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NetApp, Inc. (NTAP)

Q3 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by. And welcome to the NetApp Q3 Fiscal Year 2021 Conference Call. At this time all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions] . As a reminder, today's conference call is being recorded.

I would now like to turn the conference over to your host, Ms. Kris Newton. Ma'am, you may begin.

Kris Newton

Vice President Investor Relations, NetApp, Inc.

Thank you for joining us. With me today are our CEO, George Kurian; and CFO, Mike Berry. This call is being webcast live and will be available for replay on our website at netapp.com. During today's call we will make forward-looking statements and projections with respect to our financial outlook and future prospects, such as our guidance for the fourth quarter fiscal year 2021, our expectations regarding future revenue, profitability, and shareholder return; and our ability to continue overall growth, gain market share, and scale our cloud business, all of which involve risk and uncertainty.

We disclaim any obligation to update our forward-looking statements and projections. Actual results may differ materially for a variety of reasons, including macroeconomic and market conditions such as the continuing impact of the COVID-19 pandemic; and the IT capital spending environment; as well as our ability to gain share in the storage market, scale our cloud business, and generate greater cash flow. Please also refer to the documents we file from time to time with the SEC, and available on our website, specifically our most recent forms 10-Q and 10-K including in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Risk Factors" sections, and our current reports on Form 8-K.

During the call all financial measures presented will be non-GAAP unless otherwise indicated. Reconciliations of GAAP to non-GAAP estimates are posted on our website. I'll now turn the call over to George.

George Kurian

Chief Executive Officer and Director, NetApp, Inc.

Thanks, Kris. And thanks, everyone, for joining us today. I hope that you and your loved ones have stayed safe and healthy since the last time we spoke. I'm pleased to report that we delivered another strong quarter with our third consecutive quarter of revenue and billings growth despite the challenging environment. In the third quarter, our team delivered revenues at the top of our guidance range and operating margin and EPS above the high end of our expectations.

Our performance in Q3 was broad-based, with notable strength in Americas enterprise. The incremental sales capacity we added in FY 2020 continues to pay off. Additionally, our Run-to-NetApp competitive takeout program is delivering continued success, as we gain share and displace competitors' installed bases. Most importantly, this quarter, we once again demonstrated our ability to grow in both of our key markets – cloud and all-flash arrays. As we have said many times, cloud is additive to our business – that what we do in the cloud helps expand our on-premises business and that our enterprise-hardened software and experience provide a solid foundation for our work in the cloud.

Cloud services ARR grew to $237 million, an increase of 186% year-over-year. We saw good momentum across the portfolio, with Azure NetApp Files and Spot being the standout services, both delivering significant growth. We continue to expand with existing customers while adding new enterprise and cloud native customers. Our cloud services dollar-based net retention rate is a healthy 227%. Our cloud partners are asking us to expand regional deployments, broaden workload certifications, and invest in go-to-market activities to support this rapidly growing business. We had a significant presence at both AWS re:Invent and at Google's sales kickoff meeting. This engagement helps us stay top of mind with their sellers and reach customers with our cloud value proposition.

We are benefiting as customers move more tier-1 workloads, such as SAP, to the cloud. Our cloud volumes service delivers the performance and availability required by mission critical applications. To address the substantial cloud opportunity ahead, we are pulling forward investments with our public cloud partners – adding dedicated sales capacity and expanding our presence in additional regions. As we look ahead, we have a strong pipeline to support our Q4 target.

Our cloud partner engagement and expanding product roadmap reinforce our confidence in our long-term goal of achieving $1 billion in cloud ARR in fiscal year 2025. Our all-flash business grew 11% year-over-year to an annualized net revenue run rate of $2.6 billion. For the third consecutive quarter, we believe we outpaced the market, gaining share from competitors and converting our installed base from hybrid arrays to all-flash. At the end of Q3, 27% of installed systems were all-flash, giving us plenty of headroom for continued growth. Our all-flash arrays receive accolades from industry analysts and customers alike. They integrate cloud connectivity with the speed and efficiency of flash to deliver a smart, powerful, and trusted solution for the most demanding enterprise workloads.

In Q3, we expanded the breadth of our flash offerings with the introduction of the FAS500f, our first all-flash array leveraging QLC technology. The FAS500f is a highly scalable solution for deployments that support huge volumes of unstructured data such as medical imaging, electronic design automation, and computer-aided design and manufacturing. Our cloud services and flash systems are built on the same primary software foundation, ONTAP.

This shared R&D foundation gives us significant leverage in our R&D investment. We are able to innovate and test at cloud speed, while bringing new functionality to the enterprise data center at a pace IT can absorb. This shared innovation also benefits customers, giving them a similar operating environment and consistent data management tools on premises and in the cloud. It also enables them to move their data seamlessly to the right location at the right price at the right time.

As I noted on our last call, NetApp is helping customers accelerate their digital transformations and put their data to work to elevate their businesses. Digital transformation is now a necessity, requiring speed and agility to respond to changing business conditions. Hybrid cloud is the de facto IT architecture at digitally transformed enterprises for the foreseeable future. Having an integrated, flexible data management foundation is critical to the success of digital transformation efforts. Because of this, data is growing in scale and importance. We believe that NetApp is a primary beneficiary of this trend. We are uniquely positioned to address customers' requirements for workloads that move to the cloud, as well as those that maintain and modernize on-premises.

Let me share a few wins from the third quarter to illustrate why customers choose NetApp to manage their data in the hybrid cloud. A global pharmaceutical manufacturer needed to overcome the compliance challenges of regulatory mandates, while minimizing security risks in moving to the public cloud. They selected NetApp all-flash FAS to underpin their AI-driven healthcare because of our cloud connectivity and ability to achieve petabyte scale, along with our unique data protection and data management capabilities.

