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NETAPP
SECOND QUARTER OF FISCAL YEAR 2022
PREPARED REMARKS
NOVEMBER 30, 2021

Kris Newton: 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 third quarter and fiscal year two thousand twenty-two; our expectations regarding future revenue, profitability, and shareholder returns; the value we bring to customers; our ability to drive growth in our Hybrid Cloud segment and scale our Public Cloud segment; and our ability to manage through the current supply chain environment; 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 and uneven recovery of the COVID-19 pandemic, including the resulting supply chain disruptions; and the IT capital spending environment; as well as our ability to gain share in the storage market, grow 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.

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: Thanks, Kris and welcome everyone to our Q2 FY22 earnings call.

We delivered another strong quarter, with results all at the high end or above our guidance. Building on the momentum of last year and the previous quarter, revenue grew 11% year-over-year, with Public Cloud segment revenue growth of 85% and Hybrid Cloud segment revenue growth of 8%. Product revenue grew 9% year over year – the third consecutive quarter of year over year growth. Gross margin, operating margin, and earnings per share are all at record highs for the first half of the fiscal year. Our performance reflects continued broad-based customer demand created by the sizeable and long-term trends of cloud and data-driven digital transformation, where NetApp is playing an increasingly important role in helping customers achieve their business and hybrid cloud transformation goals.

NetApp is uniquely positioned to solve organizations' most significant challenges in both modern and traditional applications, on-premises, and in hybrid, multi-cloud environments. As I've said many times, our Public Cloud services not only allow us to participate in the rapidly growing cloud market, but they also make us a more strategic data center partner to our enterprise customers, driving share gains in our Hybrid Cloud business. We are seeing this play out in the strong results from both our Public Cloud and Hybrid Cloud segments. In Q2, we had a number of announcements that further solidify our leadership position as we continue to drive growth in our Hybrid Cloud segment, while scaling our Public Cloud segment.

Public Cloud revenue grew 85% year over year, driven by Azure NetApp Files, Cloud Insights, and Spot by NetApp. Public Cloud ARR grew to $388M, an increase of 80% year over year, and Public Cloud dollar-based net revenue retention rate remains healthy at 179%. During Q2, we advanced our cloud agenda significantly, and we remain confident in our ability to achieve our goal of reaching $1 billion ARR in FY25, with a gross margin profile that is accretive to the corporate average.

In Q2, Amazon Web Services (AWS) announced the general availability of Amazon FSx for NetApp ONTAP, a native, fully managed AWS storage service powered by ONTAP. This new first party product is fully integrated into the AWS console and is sold, supported, run and billed by AWS, making it easy and cost effective for customers to take advantage of NetApp's suite of enterprise-grade data services while running in an AWS native experience. As we saw with Azure NetApp Files, it will take time for FSx for NetApp ONTAP to ramp, but we are extraordinarily pleased with the early indicators and number of customers piloting this service.

Additionally, Google Cloud announced that NetApp will provide storage infrastructure for its Google Distributed Cloud Hosted, where data resides in customer-owned data centers and colocation facilities. Google is previewing the integration of Google Cloud VMware Engine with NetApp Cloud Volumes Service, a fully managed service that helps organizations meet their needs for storage and disaster recovery. We also expanded availability of Cloud Volumes Service in the Google Cloud.

Much like any other Google Cloud native service, Cloud Volumes Service can be provisioned and consumed against existing Google Cloud agreements making it easier for customers to expand their cloud engagements with both Google and NetApp.

Finally, Microsoft announced that whitelisting has been removed from Azure NetApp Files. Azure NetApp Files has been generally available since May 2019 with customers around the world relying on it to run their most demanding enterprise workloads in the Azure cloud. Now customers can instantaneously leverage Azure NetApp Files to accelerate the deployment of mission-critical enterprise applications to Azure. Additionally, we expanded the backup/restore service and cross-region replication capabilities for Azure NetApp Files.

