NETAPP
THIRD QUARTER OF FISCAL YEAR 2023
PREPARED REMARKS
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Prepared remarks by:
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Mike Berry, EVP and Chief Financial Officer

Kris: Hi everyone – thanks for joining us. With me today are our CEO, George Kurian, and CFO, Mike Berry. This call is being webcast live and will be available for replay on our website at netapp.com.

During today's call we will make forward-looking statements and projections with respect to our financial outlook and future prospects, such as our guidance for fourth quarter and fiscal year 2023; our expectations regarding future revenue, profitability, and shareholder returns;our alignment with secular growth trends of data-driven digital and cloud transformations; our expectations regarding the future growth in the number of cloud customers, their usage of cloud services and the resulting impact on our Public Cloud and Hybrid Cloud segments; our ability to deliver innovation, sharpen our execution and focus on our strategic growth opportunities while optimizing our operating costs; and our ability to strengthen our position, rebalance our sales and marketing efforts and drive sustained growth in both our Hybrid Cloud and Public Cloud segments in a turbulent macroeconomic environment, all of which involve risk and uncertainty.

We disclaim any obligation to update our forward-looking statements and projections. Actual results may differ materially for a variety of reasons, including macroeconomic and market conditions such as the IT capital spending environment, including the focus on optimization of cloud spending; inflation, rising interest rates and foreign exchange volatility; and the continuing impact and uneven recovery of the COVID-19 pandemic, including the resulting supply chain disruptions; as well as our ability to keep pace with the rapid industry, technological and market trends and changes in the markets in which we operate, execute our evolved cloud strategy and introduce and gain market acceptance for our products and services, maintain our customer, partner, supplier and contract manufacturer

relationships on favorable terms and conditions, manage material cybersecurity and other security breaches, and manage our gross profit margins and generate greater cash flow.

Please also refer to the documents we file from time to time with the SEC, and available on our website, specifically our most recent Form 10-K and Form 10-Q including in the “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and “Risk Factors” sections.

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

I’ll now turn the call over to George.

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

In Q3, we executed well on the elements under our control in the face of a weakening IT spending environment and continued cloud cost optimization. Disciplined operational management yielded operating margin and EPS that exceeded expectations, despite revenue coming in at the low end of our guidance. We are delivering on our commitments and responding to the dynamic environment – we adjusted our cost structure, introduced a portfolio of capacity-flash arrays to support cost sensitive customers, and continue to work with our customers to help them optimize their cloud spending. On today’s call, I will discuss our Q3 results in the context of the current environment and our plans to sharpen our execution to accelerate near-term results and enhance our long-term position.

We continued to see increased budget scrutiny, requiring higher level approvals, which resulted in smaller deal sizes, longer selling cycles, and some deals pushing out. We are feeling this most acutely in large enterprise and the Americas tech and service provider sectors. Customers are looking to stretch their budget dollars, sweating assets, shifting spend to hybrid flash and capacity flash arrays from higher-cost performance flash arrays and, as our cloud partners have described, optimizing cloud spending.

We saw signs of a softening environment early in Fiscal ‘23 and took swift action to control costs, with increased scrutiny of program spending, a hiring slowdown in Q2, and a hiring freeze in Q3. At the start of Q4, we implemented a workforce reduction of approximately 8%. Decisions that impact our employees are always difficult. I take great pride in fostering the NetApp culture and am committed to using this difficult action to refocus our team, guided by the values and mission of the company.

Our hybrid flash and QLC-based All-flash arrays continue to perform well, benefiting from customers’ price sensitivity in this challenging macro. The shift from high-performance All-flash arrays to lower

cost solutions, coupled with the lower spending environment, especially among large enterprise, and US tech and service provider customers who are large consumers of flash, created headwinds to our product and All-flash array revenues. In Q3, our all-flash array business decreased 12% from Q3 a year ago to an annualized revenue run rate of $2.8 billion.

Public Cloud ARR of $605 million did not meet our expectations, driven by a shortfall in cloud storage as a result of the same factors we experienced last quarter. Spending optimization and the winding down of project-based workloads like chip design, EDA, and HPC were headwinds again in Q3. We have a sizable base of public cloud customers, with a number of large customers who have grown rapidly over the past year and are now optimizing. Their cost optimizations mask the growth of other customers. We continue to add new customers and churn has remained consistently low. Overall, the Cloud Ops portfolio performed to plan. Cloud Insights has stabilized, and Spot continues to grow nicely, benefiting from the cost optimization trend. Our dollar-based net revenue retention rate decreased to 120% but is still within healthy industry norms.

