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NetApp, Inc. (NTAP)

Q3 2025 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to the NetApp Third Quarter of Fiscal Year 2025 Earnings Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there'll be an opportunity to ask questions. Please note, this event is being recorded.

I would now like to turn the conference over to Kris Newton, Vice President, Investor Relations. Please go ahead.

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

Hi, everyone. Thanks for joining us. With me today are our CEO, George Kurian; and CFO, Mike Berry. This call is being webcast live, and will be available for replay on our website at netapp.com. During today's call, we will make forward-looking statements and projections with respect to our financial outlook and future prospects, including, without limitation, our guidance for the fourth quarter and fiscal year 2025, our expectations regarding future revenue, profitability and shareholder returns, and other growth initiatives and strategies. These statements are subject to various risks and uncertainties, which may cause our actual results to differ materially.

For more information, please refer to the documents we file from time to time with the SEC and on our website, including our most recent Form 10-K and Form 10-Q. We disclaim any obligation to update our forward-looking statements and projections. During the call, all financial measures presented will be non-GAAP, unless otherwise indicated. Reconciliations of GAAP to non-GAAP estimates are available on our website.

I'll now turn the call over to George.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

Thanks, Kris. Welcome, everyone.

In Q3 FY 2025, we delivered revenue growth of 2% year-over-year and continued our disciplined management of the business, yielding operating margin of 30% above expectations. Although within our guidance range, we are not satisfied with our top line performance. We remain well-positioned with customers as their supplier of choice for AI and other data-driven workloads. First-party and marketplace cloud storage services and AI were bright spots in the quarter. We had line of sight to achieve our sales targets until the end of Q3, when inconsistent execution resulted in some deals slipping out of the quarter. Recognizing this, we have instituted a higher level of scrutiny on deal progression through the pipeline, with tighter controls on closing plans. We expect these actions will enhance our execution and improve our momentum. Already, a number of the slipped deals have closed.

Compared to Q3 a year ago, Hybrid Cloud revenue increased 1%, and our all-flash array business grew 10% to an annualized revenue run rate of \$3.8 billion. Although impacted by sales execution, C-series capacity flash arrays, StorageGRID object storage systems, and ASA scale-out all-flash block storage systems all delivered solid growth. Keystone, our storage-as-a-service offering, also had another strong quarter, with revenue growing almost 60% year-over-year.

We are gaining ground with our industry-leading solutions and earning recognition for our efforts. We were recently named a Customer's Choice for Primary Storage in Gartner's 2025 Voice of the Customer report, a testament to our strong market position.

We continue to deliver innovation at a blistering pace. In Q3, we introduced entry and mid-range AFF A-series high-performance, and C-series capacity flash arrays, completing the refresh of these product lines. At the start of Q4, we introduced new entry-level and mid-range ASA systems to complement the high-end ASA products introduced earlier in fiscal year 2025. These new systems make it easier for customers to scale up from smaller from a smaller starting point, or expand capabilities to remote and branch locations.

Powered by ONTAP, they deliver simplicity at scale and enable customers to produce storage costs through integrated data tiering, with consistent, streamlined operations and data protection.

The new products are already gaining traction with customers. Our ability to unify data across hybrid multi-cloud environments and strong ransomware protection puts us ahead of the competition. To support real-time AI-enabled fraud detection, a US-based financial services firm selected the AFF A90 for its scalable performance, native container support, and comprehensive security certifications. Requiring a storage solution that could provide a consistent unified namespace across their different locations with a single management interface, an electronics manufacturer chose the AFF C60 for its proven ability to span multiple locations including edge, core and cloud at the right price point for each.

We continue to see growth in demand for AI solutions, as the large market opportunity for enterprise GenAI begins to open, and customers seek a unified and structured view of their data assets. In Q3, our AI business again performed ahead of our expectations, with over 100 AI infrastructure and data lake modernization wins. These wins spanned geographies, varied in size, and included a number of service providers deploying NetApp as the storage foundation for their AI-as-a-Service offerings.