We now have fully integrated services with all the major public cloud providers to give organizations the benefits of our storage and data management expertise and experience no matter which cloud they choose. We have deepened each partnership and co-engineered services directly with the cloud providers, enabling their customers to buy directly from them. This level of integration streamlines purchasing, billing, operations and support and eliminates the complexity of additional contracts, product installations, or patching. Importantly for NetApp, these partnerships create a new and massive go-to-market growth engine, as three of the largest and most innovative companies in the world are reselling our technology. Each of these announcements represent years of hard work, partnership, and continuous innovation bringing ONTAP to the cloud at cloud speed and represent the opportunity for continued expansion. We are now the first and only storage environment that is natively integrated into each of the major public cloud providers.

We also made significant enhancements to the Spot portfolio. We introduced Spot Security, a new product designed to keep cloud infrastructure secure. Delivering continuous, automated AI-based security, Spot Security analyzes, detects, and prioritizes threats to surface the most critical vulnerabilities and provides actionable compliance, remediation, and prevention. We also released intelligent traffic flow, a new functionality to Spot Elastigroup, which further enhances our customers' ability to optimize their applications by intelligently managing and controlling incoming network traffic for optimal instance utilization and high performance. Additionally, we announced Spot PC, a fully managed, secured, and continuously optimized desktop service built together with Microsoft to provide a complete solution for Windows 365 and Azure Virtual Desktop.

At the beginning of Q3, we closed the acquisition of CloudCheckr, whose industry-leading cloud billing analytics and cloud configuration management, monitoring, and assessments solutions will augment the full suite of Spot services. In addition to being a solid technology acquisition, CloudCheckr will enhance our partner strategy for cloud, and we will leverage the CloudCheckr platform to build and extend distributor and partner businesses in both the private and public sectors.

Also in Q2, we held our annual flagship customer event, Insight, with more than 10,000 attendees and we introduced NetAppTV to stay engaged with customers throughout the year. At Insight, we announced enhancements to our hybrid cloud portfolio with the latest version of ONTAP that delivers even better performance for SAN and modern workloads like AI and analytics, expanded capabilities for object storage, increasingly automated storage system management, and autonomous ransomware protection based on machine learning. The strength of our storage offerings was recognized by Gartner, which named NetApp once again as a leader in the 2021 Magic Quadrant for Primary Storage. Gartner called out our robust product and cloud service portfolio as well as Keystone Flex subscription, our comprehensive and flexible storage as a service offering. We were also recognized among this year's top vendor solutions evaluated in the 2021 Gartner Critical Capabilities for Primary Storage across all use cases.

Growth in our Hybrid Cloud segment was driven by strength in Object Storage for the rapidly growing unstructured data and analytics use cases, and our all-flash array portfolio. In Q2, our all-flash array business reached a record high annualized run rate of $3.1 billion, an increase of 22% year on year. All-flash arrays now compose 30% of our installed base systems. We see substantial headroom to continue to help existing and new customers modernize their storage environments. Based on our continued strong revenue growth, I am confident that we once again gained share in the enterprise storage and all-flash array markets.

Like everyone in our industry, we are faced with a challenging supply environment. While the situation is dynamic and continues to evolve, we are doing everything we can to mitigate the supply chain headwinds. We believe that we can continue to manage through them and address the substantial customer demand. As Mike will explain, we have factored the ongoing supply chain uncertainty into our guidance for Q3 and the full year. I am pleased with how we have navigated these challenges and want to thank our suppliers for their support and the NetApp team for their hard work in this environment.

In summary, our Q2 results reflect healthy momentum, a clear vision, and exceptional execution across our business. As we close the first half of FY22, I'm proud of our team and what we have accomplished. We continue to bring industry-leading capabilities to market, further enhancing our differentiated position in cloud and software. As our customers accelerate their digital transformation and their adoption of hybrid cloud and hybrid work strategies, we believe we are well positioned to capture the sizeable opportunity ahead.