At a leading global clinical trial laboratory, NetApp displaced Dell to host workloads for the company's AI labs. We won because of our performance, cloud-connectivity, and data management and security capabilities. The ability to leverage NetApp cloud services when necessary was critical to the customer's decision.

Calendar 2020 was a difficult year for all of us and I'm glad to have it behind us. I want to express my gratitude to the NetApp team for quickly coming together to deliver solid results by helping our customers thrive while working remotely. We see reasons for optimism for calendar 2021 with expanding vaccine availability and improving public health conditions.

However, uncertainty about the new normal, as well as the tax and regulatory environments, remain. In uncertain markets, data is even more critical as organizations look to drive competitive advantage and we are confident in our strategy and the strength of our business going forward.

Cloud and all-flash FAS fuel the momentum in our high-margin software, cloud services and recurring maintenance revenue streams. This growth, coupled with our disciplined OpEx management, balanced approach to investing in the business, and sustained capital returns will create significant long-term shareholder value.

The new NetApp is a cloud-led software company and it's built on a solid foundation. We are a trusted partner to the world's leading organizations who are undertaking digital transformations. We have unique strategic partnerships with the world's leading clouds, including deeply integrated technology and go-to-market efforts.

And we have a strong business model, with a proven track record of turning market transitions to our advantage. As the recovery gradually unfolds, we believe we will be in an even stronger position as customers continue to turn to NetApp to help them solve the challenge of managing data in the hybrid cloud.

I'll now turn it over to Mike for more details on our results. Mike?

Mike Berry

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

Thank you, George. Good afternoon, everyone, and thank you for joining us. As a reminder, I'll be referring to non-GAAP numbers unless otherwise noted. We delivered another solid quarter, with revenue at the high-end of our guide and operating margin and EPS above expectations.

Importantly, solid execution yielded Q3 billings of $1.6 billion, up 6% year-over-year. This is our third straight quarter of year-over-year billings growth. In Q3, net revenue of $1.47 billion increased 5% year-over-year, including 2 points of currency tailwind.

We believe our two key strategic focus areas, our industry-leading all-flash storage business and Public Cloud Services, both continued to outperform the market.

When combined, software revenue, recurring maintenance and cloud revenue totaled $1.1 billion and increased 13% year-over-year, representing 72% of total revenue.

We ended Q3 with $3.8 billion in deferred revenue, an increase of 7% year-over-year. Deferred revenue continues to be a leading indicator for future recurring revenue growth. As we highlighted at our Investor Day, all-flash systems carry higher software and maintenance dollar content relative to the rest of our portfolio.

As George highlighted, our all-flash revenue of $652 million was up 11% year-over-year, positioning us for share gains for the third consecutive quarter. Only 27% of our installed systems were all-flash at the end of Q3, providing a very healthy runway for our flash business.

Public Cloud Services delivered a solid $237 million in ARR, growing 186% year-over-year and 10% sequentially. We continue to see strong demand from our customer cohorts with Q3 dollar-based net retention rate coming in at 227%. Given the strong sales pipeline heading into Q4, we expect to exit fiscal 2021 with cloud ARR of $260 million to $290 million.

We remain excited about our expanding cloud product roadmap, which includes continued co-development and deep R&D partnerships with the public cloud partners. As we head into fiscal 2022, we are investing in additional cloud sales capacity to support our expanding product roadmap and our partners' go-to-market motion. We remain confident in our ability to deliver $1 billion in cloud ARR in fiscal 2025.

Total product revenue of $775 million decreased approximately 2% year-over-year. As George noted, in the quarter we saw good engagement from enterprise accounts, particularly in the Americas, where the sales capacity added last year is paying dividends. Consistent with the growth we delivered in Q2, software product revenue of $428 million increased 14% year-over-year, driven by the continued mix shift towards our all-flash portfolio.

Recurring maintenance and cloud revenue of $627 million was an all-time company high and was up 13% year-over-year, constituting 43% of total revenue.

To help with your modeling of maintenance, please note Q3 includes a $7 million year-to-date adjustment from hardware maintenance revenue to software maintenance revenue. To be clear, this adjustment did not impact total maintenance revenue in the quarter.

Gross margin of 67.3% was at the high end of guidance. Product gross margin was 53.4% and consistent with our expectations.

Our recurring maintenance, cloud and other services business continues to be a very profitable and growing business for us, with gross margin of 82.9%.

Q3 operating expenses of $668 million were in-line with our expectations. Operating margin of 21.9% and EPS of $1.10 were both nicely ahead of our guidance, demonstrating the strong operating leverage in our business model.

Cash flow from operations was $373 million and free cash flow was $341 million, representing 23% of revenue. Year-to-date free cash flow of $650 million is up 13% year-over-year. We expect operating cash flow to grow double digits for the full fiscal year.

During Q3 we reinitiated our share repurchase program, buying back $50 million in stock. During the quarter we also paid out $107 million in cash dividends. In total, we returned $157 million to shareholders in Q3, representing 46% of free cash flow. We closed Q3 with $3.9 billion in cash and short-term investments.

Now to guidance. We expect Q4 net revenues to range between $1.44 billion and $1.54 billion, which, at the midpoint, implies a 6% increase in revenues year-over-year and includes 3 points of currency tailwind. Given our growing confidence in the business, we narrowed the revenue range to $100 million.