For many organizations, the journey to widespread use of enterprise AI begins with modernizing data lake environments to object storage. In the quarter, we enhanced our StorageGRID object storage solutions with improved scalability and flexibility, and doubled the density of object deployments, reducing rack space requirements, and lowering power and cooling costs. A leading US retail bank selected StorageGRID as its foundational platform for its private cloud storage, including AI and data lake optimization. The initial deployment is 5 petabytes, and expected to triple in size with subsequent phases later this calendar year.

Other enterprises are further along in their AI evolution, deploying GenAI models in production for inferencing and RAG. One of the world's largest banks struggled with scalability, siloed data platforms, and disparate tools for its GenAI training and inferencing workloads. To address these challenges, they selected NetApp as the storage foundation for their GenAI factory. Our ability to deliver a solution with secure and economical data movement into and out of the AI Factory, tiering for model checkpoints, and model traceability enabled us to beat the competition, and win the deal.

Now turning to Public Cloud. We further honed the focus of our Public Cloud business with the sale of the Spot by NetApp business. As many Spot and CloudCheckr customers are also customers of our other products and services, it was important to us to select the right partner to assume this portfolio, and we are confident that these customers will benefit from a more complete FinOps portfolio from Flexera. Mike will share with you the financial impact of this sale based on our expectation that the deal will close in early March.

As we've discussed in the past, our Public Cloud strategy is led by our highly differentiated first-party and marketplace cloud storage services, complemented by intelligent data and operational services such as Data Infrastructure Insights, formerly known as Cloud Insights, and workload services like InstaClustr. These services, in concert with our Hybrid Cloud products, enable customers to build a seamless intelligent data infrastructure across hybrid multicloud.

First-party and marketplace cloud storage services again grew well over 40% from last year, driving total Public Cloud segment revenue growth of 15%. Excluding Spot by NetApp, first-party and marketplace storage services made up over 70% of the Q3 Public Cloud segment revenue.

In the quarter, we announced innovations to Amazon FSx for NetApp ONTAP and Microsoft Azure NetApp Files and received the Google Cloud Ready Regulated & Sovereignty Solutions Designation for Google Cloud NetApp Volumes and Cloud Volumes ONTAP. These advancements highlight the strength of our partnership and collaboration with the leading hyperscalers, broadening our addressable opportunity.

As customers move workloads into the cloud, they choose NetApp-based storage services to deliver high performance and low TCO. A European bank is executing a large-scale migration to AWS for its VMware, database, and container applications. The customer will migrate tens of thousands of VMs and containers composing almost 15 petabytes of data, largely from a competitor's footprint, on to FSxN. FSxN will deliver significant cost savings compared to other native storage services, and its ability to support unified file and block access will reduce the bank's management overhead.

Looking forward, our mission is clear and our focus is sharp. Customers value our modern approach to hybrid, multicloud infrastructure and data management, which enables them to build an intelligent data infrastructure, and leverage the power of their entire data estate simply, securely, and sustainably. Our portfolio has never been stronger or more tightly aligned to IT organizations top priorities.

Although we didn't perform to our standards in Q3, it remains true that broad-based customer preference for our solutions, and our visionary approach for a data-driven future enables us to outgrow the market and take share. We enable customers to treat data as an enterprise-wide asset to stay agile and competitive in the age of AI.

As we close out fiscal year 2025, we believe the actions we've undertaken to improve sales execution will get us back on track in Q4. However, as you will hear from Mike, our expectations are tempered by that divestiture of Spot by NetApp, FX, and near-term headwinds to global public sector, resulting in a slight decrease to our fiscal year 2025 guide. All factors considered, we remain confident in our ability to achieve the financial goals we laid out last June at our Investor Day.

Before I close, I want to acknowledge that this is the last earnings call Mike will lead. His successor, Wissam Jabre, joins us on March 10. Mike, thank you for your partnership over the past 5 years. You helped drive growth and profitability, strengthening our performance to create tremendous shareholder value. More importantly, you have been a respected colleague and wonderful leader for NetApp, as well as a close partner and friend to me. I am confident in our ability to build on the strong foundation you've helped to establish.

I'll now hand it over to you for details on the quarter.

