Corrected Transcript

16-Aug-2017

NetApp, Inc. (NTAP)

Q1 2018 Earnings Call

CORPORATE PARTICIPANTS

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

Ronald J. Pasek
Executive Vice President and Chief Financial Officer, NetApp, Inc.

OTHER PARTICIPANTS

Joe H. Wittine
Analyst, Longbow Research LLC

Simon M. Leopold
Analyst, Raymond James & Associates, Inc.

David Ryzhik
Analyst, Susquehanna Financial Group LLLP

Steven Milunovich
Analyst, UBS Securities LLC

Wamsi Mohan
Analyst, Bank of America Merrill Lynch

Eric Martinuzzi
Analyst, Lake Street Capital Markets LLC

Maynard J. Um
Analyst, Wells Fargo Securities LLC

Kathryn Lynn Huberty
Analyst, Morgan Stanley & Co. LLC

Andrew James Nowinski
Analyst, Piper Jaffray & Co.

Jayson A. Noland
Analyst, Robert W. Baird & Co., Inc.

Alex Kurtz
Analyst, KeyBanc Capital Markets, Inc.

David Wishnow
Analyst, Jefferies

Amit Daryanani
Analyst, RBC Capital Markets LLC

Srini Nandury
Analyst, Summit Redstone Partners LLC

Steven Fox
Analyst, Cross Research LLC

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Sherri A. Scribner
Analyst, Deutsche Bank Securities, Inc.

Mark Kelleher
Analyst, D. A. Davidson & Co.

Mark Moskowitz
Analyst, Barclays Capital, Inc.

Nehal Sushil Chokshi
Analyst, Maxim Group LLC

Rod Hall
Analyst, JPMorgan Securities LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, ladies and gentlemen. Welcome to NetApp's first quarter fiscal year 2018 financial results conference call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session and instructions will be given at that time.

I would now turn the call over to Kris Newton, Vice President, Corporate Communications and Investor Relations.

Kris Newton

Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

Hello and thank you for joining us on our Q1 fiscal year 2018 earnings call. With me today are our CEO, George Kurian; and CFO, Ron Pasek. This call is being webcast live and will be available for replay on our website at netapp.com, along with the earnings release, our financial tables and guidance, a historical supplemental data table, and the non-GAAP to GAAP reconciliation.

As a reminder, during today's call, we'll make forward-looking statements and projections with respect to our financial outlook and future prospects, such as our guidance for the second quarter and full fiscal year 2018 and our expectations regarding future revenue, profitability, cash flow and shareholder returns, all of which involve risk and uncertainty. We disclaim any obligation to update our forward-looking statements and projections.

Actual results may differ materially from our statements and projections for a variety of reasons, including global political macroeconomic and market conditions and our ability to expand our total available market, enhance our product offerings, execute new business model, manage our gross profit margins, capitalize on our market position, maintain execution and continue our capital allocation strategy.

Please also refer to the documents we file from time to time with the SEC, specifically our most recent Form 10-K for fiscal year 2017 and our current reports on Form 8-K, all of which can be found on our website. During the call, all financial measures presented will be non-GAAP, unless otherwise indicated.

I'll now turn the call over to George.

George Kurian

President, Chief Executive Officer & Director, NetApp, Inc.

Thanks, Kris. Welcome, everyone. Thank you for joining us today.

With focus, market-leading innovation and disciplined execution, we delivered a strong start to fiscal year 2018. Revenue was above the midpoint of our guidance range; and gross margin, operating margin and earnings per share were all above our guidance.

NetApp is winning because we deliver solutions that enable our customers to harness the value of their data and thrive in a digital world. In addition to delivering solid results across the board, we further strengthened our leadership position by enhancing our all-flash array and converged infrastructure offerings and augmenting our Data Fabric strategy. We expanded our strategic partnership with Microsoft Azure and introduced new hybrid cloud software solutions. The accelerating turnaround of NetApp underscores our unique technology leadership and expanding opportunity.

As I've said before, NetApp is transforming to align our strategic focus, investments and executions with the changing needs of our customers. The first phase of our transformation put us on a solid foundation by shifting our business to the growth areas of the market, bringing our cost structure in line with our opportunities and substantially improving our leadership capability and execution.

As we shift to the second phase of our transformation, we are building on that foundation to deliver sustained and profitable growth. We are focused on three key priorities: first, to drive sustained top line growth, we will remain focused on the high growth areas of the market as well as address new customers and new buying centers at existing customers; second, to increase profitability as we grow, we will continue our disciplined approach to realign our resources against the biggest opportunities and to focus on productivity to expand our innovation; and third, we will maintain our focus on capital allocation, balancing shareholder returns with investment in the business for long-term growth.

Like NetApp, our customers are transforming to grow revenue and improve productivity. Through new digital business models and the Internet of Things, companies are harnessing the power of their data to enable new customer touch points, uncover business opportunities and optimize operations. These imperatives require advanced data management capabilities and a new class of hybrid cloud data services.

To address these needs, NetApp is delivering a Data Fabric that simplifies and integrates data management across cloud and on-premises environment. With our solutions, services and partnerships, we empower our customers to harness the power of the hybrid cloud, build next-generation data centers and modernize storage through data management.

In addition to driving technical innovations, we have aligned our go-to-market team to focus on the strategic solutions in our portfolio, aligned sales resources to acquire new customers and attack new buying centers, improved sales discipline to expand gross margin and are leveraging our unique position to access customers through multiple pathways tailored to their needs.