We expect consolidated gross margin to be approximately 67%, and operating margin to range between 21% and 22% in Q4. Assumed in this guidance are operating expenses of $675 million to $685 million.

Given the magnitude of our cloud opportunity, we plan to pull forward investment in both sales capacity and our product roadmap, positioning our cloud services for continued rapid growth heading into fiscal 2022. We anticipate our non-GAAP tax-rate to be approximately 18%.

And we expect earnings per share for Q4 to range between $1.06 and $1.14 per share. Assumed in this guidance is interest expense of $15 million.

In closing, I want to thank the entire NetApp team for continued execution and commitment in delivering another outstanding quarter. We remain incredibly well positioned to capitalize on the industry transitions and market opportunity ahead. I'll now hand the call back to Kris to open the call for Q&A. Kris?

Kris Newton
Vice President Investor Relations, NetApp, Inc.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from Katy Huberty of Morgan Stanley. Your line is open. Please make sure your phone isn't on mute.

Kathryn Lynn Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Thank you for the question. I wanted to – I have two questions. The first is you're expecting cloud ARR sequential growth to accelerate next quarter. Can you just talk about is that on the back of the investments that you're talking about accelerating in the quarter, or is this just pipeline dynamics where you had some deals that maybe didn't convert in January and were pushed into the April quarter?

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

A

It's on the back of pipeline dynamics. We have a strong pipeline heading into Q4, and it's our fiscal year-end, so we have every confidence that our sales teams are going to make a real good push to finish the year strong. We've had a really good year-to-date. In Q3, we saw organic growth of 123% in cloud ARR, as well as total growth of 186%. And if you look at the midpoint of our range that we have guided to, the incremental growth in Q4 is the same incremental number as what we did in Q2. So we feel good about the finish. The investments that Mike and I are both making is to help continue to scale the cloud business. The majority of the benefit of that will really be next fiscal year.

Kathryn Lynn Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Great. And then, George, how would you compare the pipeline today, the broader deal pipeline today versus three months ago? And how does that shape your view of what the demand recovery will look like over the next several quarters?

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

A

We've had three really good quarters, and if you look at our – the finish to Q3, if you look at both days sales outstanding as well as inventory turns, we had a regular January. So linearity was good throughout the past quarter. Q4 the early signs are very constructive. The pipeline is strong. Our competitive position I would not trade for anyone else in the market. So I feel really, really good about the opportunity ahead, not only in Q4 but going forward.

I think what you see in our guidance is a bit of prudence given that there's still a COVID environment, that while the vaccine availability provides incremental confidence, there are many other elements that need to come together to really give total line of sight to the new normal. That includes tax, regulation, new policy, decision frameworks of the government, the stimulus package, and other things. So we feel very good about the year. We feel really good about the pipeline heading into Q4. Our competitive position is strong and differentiated as we have demonstrated with share gains for three successive quarters. I think, what we are trying to balance is the really good confidence in our business with the fact that we're still operating in a pandemic environment. Mike, you want to add?

Mike Berry
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

So, thanks, George. Hey, Katy, it's Mike. The one thing I'd add too is when you take a look at the guide, keep in mind that on a year-to-date basis billings are up and that's really what we're focusing you folks on. About 7% in revenue when you adjust for the 14, we did about 3. So embedded in that guidance is still a pretty significant growth in billings, which to us is the leading indicator of business with our customers.

Kris Newton
Vice President Investor Relations, NetApp, Inc.

A

All right. Thanks, Katy. Next question.

Operator: Thank you. Our next question comes from Amit Daryanani of Evercore. Your line is open.

Amit Daryanani
Analyst, Evercore ISI

Q

Thanks a lot for taking my question. I guess, I was just hoping we'd talk a little bit more around all-flash array growth, which you had double digits is fairly impressive. I guess, I want to understand how much of this growth do you think is coming from conversion of your install base to all-flash array versus net new customers? Is there a way to kind of tease that out? And then over time, what's the optimal level for this 27% of your install base getting to as a percent of all-flash array?

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

A

So our overall install base, which is a very large number, is growing in both systems and customers. Right? So we feel very, very good about the opportunity. We've been in this business in the all-flash array business for many,

many years, and we are growing the penetration of the all-flash footprint in our install base by roughly 1% a quarter. And so there's a long runway ahead, a very long runway ahead of all-flash penetration. What we are feeling very, very good about is the fact that we've demonstrated share gains. We're not demonstrating the rate of penetration of the market and the rate of share gains without winning net new customers and net new workloads. Yes, install base continues to be an opportunity, but what I feel really good about is the fact that we are growing at the expense of the competition this year.

Amit Daryanani
Analyst, Evercore ISI

Q

Got it. Thank you.

Kris Newton
Vice President Investor Relations, NetApp, Inc.

A

Thank you, Amit. Next question.

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

Mehdi Hosseini
Analyst, Susquehanna International Group

Q

Yes. Thanks for taking my question. Just as a follow-up to Amit's question, how should I think about the overall flash array growth this year, because at this run rate you can do perhaps high teen growth, and I want to just get more color on that. And then I have a follow-up.

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

A

I think there's two ways that I think about it. One is what's the aggregate market and then what's the percentage of the market that is all-flash. I think as we said, the aggregate market continues to get better steadily. We feel very good about the progress we've made as part of the overall market. We think that the macro trends this coming year should be better than what we had in the past year. There's a little bit of uncertainty with the specific timing of when everything gets better, but overall sort of the bigger picture, there's no question that 2021 calendar year will be a better year than 2020.