Michael J. Berry

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

Good afternoon, everyone. And thank you for the kind words, George. They are greatly appreciated. I want to thank you for our partnership and the confidence and trust you placed in me. I will always value our relationship, and am very proud of what we have all accomplished at NetApp. As everyone knows, I will be handing the baton to Wissam sometime after this earnings call, but for now it is business as usual, so let's jump into the results.

Before I get into the financial details of Q3, let me walk you through the key themes for the quarter. As a reminder, all numbers discussed are non-GAAP, unless otherwise noted.

First, our disciplined operational management yielded operating margin above our guidance and EPS in line with our guidance, despite revenues towards the lower-end of our expectations in Q3. Second, we have adjusted our outlook for Q4 in fiscal year 2025 due to our recently announced divestiture of Spot and CloudCheckr, collectively called Spot by NetApp, the negative revenue and EPS impact from the stronger US dollar, and our Q3 revenue performance. Our forecast assumes that our Q4 is back on track in terms of our execution, somewhat offset by expected global public sector weakness.

Third, while our full year revenue guidance has reduced slightly, we remain laser-focused on driving operating margins, and free cash flow generation. Towards this end, we have taken swift action to control our expenses in Q4, as well as remain disciplined on play as we end the year. Finally, we returned over \$300 million to stockholders through dividends and share repurchases, reducing Q3 diluted share count by 3 million shares year-over-year.

Now, to the details of the quarter. Revenue of \$1.64 billion increased 2% year-over-year. While our revenue was \$44 million below the midpoint of our guidance, around a third of this was FX driven. Billings of \$1.71 billion increased 2% year-over-year. This marks our fifth consecutive quarter of year-over-year revenue and billings growth.

Product revenue of \$758 million was up 1% year-over-year. Support revenue of \$621 million declined 2% year-over-year but was roughly flat year-over-year in constant currency. Professional Services revenue of \$88 million grew 14% year-over-year, mainly driven by Keystone, our storage-as-a-service offering, which grew nearly 60% year-over-year. Public Cloud revenue of \$174 million increased 15% year-over-year, driven by hyperscaler first-party marketplace storage services. Q3 cloud revenues, excluding Spot by NetApp, grew 21% year-over-year, and we expect this to accelerate on a year-over-year basis into Q4 driven by our cloud and by our cloud storage business, signaling a continued healthy cloud demand environment.

Q3 deferred revenue was \$4.1 billion, flat year-over-year, but up 1% year-over-year in constant currency. Remaining performance obligations were \$4.5 billion. Unbilled RPO was approximately \$350 million, up 6% quarter-over-quarter. Growth in unbilled RPO is a key indicator of future Keystone growth. Q3 consolidated gross margin came in at 71%. Product gross margin was 57%, and we expect product gross margin to be around 56% in Q4. We plan to utilize the majority of our remaining strategic SSD purchases in Q4.

Our current support business continues to be highly profitable with gross margins of 92%. Q3 Public Cloud gross margins improved to 76% from 66% in the prior year. We are particularly proud of the 1,000-basis-point improvement in Public Cloud gross margins. We expect to make further progress on our Public Cloud gross margins and exit fiscal year 2025 towards the high-end of our long-term target of 75% to 80%.

Operating expenses of \$669 million was down 2% year-over-year, and down 7% from Q2 2025. Q3 again highlighted the strength of our business model and disciplined operational execution, with operating margin of 30%, ahead of expectations. EPS of \$1.91 was in line with our guidance, with revenues and gross margins below

our guidance points, but offset by operating expense control. Operating cash flow was \$385 million in Q3, compared to \$484 million a year ago, and free cash flow was \$338 million, compared to \$448 million a year ago. Our lower year-over-year cash flow results for Q3 were primarily driven by lower collections and higher cash outflows for previously secured strategic SSD purchases.

These strategic purchases resulted in much higher than usual inventory levels and inventory turns of 7 in Q3. As previously noted, we expect to utilize the majority of these purchases by the end of our fiscal year, and see a commensurate reduction in inventory ending fiscal year 2025. As mentioned on our last call, we expect free cash flow in fiscal year 2025 to be lower year-over-year due to working capital-related factors that we don't expect to repeat into fiscal year 2026. In the quarter, DSOs increased to 50, in line with seasonal averages.