Our $55 billion market opportunity consists of legacy segments that are in decline and newer segments that are growing rapidly driven by digital transformation. We have already transitioned our business away from the declining segments to the data-driven high-growth segments of all-flash arrays, converged infrastructure and hybrid cloud. We will further expand our opportunity with the general availability of our hyper-converged solution later this calendar year.

Let me discuss the results we've had in these high-growth markets before turning to innovation and customer success. We continued to substantially outpace the growth of the all-flash array market and competitors, both large and small in that space.

In Q1, our all-flash array business, inclusive of all-flash FAS, EF and SolidFire products and services, grew 95% year over year to an annualized net revenue run rate of $1.5 billion. Our strength in flash is also driving our success in SAN and converged infrastructure markets. Our share gains in the SAN market reflect our acquisition of new customers and new share of wallet within existing customers.

The all-flash FlexPod helped to strengthen our number two position in the converged infrastructure market and contributed to the 26% year-over-year growth of FlexPod revenue reported in IDC's Quarterly Converged Systems Tracker for calendar Q1 2017. We are outpacing and winning against full-stack vendors with our best-of-breed solutions.

The success of our strategic direction is evident in the continued momentum in our strategic solutions, which were 69% of net product revenue in Q1, up 22% year over year. The industry is in the early innings of the move from disk-based storage to flash as customers modernize existing data centers and build next-generation data centers to lower the total cost of ownership while gaining greater speed and responsiveness from key business applications. We have a significant growth opportunity ahead as we penetrate our installed base and displace competitors' installations with our cloud integrated all-flash solutions.

NetApp is leading this transition to flash by providing customers with solutions that deliver unrivaled scale, speed and data services. Validating the innovation, leadership and momentum of our all-flash array business, Gartner again recognized NetApp as the Leader in its Magic Quadrant for Solid-State Arrays.

In the quarter, we increased the storage efficiency of our all-flash FAS solutions with expanded inline deduplication across multiple pools of storage. Just last week at the Flash Memory Summit, we demonstrated future flash storage innovations of NVMe over Fabric and storage-class memory.

NetApp is uniquely positioned to deliver these new innovations because our approach allows our customers to non-disruptively integrate these advancements into their ONTAP and SolidFire data management architectures.

Customers are also choosing the all-flash FAS to replace legacy Tier 1 SAN installations because of its performance and density combined with industry-leading data management capabilities. At a U.S.-based financial services company, we replaced a competitor's SAN installation with our all-flash FAS systems, which provide a unified scale-out architecture and the resilience needed for Tier 1 workloads and are also modular enough to accommodate the customer's future data center consolidation plans. We consolidated SAN and NAS workloads into a single platform, allowing the company to leverage ONTAP as its data management standard.

New innovations further strengthened our leadership position in the converged infrastructure market. In Q1, we introduced FlexPod SF, a SolidFire-based converged infrastructure solution that enables digital transformation with high-end predictable performance, programmable agility, and scale-out value for multi-tenant environments.

Enterprises, cloud service providers, and partners choose NetApp because we enable their hybrid cloud strategies through our Data Fabric architecture. Our approach to hybrid cloud enabled us to make a first time ever sale to a global leader in the hospitality industry. The customer had spent a significant amount of time and money unsuccessfully trying to realize their cloud mandate with a competitive solution. After purchasing ONTAP Cloud and ONTAP Select licenses, they were able to move a Tier 1 application onto ONTAP Cloud running in AWS over a single weekend, and it now runs faster than it had on the competitor's on-premises solution. This win positions us to not only be the data management platform of choice for their cloud workloads, but also to migrate their on-premises infrastructure from the competitor to NetApp.

The NetApp Data Fabric simplifies data management across the cloud and on-premises footprints to deliver consistent and integrated hybrid cloud data services, enabling customers to unleash the full power of their data. We continue to innovate in this space, and in Q1 we enriched our solutions, services, and partnerships for hybrid cloud data services. We enhanced OnCommand Insight to provide hybrid cloud infrastructure and monitoring and analytics across the Data Fabric. We also expanded ONTAP functionality to deliver automatic and transparent tiering of inactive data to the cloud.

At the start of Q2, we acquired GreenQloud, a private startup company that created a cloud services orchestration and management platform for hybrid cloud and multi-cloud environments. GreenQloud augments our team and accelerates our leadership in hybrid cloud data services by providing NetApp with a scalable architecture, unique technology, and expertise that enhances our ability to integrate and deliver cloud data services.

Additionally, we announced the expansion of our collaboration with Microsoft to include hybrid cloud data services that will deliver enterprise-grade data visibility and insights, data access and control, and data protection and security for customers moving to Microsoft Azure. We will provide updates on this exciting collaboration later this calendar year.

In a hybrid cloud data-driven world, we have an unprecedented opportunity to strengthen and grow our business. Our Data Fabric vision and architecture is being endorsed by not only customers and industry influencers, but also the world's leading hyperscalers. Our focus, discipline, and emphasis on execution has returned NetApp to growth with expanding margins, increased shareholder value, and improving momentum. We saw continued growth in Q1 and expect to accelerate that growth in Q2 and throughout the year. We are helping our customers change the world with data, and that is driving our success.

With that, I'll now turn the call over to Ron to walk through our Q1 financial performance and go-forward expectations. Ron?

Ronald J. Pasek

Executive Vice President and Chief Financial Officer, NetApp, Inc.

