Formatted Report

17-Aug-2016

NetApp, Inc. (NTAP)

Q1 2017 Earnings Call

CORPORATE PARTICIPANTS

Kris Newton
Vice President - Investor Relations

George Kurian
Chief Executive and President

Ronald J. Pasek
Chief Financial Officer & Executive Vice President

OTHER PARTICIPANTS

Rod B. Hall
JPMorgan Securities LLC

Simona K. Jankowski
Goldman Sachs & Co.

Jayson A. Noland
Robert W. Baird & Co., Inc. (Broker)

Kathryn Lynn Huberty
Morgan Stanley & Co. LLC

James Dickey Suva
Citigroup Global Markets, Inc. (Broker)

Irvin Liu
RBC Capital Markets LLC

Eric Martinuzzi
Lake Street Capital Markets LLC

Aaron Rakers
Stifel, Nicolaus & Co., Inc.

James Kisner
Jefferies LLC

Robert Hahn
Raymond James Financial, Inc. (Broker)

Joe H. Wittine
Longbow Research LLC

Srinivas S. Nandury
Summit Redstone Partners LLC

John M. A. Roy
UBS Securities LLC

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

George Iwanyc
Oppenheimer & Co., Inc. (Broker)

David Ryzhik
Susquehanna Financial Group LLLP

Alex Kurtz
Pacific Crest Securities, Inc.

Adrienne Colby
Deutsche Bank Securities, Inc.

Steven Fox
Cross Research LLC

John A. Lucia
JMP Securities LLC

Nehal Sushil Chokshi
Maxim Group LLC

Ananda P. Baruah
Brean Capital LLC

Munjal R. Shah
Wells Fargo Securities LLC

MANAGEMENT DISCUSSION SECTION

Kris Newton
Vice President - Investor Relations

GAAP AND NON-GAAP FINANCIAL MEASURES

- 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 reconciliations
- During the call, all financial measures presented will be non-GAAP unless otherwise indicated

George Kurian
Chief Executive and President

BUSINESS HIGHLIGHTS

Revenue, Operating Margin and EPS

- In Q1 FY2017, our focus on the disciplined execution of our strategy yielded solid results on both the top and bottom lines
- We delivered revenue above the midpoint of our prior guidance range, with both operating margin and EPS above our previous guidance
- Over the course of the quarter, we strengthened our position in flash and hybrid cloud while continuing to transform our business to operate more efficiently and to lower costs
    - We are clearly making progress, but still have work to do as we operate in a low growth macroeconomic and IT spending environment
- We are controlling what we can and are increasingly confident in our ability to execute as we streamline the business and pivot to the growth areas of the market
- We believe these actions will return the company to revenue growth with improved profitability, cash flow and shareholder returns

Data Fabric Strategy

- Let me remind you of our key priorities in delivering on this commitment
    - First, we are executing on our Data Fabric strategy and the strategic solutions that form the foundation of how we enable customer success in the data-powered digital era
    - Second, we are substantially reducing cost and systematically streamlining our operations while maintaining our ability to deliver innovation and lead the market
    - And third, we're committed to a robust capital allocation program which includes a combination of share repurchases, dividends, and investment for the long-term growth of the business

Strategic Solutions

- I'll start with an update on the first priority

- Ron will update you on the other two
- Our strategic solutions aligned to customers' top IT priorities
    - This alignment drives our confidence in our ability to lead in the fastest-growing segments of the market
- In Q1, strategic solutions represented 61% of net product revenue and grew 24% y-over-y
- Conversely, net product revenue from our mature solutions declined at 24% from Q1 a year ago
- As expected, the impact of the declines in mature solutions are lessening, which will allow the growth of our strategic solutions to re-accelerate the business and return NetApp to moderated revenue growth in FY2018

Investments

- Our customers are transforming their IT organizations for success in the data-powered digital era
- They are prioritizing investments to modernize their data centers to lower costs, increase simplicity and agility, extract more value from their data, and integrate cloud resources with on-premises environments
- Clustered data ONTAP replaces legacy frame array environments to deliver next-generation enterprise storage for efficient management of data growth and service provider-like flexibility across flash, disk and cloud footprints
    - We continue to gain new customers and migrate existing customers to clustered ONTAP

Customer Demand

- Clustered ONTAP was deployed on 82% of FAS systems shipped in Q1, up from 65% a year ago
- We saw continued strong customer demand with unit shipments of clustered ONTAP systems growing 35% y-over-y
- The installed base of clustered ONTAP in 7-Mode systems continues to grow in total and clustered ONTAP is now running on 32% of that growing installed base

ONTAP 9

- We are building on this strength with the newest generation of ONTAP, which further simplifies customers' ability to deploy modern enterprise data center and hybrid cloud environments
- Introduced in Q1, ONTAP 9 builds the foundation for a Data Fabric, bridging new and traditional data center architectures, making it easy to manage and move data where it's needed across flash, disk and cloud resources
- Customers can choose the architecture of their choice: engineered and converged systems, software-defined storage or cloud, all with industry-leading efficiency, performance and density for flash environments
- No other storage solution offers customers this range of capability, flexibility and investment protection

