NETAPP
SECOND QUARTER OF FISCAL YEAR 2024
PREPARED REMARKS
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Prepared remarks by:
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Mike Berry, EVP and Chief Financial Officer

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, including, without limitation, our guidance for the third quarter and FY'24; our expectations regarding future revenue, profitability and shareholder returns; and other growth initiatives and strategies.

These statements are subject to various risks and uncertainties, which may cause our actual results to differ materially.

For more information, please refer to the documents we file from time to time with the SEC and on our website, including our most recent Form 10-K and Form 10-Q. We disclaim any obligation to update our forward-looking statements and projections.

During the call, all financial measures presented will be non-GAAP, unless otherwise indicated. Reconciliations of GAAP to non-GAAP estimates are available on our website.

I'll now turn the call over to George.

George: Thanks, Kris. Good afternoon, everyone. Thank you for joining us today.

Q2 improved on our solid start to FY'24 in what continues to be a challenging macroeconomic environment. We delivered revenue above the midpoint of guidance while our operational discipline yielded company all-time highs for gross margin, operating margin, and EPS.

We remain relentlessly focused on managing the elements within our control while driving better performance in our storage business and building a more focused approach to our Public Cloud business. We are seeing positive results from these actions, with increased profitability and a stronger position for delivering long-term growth.

In Q2, we held our Insight user conference where I witnessed the tangible excitement for the silo-free innovation our unified data storage provides. It was invigorating to be with the thousands of attendees and hear stories of the extraordinary outcomes NetApp delivers for our customers.

NetApp is at the forefront of the evolution of the storage industry, helping our customers turn disruption into opportunity with intelligent data infrastructure. Today's organizations need storage infrastructure that harnesses the power of public and hybrid clouds while keeping data secure and protected from ransomware attacks. They need infrastructure that supports dynamic workloads like AI, cloud-native, and open-source applications. And they need infrastructure that helps to create more sustainable data centers.

Only NetApp delivers an entire architecture of unified data storage solutions based on one operating system, ONTAP, that supports any application, any data type, and spans on-premises and multiple cloud environments. This comprehensive architecture delivers unparalleled simplicity of management, simplicity of deployment, and consistency of automation, all unified by common APIs and a single control plane. We further elevate the customer experience with our BlueXP sustainability dashboard and NetApp Advance, a common set of programs and guarantees that include Storage Lifecycle Program which removes the burden of upgrade cycles, as well as storage efficiency, ransomware recovery, and data availability guarantees. Intelligent data infrastructure combines unified data storage, integrated data services, and intelligent operations so customers can operate with seamless flexibility to deploy new applications, unify their data for AI, and simplify data protection in a world of limited IT resources, rapid data growth, and increased cybersecurity threats.

Looking at the results of the quarter, momentum from new products and the go-to-market changes we made at the start of the year drove 10% quarter-over-quarter growth in Hybrid Cloud segment revenue to $1.4 billion. Our all-flash array business benefited from growth of the AFF C-series, increasing 14% from Q1 to an annualized revenue run rate of $3.2 billion.

The AFF C-series all-flash array continues to exceed our expectations, delivering new-to-NetApp customers and numerous wins over the competition. In the quarter, we successfully competed against an all-flash competitor with C-series to win a $16 million deal at an Infrastructure-as-a-Service company. The customer was looking for new storage to host a broad variety of critical applications. Our ease of management for large storage environments, unique data resilience, common toolkit across all our storage systems, and the right price/performance ratio secured our win, despite the competitor's attempt to use price once they realized their value proposition was insufficient. ONTAP One, our all-in-one software license that gives customers access to the industry's most comprehensive data management suite, has laid the groundwork for future tech refresh and expansion opportunities.

Building on the success of the C-series, we introduced block-optimized and AI-ready versions. The ASA C-series family is a solution tailored to deliver high-performance and guaranteed high availability storage for critical applications, databases, and VMware infrastructure, coupled with capacity flash to make enterprise-grade block storage more affordable and sustainable than ever. We added the AFF C-series to the ONTAP AI architecture, lowering the overall cost of entry to scalable AI without sacrificing performance.

Keystone, our Storage as a Service offering, is also growing rapidly. In Q2, we added performance and availability guarantees to Keystone, expanding on the existing sustainability and storage efficiency guarantees, creating a comprehensive program to keep storage operations running optimally. We also announced NetApp Storage on Equinix Metal, powered by Keystone, providing customers with a single subscription to a full stack of compute, networking, and storage infrastructure with low-latency interconnection to all major public clouds.