Thanks, George. Good afternoon, everyone, and thank you for joining us. Before we get started, I'd like to remind you that I'll be referring to non-GAAP numbers today. With that, let's get started.

NetApp delivered another quarter of disciplined execution and strong financial performance, demonstrating the substantial progress we've made toward transforming the business, driving sustained growth, and addressing the changing market. Q1 net revenues of $1.33 billion grew 2% year over year and were above the midpoint of our guidance range. Product revenue of $723 million increased 10% year over year. This was the third consecutive quarter of year-over-year product revenue growth, driven by our successful pivot to the growth areas of the market.

The combination of software maintenance and hardware maintenance and other services revenues of $602 million were down 5% year over year. This decline was driven by the following factors: changes we made to the service pricing several years ago; renewal execution issues in FY 2017; and several years of product revenue declines.

It is important to note that total systems under contract increased slightly year over year. Although we generally don't provide services revenue guidance, we expect the year-over-year headwind for services revenue to lessen in the next several quarters and return to growth in the beginning of the next fiscal year. We are confident in these expectations, as our product revenue has returned to growth and we are seeing improvement in renewal execution from changes that we implemented at the beginning of this fiscal year.

Gross margin of 63.8% was well above our guidance range. Product gross margin of 49.9% increased approximately 3 points year over year due to improved sales discipline. Software maintenance gross margin was relatively flat year over year, while hardware maintenance and other services gross margin increased about 2 points year over year.

Operating expenses of $637 million decreased 2% year over year and, as expected, increased 3% sequentially. As I discussed during our Financial Analyst Day, the sequential increase was primarily due to merit increases. As a percent of net revenue, operating expenses of 48% represented almost 2.5 points of improvement year over year, reflecting the benefit of our ongoing transformation efforts.

Operating margin of 15.8% increased almost 4 points year over year and was above our guidance range due to higher revenue, higher gross margin and lower operating expenses. Our effective tax rate for the quarter was 19.4% and weighted average diluted shares outstanding were 278 million.

EPS of $0.62 was $0.05 above the high end of our guidance range due to higher revenue and improved gross margins. We closed Q1 with $5.3 billion in cash and short-term investments with approximately 8% held by our domestic entities. In Q1, we repurchased $150 million of our shares and paid approximately $54 million in cash dividends. Today, we also announced our next cash dividend of $0.20 per share, which will be paid on October 25, 2017.

To reiterate, we are committed to completing by the end of May 2018 the remaining $644 million of the share repurchase program that we announced in February 2015. Deferred and financed unearned services revenue was down just over 1% year over year due to the same dynamics that drove the decline in services revenue I discussed earlier.

Our cash conversion cycle extended 3 days year over year, reflecting a 12-day increase in days inventory outstanding due to higher levels of SSD raw materials on hand, partially offset by a 10-day improvement in days payable outstanding as a result of our transformation initiatives. DSO at 36 days was relatively flat year over year.

As I noted last quarter, we continue to exercise our deep business and technical partnerships with our NAND and SSD suppliers. We have enough on hand and committed supply of NAND to meet our requirements now through the end of our fiscal year.

Q1 cash flow from operations was $250 million, an increase of 10% year over year. We generated strong free cash flow of $214 million in the quarter. This represents about 16% of net revenues and has an increase of 11% year over year.

Now on to guidance. We executed well against our plans in Q1 and are pleased with the significant progress we've made toward transforming NetApp to succeed in the changing market. We're making tough decisions that enable key investments to expand our TAM and drive strong financial performance over the long term.

While we still have work to do, we remain confident in our ability to continue to execute against the plans we outlined for fiscal 2018 on our prior earnings call. To reiterate, we expect our typical seasonal patterns with revenue dollars increasing each quarter.

We also expect our year-over-year growth rate to accelerate in the back half of the fiscal year. We expect gross margin of 62% to 63% and operating margin of 18% to 20%. Further, we remain committed to delivering low-double-digit EPS growth for the year and free cash flow in the range of 17% to 19% of revenue.

Now on to Q2. We expect net revenue to range between $1.31 billion and $1.46 million which at the midpoint implies approximately 4.5% growth sequentially and 3.4% growth year over year. We expect Q2 consolidated gross margins of approximately 63% to 63.5%, reflecting a higher mix of product revenues quarter-to-quarter. We expect operating margins of approximately 16% to 17%. And finally, we expect earnings per share for the second quarter to range from approximately $0.64 to $0.72 per share.

In closing, Q1 was another strong quarter of execution reflecting the leverage in our business model with 2% year-over-year revenue growth yielding a 35% increase in year-over-year EPS growth. We are pleased with the substantial progress we've made to transform the business, drive sustained growth and increase shareholder value.

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

Kris Newton

Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

We'll now open the call for Q&A. Please be respectful of your peers and limit yourself to one question so we can get to as many people as possible. Thanks for your cooperation. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of Joe Wittine of Longbow Research. Your line is open.

Joe H. Wittine

Analyst, Longbow Research LLC

Q

Hi, thanks. If I just have one here, how about a competitive question. Product sales up close to 10% again. How are you seeing the competition respond, specifically with discounting? Have they stepped it up yet? Or if not, do you expect that to be the next logical step? Thanks.

George Kurian

President, Chief Executive Officer & Director, NetApp, Inc.