ONTAP Select

- Also introduced in Q1, ONTAP Select, a scalable software-defined storage solution helps customers achieve their business objectives by bringing together the ability to deploy storage with cloud-like agility and granular capacity scaling with the proven features of the industry's number one storage operating system
- ONTAP Select offers the flexibility to deploy ONTAP on commodity servers with the customers' choice of hypervisors

- It simplifies operations and lowers training requirements by providing consistent management across all ONTAP-based storage, whether on-premises or on the cloud

IT Transformation

- Flash plays an important role in IT transformations as customers seek to gain a competitive edge through greater speed, responsiveness, and value from key business applications as well as efficiencies through consolidation and lower power requirements
- Customers are replacing hard disk installations with flash, making flash the de facto standard for new on-premises deployments
- In this transition from disk to flash customers cannot forgo enterprise data management and data protection capabilities
- With our highly differentiated portfolio of all-flash array offerings, NetApp is uniquely positioned to enable customers to consolidate on to flash and create all-flash data centers

IDC

- IDC ranked NetApp number two in the all-flash array market with a significantly higher share than we hold in the overall storage market
- Last week we won the Flash Memory Summit, Best of Show for Most Innovative Flash Memory Customer Implementation and swept all six brand leadership categories for all-flash NAS and unified NAS-SAN arrays in the 2016 brand leaders survey

NetApp

- Our advantages in this market are reflected in the continued strong growth of our all-flash array business which grew approximately 385% y-over-y to an annualized net revenue run rate of almost $775mm inclusive of all-flash FAS, EF and SolidFire product and services
- The majority of this growth was again driven by high demand for the all-flash FAS
- In Q1, we further enhanced the all-flash FAS with increased speed and data efficiency capabilities, guaranteeing 3x performance improvement over hard disk arrays and 4:1 data reduction
- NetApp was first to market with 15-terabyte flash drives, which, in combination with storage efficiency features and ONTAP 9, delivers a flash-optimized enterprise class storage platform that is the best in the industry for mixed workload consolidation

ALL-FLASH FAS

- We are displacing our competitors' legacy SAN frame array architectures with the all-flash FAS
- It enabled us to break into a large U.S.-based healthcare company which had been a decade-long competitor stronghold
- We replaced a competitor's SAN infrastructure for the customer's mission-critical SAP environment

ENTERPRISES AND SERVICE

- The all-flash FAS beat out the incumbent and a newer all-flash competitor on performance, features, and resiliency
- Not only were we able to reduce the data center floor space required for this workload by 95%, we were also able to provide the customer a path to the hybrid cloud

- The all-flash FAS addresses requirements for next-generation enterprise storage for customers who want to improve existing infrastructure and processes
- For enterprises and service providers who are building multi-tenant public and private clouds, SolidFire delivers a storage solution that is operationally simple, able to deliver predictable services, and scale as services need to grow
    - Its unique webscale style architecture enables customers to easily build best-in-class as-a-service environments

New SolidFire Innovation

- In Q1, we delivered new SolidFire innovations across software, hardware, and systems along with a new model for purchasing storage, FlashForward Capacity Licensing
- The latest version of the SolidFire Element OS software offers a more intuitive user interface and a robust implementation of VMware Virtual Volumes for VMware operations, including native per virtual machine quality of service
- The latest SolidFire platform, which doubles performance and capacity, can be easily added to existing clusters allowing customers to rapidly deploy the newest flash technology without forklift upgrades or controller swaps
- FlashForward Capacity Licensing unbundles storage software from hardware in an efficient software purchasing model with perpetual, transferable and pooled enterprise-wide licensing

NetApp Data Management Solutions

- IT transformations are also enabling customers to accelerate time to market, improve customer satisfaction, drive innovation and gain a competitive edge by getting more out of their data
- NetApp data management solutions accelerate third platform analytic solutions by delivering an open, scalable enterprise-grade platform for building customers' critical data lakes
    - To enable the real-time enterprise, customers can run analytics in place on existing data stores without copying or having to ensure data consistency across silos
- For customers who want to leverage the nearly endless compute on-demand capabilities of the cloud to accomplish cost-effective data analysis, NetApp Data Fabric Cloud Sync Service provides a simple, automated way to get data into Amazon Web Services, run the desired cloud analytic service, and get the data back to where it is needed whether on-premises or in the cloud

Cloud Sync

- We showcased Cloud Sync at AWS Summit last week and you can expect to hear more about how we empower customers to leverage cloud resources and integrate them with their existing IT investments over the course of this FY
- Our Data Fabric strategy enables data management that seamlessly connects disparate systems, software stacks, clouds and data centers
- We give our customers the ability to manage, secure and protect their data across flash, disk, public and private cloud resources, all at the scale needed to accommodate the exponential data growth of the digital world

Data Portability and Cloud Integration

- More and more customers are telling us that they choose NetApp because we enable their cloud strategies

- By providing data portability and cloud integration coupled with our industry-leading next-generation enterprise and webscale storage solutions, we are helping our customers transform for success in the data-powered digital era

