. So it's just a really difficult thing to predict and I can only give a full year guide on it.

Jim Suva
Citigroup Global Markets, Inc.

Q

Thank you so much.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

It's going to make some quarters difficult compares. This quarter – this year in Q1, we had a very robust ELA quarter. That's going to be a difficult compare.

George Kurian
President, Chief Executive Officer & Director

A

We did not anticipate...

Jim Suva
Citigroup Global Markets, Inc.

Q

So, Ron, it sounds like...

George Kurian
President, Chief Executive Officer & Director

A

Hey Jim. We did not anticipate ELAs nor did we see them. So it performed according to plan.

Jim Suva
Citigroup Global Markets, Inc.

Q

Yeah. I just wanted to make sure there's no change in behavior. It was more just the timing of it and things like that.

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

That's right. And remember we did about $90mm in Q1 and about $20mm last quarter in Q2. So we really don't have much left to do to get to that full year 2% guide.

Jim Suva
Citigroup Global Markets, Inc.

Q

Thank you so much for the clarifications. It's greatly appreciated.

Karl Ackerman
Cowen and Company, LLC

Q

I guess Ron, looking at progress margins excluding ELAs, with enterprise SSD prices declining roughly 20% this quarter and the next, would you expect to see a massive WIP higher in your product gross margins beyond April?

And you continued to improve hardware maintenance margins, certainly an impressive feat for sure. What do you think has been the biggest key contributor to that improvement in hardware maintenance margins? And why would I be wrong to conclude that business couldn't have perhaps an eight handle on gross margin over the next few years? Thanks.

George Kurian
President, Chief Executive Officer & Director

A

Yeah. So the first part of your question we are seeing some benefit in total margin for NAND. But it's really more of a focused effort really over the last eight quarters not just in the last couple of quarters. So it's hard to anticipate what might happen and I'm not going to telegraph what I think might happen other than I'm confident we'll get back to 55% or 56% eventually on product gross margins. I've been pretty clear about that.

On the hardware maintenance margins, I think, you've got to be a little careful. We do have competitors in that space. We have to be careful what our margins are and what we charge, and we need to make sure that customers feel that we can provide a quality service at a reasonable price. And they can see those gross margins as well. So you've got to make sure they're not ridiculous.

Steven Mark Milunovich
Wolfe Research LLC

Q

George, you talked about the importance of executing in the future. Could you talk about the evolution of your go-to-market? And one thing I've heard is that, NetApp may not be as good as some competitors in selling to new customers, not as comfortable selling up to the CTO, the CIO, the CFO and I know that this is also part of your selling value to get that 55%, 56% product margin, so kind of an update on go-to-market?

George Kurian
President, Chief Executive Officer & Director

A

I think it's a place that we continue to work to improve our capabilities, right? I'd say that over the last year-and-a-half to two years we've opened up new fast ways to market. For example, with Lenovo into parts of the world that we have historically not had a lot of footprint with the hyperscalers into the top of the accounts where big digital transformation projects are, and have expanded the total addressable market as a result of solutions like our private cloud solutions. We have continued to optimize our sales coverage model, so that we can align resources to go after net new accounts, and net new workloads. And we believe there's substantial total available market for us to go address. And so this is an area where we have to improve and we're going to continue to try to do so every quarter.

Eric Martinuzzi
Lake Street Capital Markets LLC

Q

Question for George. In your prepared remarks you talked a little bit about the installed base being such a terrific opportunity because I think it was only 15% that gotten their – purchase the all-flash array. In some ways that's encouraging because it shows the wide open opportunity. But in some ways, we've heard that number at least I can recall hearing it several quarters now. I'm just wondering, what is it that's got the installed base maybe reluctant is the wrong word, but what can you do to enhance the adoption of all-flash in the installed bases?

George Kurian
President, Chief Executive Officer & Director

A

The installed base is a very very large number of systems. And so what – as we are growing our flash systems, we are also simultaneously growing our installed base, right? So both numerator and denominator are growing. The things that will help catalyze the movement are really consolidation and economic projects to improve that installed base.

As flash gets cheaper, it certainly makes it a more viable prospect to help customers upgrade their installed base as some of these next-generation data center projects get under way in our customers, there's opportunity to certainly improve that conversion. But it will take time, just given the magnitude of that installed base.

Eric Martinuzzi
Lake Street Capital Markets LLC

Q

Do you have any like a two to three-year horizon where you expect that 15% could become 25% or 30%?

George Kurian
President, Chief Executive Officer & Director

A

I don't have any forecast at this point. I do think, it'll follow the trend of our flash opportunity. And we're mindful of the fact that, hey, our installed base is an opportunity.

