NETAPP
FIRST QUARTER OF FISCAL YEAR 2021
PREPARED REMARKS
AUGUST 26, 2020

Prepared remarks by:
Kris Newton, VP, Investor Relations
George Kurian, Chief Executive Officer
Mike Berry, EVP and Chief Financial Officer

Kris: 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 second quarter fiscal year 2021; our expectations regarding future revenue, profitability, and shareholder returns; and our ability to return to growth, gain 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 including the continuing impact of the COVID-19 pandemic; the IT capital spending environment; and our ability to expand our total available market, capitalize on our Data Fabric strategy, generate cash flow and execute our capital allocation strategy.

Please also refer to the documents we file from time to time with the SEC, and available on our website, specifically our most recent Form 10-K for fiscal year 2020 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: Thanks, Kris. And good afternoon, everyone. Thank you for joining us today. We hope that you all are staying safe and healthy.

As we navigate the health, economic and social changes impacting all of us, we continue to focus on what we can control and improve our operational execution. In the face of an uncertain environment, NetApp performed well in the quarter, with revenue, operating margin and EPS all exceeding our guidance. I want to thank all of our employees for their hard work in the midst of this pandemic.

Due to the global pandemic, the macroeconomic and IT spending environments remain challenging, consistent with what we saw exiting Q4. Despite these pressures, enterprises are prioritizing transformational and hybrid cloud projects, which drove our momentum as customers turn to NetApp to help them accelerate these plans.

At NetApp, we work hard to be the best partner to our customers – a value that is even more important during these particularly challenging times. We continue to deliver heightened support for customers delivering vital public health and safety services, first responders and public sector institutions. For IT teams affected by the pandemic, we are offering 25TB of NetApp Cloud Volumes Service for Google Cloud free of charge. We also extended our partner financing program to assist partners and customers in managing their cash flow.

Uncertainty remains high, but we are moving into a new normal and adjusting to operate in a virtual environment. The majority of NetApp employees are working from home and have quickly built the muscle of interacting with each other, our customers, and our partners remotely. Our sales teams are getting in front of buyers to meet and build demand. The number of Executive Briefing Center visits, now held virtually, increased by more than 50% over briefings held in Q1 a year ago. We also saw a doubling in the number of prospects in our virtual Executive Briefing Centers compared to in-person meetings last year. And our reinvigorated Run to NetApp competitive takeout program delivered strong Q1 results with good growth in future opportunities. The improvements we made to sales coverage in FY20 and the tighter focus on execution are starting to pay off.

Our customers are also adapting to the new normal. Companies are moving beyond the initial response to the pandemic of operationalizing work from home. They are now looking to accelerate digital transformations to drive competitive advantage by delivering services and products remotely, reaching customers through digital means, and optimizing remote operations and collaboration. The acceleration of digital transformations means more enterprises are managing IT environments both on-premises and in the cloud.

NetApp leverages our rich data-centric software innovation to help customers thrive in this hybrid cloud world. We help them move applications to the cloud significantly faster than any other vendor, rapidly deploy business continuity solutions, enable remote workforces to collaborate and accelerate application software development. We bring enterprise-grade data services to the cloud and the simplicity and flexibility of the cloud to the enterprise data center. With our data fabric strategy, we help customers tackle the challenges of hybrid cloud. No matter where a customer is on their hybrid cloud journey, NetApp can help them achieve their goals.

As I stated on the Q4 call, we have two clear priorities in FY21: returning to growth in our storage business powered by share gains from our industry-leading file, block and object software and scaling our highly differentiated cloud services business. We will exploit competitive transitions, the continued growth of the all-flash market, and the accelerating shift to cloud to expand the use of our products and services.

We continue to make great progress in our cloud business. Customers are now beginning to deploy critical workloads in the cloud, which drives requirements for enterprise-grade capabilities. We bring nearly 3 decades of enterprise tested, data-centric software innovation to the cloud. Cloud providers recognize this and that is why they are choosing to partner with us. Customers also recognize this and that is why they are choosing NetApp to help them accelerate their digital transformation and cloud roadmaps.

Leading with cloud in the marketplace, enables us to reach both installed base customers and new-to-NetApp customers. In Q1, roughly half of the new-to-NetApp customers came in through our cloud business. New customers, growth at existing customers, and an expanded portfolio drove an acceleration of our cloud ARR to $178M, an increase of 192% year-over-year.

In Q1, we acquired CloudJumper, a provider of cloud-based virtual desktop services, and Spot, a leader in compute management and cost optimization on the public clouds. In addition to extending our value proposition to cover more of customers' cloud spend, these acquisitions bring strong talent with cloud

DNA to our marketing, sales, and engineering teams. And they are driving increased interest in NetApp – more customers are coming to us because they are excited by our cloud strategy and ability to help them deploy applications and optimize compute and storage in the cloud.

