NETAPP
FIRST QUARTER OF FISCAL YEAR 2023
PREPARED REMARKS
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Prepared remarks by:
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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 second quarter of fiscal year 2023, our expectations regarding future revenue, profitability, and shareholder returns; our resilience and opportunity for future growth in the turbulent macroeconomic environment; our ability to drive continued growth in both our Hybrid Cloud and Public Cloud segments; and our ability to invest into areas of high return, while managing supply chain constraints and maintaining disciplined operational management, 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 keep pace with the rapid industry, technological and market trends and changes in the markets in which we operate, execute our data fabric strategy and introduce and gain market acceptance for our products and services, 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 Form 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: Thanks, Kris. Welcome everyone; thank you for joining us this afternoon.

We delivered a great start to the year, with company all-time Q1 highs for billings, revenue, gross margin dollars, operating income, and EPS, fueled by broad-based demand across our portfolio and geographies. Achieving record results in the face of on-going macroeconomic uncertainty, decades-high inflation, and supply constraints underscores our disciplined operational management.

As organizations accelerate their data-driven digital and cloud transformations, our relevance grows. We are helping customers navigate disruption with a modern approach to hybrid, multi-cloud infrastructure and data management. Our opportunity is defined by the complexities created by rapid data and cloud growth, multi-cloud management, and the adoption of next-generation technologies, such as AI, Kubernetes, and modern databases. The urgency to address these priorities increased with the Covid pandemic and is further driven by the turbulent macroeconomy. Customers are searching for ways to reduce costs, improve flexibility, increase automation, and accelerate application delivery in the public cloud, in their own data centers, and in hybrid cloud environments. Our role in helping organizations achieve these transformation goals underpins our strategy and confidence in future growth.

Let me share with you a couple of examples how data intensive applications like AI drive demand for both our Public Cloud and Hybrid Cloud solutions.

A global e-commerce company chose ONTAP AI for several AI workloads, including natural language processing, recommendation engines, and deep learning. Our ultra-high-performance storage, close partnership with NVIDIA and tight application integration were key to the win and the customer has realized better performance and reliability while reducing its operating costs and data center footprint.

A Fortune 500 hyperscaler is adopting a hybrid cloud strategy to augment existing on-premises AI/ML workloads. It chose Azure NetApp Files to accelerate AI research and development on cutting-edge machine learning training workloads for its AI business unit. The initial footprint consists of nearly one petabyte of Azure NetApp Files storage with plenty of opportunity for continued growth.

Our AI solutions remove data processing bottlenecks at the edge, core, and cloud to enable more efficient data collection, accelerated AI workloads, faster time to insight, and smoother cloud integration.

Now, let's turn to our Public Cloud segment performance for the quarter:

In Q1, we continued to see strong demand for our Public Cloud services. Public Cloud ARR grew 73% year-over-year, exiting Q1 at $584 million. Public Cloud segment revenue grew 67% from Q1 a year ago to $132 million and dollar-based net revenue retention rate of 151% remains healthy. We continue to expand our Public Cloud customer base, the penetration into our Hybrid Cloud installed base, and the percentage of customers using multiple of our public cloud services.

Storage services constitute approximately 60% of our Public Cloud ARR. We see significant opportunity for continued growth in this part of our business as we help customers migrate or deploy data-intensive, demanding storage workloads to the cloud. Early in Q1, AWS announced that FSx for NetApp ONTAP is SAP-certified. SAP certification for Azure NetApp Files has helped drive large, business-critical deployments on that service and we are excited about the potential to see similar workloads deployed on FSx for ONTAP.

We recently announced that NetApp is the only cloud storage service provider certified and supported for use as an external data store for VMware Cloud environments, further expanding the opportunity for our public cloud storage services. We've long been known for the high levels of enterprise-grade data services we bring to on-premises VMware environments and now, we can bring those same benefits to VMware workloads running in the major public clouds.

As we discussed on last quarter's call, we made organizational changes to increase focus on renewal and expansion motions and refined our go-to-market execution to better address the cloud operations opportunity. These actions are starting to deliver results. In Q1, Spot bounced back, returning to its prior growth trajectory. Cloud Insights stabilized but remains a work in progress as we continue to optimize our sales and customer success motions.

