NETAPP
SECOND QUARTER OF FISCAL YEAR 2025
PREPARED REMARKS
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Prepared remarks by:
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Mike Berry, EVP and Chief Financial Officer

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

During today's call, we will make forward-looking statements and projections with respect to our financial outlook and future prospects, including, without limitation, our guidance for the third quarter and fiscal year 2025; our expectations regarding future revenue, profitability and shareholder returns; and other growth initiatives and strategies.

These statements are subject to various risks and uncertainties, which may cause our actual results to differ materially.

For more information, please refer to the documents we file from time to time with the SEC and on our website, including our most recent Form 10-K and Form 10-Q. We disclaim any obligation to update our forward-looking statements and projections.

During the call, all financial measures presented will be non-GAAP, unless otherwise indicated. Reconciliations of GAAP to non-GAAP estimates are available on our website.

I'll now turn the call over to George.

George: Thanks, Kris. Good afternoon, everyone. Thank you for joining us today.

I am extremely pleased with our Q2 performance. Revenue growth was driven by a 19% year-over-year increase in all-flash storage and strong performance in first party and marketplace cloud storage services. We achieved record Q2 operating margin and EPS, ahead of our expectations. Our uniquely differentiated solutions in flash, block, cloud storage, and AI address markets which are bolstered by both secular and company-specific tailwinds. We experienced solid growth across all these strategic focus areas, affirming the strength of our value proposition for both existing and new-to-NetApp customers. This positive momentum not only underscores our strong execution but also demonstrates our customers' confidence and commitment to our intelligent data infrastructure platform. We are delivering innovation at the fastest pace in our history, setting the stage for our continued success and growth.

In Q2, we held our INSIGHT customer conference, showcasing how we uniquely address the genuine and pressing challenges that customers face in navigating the complexities of hybrid multicloud IT. I personally witnessed the enthusiasm among the many new-to-NetApp and returning attendees as they recognized how NetApp empowers them to overcome these hurdles by building intelligent data infrastructures.

Organizations are proactively investing in data-driven strategies to drive competitive advantage. These businesses recognize the value of adopting a cohesive data strategy, leveraging data as a valuable enterprise-wide asset to fuel agile problem-solving. To accomplish this, they require a cutting-edge data architecture founded on NetApp's intelligent data infrastructure platform. With NetApp's expertise and state-of-the-art solutions, customers are confidently paving their way to becoming data-driven leaders.

We again delivered robust year-over-year performance in our Hybrid Cloud segment. Revenue grew 6% and product revenue grew 9%, driven by notable strength in all-flash storage. Broad-based success across the portfolio propelled our all-flash array annualized revenue run rate to an all-time high of $3.8 billion, up 19% year-over-year, the 4th consecutive quarter of high-teens to low-twenties percent annual growth. We continue to gain share in the all-flash market, far outpacing the growth rates of both the industry and all of our competition. Our leadership was further underscored with the recognition of NetApp as a leader in the 2024 Gartner Magic Quadrant for Primary Storage Platform for the twelfth consecutive year.

In the quarter, we delivered more innovation with new high-end products in our ASA block-optimized all-flash and FAS hybrid-flash array families, building on the Q1 introduction of the updated AFF A-series family of high-performance all-flash arrays. We have already seen new ASA deals close across multiple regions and industries, reaching new customers and expanding our wallet share with new workloads. The pipeline is growing as our message of simple, powerful, and affordable resonates with partners and customers. With these new systems and continued advancements to our software platform, customers no longer need to make tradeoffs between operational simplicity, advanced capabilities, and affordability in their storage.

Keystone, our Storage-as-a-Service offering again delivered another strong quarter, with revenue growing approximately 55% from Q2 a year ago. We added Cloud Insights into Keystone’s single subscription model, enabling customers to gain an integrated view across their infrastructure from virtual machines to network to storage, on-premises and in the cloud. Only NetApp can deliver a true hybrid cloud experience with flexibility and control in an agile pay-go model.

Organizations are actively evaluating how to use their corporate data with AI. These discussions dominated INSIGHT where we unveiled our expansive vision for AI in the era of data and intelligence. Just as we bridged the gap between on-premises and the leading public clouds, empowering customers to utilize their data with any application, anywhere, we are well positioned to bridge the divide between AI systems and enterprise data. We help customers bring AI to their data —regardless of location or method—through an approach that is intelligent, dynamic, and secure.

By eliminating data silos, we give customers a unified and structured view of their data assets. This empowers them to effortlessly explore, understand, unify, and prepare their data for AI applications. Customers can leverage their existing AI ecosystem tools directly on their data, while also benefiting from NetApp's AI features such as integrated data versioning, model traceability, and highly efficient retrieval for model training and inferencing. Our comprehensive solution includes policy-based classification, governance, and security measures that accompany data throughout the AI lifecycle. This includes automated AI data change detection and updates to keep data up-to-date and precise in every context.