A

It's always been competitive. We have substantial technology differentiation in big and early markets – all-flash arrays, converged infrastructure, hybrid cloud – and we're executing to our plan. Every deal is competitive. HP, Dell EMC, Pure Storage and some of the smaller vendors, everyone competes fiercely on the whole range of things at their disposal. The fact that we have grown substantially, gained share in virtually every category in our business and have expanded gross margins substantially in both product and services is clear support for our thesis that we have a unique differentiated position of technology leadership as well as partnerships, and customers are voting with their wallet in our favor.

Kris Newton

Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks, Joe. Next question?

Operator: Thank you. Our next question comes from Simon Leopold of Raymond James. Your line is open.

Simon M. Leopold

Analyst, Raymond James & Associates, Inc.

Q

Great. Maybe following up on the competitive landscape. From our discussions with the channel and customers, we've had the impression that you benefited for some time from maybe disruption at a number of your large competitors, whether it was HP and its spin-mergers or Dell EMC and their integration. These two activities are going to lap at some point. Could you help us understand how you see the competitive environment shaping up in terms of those two large competitors as we look out over the next year or so when they're lapping their integration activities?

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

I clearly think from a technology standpoint and direction standpoint, there are multiple avenues where we are sustainably differentiated. From the technology standpoint, in all-flash arrays, converged infrastructure, storage resource management as well as the evolving market for hyper-converged, we have very, very good solutions that are clearly differentiated, both with the technology that's available today as well as those that are to come.

Both HP and Dell have major holes in their portfolio for the evolution of the all-flash array market. And clearly, we are demonstrating massive differentiation in terms of performance and execution in the converged infrastructure market, which is frankly their home turf. None of these guys have a clear coherent hybrid cloud story. And so we feel very, very good about our position in the market and are confident. We are in the early stages of the evolution of these markets and, yes, they have their own execution challenges to get over. But clearly, we feel that we've got a really solid lead against them and they're going to have to come catch us, which is going to take them heck of a long time.

Simon M. Leopold
Analyst, Raymond James & Associates, Inc.

Q

Thank you.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

A

Thank you, Simon. Next question.

Operator: Our next question comes from Mehdi Hosseini of Susquehanna Group, your question please.

David Ryzhik
Analyst, Susquehanna Financial Group LLLP

Q

Hi, thanks. This is David Ryzhik for Mehdi. Thanks for taking the question. Just wanted to clarify in the deferred revenue commentary, Ron. It sounds like services becomes less of a headwind. Now, do you expect services to exit fiscal 2018 at growth? And just digging a little deeper on the renewal execution, was that pricing? Did you guys aggressively price because hardware maintenance declined, I think, 8% year over year? Just wanted to dig a little deeper there. Thank you.

Ronald J. Pasek
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

Thanks, Dave. So I touched on this last quarter as well. Just a reminder, our services revenue is made up of a waterfall, an annuity of, if you will, the last three or four years of transactions. We did make some pricing changes both at the beginning of FY 2017 and actually back into 2013. We lowered ASPs to become more competitive. However, as you saw, that did not affect our services margins. In fact, the services margins have increased the last several quarters.

Added to that, we had several years before Q3 of last year of product revenue declines. We've turned that around. That should help on the second half of this year. And we did have some service execution issues in the back half of FY 2017. So we've largely put a focus on place on the renewal execution issues. And that's why I'm confident as we continue this fiscal year, the headwind will lessen, and I think you'll see services revenue turn around and get back to growth in Q1 of 2019.

David Ryzhik
Analyst, Susquehanna Financial Group LLLP

Q

Great. Thank you so much.

Ronald J. Pasek
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

Sure.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

A

Thank you, David. Next question.

Operator: Our next question comes from Steve Milunovich of UBS. Your line is open.

Steven Milunovich
Analyst, UBS Securities LLC

Q

Yes. Thank you. Regarding your all-flash product, in terms of the quarter's shipments, is all-flash over half of what you're delivering from an array standpoint? And do you still feel that the margins are pretty neutral between all-flash versus disk?

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

That's correct. It's about 50%, and we feel very good about the trajectory and the margins of all-flash vis-à-vis hybrid.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

A

All right. Thank you, Steve. Next question.

Operator: The next question comes from Wamsi Mohan of Bank of America Merrill Lynch, your question please.

Wamsi Mohan
Analyst, Bank of America Merrill Lynch

Q

Yes, thank you. I was wondering how the maintenance attach for the flash product compares to the overall portfolio. And is that part of the reason why the hardware maintenance was down a fair amount despite the easy compares in addition to those other things that you highlighted, Ron?

Ronald J. Pasek
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

So, Wamsi, no, the attach rate is no different on all-flash versus spinning disk. And no, it had nothing to do with why services was down. It really was ASP, which we did, we planned on doing, and to some extent renewal execution from last year, which affects this year more than anything else.

Wamsi Mohan
Analyst, Bank of America Merrill Lynch

Q

If I could, a quick clarification. It appears from your guidance that OpEx could be up year on year. Is that consistent to your expectations, or is that a change from prior expectations? Thank you.

Ronald J. Pasek
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

OpEx in Q2 is up very slightly. It's three factors. One is foreign exchange, and it was about $4 million as you bridge Q1 to Q2. The other is the acquisition George mentioned, which is GreenQloud. That's additive to our OpEx. And then we simply have more variable compensation in Q2. So was your question, Wamsi, on year-over-year OpEx increase?

Wamsi Mohan
Analyst, Bank of America Merrill Lynch

Q

Yes, year over year.