We delivered a substantial amount of innovation in our cloud operations portfolio with announcements of general availability of Spot Security, Spot PC, and Ocean for Apache Spark, providing fully managed serverless infrastructure for Apache Spark, on Google Cloud. We also completed the acquisition of Instaclustr, a leading provider of fully managed open-source database, pipeline, and workflow applications. We can now combine the Spot capabilities of continuous infrastructure optimization, automation, monitoring, and security with expertise in deploying and operating fully managed open-source applications to help our customers focus on their business goals, building and releasing leading-edge applications at speed.

Onto our Hybrid Cloud segment:

In Q1, Hybrid Cloud revenue grew 6% year-over-year, driven by solid product revenue growth of 8%. All-flash array annualized revenue run rate grew 7% year-over-year to $3.0 billion. All-flash penetration of our installed base grew to 32% of installed systems. FAS hybrid arrays again posted strong unit growth. The breadth of our storage systems portfolio enables us to address a broad range of customer business, technical and economic requirements. Under a single, unified management environment, we offer high-performance all-flash arrays for mission-critical, performance-sensitive deployments, QLC-based all-flash arrays for capacity-oriented applications, and hybrid flash arrays for price-sensitive workloads.

Despite the uncertain macro, the enterprise spending environment has remained steady, driven by priority investments in digital and cloud transformations. Organizations around the globe want to learn how NetApp can increase the performance and reliability of these transformational projects, while helping reduce cost, risk, and complexity. Our ability to address a broad range of customer problems while also optimizing cloud and IT investments makes NetApp more resilient to a potential further slowdown than many of our peers.

Just as our customers are looking to save while transforming, we, too, must be agile in our response to the dynamic macro. We will continue to invest into areas of high return to drive growth, while at the same time moderating spending elsewhere.

In closing, we delivered a great quarter, kicking off a strong start to FY '23. Customer priorities are increasingly aligned with the solutions that we uniquely provide. You are seeing evidence of that in the strong growth of our revenue, billings, and profitability. I am proud of the NetApp team's focus, execution, and disciplined operational management in navigating this dynamic environment.

I'll now turn the call over to Mike to walk through the details of our outstanding Q1.

Mike: Thank you George. Good afternoon everyone and thank you for joining us.

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): As George highlighted, we had an outstanding Q1 in a dynamic environment, with all-time Q1 company highs for billings, revenue, gross profit dollars, operating income and EPS— despite an uncertain macro and unprecedented Fx headwinds;

2): Our Public Cloud business had an outstanding quarter—with excellent performance by our Cloud Volumes Service offerings from AWS, Azure and Google Cloud—which collectively grew ARR over 100% year-over-year. We also saw improved execution in our Cloud Ops portfolio;

3): As George mentioned, we continue to see healthy customer engagement and demand trends. Like everyone on this call, we are mindful of the complexity in both the macro backdrop and supply chain. We will remain extremely disciplined in running our business, while continuing to invest in our key strategic initiatives; and

4): We are reaffirming our full year guidance for revenue, margins, EPS, free cash flow and Public Cloud ARR, even when factoring in a 3-to-4-point revenue headwind from Fx, versus the 2-point Fx headwind contemplated in our guide provided last quarter.

Now to the details. As a reminder, I'll be referring to non-GAAP numbers unless otherwise noted. In Q1, despite elevated freight and logistical expense, significant component cost premiums, and unprecedented Fx headwinds, we delivered solid revenue, with both operating margin and EPS coming in above the high-end of guidance. Strong execution yielded Q1 billings of $1.56 billion, up 13% year-over-year.

Revenue came in at $1.59 billion, up 9% year-over-year. Adjusting for the 4-point headwind from Fx, billings and revenue would have been up 18% and 13% year-over-year, respectively. Our solid Q1 results were driven by broad-based demand across our portfolio and geographies. Our Cloud portfolio continues to positively impact the overall growth profile of NetApp—delivering 3 and a half of the 9 points in revenue growth.

Hybrid Cloud segment revenue of $1.46 billion was up 6% year-over-year. Within Hybrid Cloud, we delivered product revenue growth for the sixth consecutive quarter and expect this momentum to continue as we go through Fiscal ‘23. Product revenue of $786 million increased 8% year-over-year. Consistent with growth in Fiscal ’22, software product revenue of $476 million increased 15% year-over-year, driven by the value of our ONTAP software and data services. Total Q1 recurring support revenue of $598 million increased 3% year-over-year, highlighting the health of our installed base.

