NETAPP
SECOND QUARTER OF FISCAL YEAR 2023
PREPARED REMARKS
November 29, 2022

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, such as our guidance for third quarter and fiscal year 2023; our expectations regarding future revenue, profitability, and shareholder returns; our alignment with industry megatrends and expectations regarding the future growth in the number of cloud customers and their usage of cloud services; our ability to deliver innovation and focus on our strategic growth opportunities while optimizing our operating costs; and our ability to drive sustained growth in both our Hybrid Cloud and Public Cloud segments in a turbulent macroeconomic 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 inflation, rising interest rates and foreign exchange volatility, the continuing impact and uneven recovery of the COVID-19 pandemic, including the resulting supply chain disruptions; and the IT capital spending environment, including the focus on optimization of cloud spending; 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 evolved cloud strategy and introduce and gain market acceptance for our products and services, and manage our gross profit margins 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 and Form 10-Q 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 and welcome everyone to our Q2 FY23 earnings call.

Coming off a strong Q1, our team delivered a solid quarter, with all-time highs for Q2 billings, revenue, gross profit dollars, operating income, and EPS. We remain focused on disciplined operational management and the execution of our strategy which is tightly aligned with customer priorities.

On today's call, I will walk through four topics:

#1: We delivered a good quarter in a dynamic environment. However, we are disappointed with the deceleration of growth in our cloud services. Our conviction in the cloud opportunity and our ability to execute against it is unwavering.

#2: We are aligned with the durable, megatrends of data-driven digital and cloud transformations. We continue to deliver innovation that furthers our already strong position.

#3: We believe strongly in the opportunity ahead but have slightly tempered our revenue outlook for the remainder of the fiscal year due to near-term macro headwinds.

#4: We understand the imperative to deliver shareholder value in a slowing environment and will focus on our strategic growth opportunities while continually optimizing our operating costs.

Let's start with the first point – our performance in the quarter:

Q2 Public Cloud segment revenue increased 63% year over year to $142 million and dollar-based net revenue retention rate remained healthy at 140%. However, Public Cloud ARR of $603 million fell short of our expectations.

As our cloud partners discussed on their earnings calls, growth has slowed as customers look to optimize cloud spending. This macro-related optimization caused some slowing of growth in our cloud storage services, as well. Additionally, we had a few customers with very large project-based workloads, like chip design, that came to their natural conclusion, resulting in capacity reductions in those environments. We expect these customers to kick off new projects early next calendar year. As the number of cloud customers and their usage of our cloud services grows, the impact of this type of workload will be smoothed over a much broader customer base.

In our cloud operations portfolio, Spot is benefiting from the same desire to optimize cloud spending that was a headwind to our cloud storage services. Spot's value proposition is a strong engine for new logo acquisition and Q2 saw an acceleration of new Spot customer additions from Q1. As we've discussed on past calls, we continue to refine our approach to Cloud Insights and are seeing early positive signs, with growth of new Cloud Insights customers in Q2.

We continue to see healthy growth of new-to-NetApp customers and of existing NetApp enterprise customers adopting our cloud services. And those customers are growing in scale, as well. The number of customers with greater than $1 million in ARR has more than doubled from Q1 last year. Our Public Cloud Services are highly differentiated and create customer preference for NetApp. We have a multiyear advantage over our traditional competitors in this critical market, positioning us well to deliver sustained growth.

Compared to Q2 a year ago, Hybrid Cloud revenue grew 3% and our all-flash array business increased 2% to an annualized revenue run rate of $3.1 billion. Adjusting for the significant Fx headwinds, Hybrid Cloud grew 8% and all-flash grew 7% in constant currency. All flash penetration of our installed base grew to 33% of installed systems. Our lower cost, capacity-oriented all-flash arrays and FAS hybrid flash arrays both performed well.

Onto the second point – our alignment to the industry megatrends and our continued innovation:

The world is moving faster than ever, raising data-driven digital and cloud transformations to business necessities. NetApp helps meet these objectives with a modern approach to hybrid, multicloud infrastructure and data management that we term 'the evolved cloud'. We provide customers the ability to leverage data across their entire estate with simplicity, security, and sustainability which increases our relevance and value to our customers. We believe strongly in the sizeable, durable, and growing opportunity created by these megatrends.

As many of you know, we bring significant value to customers running VMware environments on-premises. With a series of announcements made in conjunction with VMware, we are now able to bring that same value to customers in the cloud. Our native cloud storage service, integrated with VMware, helps customers quickly, easily, and cost effectively migrate enterprise workloads to the cloud and accelerate modern application development using Kubernetes. We are the only certified and supported third-party cloud storage solution for VMware Cloud, which creates significant new opportunity for us. As those VMware environments move to the cloud, we can capture the data that resides on competitors' on-premises systems.