While we believe the large opportunity of enterprise AI is still ahead of us, we are already seeing accelerating momentum today. Our AI business performed ahead of our expectations in Q2 with well over 100 AI and data lake modernization wins. These wins span geographies and industries, with notable early momentum in public sector, manufacturing, financial services, healthcare and life sciences industries.

We continue to advance our strong position with the development of GenAI cloud and on-premises solutions in partnership with industry leaders. GenAI is a truly hybrid workload and only NetApp has the breadth of products and services to reduce the complexity, resources, and risks across increasingly complex hybrid multicloud environments. In Q2, we announced several updates within our AI partner ecosystem, deepening our partnership with Domino Data Labs, harnessing NVIDIA accelerated computing and AI software platforms, and releasing the NetApp AIPod with Lenovo solution in its general availability version.

To make AI-ready infrastructure readily available to public sector and other highly regulated industries, we expanded our partnership with Google Cloud to provide the foundational data storage for the Google Distributed Cloud. By enhancing Google Distributed Cloud environments with ONTAP unified file and block storage and StorageGRID object storage solutions, customers can achieve better control over their data to efficiently scale their workloads and leverage AI, while helping maintain security and regulatory compliance. This collaboration has resulted in a number of early wins, further accelerating our success in global public sector and other regulated industries.

Now turning to Public Cloud. Our highly differentiated first party and marketplace cloud storage services with the leading hyperscalers remain our focus and top priority. These services continue to grow rapidly, increasing roughly 43% year-over-year. In total, Public Cloud segment revenue grew 9% year-over-year to $168 million.

We continue to innovate rapidly in cloud storage services, broadening workload support, capabilities, price and performance points, further solidifying our strong leadership position. In Q2, we updated Cloud Volumes ONTAP to include our advanced Autonomous Ransomware Protection and write-once, read-many capabilities, strengthening our customers' ability to defend against ransomware attacks. Additionally, we enhanced Google Cloud NetApp Volumes, which is now generally available in all 40 Google Cloud regions, with petabyte-scale volumes and auto-tiering, further expanding the number of workloads we serve.

We remain focused on disciplined execution to meet the evolving needs of our growing customer base. We have broadened our all-flash storage portfolio substantially with updated high-performance flash, capacity flash, and block optimized products. We have significantly increased our range of capabilities in public cloud storage with vastly more cloud data centers, more price and capacity points, new features and, expanded workload support. We have integrated more intelligent services to make our storage the most secure with simplicity built in with scale. And finally, we continue to make it easy for customers to consume our products and services how they want, wherever they want. NetApp is at the forefront of innovation, empowering customers to build intelligent data infrastructures.

Broad-based customer preference for our solutions and visionary approach for a data-driven future has enabled us to outgrow the market and take share from competitors. Our solid track record of disciplined operational management continues to yield strong earnings growth. Our focus and momentum fuel my confidence in our ongoing ability to deliver outstanding results for customers and shareholders.

In closing, I want to thank the NetApp team for their dedication to our customers' success. I'll now turn the call over to Mike.

Mike: Thank you, George. And good afternoon, everyone. We executed a strong quarter, hitting or exceeding all our guidance ranges. We made progress towards our long-term investor day targets of mid-to-upper single-digit revenue growth and double-digit EPS growth on average through fiscal year '27. Fiscal year '25 is expected to be within both ranges.

Before I get into the financial details, let me walk you through the key themes for the quarter. As a reminder, all numbers discussed are non-GAAP unless otherwise noted.

As expected, Q2 consolidated gross margin was strong at 72%, continuing to trend near all-time highs. Gross margin leverage and operating discipline drove operating margin of 29%. Gross profit dollars grew 6% year-over-year, in line with revenue, while operating profit dollars grew 13% year-over-year, double the rate of revenue.

Q2 revenue grew 6% year-over-year, the fourth consecutive quarter of mid-to-high single-digit year-over-year growth, with product revenue, cloud, and professional services all growing above this rate in the quarter.

We returned over $400 million to shareholders through dividends and share repurchases, reducing Q2 fiscal ‘25 share count by 1 million shares year-over-year. As we discussed during last quarter's call, we intend to return up to 100% of free cash flow this year.

Due to our solid execution and strong operational management, we outperformed our expectations in the second quarter and expect our continued focus and discipline to deliver mid-single-digit year-over-year revenue growth in the second half of the fiscal year. As a result, we are raising our fiscal year ‘25 revenue and EPS expectations.

Now, to the details of the quarter. Revenue of $1.66 billion increased 6% year-over-year, towards the high-end of our guidance range. Billings of $1.59 billion increased 9% year-over-year. This marks our fourth consecutive quarter of year-over-year revenue and billings growth.

Product revenue of $768 million was up 9% year-over-year. Support revenue of $635 million grew 2% year-over-year. Professional Services revenue of $87 million grew 10% year-over-year, mainly driven by Keystone. Public Cloud revenue of $168 million increased 9% from Q2 a year ago, driven by hyperscaler first party and marketplace storage services. We expect cloud revenues to return to double-digit year-over-year growth beginning in Q3, driven by the momentum in our cloud storage business.