Before I turn the call over to Mike, I want to invite you all to join us for our Investor Day on March 22, 2022. Please mark your calendars and stay tuned for more information.

I'll now turn it over to Mike.

Mike Berry: 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.

Before we go through the financial details, I think it would be valuable to walk you through the key themes for today's discussion:

1): Q2 was another strong quarter, with results at the high end or above our guidance;

2): Our business model continues to show significant operating leverage as we grow our operating profitability and margins;

3): Our Cloud business had another outstanding quarter as we march towards the $1B ARR target; and

4): We are increasing our full year guidance for revenue, EPS and Public Cloud ARR, driven by the outperformance in Q2, the addition of CloudCheckr, and a healthy demand pipeline for the second half of our fiscal year.

Now to the details. In Fiscal Q2 we delivered strong revenue, gross margin, and operating leverage across the entire business. Outstanding execution by the NetApp team yielded Q2 billings of $1.55 billion dollars, up 7% year-over-year. Revenue came in at $1.57 billion, up 11% year-over-year. Our solid Q2 results were driven by healthy demand across both our Hybrid Cloud and Public Cloud segments. Gross margin, operating margin and EPS all came in above the high-end of guidance.

Total Hybrid Cloud segment revenue of $1.48 billion dollars was up 8% year-over-year. Within Hybrid Cloud, we delivered product revenue growth for the third consecutive quarter and expect this momentum to continue throughout Fiscal '22. Product revenue of $814 million dollars increased 9% year-over-year. Consistent with the trends we've seen over the last year, software product revenue of $475 million dollars increased 14% year-over-year, driven by the continued mix shift towards our All-flash portfolio.

Total Q2 recurring support revenue of $590 million dollars increased 7% year-over-year.

As George highlighted, our All-flash revenue run rate, which includes both product and support revenue, eclipsed $3 billion dollars for the first time in the company's history and was up 22% year-over-year.

Public Cloud ARR exited Q2 at $388 million dollars, up 80% year-over-year and 15% sequentially, driven by strong growth in Azure NetApp Files, Spot and Cloud Insights. Public Cloud revenue recognized in the quarter was $87 million dollars, up 85% year-over-year. The growing scale of our Public Cloud platform continues to positively impact the overall growth profile of NetApp—delivering 3 of the 11 points in revenue growth.

Recurring support and Public Cloud revenue of $677 million dollars was up 13% year-over-year, constituting 43% of total revenue.

When combined, software product revenue, recurring support and Public Cloud revenue totaled $1.2 billion dollars and increased 13% year-over-year, representing 74% of total revenue, up from 72% in Q2 '21.

We ended Q2 with $3.9 billion dollars in deferred revenue, an increase of 6% year-over-year. Q2 marks the 15th consecutive quarter of year-over-year deferred revenue growth, which is the best leading indicator for continued recurring revenue growth.

Total gross margin was 68%, reflecting the value of our software portfolio and Public Cloud platform. Total Hybrid Cloud gross margin was also 68% in Q2. Within our Hybrid Cloud segment, product gross margin was 55% and benefited from the continued mix shift towards software-rich all-flash systems. Our recurring support business continues to be very profitable, with gross margin of 92%.

Public Cloud gross margin of 71% was accretive to the overall corporate average. We expect Public Cloud gross margins to continue to trend towards our long-term goal of 75 to 80%, as an increasing percentage of our Public Cloud business will be built on software-only solutions. We recently introduced the new FSx for ONTAP product with AWS, and also closed the Cloud Checkr acquisition—both are software-only offerings and support our long-term margin goal.

Q2 highlighted the tremendous leverage in our operating model, with operating margin of 24%--**an all-time company high**. EPS of $1.28 was up 22% year-over-year and also represented a new quarterly record for the company.