Accomplishments

- We accomplished a lot in Q1
- Our focus on disciplined execution and pivot to the growth segments of the market is yielding results and starting to change the trajectory of our business
- We introduced substantial innovation across our portfolio that helps our customers as they transform to modernize their data centers to lower costs, increase simplicity, extract more value from their data and integrate cloud resources with their on-premises environments
- And we will introduce more exciting innovations at our Insight User Conference in Las Vegas next month

Long-Term Growth

- We're making progress, but we still have more work ahead of us to return the company to long-term growth and to our target operating margins
- We are streamlining the business and reducing our cost base to position us for future success by allowing investments in strategic opportunities while accelerating our ability to deliver shareholder value in the form of improved profitability and cash flow
- Our first quarter results provide early indicators that our strategy is working and I am very confident in the NetApp team's ability to successfully evolve the company

---

Ronald J. Pasek
Chief Financial Officer & Executive Vice President

FINANCIAL HIGHLIGHTS

Non-GAAP Financial Measures

- Before we get started, I'd like to remind you that we will be referring to non-GAAP numbers today
- Also, please note that y-over-y comparers are against a 14-week quarter we had in Q1 of FY2016
- With that, let's get started

Net Revenue

- We executed well in Q1 and overall are pleased with our results
- Q1 net revenues of $1.29B declined approximately 3% y-over-y and were within our guidance range
- Excluding the approximate $40mm benefit to software maintenance and hardware maintenance and other services revenue from the 14th week we had in Q1 of last year, net revenues were roughly flat y-over-y
- Product revenue was $660mm and for the first time in several quarters was essentially flat on a y-over-y basis

Strategic Solutions

- As we've discussed, we expect the growth of our strategic solutions to improve our overall product revenue growth trajectory over the course of FY2017

- Though we still have a lot of work to do, the product revenue results are a good indication of the progress we're making here
- The combination of software maintenance and hardware maintenance and other services revenue of $634mm were down approximately 6% y-over-y due to the extra week in Q1 FY2016

Gross Margin

- Gross margin was 62.4% and within our guidance range
- Product gross margin of 46.7% was flat sequentially
- Although product gross margin remains below where we'd ultimately like it to be, we feel good about the stabilization
- On a y-over-y basis, product gross margin was down about 4.5 points

Operating Expenses

- Software maintenance gross margin was relatively flat y-over-y while hardware maintenance and other services gross margin increased just under 4 points y-over-y
- Operating expenses of $652mm decreased 13% y-over-y
    - This decline reflects that early results of our transformation efforts as well as the benefit of the return to a typical 13-week quarter, partially offset by SolidFire
- Operating margin of 12.1% was above our previous guidance range

Cost Structure

- As I discussed on our last earnings call, aligning our cost structure with the opportunities in front of us is my top priority and completely within our control
- Although we have made progress on this front, we will continue to take additional steps throughout the year to permanently lower our cost structure, including but not limited to, headcount reductions and continue to drive greater efficiencies across the business
    - We will continue to communicate specifics as these savings are realized

Tax Rate and EPS

- Our effective tax rate for the quarter was 16.6%
- Weighted average diluted shares outstanding were 282mm
- EPS of $0.46 was $0.07 over the high end of our prior guidance range, reflecting lower operating expenses, higher revenue, and the benefit of our share repurchases
- Our cash and balance sheet metrics remain healthy
- We closed Q1 with $4.4B in cash and short-term investments with approximately 13% held by our domestic entities
    - We repaid the SolidFire loan in Q1 out of global profits

Share Repurchasing

- We remain deeply committed to completing by the end of May 2018 the remaining balance of our share repurchase program that we announced in February 2015
- In Q1, we repurchased $175mm of our stock and paid approximately $53mm in cash dividends

- Today, we also announced our next cash dividend of $0.19 per share, which will be paid on October 26, 2016 to shareholders of record as of the close of business October 7, 2016

Inventory, DSO and FCF

- Deferred and financed unearned services revenue was up 8% y-over-y
- Inventory turns increased to 24 and DSO was 35 days
- Q1 cash flow from operations was approximately $228mm vs. $129mm in Q1 a year ago
- We generated strong FCF of $192mm in the quarter
- Representing about 15% of net revenues, FCF grew over 100% y-over-y

GUIDANCE

Market Conditions

- Now to guidance
- As George discussed, we are aggressively pivoting to the growth areas of the market, while at the same time transforming the company in order to streamline the business, drive greater efficiency and rapidly address the changing market
- As we've outlined today, we executed well against our plans in Q1 and are encouraged by the early signs of progress that we're seeing
    - While we still have a lot of work to do, we remain confident in our ability to continue to execute against the plans we outlined for FY2017 on our prior earnings call

Net Revenue and Gross Margin

- For Q2, we expect net revenues to range between $1.265B and $1.415B, which at the midpoint implies a sequential increase of 4% and 7% decrease y-over-y on a difficult compare
- We expect Q2 consolidated gross margins of approximately 62% to 63% and operating margins of approximately 13% to 14%
- And finally, we expect EPS for Q2 to range from approximately $0.51 to $0.56 per share

QUESTION AND ANSWER SECTION

Rod B. Hall
JPMorgan Securities LLC

Q

I just wanted to ask about the cDOT conversion, I ask about it every quarter, and it seems like you made good progress this quarter up to 32% of the installed base. At what point do you – I mean, do you think this just continues to grow linearly, George? Or how do you see this progressing? Should we just assume it continues to grow kind of at the rate it has been the last few quarters?