We are confident that we remain well positioned to take advantage of the secular growth trends of data-driven digital and cloud transformations. We are aligned to customers' top priorities and have demonstrated success in controlling the elements within our control. Building on that solid foundation, we are sharpening our execution to accelerate near-term results while strengthening our position for when the spending environment rebounds. We have three areas of focus:

- First: we will remain prudent stewards of the business and will continue to tightly manage the elements within our control.
- Second: we are reinvigorating efforts across the company in support of our storage business.
- Third: we are building a more focused approach to our Public Cloud business.

Starting with the first area of focus – remaining prudent stewards of the business and managing the elements within our control. We will maintain our focus on cost controls so that expenses do not grow ahead of revenue. We will achieve this by maintaining our scrutiny on program spending and hiring, as well as focusing our investments on the products that represent the biggest opportunity. We've made difficult decisions to reduce investment in products with smaller revenue potential like Astra Data Store and SolidFire. The results of this focus are visible in our ability to maintain our free cash flow, operating margin, and EPS guidance despite lower revenue.

On to the second focus area – reinvigorating our storage business. As we moved rapidly to embrace cloud, we lost some momentum in our Hybrid Cloud business. We are taking decisive action to strengthen our position and performance by better addressing the areas of market growth, delivering more customer value, and realigning our go-to-market activities to better address this opportunity.

We were slow to fully embrace the customer desire for lower-cost, capacity-oriented All-flash systems. At the start of Q4, we rectified that situation with the introduction of the AFF C-series – the most comprehensive, industry-leading portfolio of QLC-based all-flash arrays that addresses a wide range of workloads and price points. These products will help customers manage through a cost sensitive environment while, at the same time, supporting their pursuit of sustainability targets. Initial response has been very positive, and we are already quoting deals for customers. The AFF C-series will drive AFA revenue and support product gross margin as customers rotate from lower margin hybrid flash to All-flash systems.

In addition to expanding our product portfolio, we've introduced a number of innovations to improve the customer experience and bring predictability to their investment process. In Q3, we released BlueXP, a unified control plane that helps decrease resource waste, complexity, and the risk of managing diverse environments. As a part of our sustainability commitment, we're previewing a new dashboard in BlueXP to help customers understand their data center carbon footprint across environments. Early in Q4, we introduced NetApp Advance, a best-in-class portfolio of programs and guarantees, which is already helping us win new customers and drive revenue.

We are rebalancing our sales and marketing efforts to better address the significant storage market opportunity, including aligning compensation plans to drive sales of our reinvigorated storage portfolio. We believe that these actions will enable us to drive product revenue growth and regain share in the all-flash array market.

Finally, our third area of focus – building a more focused approach to cloud. While we are reinvigorating our storage business, we have no intention of taking our foot off the pedal in Public Cloud. It represents a huge growth opportunity for us with a gross margin profile that is accretive to the business. Additionally, our Public Cloud Services are highly differentiated, with a multiyear advantage over our traditional competitors, and create customer preference for NetApp.

We have sharpened the focus in our Cloud Ops portfolio and have taken actions that could have future revenue and ARR implications. We believe that our Cloud Ops services will continue to deliver stable, steady growth over the long term.

Our customer success team has made good progress in driving utilization of our Cloud Ops services, but we need to do more with our cloud storage and data services. Additionally, we recognize that we have not been using our go-to-market resources to their best effect here. In addition to refocusing our sales team on the reinvigorated storage portfolio, we are identifying ways to most effectively align our sales resources to the buying centers and consumption models for all our solutions.

Our cloud storage business is predominately consumption-based and largely driven by our hyperscaler partners. These factors, coupled with the current cloud cost-optimization environment have impacted our ability to forecast ARR. However, as we grow the business, the impact from a subset of customers will be mitigated, smoothing its growth and improving predictability. I want to underscore my confidence in this opportunity. The migration of enterprise applications, like SAP and VMware, to the cloud, as well as cloud-native applications, like artificial intelligence, create a massive market in which we can grow.

We believe strongly that Public Cloud services can be a multibillion-dollar ARR business for us. However, achieving that target will take longer than we initially planned due to the industry-wide slowdown in cloud spending and our recent performance.