Ronald J. Pasek
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

It's just some calendarization and no structural issues, as I mentioned. Full-year OpEx is only up slightly, essentially just for merit increases.

Wamsi Mohan
Analyst, Bank of America Merrill Lynch

Q

Okay. Thanks, Ron.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks, Wamsi. Next question.

Operator: Your next question comes from Eric Martinuzzi of Lake Street Capital. Your line is open.

Eric Martinuzzi
Analyst, Lake Street Capital Markets LLC

Q

I'm curious about your estimation of installed base penetration on the flash product. That to me seems like probably the low-hanging fruit here in the success you're seeing on the product side.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

We are in the very early innings of our installed base. It's less than 10%. And as we said, we've gained share in the SAN market, which has been the predominant location for all-flash storage. We feel very, very good about our position in the all-flash NAS market. And as you know, we've won many, many awards year over year for technological leadership. So as we see the market for NAS transition as well, we have substantial room to go.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

A

All right. Thanks, Eric. Next question.

Operator: Your next question comes from Maynard Um of Wells Fargo, your question please.

Maynard J. Um
Analyst, Wells Fargo Securities LLC

Q

Hi, thank you. Can you just update us on the changes to your go-to-market and to the compensation? I think it's now been a little more than three months. And it doesn't look like there was much of an impact, but curious what impact you're seeing, or if it's still too early to see what the full impact of those changes are.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

I think the things that you should focus in on is the improved results on product revenue and gross margin were due to the compensation changes we've made. We've also aligned resources to hunt versus farm our installed base, which is allowing us to accelerate our momentum against the competition by acquiring new accounts and new wallet share in existing accounts. So we feel very, very good about the changes that we've made.

In terms of renewals, we brought renewed organizational focus as single owner for renewals execution across the company. And we've got a disciplined approach that makes us feel much more confident about our execution plan. We feel good about the progress year to date. We still have more work to do, but early signs are good.

Maynard J. Um
Analyst, Wells Fargo Securities LLC

Q

Great, that's helpful. And then can you just walk us through some of your vertical markets, places where you're seeing strength and softness and what you're anticipating in terms of your guidance next quarter from U.S. government? Thanks.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

Broadly speaking, we don't have any specific commentary across the different vertical markets. We see a good balanced book of business and see strength across a broad range. All of our feeders executed well.

I think if you look at our public sector business, it essentially mirrors the administration's spending priorities. We saw strength in the Department of Defense and relative balance on the civilian segment of public sector. We think that this will be a normal end-of-year flush budget, and we feel good about our market share position. We've got a broad reach into the market, clearly differentiated technology, and long-term relationships with the customers. And we feel good about our position there. Thanks.

Maynard J. Um
Analyst, Wells Fargo Securities LLC

Q

Thank you.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

A

Thank you, Maynard. Next question.

Operator: Our next question comes from Katy Huberty of Morgan Stanley. Your line is open.

Kathryn Lynn Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Yes, thank you. Ron, product margins were up year on year and sequentially. So can you just talk through what the drivers were? And when we think about the next few quarters, where could product margins go, assuming memory prices remain elevated? And then where do you think they could go longer term as NAND prices ease? Thanks.

Ronald J. Pasek
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

Thanks. So I think we were pretty clear that one of the focus areas for us was product margins. We believe that we were not executing as well as we thought. We did make some changes to compensation, as George indicated. I think at our Analyst Day, I didn't give specific guidance on where product margins would end up, but I do think we're executing well. I think what you'll see is it's baked in some of the guidance we gave for the full year of the 62% to 63%. And ultimately, I think when we have our Analyst Day next year, I'll give you a guide on FY 2019, but I still think we have some ways to go.

Kathryn Lynn Huberty
Analyst, Morgan Stanley & Co. LLC

Q

Thank you.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

A

Thank you, Katy. Next question.

Operator: The next question comes from Andrew Nowinski of Piper Jaffray. Your line is open.

Andrew James Nowinski
Analyst, Piper Jaffray & Co.

Q

All right. Thanks for taking the question. A lot of them have been asked, but just a question on SolidFire. I think last year, it was 2% of your total revenue, but I know you've made some changes to having trained the broader sales force and started selling it now versus using specialists. So I am just wondering if you could give us any traction on – or any color on the traction SolidFire had this quarter and what you think you can do going forward? Thanks.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

SolidFire has been integrated into the NetApp Go to Market organization and into the Product groups. We feel good about the integration so far. We've enabled our field sellers as well as our channel partners to be able to sell the technology. It's part of our strategic portfolio and we've accelerated innovations in that portfolio. This quarter in

Q1, we announced FlexPod SF, a converged infrastructure solution combining Cisco computer network together with SolidFire storage and data management. We're excited to bring that to the market and we started to see positive reviews from that. And as we said before, you'll see us bring a SolidFire-based hyper-converged solution to market later this calendar year. So overall, steady as we go. We still have more work to do, but we feel good about the work that we've done so far.

Andrew James Nowinski
Analyst, Piper Jaffray & Co.

Q

Great. Thanks.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks, Andy. Next question.

Operator: Our next question comes from Jayson Noland of Baird, your question please.

Jayson A. Noland
Analyst, Robert W. Baird & Co., Inc.

Q

Okay. Great. I wanted to ask on NetApp HCI, George, GA in calendar Q4, I assume you've got some betas in the field. I guess what are your expectations for the second half of this fiscal year? And is this solution competitive to Nutanix and VSAN or is it sort of a different part of the market?