Q2 deferred revenue was $4.1 billion, up 2% percent year-over-year. Keystone, our storage-as-a-service offering, continues to gain traction in the market. Remaining performance obligations were $4.4 billion. Unbilled RPO was approximately $330 million, up 11% quarter-over-quarter. Growth in unbilled RPO is a key indicator of future Keystone growth.

Q2 consolidated gross margin came in at 72%. Product gross margin was 60%. We highlight that both consolidated and product gross profit dollars grew mid-to-high single-digits year-over-year in Q2, in-line with revenue. We have made strategic purchase commitments to lock-in the majority of SSD supply and mitigate rising prices in calendar year 2024, which continues to give us confidence in our product gross margins as we move into the second half of fiscal year ‘25. We continue to forecast product gross margins to decline slightly in the second half of fiscal year ‘25 as compared to the first half but remain in the high 50% range for the full year, consistent with our prior guidance.

Our recurring support business continues to be highly profitable with gross margins of 92%. Our support retention rates and associated margin structure represent the continuing innovation we deliver to our customers through ONTAP. Q2 Public Cloud gross margins improved to 74% from 66% in the prior year. We are particularly proud of the improvement in Public Cloud gross margins and highlight that one-third of the year-over-year expansion in total gross profit was driven by Public Cloud in the quarter. We expect to make further progress on our Public Cloud gross margins and exit fiscal year ’25 at the lower-end of our long-term target of 75-80%.

Operating expenses of $719 million was up 2% year-over-year and up 1% from Q1 ‘25. Q2 again highlighted the strength of our business model and disciplined operational execution with operating margin of 29%, ahead of expectations. EPS of $1.87 was above the high end of our guidance, driven by higher revenues and higher gross margins compared to our initial forecasts.

Operating cash flow was $105 million in Q2 compared to $135 million a year ago, and free cash flow was $60 million compared to $97 million a year ago. Our lower year-over-year cash flow results in Q2 were primarily driven by upfront payments for strategic SSD purchases which are forecasted to be predominantly utilized during fiscal year ’25. These strategic purchases resulted in much higher inventory levels versus all of fiscal year ‘24 and reduced inventory turns to only 6 times in Q2. In the quarter, DSO’s increased to 48, in-line with seasonal averages.

During the quarter, we returned $406 million to stockholders through share repurchases and cash dividends. We have approximately $800 million remaining on our existing repurchase authorization. We also repaid $400 million in debt with available cash in the quarter as planned. Our balance sheet remains healthy. We ended the quarter with approximately $2.2 billion in cash and short-term investments against $2 billion in debt.

Now turning to guidance, starting with the full year. We are raising our revenue guidance for the full year to between $6.54 billion and $6.74 billion, representing approximately 6% year-over-year growth at the midpoint. We expect fiscal year 20’25 consolidated gross margin to be 71-72%, unchanged from prior expectations. Importantly, we expect gross margin dollars to increase to $4.75 billion at the midpoint, driven by growth across product, support, and cloud revenue. We expect fiscal year ‘25 operating margin to be 28-28.5%, up 75 basis points at the midpoint compared to prior expectations. We are raising our net interest income expectations slightly to $55 million, driven by higher interest income. We expect our tax rate for the full year to be 20-21%. As a result, we expect EPS to be in the range of $7.20 to $7.40, which at the midpoint, implies 13% growth year-over-year.

Year-to-date, our free cash flow has trended lower year-over-year despite higher revenue and net income due to the timing of higher incentive compensation and our strategic SSD purchase commitments in the first half of the year, which have been instrumental to our supply chain management strategy in a rising commodity cost environment. The lower cash flow results are due to the timing of cash payments, not a change in our normalized cash conversion cycle.

We expect SSD-related cash outflows to slow in the rest of our fiscal year and expect cash flow generation to be higher in the second half of the year compared to the first half and grow year-over-year versus the second half of fiscal year ‘24. Even with this improvement, we now expect free cash flow in fiscal year ‘25 to be slightly lower year-over-year driven by the timing of these cash payments.

Turning now to our third quarter guidance. We expect Q3 revenue to range between $1.61 billion and $1.76 billion, which at the midpoint implies 5% growth year-over-year. We expect Q3 consolidated gross margin to be 71-72%, and operating margin to be approximately 29%. We expect net interest income to be $10 million in the quarter and our tax rate to be 20-21%. EPS is expected to be in the range of $1.85 to $1.95. While our Q3 guidance for EPS forecasts a year-over-year decline, we note that last year’s Q3 represented a record high in product gross margin as well as an unusually low tax rate. Normalizing for these factors, our Q3 EPS guidance forecasts year-over-year EPS growth. As a reminder, we expect double-digit EPS growth on average from fiscal year ‘25 to fiscal year ‘27, and our fiscal year ‘25 guidance is on track towards this goal.

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

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

Kris: Thanks Mike. Operator, let’s begin the Q&A.