I think within that, then we have gained share in the market, and within our overall portfolio, we see all-flash continuing to be a greater part of the mix, especially as newer technologies that make flash more cost effective comes to market. So things like QLC where we're in the early innings of. So as I said, we don't think flash will be 100% of the storage market. We think it will be a substantial percentage, and we think that that transition affords us opportunity to gain share of new customers as well as to sell more software-rich, higher-margin configurations to customers.

Mehdi Hosseini
Analyst, Susquehanna International Group

Q

Great. And just as a follow-up to that, how do you see material costs, specifically NAND costs impacting, especially in the context of increased QLC procurement?

Mike Berry
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

Hey, Mehdi, it's Mike. So, I'll answer that in two ways. One is we did obviously in the first half, we saw significantly higher NAND prices. They have modulated a bit and came back to I'll call it relatively flat in Q3. We do expect it to be a tailwind to us slightly in our Q4.

Looking into 2022, I think, you'll see that continue. We are starting to see some of the demand pick up, especially in the second half of next year, especially around mobile and hyperscalers as well. As you all know, mobile is 30%, 40% of that business, so we expect in the second half of next year for that to kind of reverse itself. Also keep in mind DRAM prices are up quite a bit for us. It's not nearly the percentage of component costs, but that offsets a little bit. And for us QLC, look, we're just getting started with that. So there's not much of an impact I'll call it in the near term.

Mehdi Hosseini
Analyst, Susquehanna International Group

Q

Thank you.

Kris Newton
Vice President Investor Relations, NetApp, Inc.

A

Thank you, Mehdi. Next question.

Operator: Next question comes from Nik Todorov of Longbow Research. Your line is open.

Nikolay Todorov
Analyst, Longbow Research LLC

Q

Yeah, thanks. George, you talked about your cloud partners asking for additional broader workload certification. Maybe you can give us a little bit more color on that. And also any additional color you can give us on the different customer sets that are adopting your cloud services? Is there any way you can delineate between the growth you're seeing from existing enterprise customers versus new cloud-only customers and also what are you seeing from your public sector customers when it comes to demand for CDS? Thanks.

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

A

Okay. So let me get that in three ways. The first was, listen, we are certified for a broad range of workloads with Microsoft and Google, and they are – we are pursuing additional workloads with them as customers deploy on our platforms. This could be software vendors that are deploying Software-as-a-Service environments in the public clouds. This could be new types of applications, containerized applications, cloud-native applications. There are a whole new set of opportunities for NetApp. And it is also certifications and deployments in parts of the world where we haven't deployed yet.

So we completed the FedRAMP certification which opens up the public sector market for our Azure NetApp Files. There's opportunity to do that with other cloud providers and other services. For example, our monitoring services are in the portfolio. That's one set of things that we're going to keep doing. The other is expanding deployments. So we've covered – with some of the cloud providers, we've covered the large markets. Now we're starting to pursue parts of the world, for example, in Asia-Pacific or Latin America that we didn't cover before. And so this is the ongoing build-out.

I think with regard to the sets of customer types that we see, we are really excited at the progress that we've achieved this year. We are acquiring customers at an accelerating pace in our cloud business, and once they join

NetApp's cloud portfolio, our dollar-based retention rate shows up really strongly. They really like our offerings, and they expand deployment substantially with us. They are across a broad range of verticals, more in the less-regulated than in the regulated industries where we are still going through certifications.

The second is they cover a broad range of customer types, whether they are digital natives that never bought from NetApp, enterprises that were primarily competitors' customers or customers that use NetApp. As our all-flash array business and our cloud businesses have demonstrated for multiple quarters in a row, cloud is additive to our overall business. And there are customers who start with us in the cloud who then come back and buy stuff in the data center. So very pleased with the progress. The work that we are doing with the cloud providers will continue to expand in scale and scope, and which is why again I feel really good about our long-term opportunity and the ability to reach the $1 billion ARR target in fiscal year 2025.

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

All right. Thanks, Nik. Next question.

Operator: Our next question is from Steven Fox of Fox Advisors. Your line is open, sir.

Steven Fox
Analyst, Fox Advisors LLC
Q

Thanks. Good afternoon. I was wondering if you could just talk about what the impact of the mix of all-flash arrays was on margins. Not necessarily – I understand the software percentage helped, but like I think last quarter you benefited from larger scale system sales. What was it like this quarter? And what's your thinking into the next quarter? Thank you.

Mike Berry
Executive Vice President and Chief Financial Officer, NetApp, Inc.
A

Hey, Steven. It's Mike. Thanks for the question. So, yes, we talked a lot in Q2 about the AFS, the all-flash systems being driven by high-end. And when we gave our guidance for Q3, we talked about, hey, we thought that would normalize a little bit. And that's exactly what happened.

So we had another very strong quarter in all-flash systems, but it was a little bit more I'll call it normally distributed between low, mid, and high. And that's what we saw. And I think you can see that in the product margins.

And then again they were helped a little bit by lower NAND costs. So it came in pretty much what we expected, a much more normal distribution. And that's also what we're expecting going into Q4. Again, it's tough for us to do demand shaping of those. And because of the great flexibility in our products, our customers can do different configurations to still achieve that performance. So we expect it to be pretty normal and similar to Q3.

Steven Fox
Analyst, Fox Advisors LLC
Q

Great. Thank you very much for that.

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

Thanks, Steve. Next question.

Operator: Our next question is from Shannon Cross of Cross Research. Your line is open.

Shannon Cross
Analyst, Cross Research

Q

Thank you very much. You mentioned strength in the Americas enterprise, and wonder if you could dig a bit deeper into it, maybe on a sector basis.

And then what are you seeing and hearing from your customers as you look forward over the next few quarters? You can either stick with Americas or you could go and talk geographically. Thanks.