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

I think, first of all, we have multiple avenues to accelerate the momentum of NetApp. Clearly, we've demonstrated that in the all-flash array category and the converged infrastructure category. We have more exciting announcements around the cloud and other areas of our business that you should come to Insight to hear about. With regard to the hyper-converged solution, as we said, our approach is to bring to the enterprise an enterprise-grade hyper-converged solution that deals with some of the challenges that first-generation hyper converged solutions like VSAN and Nutanix have. This is the ability to deliver a guaranteed mix workload performance to have modular scalability and upgradability of your storage environment and your compute environment as well as to deploy mission-critical workloads like databases and other things beyond VDI, which is where the primary first-generation vendors have been. So we feel good. The early reviews of it have been positive from industry analysts and from the customers and partners that we've shared. We'll tell you more, come to Insight.

Jayson A. Noland
Analyst, Robert W. Baird & Co., Inc.

Q

Thanks.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

A

Thank you, Jayson. Next question.

Operator: Next question comes from Alex Kurtz of KeyBanc Capital Markets. Your line is open.

Alex Kurtz
Analyst, KeyBanc Capital Markets, Inc.

Q

Yeah. Thanks for taking the question. George, if you guys continue to execute on the product front here double-digit growth, could you see kind of revisiting the OpEx growth rates for the business and maybe stepping it up, given some of the dislocation with some of the larger OEMs that you compete against?

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

We're going to continue to stay disciplined, right? We've provided guidance for the year. We think that continuing to prioritize the markets that we compete in and our approach to access customers through partners is a good way to grow our business. We're seeing the early results and they've proven good. We think that we can certainly accelerate the top line in the second half of the year as we said through the course of the year because of the momentum we're seeing, but we're going to continue to stay disciplined.

Ronald J. Pasek
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

I'd just add that what we talked about at Analyst Day was that the transformation was not an event, it's something we'd do ongoing. So we believe we still have work to do. That's why we believe we can hold our cost structure roughly flat.

Alex Kurtz
Analyst, KeyBanc Capital Markets, Inc.

Q

Thanks, guys.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks, Alex. Next question.

Operator: Our next question comes from James Kisner of Jefferies. Your line is open.

David Wishnow
Analyst, Jefferies

Q

Hi, guys. It's David Wishnow on for James. A quick question. So, obviously, you've had very good adoption of strategic revenue. I just wanted to ask a question. You saw sequential decline in the proportion of products revenue that was strategic versus legacy. And also, it looks like this is the first time you've seen a sequential decline in the run rate for the all-flash array. Is there something going on with customer adoption or just who's ordering when in the year that is causing that?

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

I think just a couple of things there. In terms of the mature business, as we've said consistently, mature does not go to zero. Right? There are three components to mature: add-on storage; the OEM business; and 7-Mode. And of those three, the only thing that really goes away over a period of time is 7-Mode, which is already a very, very small number. The mature business did – we saw the add-on storage component of the mature business grow quite substantially because of the strength of our product revenue in the strategic side to which add-on storage gets attached. That's the first point.

The second is with regard to seasonality in the all-flash array business, it's a big business now. And so we saw the natural seasonality in our business on the sequential side. If you compare year-on-year, however, we are dramatically outpacing the market, and our business is big numbers, and we intend to sustain that year-on-year momentum through the fiscal year.

David Wishnow
Analyst, Jefferies

Q

Okay., perfect. Thank you.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

A

Thank you, David. Next question.

Operator: Our next question comes from Amit Daryanani of RBC Capital Markets. Your line is open.

Amit Daryanani
Analyst, RBC Capital Markets LLC

Q

Thanks a lot and thanks for taking my question, guys I guess to stop just on your product growth numbers that you've had so far, a question I get asked a lot of time on NetApp is just what's your ability to sustain this product growth as you get to the back half of the year in the Jan and April quarters when compares presumably get tougher? Just maybe help us understand what are the two, three big levers you have that can show positive product growth in the back half? Thank you.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

I think there's sort of three or four things that I would say, Amit. I think the first is we have clear differentiated technology leadership and momentum in large markets like all-flash arrays, converged infrastructure and the hybrid cloud where we are in the early innings of a multiyear transition of very, very large enterprise infrastructures and we are demonstrating our technology leadership by outpacing competitors of all sizes and shapes.

The second is that our portfolio is going to expand through the course of the year. Without telling you more, I'd ask you to come to NetApp Insight and see some of the exciting innovations that we have. We've demonstrated some of them at Flash Memory Summit. Clearly, hyper-converged is another arrow in our quiver. It's for the second half of the year, but we have multiple ways to accelerate the momentum of our business through the fiscal year. And we feel very confident about that.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks, Amit. Next question.

Operator: Our next question comes from Srini Nandury of Summit Redstone. Your line is open.

Srini Nandury
Analyst, Summit Redstone Partners LLC

Q

All right. Thank you for taking my question. This is on HCI again. George, can you comment on your conversations you're having with your channel partners, technical partners and customers on the upcoming HCI product? And, more importantly, do you know if your customers currently have this product on beta or trial or early access? Thank you.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

As I said, I think HCI is one of many avenues for growth of NetApp. Our approach to HCI is to deliver enterprise-grade data services and modular flexibility that allows customers to deploy production workloads and mix infrastructures on an HCI platform. It's different from the first-generation HCI vendors, and so we've had early demos and feedback from partners who are excited about it.