In closing, we have seen tangible success from our efforts to manage the elements within our control in a challenging environment. Despite our lowered revenue outlook, we have preserved free cash flow and EPS expectations. In the first three fiscal quarters of this year, we have returned over $1 billion to shareholders and reduced share count by 4%. We are sharpening our execution to accelerate near-term results and enhance our position for the long-term. We are taking these steps now, so that, as we begin FY ‘24, we are in a new, more focused operating model to attack the opportunity ahead, drive growth, and deliver shareholder value.

Before turning the call over to Mike, I want to give my thanks to the NetApp team for their operational discipline and rapid response to set us up for better results. I have seen first-hand how hard they are working to navigate the challenging environment and I appreciate their efforts.

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

Before we go through the financial details, I think it would be valuable to reiterate the key themes for today’s discussion that George highlighted:

#1): Despite the temporary headwinds to revenue, our disciplined operational management yielded op margin and EPS above the high-end of guidance;

#2): The macro backdrop and demand environment continue to be major headwinds. The weakening IT spending environment was most pronounced in our large enterprise and U.S. technology and service provider customers and materially impacted our All-flash revenue in Q3, while significant cloud optimization across all 3 major hyperscalers continued to weigh heavily on ARR growth. Although the U.S. dollar weakened slightly during Q3, Fx continues to be a material headwind to our financial results on a year-over-year basis;

#3) As we navigate through this fluid demand environment, we remain laser focused on driving operating margins and free cash flow generation. Towards this end, we took swift action in Q3 to control costs through increased program spending scrutiny and a hiring freeze. And at the start of Q4, we implemented a reduction in force of approximately 8%. In addition to adjusting our own cost structure, we also introduced C-Series, a portfolio of QLC capacity-flash arrays to support cost sensitive datacenter customers, and we continued to work with our Cloud customers to help optimize their spending.

#4): As a result of our disciplined cost management, we are reiterating our full-year EPS guide of $5.30 to $5.50. We are also confident in our free cash flow target of $1.1 billion, adjusting for the restructuring and one-time cash tax payment in Q4. From a capital allocation perspective, we remain committed to returning more than 100% of Fiscal ’23 Free Cash Flow to investors through dividends and share repurchases.

Now to the details. As a reminder, I’ll be referring to non-GAAP numbers unless otherwise noted. Q3 billings were $1.57 billion, down 11% year-over-year. Revenue came in at $1.53 billion, down 5% year-over-year. Adjusting for the 340-basis point headwind from Fx, billings and revenue would have been down 7% and 2% year-over-year, respectively. Even with the challenging Q3, our Cloud portfolio continues to positively impact the overall revenue growth profile of NetApp.

Hybrid Cloud segment revenue of $1.38 billion was down 9% year-over-year. Product revenue of $682 million decreased 19% year-over-year, as customers took a decidedly cautious approach to capital spending. Total Q3 recurring support revenue of $616 million dollars increased 5% year-over-year, highlighting the health of our installed base.

Public Cloud ARR exited Q3 at $605 million, up 29% year-over-year. Public Cloud revenue recognized in the quarter was $150 million, up 36% year-over-year and 6% sequentially. As highlighted by our 3 major hyperscaler partners, customers continue to optimize their cloud spend as organizations are exercising caution, given the macroeconomic uncertainty. While the timing of the recovery remains unclear, we are confident the secular trends of AI, machine learning, IoT and high-performance computing, along with the migration of enterprise apps like VMware & SAP, will drive long-term growth in Cloud storage consumption.

Recurring support and Public Cloud revenue of $766 million was up 10% year-over-year, constituting 50% of total revenue.

We ended Q3 with $4.2 billion in deferred revenue, an increase of 6% year-over-year. Q3 marks the 20th consecutive quarter of year-over-year deferred revenue growth, which is the best leading indicator for recurring revenue growth.

Total gross margin was 67% in Q3, in line with our guidance. Total Hybrid Cloud gross margin was also 67% in Q3. Within our Hybrid Cloud segment, product gross margin was 46.5%, including a 2-point year-over-year headwind from Fx. As noted, our large enterprise and U.S. tech and service provider customers have continued to reduce capex spend as they right-size their spending envelops. These customers are the most forward leaning technology adopters and the biggest consumers of All-flash systems in the economy, and their pause in capex spending has had a material impact on our total revenue, All-flash mix and product margins. And while the supply chain component premiums and NAND pricing notably improved in Q3, we had to work through higher-cost inventory during the quarter. We expect the improving supply chain and NAND pricing to be a tailwind to product margin in Q4 and Fiscal ‘24.