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

A

I think I'll just say that we feel very good about the finish to Q3. The book of business was balanced geographically. We drew out the Americas because of the fact that the performance was particularly strong in the Americas.

As you know, our business is preponderantly enterprise, meaning small medium business is a small percentage of our total business. It didn't perform badly; it performed well. But it's a small percentage of our total business.

On the enterprise, I think what we saw was a continuation of the trends that we saw in Q2, which is stabilization of demand, normal linearity through the quarter, the sort of COVID-strong segments, meaning the ones that were – had business models that were less impacted by COVID, like financial services or health care, continued to be strong demand sources for us. And we have really good offerings in that part of the market.

I think with regard to the outlook, again, I think as we said, many, many customers are starting to prioritize the new normal, what business looks like going forward. Digital transformation becomes a key part of any business' go-forward plans. And we are a big part of enabling a modern data foundation for digital transformation.

So those projects continue to move forward. NetApp has really good technology to also help in hybrid cloud and cybersecurity projects, for example, protection against ransomware and other types of malicious data threats. And we saw good pickup across the portfolio for that as well.

Shannon Cross
Analyst, Cross Research

Q

Thank you.

Kris Newton
Vice President Investor Relations, NetApp, Inc.

A

Thank you, Shannon. Next question.

Operator: Next question is from Ananda Baruah of Loop Capital. Your line is open.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Hey, guys. Appreciate it. Just would love to get your thoughts. You talked about increasing the investment on sales capacity and deal coverage on cloud. Should we anticipate any impact to margins intermediate term as you ramp that? Or does the momentum just kind of overwhelm the incremental cost? Thanks.

Mike Berry
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

Hey, Ananda, it's Mike. So I think a little bit different than what we did last year, when we did a really great thing by bringing on the 200 sales folks. For us this is just much more continued investment in that business.

And I think that you'll see it more or less just play right into the P&L, as we've talked about continued great growth in that business. So our goal is to continue to have sales capacity in line with that revenue growth to continue to drive it. So I wouldn't expect to see any kind of a bump on margins specifically related to that.

Ananda Baruah
Analyst, Loop Capital Markets LLC

Q

Awesome. Okay. Great. No, that's great. Appreciate it.

Kris Newton
Vice President Investor Relations, NetApp, Inc.

A

All right. Thanks, Ananda. Next question.

Operator: Okay. Sidney Ho of Deutsche Bank, your line is open.

Sidney Ho
Analyst, Deutsche Bank Securities, Inc.

Q

Great. Thanks for taking my question. As I kind of look at your fiscal fourth quarter revenue guidance, at the midpoint it will be up 6% year-over-year, up 1% quarter-over-quarter. Do you expect every reportable businesses to be up similarly on a sequential basis? I'm particularly interested in your comment on software maintenance, given how strong it was in the quarter. I understand there was a reclassification that helped the software side last quarter. Thanks.

Mike Berry
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

Yeah, so if you bifurcate the different revenue numbers – and keep in mind, Sidney, that that was – if you look at total maintenance, there was no impact to that.

So as we look to Q4, we would expect to see maintenance continue to be strong in the quarter. I think sequentially you saw maintenance actually drop a little bit. We would expect to see it grow slightly. Cloud continue to grow. And then product revenue likely growing or similar levels to what we've seen in Q1, Q2, and Q3.

And this goes back to Katy's question, because, again, I just want to keep talking about this as, keep in mind that billings growth has been 6%, 10%, and 6% in the first three quarters; product growth over that time when you back out the 14th week has averaged about 3%. So mix matters here a lot.

And so to that point and to the earlier question on maintenance, we do expect to see continued growth in maintenance, as we do more all-flash systems, continued growth in cloud. And product revenue will be a result really of the mix in all-flash. Hopefully that helps.

Sidney Ho
Analyst, Deutsche Bank Securities, Inc.

Q

Yeah. Thank you.

Kris Newton
Vice President Investor Relations, NetApp, Inc.

A

All right. Thanks, Sidney. Next question.

Operator: Yes. Simon Leopold of Raymond James, your line is open.

Victor Chiu
Analyst, Raymond James & Associates, Inc.

Q

Hi. This is Victor Chiu in for Simon Leopold. I wanted to follow-up on the enterprise spending question that someone asked previously.

Do you have a sense for which areas enterprises will be prioritizing as they resume spending into recovery? For example, campus investments versus data center investments, et cetera, and how kind of NetApp falls into that picture?

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

A

We don't do a lot of business in the campus. I think the primary part of our business is in the data center, and I think as I mentioned earlier, we saw a good pickup in -throughout the year people have been prioritizing big transformational projects which we cannot defer because they don't want to fall behind their competitors. We saw priorities in hybrid cloud and modernizing data center environments using flash technology. Those are our key bets, and they've played out really well for us throughout the year. I think in Q3 we saw normal linearity.

So you could see from our DSO and from our inventory turns that we did not have a back-end loaded quarter. It was pretty steady linearity throughout the quarter, and we feel good about that. That's a good sign heading into the rest of the calendar year for us. And so we feel – we've done well. We've controlled what we can control really well. The macro environment is still uncertain, but it's getting better. And so we'll take those, and we'll continue to execute.

Victor Chiu
Analyst, Raymond James & Associates, Inc.

Q

That's helpful. And just quickly along the lines of drivers, could you provide us an update around your as-a-service offering and progress you're seeing there? Has the pandemic disrupted the push-out of the timeline of kind of the trials and acceptance around that?