Clearly, we've got to get in the market and start to accelerate momentum once we're in the market, but we feel good so far. Clearly, differentiated approach, just like we brought to the solid-state storage market where we were ready for the enterprise customers' use of solid-state technology, not the early adopter niche providers. And so we feel good about where we are.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks, Srini. Next question.

Operator: Our next question comes from Steven Fox of Cross Research. Your line is open.

Steven Fox
Analyst, Cross Research LLC

Q

Thanks. Good afternoon. Just one question from me please. You mentioned that mix is going to help your gross margins this quarter. Can you be a little bit more specific on what mix drivers are most important? And then what you're thinking in terms of directionally about mix and margins in rest of the fiscal year? Thanks.

Ronald J. Pasek
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

Okay. Sorry, Steven. I think what you'll see on mix is a proportion of product revenue, product margin to total revenue margin will be up in Q2. You have service revenues basically flat, which are higher revenues and higher margins – I'm sorry, higher margin. So the mix question really is just between product and services margin, and it's a slight headwind to margin in Q2, still above the 63%, but a slight headwind. And what I said was, as you go through the year, product revenue continues to grow. So, all things being equal, it is a little bit of a headwind to margin on a total margin basis.

Steven Fox
Analyst, Cross Research LLC

Q

Got it. Thanks.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

A

Thank you very much, Steven. Next question.

Operator: Our next question comes from Jim Suva of Citi. Your line is open.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you very much. The details have been great so far. I have one question. In your prepared comments, you talked about some success with I believe it was Azure, cloud provider Azure. Can you help us understand, when you look at that relationship long term, do you expect it to mirror your portfolio as far as product versus software versus services, or is it more leaned towards one of those three buckets? Or how should we think about that and the profitability as such? Thank you so much.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

I think it's early to comment about the specifics of the Microsoft relationship. We'll have more news later this calendar year. We're really excited about the collaboration because it's multifaceted. On the cloud side, it's developing new cloud data services based on NetApp ONTAP innovation that will be offered on the Azure Cloud. And it will allow us to not only enable our customers to be successful in hybrid cloud architectures and deployments, but also will bring multiple competitors' workloads to NetApp infrastructure on-premises as well as to the public cloud.

On-premises, we have agreed to an engineering collaboration to deliver an integrated solution architecture that combines Azure and Azure Stack with NetApp ONTAP so that customers can unlock greater value from their data and speed the migration of enterprise apps to that next-generation architecture.

And we are also working with Microsoft on integrating our Data Fabric technology, technologies like our FabricPool automated storage tiering technology or to enable our cloud control backup archival and compliance solution for Office 365. So it's a broad-based multidimensional relationship. And we think that it will be a substantial differentiator for us in the market and is going to be sustainably differentiated for multiple years on a very, very broad basis. So stay tuned, we're really excited. We'll tell you more as the services come to market.

Jim Suva
Analyst, Citigroup Global Markets, Inc.

Q

Thank you so much for the details and congratulations.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

Thank you.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks, Jim. Next question.

Operator: Our next question comes from Sherri Scribner of Deutsche Bank. Your line is open.

Sherri A. Scribner
Analyst, Deutsche Bank Securities, Inc.

Q

Hi. Ron, I was just curious on the gross margin along the full-year guidance, 62% to 63%. Clearly, you're above that and guiding to higher than that in the second quarter. So the first half well above that rate. I know you said product gross margins would pressure the margins in the second half of the year. Over the past couple years, you haven't seen that much pressure. So I guess my question is, is that number conservative, or do you really expect gross margins to be below that 62%, which is where it would be to get to that 62% – 63% for the full year? Thanks.

Ronald J. Pasek
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

I think what I was trying to say, Sherri, is just simply the mix of product margin versus services margin in the second half is much higher. That puts a little pressure on the overall margin rate. But the product margins that you're seeing in Q1 and what's implied in Q2 should hold. So I think what we're saying is it's just a mix issue between the products and services margins. That's it.

Sherri A. Scribner
Analyst, Deutsche Bank Securities, Inc.

Q

Okay, thanks.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks, Sherri. Next question.

Operator: The next question comes from Mark Kelleher of D.A. Davidson. Your line is open.

Mark Kelleher
Analyst, D. A. Davidson & Co.

Q

Thanks for taking the questions. Most of mine have been asked. But, Ron, I was just looking at the balance sheet. The commercial paper notes were up. Can you just touch on that? What's that? That was up pretty significantly.

Ronald J. Pasek
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

I touched on this at the Analyst Day. There was a question about whether we would need more debt to complete the share repurchase program that we have in place. And we did, in fact, acquire about $400 million more in commercial paper, and that's simply to complete that commitment. We have about $644 million left, which we should be done with the rest of that by the end of May 2018.

Mark Kelleher
Analyst, D. A. Davidson & Co.

Q

Okay, great. Thanks.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks, Mark. Next question.

Operator: The next question comes from Mark Moskowitz of Barclays, your question please.

Mark Moskowitz
Analyst, Barclays Capital, Inc.

Q

Thank you. Good afternoon. I just want to come back to services attach. Can you help us understand if your system install activity is doing quite well? Is that really implying that your services or maintenance attach is a lot less per customer? And is that an incentive to win more business, or is that reflective of all-flash arrays just don't require as much spares and maintenance? Any help will be greatly appreciated.