Turning to Public Cloud. As we said last quarter, our priority is growing first party cloud storage services. We aligned our cloud sales specialists to our hyperscaler partners' go-to-market structures at the start of the fiscal year and are seeing new customer additions and growth in those services. However, that growth has been masked by weakness in subscription services, which have declined to 23% of Public Cloud ARR.

During the quarter, we engaged in a strategic review to sharpen the focus of our cloud portfolio. As a result, we will continue to prioritize cloud storage offerings delivered through the hyperscalers, while refocusing some services, such as Cloud Insights and Instaclustr, to complement and extend our hybrid cloud storage offerings, creating greater differentiation and additional value for customers. We will integrate other services that are sold as standalone subscriptions today, such as data protection, into the core functionality of Cloud Volumes. We will also carefully manage the transition of cloud storage subscription services to align to customer preference for consumption offerings. And, we have decided to exit the SaaS backup and virtual desktop services.

We anticipate ARR headwinds of approximately $55M from exited services and unrenewed subscriptions in the second half of FY'24. Growth in first party and marketplace services are expected to partially offset this decline, positioning us to enter FY'25 with a more focused and much healthier business from which to grow.

Now to the results of the quarter. Public Cloud segment revenue in Q2 was $154 million, flat from Q1 and up 8% year-over-year. Our first party and marketplace offerings are highly differentiated and are tightly aligned with customers' buying preferences; these services grew over 30% from Q2 a year ago. We continue to see customer expansion and deepening partnerships, as well as increases in customer count, capacity, revenue and ARR in this part of the portfolio.

In Q2, we extended our partnership with Google with the introduction of Google Cloud NetApp Volumes. Now, we are not only the only vendor to have a natively integrated storage service in the public cloud, but we are natively integrated into all three of the leading hyperscale vendors. And we are not standing still with this advantage. Just two months after introducing the GCNV service, we announced the availability of a new lower-cost tier of Google Cloud NetApp Volumes, expanding the offering to address a greater range of workloads.

These partnerships uniquely position and enable us to participate in the innovation and adoption of AI services in the public cloud. As examples, during Q2, we announced support for Google Cloud's Vertex AI with Google Cloud NetApp Volumes, as well as cross-protocol, hybrid cloud AI pipelines on Amazon FSx for NetApp ONTAP with support for SageMaker Studio notebooks.

Our position with the hyperscalers also enables us to displace legacy on-premises competitors as customers migrate workloads to the cloud. A US-based medical equipment company chose FSx for NetApp ONTAP to replace a competitor's SAN systems when they moved their database workloads to the cloud. This is the customer's first engagement with NetApp. Following a successful initial deployment, they are evaluating FSxN for workload consolidation and disaster recovery.

Looking forward, our focus is clear and is delivering results. We expect the momentum we saw in Q2 to continue through FY'24, despite continued softness in the demand environment due to the challenging macro. Customers value our modern approach to hybrid, multicloud infrastructure and data management which enables IT organizations to leverage data across their entire estate simply, securely, and sustainably. With recent innovations that enable us to address a broader set of markets more efficiently, I am confident that we are well positioned to deliver positive outcomes for customers and stockholders.

I'll now turn the call over to Mike.

Mike: Thank you, George. And good afternoon, everyone.

Q2 was a very solid quarter in what continues to be a challenging macro environment with soft IT spend.

Our relentless focus and consistent execution delivered results that met and exceeded our guidance ranges and drove record-setting non-GAAP profitability measures across consolidated gross margin, product gross margin, operating margin, and EPS.

Before I get into the financial details, let me walk you through the key themes for the quarter. As a reminder, all numbers discussed are non-GAAP unless otherwise noted.

- Our modern, innovative solutions are resonating with customers and our disciplined operational management drove profitability margins to a record high. As we look ahead, we expect our industry leading solutions and unwavering focus to drive revenue growth and profitability in the second half of the fiscal year.

- Q2 consolidated gross margins of 72% were at an all-time high driven by product gross margin of 61%, also at an all-time high. Gross margin leverage and the returns on our strategic investments drove record operating margins of 27% and record EPS of $1.58.
- During the quarter, we returned approximately $403 million to stockholders through cash dividends and share repurchases, reducing share count by 4% versus Q2’23. Over the course of the year, we expect to return at least 100% of free cash flow to stockholders.
- Given our growth, profitability and working capital improvements, we expect operating cash flow for the full year to normalize and track relatively in-line with net income for the full year.
- Due to our solid execution and operational efficiencies, we outperformed the second quarter and expect our continued focus and discipline to deliver year-over-year revenue growth in the second half of the year. As a result, we are raising all our guidance measures for FY’24.