At the start of November, we introduced BlueXP, the next big step in fulfilling our vision to give customers the simplicity, security, savings, and sustainability needed for an evolved cloud. It delivers true hybrid, multicloud operations by bringing storage and data services together in a single, unified control plane. BlueXP is a highly differentiated solution that enables customers to deploy, discover, manage, and optimize not only infrastructure and data, but supporting business processes—across multiple clouds and on-premises environments.

In addition to bringing forward technical capabilities, we are helping customers achieve their environmental goals by creating energy-efficient products. We have added power and temperature reporting in Cloud Insights to give customers a real-time view into energy expenditure and our carbon footprint reports provide a reasonable estimate for the carbon impact of their NetApp systems. We enhanced our storage efficiency with a 4:1 efficiency guarantee for SAN workloads to help customers minimize their storage footprint and lower energy usage.

We not only help customers practice sound environmental stewardship, we practice it ourselves. I am proud to announce that EcoVadis, the leading evidence-based ESG rating agency, awarded NetApp a gold ranking, placing us within the top 7% of evaluated companies.

Now the third point – the macro environment and our business outlook:

As we moved through the quarter, we saw increased budget scrutiny, requiring higher level approvals, which resulted in smaller deal sizes, longer selling cycles, and some deals moving out of the quarter. In Q2, we felt this most acutely in the Americas hi-tech and service provider sectors. We see no change to our underlying opportunity and are confident in our position. However, current economic realities and unprecedented Fx headwinds are and will continue to impact IT spending, causing us to temper our revenue expectations for the second half.

And finally, point four – driving shareholder value:

In response to the slowing topline, we are being agile and taking action to lower operating expenses. Already, we have implemented a broad-based hiring freeze, and are reducing discretionary spending, as well as further optimizing our real estate footprint. We will remain disciplined as we continue to shift resources away from lower yield activities to our biggest opportunities.

In closing, we are clearly aligned with our customers' strategic priorities and remain confident in our long-term opportunity, despite the current external headwinds. By focusing on what we can control, we will aggressively seek to maximize the near-term return on our product and services portfolio while leveraging our leadership position in all-flash, cloud storage, and cloud infrastructure optimization.

I would like to thank the entire NetApp team for delivering a strong first half. In a challenging environment, we remain focused on innovation, execution, and operational discipline.

I'll now turn the call over to Mike.

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 delivered a strong Q2 in a dynamic environment, with all-time Q2 company highs for billings, revenue, gross profit dollars, operating income and EPS;

#2: We have adjusted our outlook for the second half of the fiscal year due to an increasingly challenging macroeconomic environment and unprecedented Fx headwinds;

#3: As we navigate through the current macro environment, we are laser focused on driving operating margins and free cash flow generation. As George noted, we have taken actions to reduce our full year expense envelope and will remain fluid in assessing further opportunities to take costs out of the business.

#4: As a result of these cost savings measures, the entirety of the Op margin and EPS guidance revision for the full year is being driven by the incremental 1 to 2 points from the deepening currency costs we have seen since our Q1 call; and

#5: 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. From a capital allocation perspective, we will continue to pause Cloud Operations acquisitions for the remainder of Fiscal '23. We now plan to return more than 100% of Fiscal '23 Free Cash Flow to investors through dividends and incremental share repurchases.

Now to the details. As a reminder, I'll be referring to non-GAAP numbers unless otherwise noted. Q2 billings were $1.6 billion, up 3% year-over-year. Revenue came in at $1.66 billion, up 6% year-over-year. Adjusting for the 540-basis point headwind from Fx, billings and revenue would have been up 9% and 12% year-over-year, respectively. Even with the challenging Q2, our Cloud portfolio continues to positively impact the overall growth profile of NetApp—delivering 3 and a half of the 6 points in revenue growth.

Hybrid Cloud segment revenue of $1.52 billion was up 3% year-over-year. Product revenue of $837 million increased 3% year-over-year. Total Q2 recurring support revenue of $607 million increased 3% year-over-year, highlighting the health of our installed base.

Public Cloud ARR exited Q2 at $603 million, up 55% year-over-year. Public Cloud revenue recognized in the quarter was $142 million, up 63% year-over-year and 8% sequentially.