Public Cloud ARR exited Q1 at $584 million, up 73% year-over-year, driven by strength in Cloud Storage services, led by Azure NetApp Files, AWS FSx for ONTAP and Google CVS. Public Cloud revenue recognized in the quarter was $132 million, up 67% year-over-year and 10% sequentially.

Recurring support and Public Cloud revenue of $730 million was up 11% year-over-year, constituting 46% of total revenue—a new record for NetApp.

We ended Q1 with $4.2 billion in deferred revenue, an increase of 7% year-over-year. Q1 marks the 18th consecutive quarter of year-over-year deferred revenue growth, which is the best leading indicator for recurring revenue growth.

Total gross margin was 67%, in line with our guidance. Total Hybrid Cloud gross margin was 66% in Q1. Within our Hybrid Cloud segment, product gross margin was 50%, including a 2-point year-over-year headwind from Fx. Our growing recurring support business continues to be very profitable, with gross margin of 93%.

Public Cloud gross margin of 70% was again accretive to the corporate average. The sequential increase in Public Cloud gross margin was driven by improving software mix within our Public Cloud business. We remain confident in our long-term Public Cloud gross margin goal of 75 to 80%, as we continue to scale the business and an increasing percentage of our Public Cloud revenue is driven by cloud and software solutions.

Q1 highlighted the strong leverage in our operating model, with operating margin of 23%, despite the ongoing supply chain and currency headwinds. EPS of $1.20 came in nicely ahead of guidance.

Cash flow from operations was $281 million and free cash flow was $216 million. During Q1, we had strong cash collections while we continued to invest in inventory that included paying substantial premiums for constrained trailing-edge analog parts. This purchasing strategy allowed us to meet as much customer demand as possible but was clearly a headwind to cash flow and gross margins. We are seeing early signs of relief in supply availability. The timing of a full supply recovery remains uncertain, however, as our inventory levels start to normalize, it will be a tailwind to free cash flow as we go through Fiscal '23. During Q1 we repurchased $350 million in stock and paid out $110 million in cash dividends. In total we returned $460 million to shareholders, representing 213% of free cash flow. We closed Q1 with $3.4 billion in cash and short-term investments.

Now to guidance. We are reaffirming our Fiscal '23 guidance. Our revenue guide of 6 to 8% growth year-over-year now includes 3-to-4 points of Fx headwind—versus the 2-point headwind assumed in our original guidance provided last quarter. We will continue to grow and invest in our Public Cloud business and expect to exit Fiscal '23 with Public Cloud ARR of $780 to $820 million. At the ARR mid-point, we expect our Public Cloud segment to drive 4-points of total company revenue growth.

In Fiscal '23, we expect gross margin to range between 66 and 67%, as elevated component costs and logistical expenses from supply constraints continue to weigh on product margins. Adding to these product cost overhangs is an additional 1-point from incremental Fx headwinds—as you know, the vast majority of our bill of materials is procured in U.S. dollars.

We are cautiously optimistic that supply constraints will ease further in the second half of our fiscal year, reducing our dependence on procuring parts at significant premiums—we should also start to see a benefit from declining prices for our hardware components. While the timing is uncertain, we remain confident that our structural product margins will normalize back to the mid-50s in the fullness of time.

Despite the incremental currency headwinds, we remain committed to driving operating margin of 23 to 24% and EPS of $5.40 to $5.60 for the full year. Like all of you, we are closely monitoring the demand signals and broader macro trends. As George noted, customer engagement and demand remain healthy, however, given the fluidity of the environment, we will continue to be appropriately measured in our outlook and extremely disciplined with our spending envelope.

We continue to expect to generate greater than $1.4 billion in operating cash flow and $1.1 billion in free cash flow for the full year.

Now on to Q2 guidance. We expect Q2 net revenues to range between $1.595 billion and $1.745 billion which, at the midpoint, implies a 7% increase year-over-year, including 4-points of currency headwinds. We expect consolidated gross margin to range between 66 and 67% and operating margin to be approximately 23%. We anticipate our tax-rate to be between 21 to 22%. And we expect earnings per share for Q2 to range between $1.28 and $1.38 per share. Assumed in our Q2 guidance is net interest expense of $5 million and a share count of approximately 223 million.

In closing, I want to thank the entire NetApp team for the outstanding execution in Q1— as a result the year is off to a strong start!!

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

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