Cash flow from operations was $298 million dollars and free cash flow was $252 million dollars. DSO in Q2 was an impressive 38 days, highlighting a strong collections process and healthy linearity throughout the quarter. Year-to-date free cash flow of $443 million is up 43% year-over-year. During Q2 we repurchased $125 million dollars in stock and paid out $112 million dollars in cash dividends. In total we returned $237 million dollars to shareholders, representing 94% of free cash flow. We closed Q2 with $4.5 billion dollars in cash and short-term investments.

As you all know, the dynamic supply chain headwinds have intensified recently. Our excellent supply chain and procurement team continues to work closely with our partner ecosystem, with the goal of meeting as much customer demand as possible. Towards this goal, we will continue to invest incremental dollars into inventory and longer-term commitments. That said, we do anticipate the supply chain challenges facing the overall technology industry to impact our product revenue and product gross margins in the second half of Fiscal '22—these supply chain headwinds, and our ongoing actions to mitigate them, have been factored into our Q3 and updated full year guidance.

With our strong execution in Q2, the addition of CloudCheckr, and a healthy demand pipeline for the second half of our fiscal year, we are raising our Fiscal '22 revenue guidance. We now expect revenues to grow 9 to 10% year-over-year, even with the challenging supply chain environment. We also have growing confidence in our expanding Public Cloud opportunity, driven by enhanced go-to-market activities, deeper and broader cloud partnerships and continued product innovation. As a result, we are raising the guidance on our organic Public Cloud ARR, with a new range of $475 to $500 million dollars. As you know, we closed the CloudCheckr acquisition early in Q3. We anticipate CloudCheckr to contribute an additional $35 to $40 million dollars in Public Cloud ARR exiting the year. In total, our new guidance for exit Fiscal '22 Public Cloud ARR is $510 to $540 million dollars which, at the midpoint, implies a 74% increase year-over-year.

For Fiscal '22, we continue to forecast total gross margin to be approximately 68%. However, the current supply chain challenges—with temporarily higher freight and expedite charges—will pressure product margins in Q3 and Q4. We now anticipate product margins to be approximately 54% for the full year. We are reaffirming our full-year operating margin guidance of 23 to 24%. We are forecasting operating expenses to range between $2.795 and $2.815 billion dollars, driven by investment in revenue generating activities, including expanding our Public Cloud portfolio, and investments in both our Cloud and customer success sales teams. Our new op ex guidance also includes $10 million dollars per quarter from CloudCheckr. As we discussed at our investor day last September, we remain committed to growing revenue faster than operating expenses.

We are raising our Fiscal '22 EPS guidance. We now expect EPS to range between $4.90 and $5.10—representing 23% year-over-year growth, at the mid-point. Implied in this guidance is our expectation that other income and expense will be a negative $60 million dollars and our effective tax-rate will remain at 19%.

We remain committed to delivering more than $1.2 billion dollars in free cash flow in Fiscal '22, as our Hybrid Cloud business continues to fund the growth in our Public Cloud platform.

Now on to Q3 guidance. We expect Q3 net revenues to range between $1.525 and $1.675 billion dollars which, at the midpoint, implies a 9% increase year-over-year. We anticipate consolidated gross margin to range between 67 and 68% and operating margin to be approximately 23%. Assumed in this guidance are Q3 operating expenses of $705 to $715 million dollars, which includes CloudCheckr. We expect earnings per share for Q3 to range between $1.21 and $1.31 per share. Assumed in our Q3 guidance is our expectation that other income and expense will be a negative $15 million dollars and our tax-rate will be approximately 19%.

In closing, I want to thank the entire NetApp team for the outstanding execution in the first half of our fiscal year. The team stayed focused on our core priorities and were not distracted by external events out of their control. We are excited to build on that momentum as we continue to scale a truly differentiated Public Cloud platform, while maintaining an unwavering focus on the Hybrid Cloud business. As George mentioned, we plan to host an Investor Day in the spring, where we will further discuss the long-term value drivers for our shareholders, customers and partners.

I'll now hand it back to Kris to open the call for Q&A. Kris?

Kris Newton: 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?