During the quarter, we returned \$306 million to stockholders through share repurchases and cash dividends. We have approximately \$600 million remaining on our existing repurchase authorization. Our balance sheet remains healthy. We ended the quarter with approximately \$2.3 billion in cash and short-term investments, against \$2 billion in debt.

Before I go through our updated guidance, I want to quickly level set on two of the changes that happened from our last guidance in November. First, as we have all seen, the strength of the US dollar is having a negative impact on reported results. For NetApp, the expected impact to the second half of fiscal year 2025, as compared to our previous guidance, is approximately \$30 million less in reported revenue and an \$0.08 impact to EPS. Second, we plan to close the Spot divestiture in early March, and this will result in around \$15 million less in cloud revenue in Q4. The transaction is expected to be largely neutral to EPS.

Now, turning to guidance starting with the full year. Our new revenue guidance for the full year is between \$6.49 billion and \$6.64 billion, representing approximately 5% year-over-year growth at the midpoint. The slight reduction in our full year guidance is primarily driven by FX and the planned divestiture of Spot. We now expect fiscal year 2025 consolidated gross margin to be approximately 71%. We continue to expect fiscal year 2025 operating margin to be 28% to 28.5%. We expect net interest income to be approximately \$55 million. We expect our tax rate to be 20% to 21%. As a result, we expect EPS to be in the range of \$7.17 to \$7.27, which at the \$7.22 midpoint implies 12% growth year-over-year.

Turning now to our fourth quarter guidance. We expect Q4 revenue to range between \$1.65 billion and \$1.8 billion, which at the midpoint implies 3% growth year-over-year. We expect Q4 consolidated gross margin to be between 69% and 70%, and operating margin to be approximately 28%. We expect net interest income to be approximately \$10 million in the quarter, and our tax rate to be 20% to 21%. EPS is expected to be in the range of \$1.84 to \$1.94.

In closing, I want to thank the NetApp ecosystem for their commitment and investment in our company. I am confident in our ability to help our customers successfully achieve their digital and cloud transformation goals. We are well-aligned to priority IT investments, and are committed to deliver sustainable, long-term value for our stockholders.

Before handing the call to Kris for Q&A, I want to thank our employees, customers and shareholders for their commitment to NetApp during my five years in this role. It has been an honor and a privilege to be the CFO at NetApp, and I am confident that George, Wissam and the whole NetApp team will continue to deliver shareholder value going forward.

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

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

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

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] Our first question today is from Aaron Rakers with Wells Fargo. Please go ahead.

Aaron Rakers

Analyst, Wells Fargo Securities LLC

Q

Yeah. Thanks for letting me ask a question. And, Mike, it's been great working with you. And look – wish you the best. Real quickly, George, you had mentioned some comments in your prepared remarks around just sales execution. I'm curious if you could kind of double-click on that a little bit, what efforts you've put in place to kind of rectify those issues. And any thoughts on the duration of which those could show up maybe on the other side of those efforts? Thank you.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

A

Yeah. We have a strong pipeline, fueled by both secular growth drivers and company-specific growth drivers, and a fully refreshed product portfolio that is highly differentiated. As we progressed through the quarter, we saw good momentum across our business, but at the last couple of weeks of the quarter, several of the large seven- or eight-figure deals that we had expected to close in the quarter began to take longer to get through procurement into order fulfillment. And so, what this required us to do is to inspect at a much higher level of detail in terms of our closing plans for every transaction. Already what we have seen is many of the deals that pushed from Q3 have closed in Q4, particularly many of the largest ones in the quarter. And so, we expect to bring this ongoing discipline through Q4, and then it becomes part of the normal course of business as we head into the implementation of fiscal year 2026 sales plans.

Aaron Rakers

Analyst, Wells Fargo Securities LLC

Q

Thank you.

Operator: The next question is from Meta Marshall with Morgan Stanley. Please go ahead.