And then, I also wanted to ask about gross margin. By your comments there I assume that you're seeing pricing relatively stable. I mean, you don't see any issues as you move to cDOT or anything like that with pricing. So if you could just kind of comment on that as well, it'd be helpful.

George Kurian
Chief Executive and President

A

Okay. First of all, I'd just say that we're pleased with the progress on cDOT penetration of our installed base and new customers. I think when you think about our installed base, it's a very large installed base that we've built up over 20 years and it's growing. And so the percentage of systems that are – we represent is a very large number.

The cDOT conversions are lumpy. They go up and down. The pace at which they move are tied to customers' IT spending and their readiness for conversion. In aggregate, you're seeing us continue to progress the conversion of the installed base. I would just say that, I would not – we're not planning the business around any particular quarter-on-quarter model. I think in aggregate, we're pleased with the progress and we continue to want to get our customers over to clustered ONTAP, and you're seeing that.

In terms of gross margins, I think a couple of things. The first is the value proposition of all-flash FAS, clustered ONTAP are showing up in the differentiation in customer acquisition and the shipments that we are delivering to customers. The gross margin model that we showed last quarter to this quarter has stayed stable and it's – you know, the market remains competitive, but we have differentiated technology in the market, as well as as we outlined in our cost focus, we continue to do work in the supply chain on both the cost of goods sold as well as the operating structure of the company to support that model. Ron, do you have…

Ronald J. Pasek
Chief Financial Officer & Executive Vice President

A

Yeah, I'll remind you what I said last quarter as well. Discounting is a function of what we're seeing in the marketplace plus product promotions we're running. And so we're still doing some of those but de-emphasizing certain ones and emphasizing others.

Simona K. Jankowski
Goldman Sachs & Co.

Q

I just wanted to confirm that I heard you correctly that the installed base is still growing? And related to that, would you expect your services business to return to growth in future quarters?

George Kurian
Chief Executive and President

A

The installed base is growing. That's correct, Simona. It's a very large number and it's growing. I think in terms of the services business, the first thing I'd just tell you is, the year-on-year compare was from a 14-week quarter last year to a 13-week quarter this year. And if you adjust for that, the services business was essentially flat. If you look at our deferred revenue, it shows strength reflecting the nature of the long-term contracts that we have with customers as well as the strategic value and the business criticality of our solutions.

Kris Newton
Vice President - Investor Relations

A

Thanks.

Simona K. Jankowski
Goldman Sachs & Co.

Q

So you expect that to be – just clarifying, so you expect that to grow in future quarters vs. being flat or +/-?

Ronald J. Pasek
Chief Financial Officer & Executive Vice President

A

Yes. As the installed base grows, that services revenue will grow as well.

Jayson A. Noland
Robert W. Baird & Co., Inc. (Broker)

Q

George, on the progress with AFA. I wanted to ask the mix within there. I assume a lot of that is all-flash FAS vs. SolidFire and E-Series, if you could confirm that first. And then ask about the competitive dynamic. It seems pretty intense right now. And I guess my question is, why is AFA so much more intense than the traditional storage business?

George Kurian
Chief Executive and President

A

First of all, the progress we've seen this quarter reflects – the biggest part of it reflects continued success with all-flash FAS. We've been encouraged by the progress with SolidFire as well with new customer acquisitions led by the NetApp sales team. But as we had outlined in prior statements, SolidFire today is immaterial to the revenue. It's consistent with the plan that we've laid out for you and we're encouraged by the early signs of progress.

In terms of the all-flash array market, I think what we see is that the larger system vendors who have now integrated all-flash offerings as part of their enterprise-grade storage models continue to get the lion's share of enterprise storage footprints. I think the progress we've made with our all-flash arrays reflects the differentiation of our clustering technology, the storage efficiency, the performance and reliability of our offerings. And so we feel very, very good about where we are.

Kathryn Lynn Huberty
Morgan Stanley & Co. LLC

Q

U.S. public sector revenue grew this quarter. Are you starting to see larger deals? And do you expect that to continue as we go into the FY-end for that segment? Thanks.

George Kurian
Chief Executive and President

A

Thanks, Katy. We're encouraged by the progress with U.S. public sector. I'll just tell you there was no specific pattern that we noticed. We've also continued to monitor the U.S. public sector spending patterns as we head into the November election season. So we feel good about our position in the market, the competitiveness of our offerings, as well as progress we're making with some of the agencies. But we'll continue to monitor this sector as we head into the November season.

James Dickey Suva
Citigroup Global Markets, Inc. (Broker)

Q

I have a housekeeping question for Ron and then maybe a strategy or market insight for George.