Our growing recurring support business continues to be very profitable, with gross margin of 93%.

Public Cloud gross margin of 69% was accretive to the corporate average for the ninth consecutive quarter. We remain confident in our long-term Public Cloud gross margin goal of 75 to 80%, as the business scales and an increasing percentage of our Public Cloud revenue is driven by cloud and software solutions.

While revenue came in at the low-end of guidance, Q3 highlighted our operational discipline and cost controls, with operating margin of 24%, including 2-points of Fx headwinds. EPS of $1.37 came in above the high-end of guidance and included $0.14 of year-over-year Fx headwind.

Cash flow from operations was $377 million and free cash flow was $319 million. Inventory turns increased to 12 in Q3—up from 9 in Q2—as supply chain challenges eased in the quarter, enabling us to take down inventory by nearly $70 million sequentially.

During Q3, we repurchased $200 million in stock and paid out $108 million in cash dividends. In total, we returned $308 million to shareholders, representing 97% of free cash flow. Share count of 219 million was down 4% year-over-year.

We closed Q3 with $3.1 billion in cash and short-term investments, up $108 million sequentially.

Now to guidance.

As George discussed, we have seen continued softening in the macro backdrop, with customers taking a decidedly cautious approach to spending. We now expect Fiscal ’23 revenue to be roughly flat year-over-year, which includes 3-to-4 percentage points of Fx headwind.

In Fiscal ‘23, we continue to expect gross margin to range between 66% and 67%, as elevated component costs and Fx headwinds weigh on product margins. While the timing is uncertain, we remain confident that our structural product margins will normalize back to the mid-50s in the fullness of time—particularly when you factor in our new C-series portfolio, which will largely displace lower-margin hybrid spinning disk systems in our product mix.

Given our disciplined cost controls, we are raising our Fiscal ‘23 operating margin guidance—we now expect op margin to range between 23% and 24%, which includes approximately 2 points of Fx headwind. Last quarter, we committed to protecting both EPS and Free Cash Flow during this uncertain macro environment. Today, we are reiterating our full-year EPS guide of $5.30 to $5.50, which includes $0.54 of currency impacts. We also continue to expect to generate $1.1 billion in free cash flow, excluding one-time items.

From a capital allocation perspective, we remain committed to returning more than 100% of Fiscal ’23 Free Cash Flow to investors through dividends and share repurchases.

Now on to Q4 guidance. We expect Q4 net revenues to range between $1.475 billion and $1.625 billion which, at the midpoint, implies an 8% decrease year-over-year, or a 6% decrease in constant currency. In this macro environment, we expect customers to continue to optimize their cloud spend at our 3 major hyperscaler partners. As a result, we expect Cloud revenue and ARR to be approximately flat sequentially in Q4. Please note as we head into Fiscal ’24, we plan to anchor our Cloud segment guidance on revenue dollars, instead of ARR. To be clear, we will continue to disclose Cloud ARR as a key metric as we go through the year.

We expect consolidated gross margin to be approximately 67%. As we head into Q4, we are forecasting a material reduction in component premiums, decreasing NAND costs, and engineering product efficiencies. As such, we are confident that product margins will rise in Q4. These trends also position us nicely heading into FY ‘24 to drive leverage through our business model—particularly as customers begin to reengage on All-flash capacity buildouts and customers mix shift away from hybrid spinning disk systems to new QLC All-flash solutions. While the exact timing is unclear, large enterprise and U.S. tech and service provider customers are the largest consumers of data and

storage in the global economy and our All-Flash ONTAP systems are structurally linked to their data growth cross cycle.

In Q4, we expect operating margin to range between 23 and 24%. We anticipate our tax-rate to be approximately 21%. We are forecasting earnings per share for Q4 to range between $1.30 and $1.40 per share. Assumed in our Q4 guidance is net interest income of $7.5 million and a share count of approximately 218 million.

In closing, I want to thank the entire NetApp team for their continued commitment in such an uncertain economic environment. I'll now hand it back to Kris to open the call for Q&A. Kris?

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