Meta A. Marshall

Analyst, Morgan Stanley & Co. LLC

Q

Great. Maybe just kind of following up on that question. So, it sounds like it was more execution-based versus I just want to kind of clarify that customers maybe weren't kind of a little bit more uncertain, kind of in that first month of the year, just as we have seen kind of administration change. And then second question, just kind of any commentary around public sector. Thanks.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

A

In Q3, and continuing in Q4, we have seen a degree of caution in the European markets, particularly the ones like France and Germany, where there are no governments in place. We have seen a little bit more caution in US public sector as part of our Q4 guide. In Q3, US public sector performed according to plan. You are correct that January always is the first month of the calendar year for many customers, and so that sometimes budgets take a little longer to get unfrozen. We have good line of sight into our pipeline, and we are progressing the deals according to plan.

Meta A. Marshall

Analyst, Morgan Stanley & Co. LLC

Q

Great, thank you.

Operator: The next question is from Mehdi Hosseini with SIG. Please go ahead.

Mehdi Hosseini

Analyst, Susquehanna Financial Group LLLP

Q

Yes. Thanks for taking my question. I just want to better understand the competitive landscape. I understand that there were some execution issues, but where are we in terms of increasing the QLC mix that would give you better costs? And how do you see the competitive environment into spring and later in the year? Thank you.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

A

We did not see any changes to the competitive landscape. It's always been competitive, and our portfolio has been strong. As I mentioned in my prepared remarks, we have refreshed the entire product portfolio of both the AFF series A and C, and the ASA or block storage series. We have seen good traction in the quarter in the C-series product family, in the ASA product family, as well as with StorageGRID. So, we are winning new footprints with those products. And I didn't see any fundamental change to that dynamic during the quarter.

Operator: The next question is from Amit Daryanani with Evercore ISI. Please go ahead.

Irvin Liu

Analyst, Evercore Group LLC

Q

Hi. This is Irvin Liu on for Amit. And thank you for the question. And congratulations on your retirement, Mike. I wanted to ask about how you are thinking about product gross margins. I think the 56% you guided to for fiscal Q4, it reflects some benefit from your strategic SSD purchases. But is there any way to help us think about the direction of product gross margins beyond Q4 once you use up some of these strategic purchases? And then, to what degree can you pass through some of these higher commodity costs to your customers?

Michael J. Berry

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

A

Yeah, great question. So, let me take a step back and talk about gross margins as a whole. I'll talk about Q4 even though we're not guiding for fiscal 2026, I do want to give you a view of what we're thinking as we sit here today.

So, first of all, hey, let's back up for a second, folks. We've always said our goal here at NetApp is to drive incremental gross margin dollars, and we've done that in 2025. The really good news is the mix of gross margin is a lot better now, diversified between the different product lines, particularly product support and cloud.

The progression of the gross margins has largely played out as we expected at the beginning of the year, with cloud gross margins increasing materially, and product gross margins declining throughout the year as we used up some of those strategic pre-buys.

I do want to underline a couple things. Hey, folks, we did those pre-buys in 2024 and through the first half of 2025, and you can see it in our product margins. As some of that has worked through those higher costs is what's reflected in the P&L. As we sit here today in Q4, what we're expecting from those pre-buys is really close to where the market is. So, I will then talk about in a second what that means for 2026.

Your second part of your question, though, I want to hit first, which is we all know there's two pieces of gross margin. There's revenue and there's costs. On the revenue side, we did implement some price changes going into Q3. Given the longer sales cycles in our business, we really didn't see a material impact in our fiscal 2025, but we do expect to see this tailwind pick up as we enter fiscal 2026.

Another tailwind is the introduction of our new products that George talked about, specifically the A-series where we continue to introduce new products that deliver better performance for our customers at a better cost structure for NetApp. Also, as these new products become a bigger portion of our billings in fiscal 2026, that should also be a tailwind to margins. So, that's the revenue side.