Ron, on the OpEx specifically, the general administrative side; it looks like it was kind of at very low levels or multi-low levels. Is that level sustainable or is there even more room to get more efficient there? Or were there some type of benefit that happened this quarter? Just for modeling for kind of long-term run rate for that line item as it came down a lot both sequentially and y-over-y, even though y-over-y we understand a week, but sequentially it came down a lot too and compared to history it's really low. And then George on kind of...

Ronald J. Pasek
Chief Financial Officer & Executive Vice President

A

It is low.

Kathryn Lynn Huberty
Morgan Stanley & Co. LLC

Q

Yeah. And then, George, on the insight for the market. Any impact of Brexit? Your company had a full month of sales and revenues through the month of July. Did you see any order delays, did those come back in August, or is it creating a little more uncertainty in the U.K.? And how should we think about if any impact there that you've seen? Thank you and congratulations.

Ronald J. Pasek
Chief Financial Officer & Executive Vice President

A

Sure, Jim. So, yeah, with respect to G&A, this is early part of the work, we've talked to you about relating to transformation both in really all the support functions and in some of the line organizations as well. So it is – some of it did happen a little quicker than we thought and will continue throughout Q2, maybe at not the same levels, but it is a permanent reduction to the levels of G&A. It's part of our strategy.

George Kurian
Chief Executive and President

A

With regard to Brexit, I think both in terms of the commercial impact as well as the FX impact to our business, they were immaterial this past quarter. It's too early to tell. And so we monitor that in discussions with our large customers, but we didn't see anything material to our business.

Irvin Liu
RBC Capital Markets LLC

Q

I wanted to go back on the product gross margin question. It's been below 50% for the second consecutive quarter. There's been discounting and promotional activity. But can you just talk about how the margin profiles of strategic and the mature product businesses might differ, especially as the mix of strategic increases?

George Kurian
Chief Executive and President

A

There's no material difference between strategic and mature in terms of product gross margin. In terms of our overall gross margin, as we said, as part of our focus on cost management we continue to take a hard look at every category of cost of goods sold as well as the cost of goods on the services side. And so we continue to work to maintain our gross margins in aggregate in the ranges that we've guided to.

Eric Martinuzzi
Lake Street Capital Markets LLC

Q

Yes. As I look at the strategic product growth here, you exited FY2016, I think it was at 21% rate and you put up Q1 here at about a 26% rate. So that acceleration, obviously you got a terrific execution. As we look out to the remainder of the year, is this something that is sustainable? You talked about a difficult comp in Q2, but I don't know that I have the level of detail in between the two segments, between strategic and mature. But is that acceleration in FY2017 sustainable?

George Kurian
Chief Executive and President

A

So first of all, the strategic revenue grew 24% in Q1 and we feel that we are encouraged by that growth rate year-on-year, it was 14% in Q4 year-on-year. So we feel good about the progress in the strategic solutions. As I said, we think that as the mature solutions become a smaller percentage of our business, they become less of a headwind in terms of overall revenue growth, and our plan is to get product revenue back to growth at some point this year.

Aaron Rakers
Stifel, Nicolaus & Co., Inc.

Q

I wanted to take a longer-term view and understand some of the things that you've done here recently through the quarter. How should we think about your ONTAP Select as well as the purchasing model of FlashForward for your SolidFire solutions? Or put another way, how are you guys thinking about the model implications from software-defined storage or rather the debundling between software and hardware going forward?

George Kurian
Chief Executive and President

A

Let me take that from a customer perspective and then Ron can comment on the financial implications. First of all, from a customer perspective, we think that the value of differentiated storage and data management capabilities, as we've always said, is in software. And we have among the best storage and data management platforms in the industry without question for traditional enterprise with clustered ONTAP and for webscale enterprise with SolidFire. So we feel very good about our position in those markets. The software value of those products protect and differentiate gross margins.

ONTAP Select is an offering that we've made available to customers who have the engineering capability to integrate software with systems for specific deployments. I think the range of customers who have that level of engineering capability is small and so we think that the preponderant majority of our business will continue to stay integrated systems.

With regard to SolidFire's FlashForward Licensing model, it essentially allows customers to simplify procurement of software, so that they can build a pool of storage that is enterprise-wide and then buy hardware as they needed and integrate it on to that software umbrella. Typically, what we have seen with that type of model is that it allows us to get larger footprint sooner in customers as they standardize on SolidFire for a broad range of use cases.

Ronald J. Pasek
Chief Financial Officer & Executive Vice President

A

I'll just add that what you're describing is a way that our customers can consume our products and we're well aware of the change. It is a very small piece of our business, not material at this point, but it's something we do want to accommodate.

James Kisner
Jefferies LLC

Q

So I suppose I have a little bit of working capital – it looks to me like your cash conversion cycle is hitting a multi-year low, you had very strong collection, just wondering how we should think about DSOs and cash conversion cycle going forward? And do you still expect FCF to be in the mid-teens as a percent of revenue for the year? Thanks.

George Kurian
Chief Executive and President

A

So, yeah, we benefited from a huge improvement quarter-to-quarter, which is seasonal in DSO. We had a relatively back-end loaded quarter in Q4 which had an artificially high effect on DSO. That came back into the norm. It's still – at 35, it's still five days higher than it was Q1 a year ago.