Recurring support and Public Cloud revenue of $749 million was up 11% year-over-year, or 16% in constant currency, constituting 45% of total revenue.

We ended Q2 with $4.1 billion in deferred revenue, an increase of 5% year-over-year, or 10% in constant currency. Q2 marks the 19th consecutive quarter of year-over-year deferred revenue growth, which is the best leading indicator for recurring revenue growth.

Total gross margin was 66.3%, in line with our guidance. Total Hybrid Cloud gross margin was 66% in Q2, including a 2-point year-over-year headwind from Fx. Within our Hybrid Cloud segment, product gross margin was 50%, including a 3-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 68% was accretive to the corporate average for the eighth consecutive quarter. We remain confident in our long-term Public Cloud gross margin goal of 75 to 80%, as the business scales and an increasing percentage of our Public Cloud revenue is driven by cloud and software solutions.

Q2 highlighted the strong leverage in our business model, with operating margin of 24%, including 2-points of Fx headwinds. EPS of $1.48 came in nicely ahead of guidance and included a $0.21 year-over-year Fx headwind.

Cash flow from operations was $214 million and free cash flow was $137 million. Q2 included our annual repatriation tax payment and continued cash outflows for certain inventory and premiums for constrained trailing-edge analog parts. Additionally, collections were lower than expected due to a backend loaded quarter for invoicing linearity that you see in the higher accounts receivable balance

Our component purchasing strategy allows us to meet as much customer demand as possible but remains a clear headwind to cash flow and gross margins. We are seeing 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 the second half of Fiscal ‘23. During Q2 we repurchased $150 million in stock and paid out $108 million in cash dividends. In total we returned $258 million to shareholders, representing 188% of free cash flow. Share count of 220 million was down 4% year-over-year.

We closed Q2 with $3.0 billion in cash and short-term investments.

Now to guidance.

As George discussed, we have seen softening in the macro backdrop, with customers taking a decidedly cautious approach to spending. Additionally, currency headwinds have only continued to increase. We now expect Fiscal ’23 revenue to grow 2 to 4% year-over-year, which includes 5 points of Fx headwind—versus the 4-point headwind assumed in our prior guidance.

We now expect to exit Fiscal ‘23 with Public Cloud ARR of approximately $700 million, which equates to our Public Cloud segment driving 3-points of total company revenue growth for the full year.

Three drivers are impacting the near-term growth rate of Cloud ARR.

#1: In this macro environment, we project continued optimization of storage services as we help our customers manage their spending, which benefits Spot, but will offset some incremental near-term storage services ARR.

#2: We expect that project-based workloads will grow in both number and scale, but as they ramp it will take some time to materialize into sizable ARR; and

#3: We continue to tighten up the Cloud Insights sales motion, but we don't expect this meaningful cross-sell opportunity to materialize until we head into Fiscal '24.

In Fiscal '23, we continue to expect gross margin to range between 66 and 67%, as elevated component costs and Fx headwinds weigh on product margins—as you know, the vast majority of our bill of materials is procured in U.S. dollars. We are 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 see a benefit from declining NAND prices in Q4. 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.

For the full year, we expect operating margin of approximately 23%, which now includes approximately 2 points of Fx headwind and EPS of $5.30 to $5.50, which now includes more than $0.70 of currency impacts. It's important to reiterate that we are offsetting the full year revenue adjustment with an extremely disciplined approach to our spending envelope. As a result, the entirety of the Op margin and EPS guidance revision for the full year is being driven by the incremental 1 to 2 points from the deepening currency costs we have seen since our Q1 call.

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. From a capital allocation perspective, we will continue to pause Cloud Operations acquisitions for the remainder of Fiscal '23, as we sharpen our portfolio focus by refining the Cloud Insight value proposition and sales motion, accelerating the integration of Spot and CloudCheckr into a single finops suite, and driving the successful integration of InstaClustr. As I said earlier, we now plan to return more than 100% of Fiscal ’23 Free Cash Flow to investors through dividends and incremental share repurchases

Now on to Q3 guidance. We expect Q3 net revenues to range between $1.525 billion and $1.675 billion which, at the midpoint, implies a 1% decrease year-over-year, or 4% growth in constant currency. We expect consolidated gross margin to be approximately 67% and operating margin to range between 22 and 23%. We anticipate our tax-rate to be between 21 to 22%. And we expect earnings per share for Q3 to range between $1.25 and $1.35 per share. Assumed in our Q3 guidance is net interest income of $5 million and a share count of approximately 220 million.

In closing, I want to thank the entire NetApp team for their continued commitment in such a dynamic environment. 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.