As I've said many times, our cloud services make us a more attractive strategic partner to customers and help us gain share in the enterprise data center. Our industry-leading storage operating system software, ONTAP, is key to our success in the cloud and on-premises. ONTAP is the most powerful, most cloud-connected, and most efficient storage operating system on the market. Not only do we provide customers with a consistent operating system across data center and cloud to unify their hybrid cloud, we provide them with the flexibility of a cloud-like purchasing experience through our Keystone service.

One of the key features of ONTAP is FabricPool, which allows customers to create policies for the automatic tiering of infrequently accessed data to a more cost-effective tier such as Azure, AWS, Google, or any S3 target, including our object storage solution, StorageGRID. During these uncertain economic times, customers are finding even greater value in our ability to help them take advantage of high-performance all-flash arrays while reducing total cost of ownership through automated tiering to a lower cost cloud or object tier. This and other industry-leading capabilities helped drive strong growth for both StorageGRID and the A-series all-flash FAS array. Based on the strong 34% year-over-year growth in our all-flash business, we expect we have gained share in this important market.

NetApp is uniquely positioned to help customers unlock the best of cloud for their digital transformation. We are building on a strong foundation of industry-leading data-centric software innovation, trusted customer relationships and an open-ecosystem approach that is strengthened by partnerships with the leading public cloud companies who endorse our Data Fabric Strategy.

With the ongoing pandemic, the near future remains uncertain for many companies, and no one knows when we will return to a more normal and predictable environment. Despite the uncertainties, one thing is clear: data is growing in scale and importance. We help the world's leading organizations solve the challenge of managing their most critical data.

In closing, I want to reiterate my confidence for NetApp's future. We have strengthened our leadership team, broadened our portfolio, and enhanced our partnerships. We are listening to the market and customers and will continue to respond to their requirements with speed and agility. We will continue to be agile in our response to the market conditions created by the pandemic while positioning NetApp to address the long-term opportunity. Our strong business model and disciplined management supports our ability to accomplish our strategic objectives. We are tightly aligned to our customers' priorities and deeply committed to creating value for our customers and shareholders alike.

Finally, I want to call out a couple of key events happening this quarter. I hope that you will all be able to join our Virtual Analyst Day on September 16. You can register from our investor relations website. Our flagship user conference, Insight, will be fully virtual October 26 to 29. We hope you can tune in to hear more about how NetApp helps customers unlock the best of cloud.

I'll now turn it over to Mike to walk you through the results of the quarter.

Mike: 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.

As George noted, despite the continued macro uncertainty in Q1 as a result of Covid-19, we delivered revenue, operating margin, and EPS above the high-end of guidance. Importantly, solid execution by the sales team, in a very difficult environment, yielded Q1 billings of $1.15 billion, up 6% year-over-year.

In Q1, net revenue of $1.3 billion, increased 5% year-over-year, including a point of currency headwind. Our two key strategic focus areas, our storage business, powered by our industry-leading file, block, and object software, and Public Cloud Services, both outperformed the market in the quarter. Our all-flash revenue of $567 million, was up 34% year-over-year, nicely positioning us for share gains in the quarter. We remain confident in the growth opportunity for all-flash adoption. At the end of Q1, 25% of our installed systems were all-flash—providing a healthy runway as customers continue to embrace the cloud-connectivity and investment protection offered by our flash solutions.

Public Cloud Services delivered an impressive $178 million in ARR, growing 192% year-over-year and 60% sequentially. Our recent acquisitions of Spot, Cloud Jumper and Talon contributed a total of $44 million of ARR as of the end of the quarter. Even excluding these acquisitions, the growth of our Public Cloud Services business accelerated to 120% year-over-year. We plan to provide an updated framework for our Public Cloud Services opportunity at our upcoming virtual analyst day.

Total product revenue of $627 million decreased approximately 3 % year-over-year. In the quarter we saw growth in our largest global enterprise accounts as customers initiated digital transformation and hybrid cloud projects.

To provide improved visibility into the value created by our high-margin software franchise, we are now breaking out product revenues between software and hardware. Software product revenue of $311 million increased 2 % year-over-year, driven by an increase in our software-rich all-flash FAS. Hardware product revenue of $316 million decreased 7 % year-over-year, as spinning disk solutions continued to decline. The engineering DNA of NetApp and the value we provide to customers and shareholders is grounded in software—we will continue to highlight and invest in this innovation engine.

Software maintenance and hardware maintenance revenue of $608 million was up 14% year-over-year—and up 6% year-over-year when adjusted for the approximately $40 million, related to the extra week in the quarter. These two recurring revenue lines comprised roughly 47% of total net revenue.