The other huge benefit to cash conversion was a really low inventory, probably historically low inventory. That's a little bit of an anomaly. It's probably too low. You shouldn't expect that level going forward, but it should be an improvement from the prior year. We continue to focus on working capital. It's one of the parts of our transformation efforts, keenly aware of it. So it is not an accident that these things happened and we're going to continue to drive it.

Robert Hahn
Raymond James Financial, Inc. (Broker)

Q

Just a follow-up question for Ron. When you mentioned promotional activity you mentioned reducing some programs and growing others. Could you be more specific in where you're driving more or less promotional activity and to what extent you think gross margin pressure is within your control on temporary? Thanks.

Ronald J. Pasek
Chief Financial Officer & Executive Vice President

A

Yeah. What I described last quarter were two promotions which we were still running: one was on flash, and one was on cDOT. Some of those are running their course, not needed as much anymore. We are looking at additional promotions that I don't want to talk [ph] discreetly (38:01), but they tend to be what's really important to us at any given time. That's really a function of what's going on in the marketplace.

George Kurian
Chief Executive and President

A

In broad brush strokes, as we accelerate certain strategic technologies to market, we pivot our focus there with promotions and other things for a period of time and we draw down on to the pieces that are more mature or well-penetrated. And I would just continue to think about that as part of our ongoing portfolio management.

Joe H. Wittine
Longbow Research LLC

Q

Maybe just a clarification on the buckets that you're breaking out. Appreciate you doing that. What exactly is in the mature bucket at this point? Are customers still adding to legacy ONTAP 7 environments? And then within strategic also, does that – what chunk of strategic is still, what some would consider, legacy on-prem arrays that are running clustered cDOT? Thank you.

George Kurian
Chief Executive and President

A

So mature is essentially the OEM products that include E-Series and our legacy FAS OEM products, 7-Mode systems and add-on hardware. Add-on hardware is equipment that is purchased after a initial configured system sale; for example, add-on storage. The strategic solutions include our clustered data ONTAP operating systems, all flash arrays, the branded E-Series, OnCommand Insight, SolidFire and the – some of our hybrid cloud solutions.

There are customers who are adding on to some of their 7-Mode environments for purposes of business continuity, for purposes of this is an application that I don't want to migrate to clustered ONTAP because it's an IT area that they're no longer investing in, or they feel that their current environment is good. And so you see people continuing to add on in small numbers, systems and add-on storage to their 7-Mode footprint. The majority of customers that are deploying new configurations as represented by the percentage of shipments out the door are deploying clustered ONTAP configurations.

Srinivas S. Nandury
Summit Redstone Partners LLC

Q

George, can you talk about the relative growth rates of your all-flash FAS vs. the growth rate of EF all-flash series as you currently see? Thank you.

George Kurian
Chief Executive and President

A

The EF-Series – thank you for the question. The EF-Series is focused on a much smaller range of use cases, primarily the performance-oriented segment of the market where customers want industry-leading performance for specific dedicated environments like databases. All-flash FAS represents the focus for the broadest range of customers who are looking at replacing disk-based solutions for general purpose storage environments with all-flash configurations. And SolidFire uses flash-based technology to build webscale cloud designs for customers, people that want to replicate what Amazon or Google or Facebook have deployed in their data centers in their own environments. And so those are the three pieces. We think that all-flash FAS and SolidFire will be the majority of the business going forward.

John M. A. Roy
UBS Securities LLC

Q

So real quick. Looking out to the back half of the year on a competitive landscape, what do you kind of see happening with the Dell-EMC? Are you seeing them get more aggressive as they combine? And what do you think that might happen with HP getting rid of services? Are any of these going to change the competitive landscape? Thank you.

George Kurian
Chief Executive and President

A

Well, first of all, let me say that from a technology perspective, we feel very, very good. We have taken flagship customers from both EMC and HP this past quarter as – with our all-flash technology. And we feel that as customers look to build all-flash data centers, we've got a technological lead that is very strong, and the roadmap of both all-flash and hybrid cloud solutions from us is resonating with customers.

Every transaction is competitive. And so to the extent that we are displacing competitors in large accounts, these are highly competitive transactions. We think that, that nature of competitive dynamic will continue. And so what we are doing on our side is both building differentiated capabilities in software as well as dealing with the cost structure of the company, both in COGS and OpEx to allow us to compete effectively in the market.

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

Q

I just want to talk about your go-to-market strategy. I noticed your indirect revenue picked up a few percentage points sequentially, where's your focus there? Do you have enough – is there any seasonality to that? And do you have enough direct sales force? Where is your investments being made right now?

George Kurian
Chief Executive and President

A

We have a new leader of our go-to-market organization, Henri Richard, who is focused on accelerating our penetration and returning product revenue to growth. The indirect channel is an important strategic asset to NetApp. We work closely with our channel to help them accelerate capabilities into the market for our all-flash arrays, for clustered data ONTAP as well as for SolidFire. We also had a strong quarter on the OEM side, which is reflected in both the mix of mature as well as the mix of indirect channel. And so we're going to continue to focus on the right mix of direct and indirect and the channel is a really important part of our go-to-market model.