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

A

We serve customers in multiple ways. As an as-a-service offering, we have ways to support them on public cloud environments which are as-a-service and instantaneous. We have the ability to give them financial solutions and/or managed subscription solutions.

Our Keystone portfolio continues to make progress in the market. We have some good wins in the quarter. We've had some good successes against competitors, and we feel really good about our offering there. It's early going, and we don't – unlike some of our other competitors – we don't think that the market has a single mandate. Customers want to buy in multiple ways, and we have the ability to meet those requirements in multiple ways.

Victor Chiu
Analyst, Raymond James & Associates, Inc.

Q

That's helpful. Thank you.

Kris Newton
Vice President Investor Relations, NetApp, Inc.

A

All right. Thanks, Victor. Next question.

Operator: Karl Ackerman of Cowen, your line is open.

Karl Ackerman
Analyst, Cowen and Company

Q

Yes. Thank you. Mike, how should we think about the growth you're seeing in your as-a-service offerings between existing accounts versus new accounts? And I'm hoping you could shed light on the margin and content differential between new and existing accounts this quarter as well as in the context of your progression toward the $1 billion cloud ARR target. Thank you.

Mike Berry
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

Yeah, so, if we take a look at new versus existing accounts, as George talked about we really look at the public cloud business as being the driver of new customers for us. And we have seen that. In addition, when you look at the dollar-based net retention that is obviously our existing customers we're seeing great growth there as well.

One of the nice things about the cloud business is from a margin perspective, it's not going to vary that much in terms of new versus existing. Certainly existing customers that have more than one product, you'll start to see some margin expansion there as well. But as we look across new versus existing, I don't think there's a material difference there. However, I think that will help expand those margins as we go forward. We've talked about our driver call in terms of driving gross margins in the cloud business. Especially as they take on more than one product, more data services and more solutions, that will certainly help us scale that business at a higher margin.

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

A

If I could add, as we mentioned at our Financial Analyst Day, cloud over time will become accretive to the margins, gross margins of the overall business. We feel good about the progress we have made towards achieving that objective. We're not breaking out the cloud gross margins, but we did make progress even this past quarter. So we're making steady progress towards achieving that objective.

With regard to Keystone, Keystone does not – we have not seen to date an existing customer that has an all-flash deployment suddenly show up and say I want to convert that to a Keystone deployment. These are usually net new environments in customers and/or net new customers. It's not like we're seeing our traditional deployed environment convert to a Keystone basis. And so these are additive opportunities to our overall business, and they are healthy margin opportunities.

Karl Ackerman
Analyst, Cowen and Company

Q

Very helpful. Thank you.

Kris Newton
Vice President Investor Relations, NetApp, Inc.

A

Thank you, Karl. Next question.

Operator: The next question comes from Rod Hall of Goldman Sachs. Your line is open.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Thanks for the question. I just wanted to check in with you guys on supplies. I know that the semiconductor supply shortage is affecting a lot of people. Just curious if you could comment on whether you're anticipating that in the guide and also what you think the supplies outlook is for the remainder of this year. And then maybe real quick you could comment that AFA number was super strong again. Just comment on whether you think you've gained share again and substantial share like you did last quarter or maybe a little bit less share. Just curious what you think that overall AFA market has done this quarter.

Mike Berry
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

Hey, Rod, it's Mike. I'll take the first part and then George will jump in on the second. So as we – so when we looked at the semi supply chain, yeah, lots of news and noise out there on that one. We don't expect there to be any impacts for Q4.

As we look into next year, for us it's hopefully not as much of a P&L impact. We will likely, like other folks go buy ahead a little bit to make sure that we have enough of that supply. We had 19 times inventory turns. We've talked about this back when I first started last year. I'd expect to see that come down a little bit. It's the prudent thing to do given the cost of capital to make sure we have that supply. So I would expect it to impact more the balance sheet than the P&L. But certainly we'll keep you up to speed as we go through this.

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

A

With regard to the all-flash array number, we feel that we continue to take market share. I think that our portfolio continues to be the best one in the market, and based on other people that reported this week or today, we have taken share. Right? So we'll wait for the rest of the roundup to come, but we feel really, really good about our position in the market. We've had three really good quarters. We're focused. We're executing, and we're taking share. And I feel really good about our position, better today than even at the start of the year.

Rod Hall
Analyst, Goldman Sachs & Co. LLC

Q

Great. Okay. Thank you.

Kris Newton
Vice President Investor Relations, NetApp, Inc.

A

Thanks, Rod. Next question.

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

Wamsi Mohan
Analyst, Bank of America Merrill Lynch

Q

Hi. Yes. Thank you. You noted this pull-forward in some of the spend relative to cloud, and I was wondering, A, are you changing or think that that would change the CDS number of 400 to 500 for fiscal 2022 and secondarily how long should we expect that elevated OpEx? Is it a one-quarter phenomena or is that going to be sort of the new normal and then we see OpEx sort of trend from there? Thank you.

Mike Berry
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

Yeah. Hey, Wamsi. It's Mike. So on that as we just talked a couple minutes ago, we just expect to continue to invest in the cloud business as we see the opportunity and we clearly see a great opportunity. And that's both in sales and in R&D to make sure we're moving the product roadmap forward. So I don't think, again, you'll see a bump or a reduction in the margins as it relates to that.

The goal is to continue to invest in that as we go forward. Look, we haven't – we will talk to you about where we think we'll finish next year when we get into fiscal 2022. But we think that this is – as you know, George and I have both talked about a disciplined spending on OpEx, disciplined spending for us also means we want to invest where we see a return, and we absolutely see a return on those dollars.