Ronald J. Pasek
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

So, Mark, when you sell a new system, be it flash or anything else, you sell a three-year service contract. You recognize the revenue ratably every month over the life of that contract. So yes, our attach rate on new systems is actually quite good, but it doesn't move the services number to any great extent because it's a huge number to move. So most of the variance you're seeing is, as I said, pricing changes we made several years ago and then renewals on other things coming up for renewal that are older systems where we've improved our execution but did have some execution issues in the second half of last year.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

A

All right. Thanks, Mark. Next question.

Operator: The next question comes from Nehal Chokshi of Maxim Group. Your line is open.

Nehal Sushil Chokshi
Analyst, Maxim Group LLC

Q

Yes, thanks for the question. So look, you guys put up 10% year-over-year growth on the product revenue. That's off really difficult comps. And the prior quarter you did 12% year-over-year growth on the product revenue. So this seems to be very strong growth and yet you have the installed base that you had three years of a year-over-year decline, so that's a little bit of a challenge. But once that normalizes out, why shouldn't you guys be more confident that you can do much better than a low single-digit year-over-year growth that you have been talking about?

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

I think, Nehal, thanks for the question. We feel very good about our position. As we said, we have differentiated technology partnerships and pathways to market across three or four very large markets that are in the early innings of their development, all-flash arrays, converged infrastructure, and hybrid cloud. I think what we are focused on is executing – executing flawlessly. You've seen us post good numbers. We've got to do that through the course of this year. And we see accelerating momentum, as we said, through the second half of this year. And you know what, we'll provide more guidance as we see the execution plans play out. But so far, we feel extraordinarily good. And as we said, we have substantial and differentiated technology leadership against competitors, both big and small, and they've got a long way to catch us.

Nehal Sushil Chokshi
Analyst, Maxim Group LLC

Q

Great, thank you.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

A

Thanks, Nehal. Next question.

Operator: Thank you. Our last question comes from Rod Hall of JPMorgan. Your line is open.

Rod Hall
Analyst, JPMorgan Securities LLC

Q

Great. Thanks, guys, for fitting me in there. I just had two. I noticed that your inventory levels are down just a little bit on last quarter, and so I wanted to just check in on your – where you're at with memory hedging, NAND hedging? Do you have enough supply to kind of keep you hedged on the margins for a couple more quarters or where do we stand with that?

And then I also wanted to come back to the sales execution point, the new, I guess, sales comp or incentive program. What surprised you there? Because clearly, this margin was surprisingly good. Were you just surprised about how quickly the sales team took up those new programs? Or can you give us a little bit more color about what the positive surprise there was? Thanks.

Ronald J. Pasek
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

Sure. Let's start with inventory. So inventory has a normal seasonal pattern. It should decrease from Q4 because it's our highest quarter. What I tried to articulate in my prepared remarks is we did – if you look at inventory year over year, Q1 this year versus last year, it did go up and simply and mostly because of positions we did take on NAND supply. So that was conscious and something we felt the right thing to do.

I'll start on the compensation. So I think typically what we see is when we pay people to do things, they do them. And I think in this case, we had – what we've said is we had paid some of sales management to focus on gross margin. And this year, we're paying all of sales management to focus on gross margin. It's having a good effect and the intended effect.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

So I think...

Rod Hall
Analyst, JPMorgan Securities LLC

Q

Can I just clarify on the NAND question, guys? Could you just say how far out you're hedged at this point? Is it a couple quarters? Is it...

Ronald J. Pasek
Executive Vice President and Chief Financial Officer, NetApp, Inc.

A

What I said in my remarks is that we have secured supply to now the end of our fiscal year, so out till April of next year.

Rod Hall
Analyst, JPMorgan Securities LLC

Q

Okay.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

A

The last time we updated you guys, it was till the end of our calendar year. This time, it's through the end of our fiscal year. So we've got good technological and commercial relationships with the leading NAND suppliers, and we've got supply assured through the end of our fiscal year.

With regard to the question on sales compensation and execution, listen, we're pleased with the results and our sales team has done a real good job. We're one quarter in. We got to do that a few more quarters in a row and then we'll be very confident. So we feel good about the start.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

And thank you very much, Rod. I'll pass it back to George for some closing remarks.

George Kurian
President, Chief Executive Officer & Director, NetApp, Inc.

I'm excited by what fiscal year 2018 brings. Customers and industry leaders are also excited by our strategic direction. And increasingly, they are choosing NetApp as their partner for data-driven digital transformation.

We delivered a strong start to the year and introduced substantial innovation across our portfolio. And we will introduce even more exciting innovations at our Insight User Conference in Las Vegas in October. We are building on a strong foundation and are, without question, the best positioned and the best executing company in the industry. We have technology leadership that's differentiated and sustainable in several large markets, like all-flash arrays, converged infrastructure and the hybrid cloud, that are in the early innings of their evolution across the enterprise IT landscape. And we have accelerating momentum on the top line and leverage in our business model that is yielding solid results on the bottom line. With our scale, talent, technologies and partnerships, we have a unique position to lead the industry and I am even more confident than ever in our future.

I want to thank the NetApp team for your laser focus, commitment to transformation and the execution results that we are delivering together. I look forward to talking with you again next quarter.

Kris Newton
Vice President, Corporate Communications & Investor Relations, NetApp, Inc.

Thank you.

Operator: Ladies and gentlemen, this concludes today's conference. Thank you for your participation and have a wonderful day.