George Iwanyc
Oppenheimer & Co., Inc. (Broker)

Q

So just following up on the OEM strength, is that part of the business stabilizing at this point? Do you expect any growth there?

George Kurian
Chief Executive and President

A

OEM is down substantially from years past. It is still dependent on the business of our end customers, but to the extent that there is material seasonality to that business, it's a smaller percentage of our business this year than it was in the past. I'll just leave it there.

George Iwanyc
Oppenheimer & Co., Inc. (Broker)

Q

Okay. And...

Kris Newton
Vice President - Investor Relations

A

Thanks. Go ahead, George.

George Iwanyc
Oppenheimer & Co., Inc. (Broker)

Q

And just following up, with the incremental improvement that you're seeing on the mature product side, do you expect that to continue to be the case as we go through the FY and quarter by quarter the y-over-y pressure eases?

Ronald J. Pasek
Chief Financial Officer & Executive Vice President

A

Yeah, I mean, you should continue to see that decline throughout the remainder of this year and probably into next year. It won't go to zero, but the decline will slow as the year progresses and we go into FY2018.

David Ryzhik
Susquehanna Financial Group LLLP

Q

What percent of the growth in cDOT unit shipments is due to all-flash FAS? And also, if you can characterize the adoption rate of cDOT in the U.S. public sector as well as by geography? Thanks so much.

George Kurian
Chief Executive and President

A

We don't break out the adoption rates by geography. I think in general, we are pleased with the progress of clustered data ONTAP across all our geographies. The largest footprint of our installed base is clearly in North America. And so if you look at the remaining footprint, just because of the size of the footprint, we still have a large number of systems to convert which we see as opportunity for us to do so over the next few quarters.

In terms of the mix of all-flash and hybrid, our guidance to our field is to sell the best value solution under the clustered ONTAP umbrella. Whether they – a customer wants flash, we sell them flash; if they say, hey, I want to continue to do hybrid, we'll sell them hybrid.

Our overall goal is to sell our clustered operating system and clustered systems to the broadest range of customers. The all-flash systems are growing at a faster rate than hybrid, I'll just leave it there.

Alex Kurtz
Pacific Crest Securities, Inc.

Q

Just want to go back to the product, the longer – medium to longer term outlook on product margin, should we just expect where you've been the last few quarters is where the business is going to be trending? Just like more competitive environment, lower volume, and that's really where you guys are sort of going to be tracking over the next, I don't want to put a specific timeframe on it, but over the maybe next year to year-and-a-half? Or is there something in the product mix that's coming up that could really drive it back to near historical levels?

Ronald J. Pasek
Chief Financial Officer & Executive Vice President

A

Yeah. What I've tried to intimate on my prepared remarks was that we're not happy with where it is. I'd like to see it grow. But, to some extent – we can do certain things on the cost side, the offering side, the mix side, but to some extent, it's a function of the competitive environment. So although I'd like to have it grow, I can't tell you for sure that it's going to happen. You're right; it's historically at a very low level. It puts pressure on the business model, I'd like to see it higher, but I also want to be competitive.

Alex Kurtz
Pacific Crest Securities, Inc.
Q

And just to clarify one thing, I'd imagine the all-flash arrays carry a higher product margin. So how do I – how should we interpret that as far as reflecting your overall product margin? Does that mean the other products are being discounted more and that's sort of the results we're seeing here?

Ronald J. Pasek
Chief Financial Officer & Executive Vice President
A

No, I really don't think you should assume that there is a huge difference in product margin between flash and traditional storage. So that's not what's going on here at all. This is really just a function of the competitive environment.

Adrienne Colby
Deutsche Bank Securities, Inc.
Q

I was wondering with the progress you've made in the SolidFire integration, is M&A a priority? Can you update us on your capital allocation priorities?

Ronald J. Pasek
Chief Financial Officer & Executive Vice President
A

Yeah. So the priorities are very, very clear. We're prioritizing the share repurchase. We're on track to make the commitment to be done by May of 2018 on the $2B that we outlined. Also, the dividend, continue to pay and ultimately feed the dividend. To a far lesser extent, you'll see us being acquisitive. There are some things out there that we might be interested in, they're not going to be big, tend to be small IP-based acquisitions. But that's the order of how we think of the capital allocation strategy.

George Kurian
Chief Executive and President
A

We're focused on bringing SolidFire to the broadest range of our customers through our broadest set of go-to-market partners. We're pleased with the initial progress, but we have a lot of work to do. And so we're going to stay focused on it.

Steven Fox
Cross Research LLC
Q

Just on the operating margin targets that you've laid out, getting back to the high-teens, hopefully exiting this year and then doing that for the full year next year. If we just think about the controllables around that vs. the growth prospects and mix, can you sort of outline the big three – two or three things that would drive margins higher from here? Thanks.

Ronald J. Pasek
Chief Financial Officer & Executive Vice President
A

Yeah. It's mainly, as you said, the cost structure; certainly the operating expenses. You should expect to see us make the commitment of essentially on a run-rate basis of being $130mm net lower as we exit Q4 2017 from Q3 2016. That is a combination of OpEx mostly, and to some extent, COGS.