Wamsi Mohan
Analyst, Bank of America Merrill Lynch

Q

Okay. Thanks, Mike. And if I could, sorry if I missed this, but you had extremely strong free cash flow margins in the quarter. Can you comment on what drove that?

Mike Berry
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

Yeah. Absolutely. I'd love to talk about cash. So, hey, two things on cash, Wamsi. Thing one is keep in mind that compared to last year, we paid virtually all of our US Federal taxes in Q2 of last year, so let's talk about year-to-date. The margins were great in this quarter. I think it was 23%. On a year-to-date basis, our free cash flow was up 13% year-over-year.

Also keep in mind that in that number in fiscal 2021, we've also paid about $75 million of taxes related to the IP transfer from the Spot acquisition. So it's actually a little bit stronger than that. As George talked about, our DSOs were super strong. They were 49 days. Any time you get below 50, it's great. So linearity certainly helped our invoicing and our collections in the quarter. But, yeah, very strong free cash flow results, feel really good about that on a year-to-date basis.

Wamsi Mohan
Analyst, Bank of America Merrill Lynch

Q

Thanks a lot.

Kris Newton
Vice President Investor Relations, NetApp, Inc.

A

All right. Thanks, Wamsi. Next question.

Operator: Thanks. Our next question is from Jim Suva of Citigroup Investment. Your line is open.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you. You've provided a lot of good clarity, and I have one question, and it's probably best for both George and Mike to answer it. But can you just walk us through when NAND pricing goes higher, like, George, how does your sales force react to that?

And then, Mike, maybe the margin and revenue impact. Does it impact margins a lot? Can you offset it fast enough? Or does your billings get impacted favorably from higher NAND prices? I'm trying to word it – not word – I'm wondering about the relationships, the talks, and the financial of when component pricing since you're doing so well in all-flash arrays, when NAND component pricings go up what's the sales force reaction and the financial implications.

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

A

Okay. Maybe I can start first. We have a broad range of purchasing agreements with customers. I think for some, there are preferred pricing agreements or master purchasing agreements, where they're locked into pricing schedules where we don't have the ability to move pricing up or down depending on what happens to NAND prices. In the transactional environment, where there's no long-term pricing agreements, we are – we take a look at the impact of commodity prices. We typically pass that through either beneficially or to disadvantaged to customers. We're not trying to hedge it. I think we are cognizant this time in the COVID environment of the particular challenge that our customers face, so we try to be a good partner to them. As Mike and I both said at Financial Analyst Day, post-COVID, given the continued progress of our all-flash array business, we see the ability to return to the mid-50s product gross margins.

Mike Berry
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

Yeah, and just to keep going down that path, Jim, as George talked about, we do see that path. We don't expect to see the kind of increases that we saw I think earlier in the first half. Supply and demand will certainly dictate that. The other thing to keep in mind too is this is why we've talked about this so much, I will always push you to look at total gross margins because also, hey, cloud billings, not impacted by it. The more we do renewals, which is a huge part of our business and it's been a great success story also helps as well.

So from a financial perspective, is it something we look at, sure. But there's so many other things too that drive it. Keep in mind NAND may go up. DRAM may go down. Something else may move around. We have a great supply chain team. They're looking at it all the time in terms of what it means financially. But again we don't know going into next year where the final supply and demand will end. We'll certainly keep you up to date every quarter.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

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

Kris Newton
Vice President Investor Relations, NetApp, Inc.

A

All right. Thank you, Jim. Next question.

Operator: Next question comes from Nehal Chokshi of Northland Capital. Your line is open.

Nehal Sushil Chokshi
Analyst, Northland Capital Markets

Q

Thank you. And great quarter and looks like good guidance to me. Can you talk about – it was great that you guys are talking about a $1 billion ARR by fiscal year 2025 for public cloud services, but what do you expect to be the sustainable growth rate after you get there and what's sustainable dollar base net revenue retention rate to drive that as well?

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

A

Listen, I think we have strong aspirations to grow our cloud business. I think we have every confidence that we have a multiyear game plan of achieving the $1 billion ARR number. I think we'll give you the ability to sustain growth rates beyond that when we get to it.

What I'll give you a sense of is, cloud is a gigantic market. And the growth of cloud over the next five years will be much bigger than the growth of cloud over the past five years.

So if you think that there is constraints to overall TAM, I just think that even the $1 billion ARR will be a small part of the overall cloud market in that timeframe. So we're not TAM constrained.

I think our position in the market is unique. And we are continuing to execute on product roadmap expansions and go-to-market investments, as Mike and I have talked about in prepared remarks.

With regard to dollar-based net retention, I think it reflects the strength of our offerings. When a customer signs up and is activated and starts to work with us, they grow substantially in terms of their usage of our products, which is really good.

I think both Mike and I see that over time, it should trend back towards more industry norms. I think 227%, which we had this quarter, is well above industry norms, reflecting the early phase of our cloud journey. Mike, feel free to add.

Mike Berry
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

Yeah, and I can keep going down that path. And we talked about this at Investor Day.

We do expect it to come back to call it industry norms, if that's call it 110%, 120%, 130%. Very importantly, once you get to $1 billion, and you folks all know this, certainly we want it to continue to be a driver of new customers.

But, gosh, that upsell/cross-sell renewal motion is so critical. That's actually part of the sales investment that we're making, is to make sure we have that great support team that can go in there and help our customers, once they sign up for those services.

So and there's a lot of great examples of companies that do that well. So we do expect in conjunction with getting there that we'll be able to continue to drive great retention. But it will come down to the industry norms over time.