Now, to the details of the quarter.

Q2 billings of $1.5 billion decreased 9% year-over-year, and revenue of $1.6 billion decreased 6% year-over-year, as IT budgets remain constrained in a challenging macro environment. Adjusting for the FX tailwind of 160-basis-points, billings and revenue would have decreased 11% and 8% year-over-year, respectively.

Hybrid Cloud revenue of $1.4 billion decreased 7% year-over-year, and product revenue of $706 million decreased 16% year-over-year.

As discussed last quarter, the first half of FY’23 revenue, and most notably product revenue, benefited from elevated levels of backlog entering FY’23. For the second half of FY’24 year-over-year comparisons should be more apples-to-apples. Support revenue, an attach to our install base and indicative of the value of our products, grew 3% year-over-year to $623 million. We are pleased with the momentum of our product portfolio and our go-to-market initiatives implemented at the start of FY’24.

Public Cloud revenue increased 8% year-over-year to $154 million and was relatively flat from Q1’24. As George noted, year-over-year growth was driven by hyperscaler first party and marketplace services, partially offset by continued declines in subscription services.

Now, for our operating results.

Q2 consolidated gross margin increased 580 basis points year-over-year to 72% and product gross margin increased 1,080 basis points year-over-year to 61%. Product gross margin benefited from three main factors:

#1) A mix shift to higher margin and higher capacity products.
#2) Favorable COGs stemming from lower component costs and our strategic purchase agreements for NAND.
#3) Price discipline in a cost sensitive, competitive pricing environment.

I want to be very clear on this point: there were no unusual or one-time transactions that drove the higher product gross margin results.

As we discussed in prior calls, we continue to make strategic purchase commitments to lock-in NAND pricing and mitigate margin pressure from rising prices in the future, as NAND prices largely bottomed out in Q2.

Operating expenses of $706 million were flat year-over-year and grew $3 million quarter-over-quarter. Within a relatively consistent OPEX envelope, we will continue to reallocate investments to areas of higher opportunity to drive long-term growth.

In Q2 operating margin increased 320 basis points year-over-year to 27%, which includes 80 basis points of FX tailwind. EPS grew 7% year-over-year to $1.58, which includes a $0.07 FX tailwind. These record results demonstrate the strength of our business model, product relevance and unwavering focus and execution.

As expected, Q2 operating cash flow of $135 million was impacted by seasonally lower collections and repatriation tax payments. DSO was 46 and inventory turns were 15. More importantly, YTD operating cash flow of $588 million grew 19% year-over-year compared to a decline of 8% the same period a year ago. Free cash flow came in at $97 million, bringing the year-to-date amount to $515 million, up 46% year-over-year.

During the quarter, we returned $403 million to stockholders through share repurchases and cash dividends, ending the quarter with approximately $230 million in net cash.

Our balance sheet remains healthy. Total deferred revenue as of the end of Q2 was $4.0 billion. The slight decline year-over-year is driven by lower multi-year support and public cloud subscription billings. We ended the quarter with approximately $2.6 billion in cash and short-term investments.

Now turning to guidance.

Given the success of our product portfolio and consistent execution on operational improvements, we are raising our FY'24 guidance in still a soft IT spending environment.

We now expect FY'24 revenue to be down approximately 2% year-over-year, an improvement from our previous guidance. We expect to see continued strength in product and hyper-scaler first-party and marketplace services as we work through minor headwinds from public cloud subscription services.

Consolidated gross margins are expected to be approximately 71%. For the second half, we expect product gross margin to range between 58% to 60% driven by continued mix shift to all-flash products and taking into account the current pricing environment and our commitment to maintain pricing flexibility.

Operating margin is expected to be approximately 26% and EPS to be in the range of $6.05 to $6.25 with the assumption of net interest income of approximately $30 million and share count of 212 million.

Operating cash flow is expected to move in-line with net income, although there will be some quarterly variance based on working capital.

In Q3, we expect revenue to range between $1.51 billion and $1.67 billion, which at the midpoint implies an increase of 4% year-over-year. We expect Q3 consolidated gross margins to be roughly 71%, and operating margin to be approximately 28%. EPS is expected to be in the range of $1.64 to $1.74.

In closing, I want to thank our customers, employees and investors once again for their steadfast commitment and investment in NetApp. I remain confident in our ability to manage the elements in our control and focus our key priorities to help customers successfully achieve their digital and cloud journeys. Our portfolio is well aligned to priority IT investments, and we are committed to delivering sustainable, long-term value for our stockholders.

I'll now turn the call over to Kris to open the Q&A. Kris?

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