Those are the big efforts we're making to improve the bottom line, to your point, assuming maybe we don't see top line growth. So the assumption is – the guidance I gave for op margin for the year is 15% to 17% and that's with SolidFire in there. And then what I said was, we expect to be around 18% in FY2018 with SolidFire.

Steven Fox
Cross Research LLC

Q

And just to clarify one point on mix, it sounds like from everything I've heard on the call that there's not a major mix assumption that has to happen. Obviously, the strategic business wants to grow, but is there anything we should think of, that would be a major swing factor around gross margins going forward?

Ronald J. Pasek
Chief Financial Officer & Executive Vice President

A

No, not at all.

John A. Lucia
JMP Securities LLC

Q

Last quarter you talked about customers acting with caution due to an uncertain macro. I didn't really hear you touch on that much this quarter. I was just wondering if you've seen any improvement in terms of purchasing patterns in the storage market in general, would just like to get your take on that.

George Kurian
Chief Executive and President

A

The quarter came in line with expectations and in line with historical linearity. I would say that the macro continues to be uncertain. I don't think that we've seen a fundamental shift in the macro environment. I would say that solid-state storage is clearly seeing interest because of the really quick return on investment, the substantially better total cost of ownership, and so people are prioritizing that potentially within their spend envelope. But I think overall from a macro perspective, it's still relatively choppy.

Nehal Sushil Chokshi
Maxim Group LLC

Q

Between the stabilizing product revenue on the y-over-y growth basis as well as the product gross margins stabilizing plus-50% of your market value in a net cash position, I think you guys are effectively trading at 5x [ph] EV of FY something (53:16) FCF. So my concern here is that you guys become a prime private equity target and will you look to return cash to shareholders at an accelerated rate in order to make sure that the long term-oriented shareholders are protected from private equity firms basically cherry-picking off what is a very attractive asset?

George Kurian
Chief Executive and President

A

I think, first of all, we've laid out our plan for the company which includes driving the strategic solutions to growth. We've said that the mature solutions will become less of a headwind and that is playing out and the quarter is a representation of that playing out. We've optimized the cost structure to continue to deliver a favorable set of both FCF and operating cash flow metrics that in turn gives us increased confidence that we can support the capital allocation program that we've laid out. We've laid out a capital allocation program that includes dividends, share buybacks and the investment of capital for strategic activities, and we remain committed to that.

Ananda P. Baruah
Brean Capital LLC

Q

Hey, for probably George and Ron, just staying on the capital allocation topic, if the model plays out guys sort of through 2017 into 2018, as you believe that it can, and hope that it does, why actually – I'd love to hear the thinking behind staying committed to the buyback target that you guys have as the stock would seemingly work higher, so kind of totally get it at lower levels, but why not pivot some of that capital maybe towards the dividend, as the dividend yield gets lower as the stock moves higher. If that's baked into your thinking, then I'd love to hear about it. But it sounded like, Ron, you guys feel pretty committed to the current dollar target. So – and then if you could just sort of – if there's any, like, just the thought process behind pegging yourselves to that target, what was sort of the thinking that led you to that in the context of the question? Thanks.

Ronald J. Pasek
Chief Financial Officer & Executive Vice President

A

Yeah, sure. It was a commitment made certainly before I got here. It's the type of thing our long-term investors want to see. I think that the dividend is something we give people regardless of what's going on and some investors really would like – really to see us pay only a dividend, some want us to only do repurchase. So we do a combination of both and keep both happy. I think your question is good, but at the same time we made the commitment and we're going to follow through with the commitment.

Munjal R. Shah
Wells Fargo Securities LLC

Q

Just wanted to clarify, your guidance implies that OpEx will increase sequentially in Q2. So could you please confirm that? And how should we think about OpEx in H2 and as we exit the FY?

Ronald J. Pasek
Chief Financial Officer & Executive Vice President

A

Yeah, you're right. We came in lower than I thought we would in Q1. And so there's a very slight increase to OpEx in Q2, if you take the midpoint. As I tried to intimate the cost reductions don't always come very smoothly, there are other things we spend money on that cause little blips through quarters. However, in general, I think as we exit the rest of the year, you should see OpEx continuing to come down through Q3 and into Q4.

George Kurian
Chief Executive and President

Q1 HIGHLIGHTS

Strategy

- We are pleased with our Q1 results and the clear progress we're making with our strategic solutions, but we still have more work ahead of us and we remain focused on disciplined execution of our strategy
- We are committed to the fundamental change that we outlined with the three key priorities
- Let me remind you of them once again

Strategic Solutions Portfolio

- The first is to pivot to the faster-growing parts of the market and align ourselves closely with our customers, business and IT transformation priorities with our focus on the strategic solutions portfolio

- The second is to reduce cost by streamlining and improving the efficiency for our business
- The third is to support and continue the robust capital allocation plan that we have that includes shareholder returns an investment for the long-term growth of the business
    - We brought a lot of innovation to the market in Q1
- You can expect to see even more exciting innovations this year, some of which we'll showcase at our Insight User Conference next month
- I look forward to speaking with you all again next quarter.