Nehal Sushil Chokshi
Analyst, Northland Capital Markets

Q

Okay. Great. Then if I can bring that into on a shorter term basis, you've provided a target of $260 million to $290 million for the end of this year. At the low end of that range, what would have to occur? As that seems like it would be probably a disappointing outcome.

And then conversely at the high end of the range, what would have to happen? As that would seem to be an amazing outcome actually.

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

A

I think it's all execution. I think we see a good, a strong pipeline in Q4. It comes down to transaction execution, getting customers signed up, managing through the COVID challenges that customers are still facing, right. We have customers whose employees are not on-site, who we can get to negotiate with only a certain number of days of the week. And that's what it comes down to.

I think the overall demand profile for our services is fantastic. I think we've added customers at an accelerating pace through the course of the year. And the types of workloads that we are deploying, these are mega market opportunities, databases, virtual machines, file sharing, high-performance computing.

So we're not opportunity constrained. I think we just got to execute and bring in the transactions.

Nehal Sushil Chokshi
Analyst, Northland Capital Markets

Q

Yeah. Great. Thank you.

Kris Newton
Vice President Investor Relations, NetApp, Inc.

A

All right. Thanks, Nehal. Next question.

Operator: Next question comes from Jason Ader of William Blair. Your line is open.

Billy Fitzsimmons
Analyst, William Blair & Co. LLC

Q

Hey, everyone. This is Billy Fitzsimmons on for Jason Ader. Thanks for fitting me in.

I know you talked on how Spot was a standout in the quarter. And you also talked about at the Analyst Day how there were only 5% of customers where there is overlap between Spot and NetApp.

And obviously there have also been some changes to your sales org in the last couple quarters, Cesar [Cernuda] joined in July. So to that end, George, can you please talk about how the typical customer conversation has evolved versus a year or two ago, given some of those leadership changes, as well as the introduction of some newer products and some of those products through acquisitions, such as Talon, CloudJumper, Spot?

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

A

Yeah, I think, first of all, we have a massively larger customer base now than we did a couple of years ago, right. Even a year ago. We have a massively larger customer base, whether that's acquired through NetApp sales force, whether that's acquired through Microsoft or Google sales force, or Spot.

The installed base of customers to whom we can cross-sell and upsell products, like Mike mentioned, is massively larger at this point than it was a year ago.

I think with regard to what Spot brings to the table is they bring two assets to the table. One is that they are able to solve a large and growing customer problem, which is the problem of unused or unspent cloud dollars. And that is a topic that is near and dear to every CFO and CIO that I talk to, including Mike at NetApp.

We're a customer of Spot. And they save us a substantial amount of money. We are able to use Spot not only to go after cloud-native digital native customers that never bought from NetApp, as well as to now find ways into new parts of large enterprises that didn't know NetApp and now get pleasantly surprised and buy the whole cloud portfolio.

So I'm super excited. They also have a really good offering for container-based workloads that in combination with some of our storage offerings gives us a really expanded set of differentiated capabilities for truly cloud-native applications.

Billy Fitzsimmons
Analyst, William Blair & Co. LLC

Q

Perfect. Thanks, George.

Kris Newton
Vice President Investor Relations, NetApp, Inc.

A

All right. Thanks, Bill. Next question.

Operator: Thank you. And our last question comes from Paul Chung of JPMorgan. Your line is open.

Paul J. Chung
Analyst, JPMorgan Securities LLC

Q

Hi. Thanks for taking my questions. So you mentioned nice market share gains in all-flash. So just a follow-up there. Can you just expand on how you're displacing competitors, which types of verticals you're seeing more success? I know your gross margins are down mostly on mix, but any impact from pricing? Just anything you want to highlight on how you're beating competition? Thank you.

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

A

With regard to the competitive programs, our Run-to-NetApp competitive program continues to have really good results. Q3 was the strongest of the three quarters that we've had the program running.

And it is a broad mix of customers. Given the mix of our business, they're mostly enterprise accounts. And we are winning new footprints meaning new workloads, displacing the larger legacy incumbents. So whether it's an HD or a Hitachi with their products or whether it's Dell going through a transition of its mid-range, we are winning against those players. The strength of NetApp is our software differentiation, the fact that we can simplify a customer's data center quite substantially with a single unified architecture and be able to give them a good roadmap to cloud in a way that nobody else can do.

And the midrange is the sweet spot, right? That's the place where it's the largest market segment and it is where we are most differentiated. So we feel really good. We got to just keep executing. We've got the game plan in place. We're focused. We're driving good results. We just got to keep on it. And I feel really good about the progress we've made to date.

Paul J. Chung
Analyst, JPMorgan Securities LLC

Q

Thanks so much.

Kris Newton
Vice President Investor Relations, NetApp, Inc.

All right. Thank you, Paul. I'm going to pass it over to George for some final comments.

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

Thanks, Kris. In closing, I want to again thank the NetApp team for delivering another quarter of solid results. It's been over a year since the COVID pandemic impacted all of our lives, and despite this challenging environment, we have successfully executed against our strategy. We have refocused the business and shown that we can grow both our cloud storage, our core storage, and cloud businesses simultaneously.

We have improved execution, and our increased sales capacity continues to yield positive results, and we've maintained fiscal discipline, maintaining operating margins of 20% year-to-date. As the recovery unfolds, I'm confident that we're in a great position to continue to capitalize on the growing importance of data and on our unique position in helping customers manage their data in the hybrid cloud.

Thank you. Stay safe, and we'll talk again next quarter. God bless.

Operator: Ladies and gentlemen, this does conclude today's conference. Thank you all for participating. You may all disconnect. Have a great day.