When combined, software revenue and recurring maintenance revenue totaled $919 million in Q1, representing 71% of total revenue. We ended Q1 with $3.6 billion in deferred revenue, an increase of 3% year-over-year, as we continued to grow our installed-base.

Gross margin of 68 % was up nearly 1-point year-over-year. Product gross margin was 51.4 %, a decrease of 2 points year-over-year and in-line with our expectations. The year-over-year decline was driven by materially higher NAND costs and COVID-related pricing trends—we believe both of these headwinds are transitory in nature. However, given the uncertainty in the macro environment, we are cautiously assuming that a combination of these factors will persist throughout the remainder of Fiscal ‘21. In the interim, we will continue to focus on reinforcing our strategy of selling on the value of our solutions.

The combination of software and hardware maintenance and other services continues to be a very profitable and growing business for us, with gross margin of 83.4%, up a point year-over-year. The margin expansion was driven by continued leverage in our support model and exhibits the strong margin profile of a business with a software and recurring revenue model.

Q1 operating expenses of $673 million increased approximately 3% year-over-year, driven by the incremental $30 million associated with the extra week in Q1 and higher variable compensation resulting from the better than expected revenue and profitability. Operating margin was 16.3%, up 2 points from Q1 of last year. EPS of $0.73 was up 12% year-over-year.

Cash flow from operations was $240 million and free cash flow was $188 million, representing 14% of revenue. Cash flow from operations included a one-time tax payment of $57 million related to acquisitions. Excluding this item, operating cash flow would have been $297 million and free cash flow would have been $245 million, or 19% of revenue. During the quarter we paid out $107 million in cash dividends, representing 57% of free cash flow. As we noted on the Q4 call, we believe it is prudent to pause our share repurchase program until we have a better sense for the timing and magnitude of the broader economic recovery. Weighted average diluted shares outstanding were 222 million, down 21 million shares year-over-year, representing a 9% decrease. We will maintain our cash dividend of $0.48 per share in Q2.

We ended Q1 with $3.8 billion in cash and short-term investments. As you know, during the quarter we raised $2 billion in long-term debt. As of the end of the quarter, we used approximately $900 million of our debt raise to reduce our commercial paper balance and pay down 2021 senior debt maturities. The debt raise further enhances our already strong liquidity position, while also providing financial flexibility from additional domestic cash balances during the current economic environment. To be clear, even with this added liquidity, we will maintain our long history of disciplined M&A.

Now to guidance. We expect Q2 net revenues to range between $1.225 billion and $1.375 billion which, at the midpoint, implies a 5% decline in revenues year-over-year and includes a point of currency tailwind. As a reminder, the maintenance revenue benefit in Q1 from the extra week will not repeat in Q2—as a result, we expect our total maintenance revenue in Q2 to grow year-over-year while being down approximately $30 million sequentially from Q1. As a result of this sequential mix shift between product and maintenance revenues, we expect consolidated gross margin to range between 66 to 67 %. We expect operating margin to be approximately 16% in Q2. Assumed in this guidance are operating expenses of $655 to $665 million including $20 million related to our recent acquisitions. We anticipate our non-GAAP tax-rate to be between 16% and 17%. And we expect earnings per share for Q2 to range between $0.66 and $0.74 per share. Assumed in this guidance is interest expense of $15 to $20 million, driven by increased interest expense from our recent debt offering. As a reminder, Q2 tends to be our seasonal trough for free cash flow; this is further compounded by our annual cash tax payments associated with repatriation tax-reform.

Q1 earnings clearly came in better than expected. When comparing our Q2 EPS guide relative to the Q1 print, please remember the items I walked through earlier, as they materially impact the normal sequential compares.

As promised, we will be very disciplined around our cost structure. As outlined in our 8-K filing today, we are realigning resources and investments to continue to optimize our business to fund our biggest strategic priorities: returning to growth in our storage software and systems business, while scaling Public Cloud Services. Going forward, we will remain disciplined around our opex envelope as we look for reinvestment opportunities that allow us to position the company for long-term success.

Also noted in today’s 8-K filing is the departure of Scott Allen, Senior Vice President and Chief Accounting Officer. I want to personally thank Scott for all his contributions to NetApp over the past 4 years—he will definitely be missed. We wish Scott the best in the next chapter of his career.

In closing, I want to reiterate our confidence in our strategic roadmap and our commitment to continue to evolve NetApp into a cloud-led company, building on our rich data-centric software heritage. We believe this transition, coupled with solid execution, will drive significant long-term value for our shareholders. We hope all of you can join us at our upcoming Virtual Analyst Day on September 16th.