NETAPP
THIRD QUARTER OF FISCAL YEAR 2021
PREPARED REMARKS
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Prepared remarks by:
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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 fourth quarter fiscal year 2021, our expectations regarding future revenue, profitability, and shareholder returns; 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: 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'20 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 25.

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 is 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: 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 two 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. And 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 ’21 with Cloud ARR of $260 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 22, 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 ARR in fiscal ‘25.

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 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 to $685 million. Given the magnitude of our cloud opportunity, we plan to pull forward investments in both sales capacity and our product roadmap; positioning our cloud services for continued rapid growth heading into fiscal '22. 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 the 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 it back to Kris to open the call for Q&A. Kris?

Kris: 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?