Nikolay Todorov
Longbow Research LLC

Q

It sounds like you're rightfully cautious on the large customer side in the U.S. public sector. But I just wanted to understand your underlying guidance assumptions for the channel business. Are you guys as rightfully as cautious as there? Or there's a little bit more optimism and to that end of the market? And overall, what is the outlook for 2019 hardware spending that you're getting from the channel business?

George Kurian
President, Chief Executive Officer & Director

A

We have roughly 80% of our business fulfilled through the channel and that's the number that we break out in the categorization of our financial metrics. That number has stayed relatively stable for a very long period of time and we don't foresee a substantial mix shift this coming quarter or next year, right?

I think within that channel number there are a set of customers that the channel fulfills for large customers, and others for small. The small medium customer segment performed better this past quarter. We continue to believe they are a growth opportunity for us given our share in that market. We're more cautious about the large customers who have global businesses.

Rod Hall
Goldman Sachs & Co. LLC

Q

Well, it's a miracle. Okay, thanks for the chance again. I wanted to zero in on the y-over-y growth rate on the revenue. I just – I'm looking at the trend here, back in April of 2018 it was 11%, 11.6%, then 7.2%, then 1.6% in January and then you're guiding for basically flat, maybe down just $1mm or $2mm.

And so, I guess what I wanted to ask is whether you believe this April guided quarter is the bottom on that trend? And if you don't believe that, why not? And if you do believe it, why do you believe it's the bottom?

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

So I think what you've got to remember is the guide we gave which looks roughly flat y-over-y has two points of currency headwind. The 11% you mentioned last year had two points of currency tailwind. I would think it would be – we're going to do mid single-digits next year that's the guide I can tell you right now. So I don't know how that will quarterize, but obviously that has to be – we have to be growing from where we're ending Q4.

Rod Hall
Goldman Sachs & Co. LLC

Q

So Ron, you'd be just saying that then the January quarter is the bottom and if you add the two points back, you're kind of – well, you're kind of flat lining on the growth that you saw in January and then from here, we can guess what the trajectory might be?

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

That's right. That's right.

Nehal Sushil Chokshi
Maxim Group LLC

Q

So I think DSOs were up five days y-over-y. So presumably that means that things were a little bit more back-end loaded than usual, yet you talked about how you did see a slowdown at the back end of the quarter. So a) can you help bridge that perhaps maybe you saw a loosening up of that demand at the end of the quarter, but not enough to make up for the shortfall at the beginning of January?

Ronald J. Pasek
Executive Vice President & Chief Financial Officer

A

Yeah. Nehal, it was really odd. It was not back-end loaded. We saw kind of that demand as we talked about kind of wane in January, so that's not the issue. When I dissect the reason for the escalation DSOs, which is not significant, it's just the mix of customers that has slightly different terms than they did last year. Wherever you end up with collections at the end of the quarter based on that group of customers can be different than the prior year compare – or prior quarter compare.

I would point out that we're still in a very negative cash conversion cycle, so I'm pretty happy about that.

Nehal Sushil Chokshi
Maxim Group LLC

Q

Okay. And then my...

Kris Newton
Vice President-Corporate Communications & Investor Relations

A

All right. Go ahead, Nehal.

Nehal Sushil Chokshi
Maxim Group LLC

Q

Yeah. George you mentioned that you're a bit behind on the operational capability of the cloud data services with your cloud service providers. Could you delve into why it's behind? And then also there has been some management shakeups at some of these cloud service providers. Does that create some opportunity for NetApp as well?

George Kurian
President, Chief Executive Officer & Director

A

Well, we've got really good long-standing relationships with them. We are performing deep technical integration of our technology into their service delivery platform, and we're going through testing and certification, right? So we are going to be imminently available and we look forward to that.

We are excited at the production pilots that we have going on with their customers. So stay tuned. I think we have an expanding range of opportunities through those cloud providers.

Kris Newton
Vice President-Corporate Communications & Investor Relations

A

All right. Well, thank you, Nehal. We appreciate it. And now I'll pass it back to George for some final remarks.

George Kurian
President, Chief Executive Officer & Director

Q3 HIGHLIGHTS

Gross Margin, Operating Margin and EPS

- Despite the near-term demand headwinds created by the uncertain macro, we were able to beat on gross margin, operating margin and EPS
- We continue our strong discipline in managing the business
- As the economic uncertainty abates, we are well-positioned to reaccelerate our positive momentum by capitalizing on the key market transitions created by digital transformation
- We are playing into these transitions from a position of strength
- Our solutions allow us to reach new buyers, while growing our installed base
    - We are a leader in all-flash
- The momentum in our private cloud business is accelerating
- Our public cloud solutions with large hyperscalers are poised to deliver strong growth in FY2020

- All of this supports our confidence in our long-term model for mid single-digit top line growth.