Now, specifically on component cost, we expect to use a majority of the pre-buys up in fiscal 2025. As I just mentioned, folks were basically at the same as the industry as today. So, as we go into fiscal 2026, we expect there to be continued weakness in the NAND market, we've seen that over the last two quarters, and it's expected to continue into the first half of our year. So, based on these current projections, we expect Q4 2025 to be the high point of our component costs. Expect to see costs remain steady entering fiscal 2026, and then start to decline. What that means is assuming mix stays consistent, because mix is super important, we would expect 56% to be the low point of product gross margins, and start to increase as we enter 2026. So hopefully, that answers that question.

And I just have to give one shout out to, a, shifting to cloud margins for a second. We are particularly proud of the 1,000-basis-point increase that we've seen there, and we expect those margins to continue to increase. In addition, with the divestiture of Spot, we actually get about another 100 basis points of cloud margin goodness. So, that's gross margins as a whole. Again, we're not guiding 2026, but hopefully that helps with people worrying about what was going to happen going into next year.

Irvin Liu

Analyst, Evercore Group LLC

Got it. Thank you.



Operator: The next question is from David Vogt with UBS. Please go ahead.

David Vogt

Analyst, UBS Securities LLC

Great. Thanks, guys, for taking my question, and my congratulations on the retirement. We'll miss you. Maybe, George, can you talk about obviously deals closing late in the quarter or getting pushed out, yet your all-flash array business seem to perform reasonably well in the quarter, at least from the metrics. Can you talk into more specificity in terms of what was sort of the deciding factors that got pushed to the right? Was it the size of the deals? Was the price? Was it – what type of technology? Just trying to get a little bit better sense for maybe



where customers maybe got a little bit of a pause and why it shifted a little bit more to the right. I know you touched on it earlier, but just some more color around that, given that, all-flash ARR looked pretty good in the quarter.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

A

I think that our all-flash numbers would have been substantially higher if we had been able to close the transactions that moved to the right. Those were primarily flash-based product transactions. There were a few different reasons. Clearly, there were some clients that were not yet ready to make the procurement decision at the window that we wanted them to, and where they had previously communicated that they might be ready to do it. Some of this as you can imagine was because it's the first few weeks of a new calendar year, and the budgets haven't yet flowed down to the departments.

In other cases, clients wanted to upsize their transactions, so they wanted to consolidate more equipment under the same procurement vehicle. And so, it took us longer to close. And I think those were fundamentally a couple of the main reasons. In Europe, we saw a couple of deals push because of the softness in the overall market. And so, it's taking them a little bit more caution in some of those cases in Europe.

David Vogt

Analyst, UBS Securities LLC

Q

Great. Thank you. That's helpful.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

A

Thank you.

Operator: The next question is from Jason Ader with William Blair. Please go ahead.

Jason Ader

Analyst, William Blair & Co. LLC

Q

Yeah. Thank you. Good afternoon. Could you get – I think you said \$15 million in the quarter from Spot. Can you just give a sense of like the – if you could annualize the Spot impact so we can get a sense of what we need to take out of our models for FY 2026. And then, just a quick second question. I know I'm supposed to ask one, but can you give us the US Fed exposure overall or sort of for the fiscal year? What's your US Fed exposure?

Michael J. Berry

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

A

Hey, Jason, it's Mike. So, on the first question, so the business that we are divesting, for the trailing 12 months, the cloud revenue has been about \$94 million, been relatively consistent. It bounces around a little bit by quarter. From a gross margin perspective, the gross margins are relatively consistent with the cloud gross margins, but slightly lower. Hence, my earlier comment about getting a little bump in gross margins. And then, when all is said and done, we expect it to be relatively neutral to EPS. As George mentioned, and we both did, the as reported number in Q3 was 15% growth, excluding it from both the previous year and this year it moved up to 21%. So hopefully, that helped size...

Jason Ader

Analyst, William Blair & Co. LLC

Yeah.

Q

Michael J. Berry

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

...the businesses we divested.

A

Jason Ader

Analyst, William Blair & Co. LLC

And fed?

Q

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

Listen, I think the US public sector business, the incremental, caution is factored into our Q4 outlook. Some of that is related to the near-term efficiency direction that some parts of the administration have been directed to undertake. We think that these are tied to technology-led productivity improvement initiatives over time. And so, once they stabilize, it should be a benefit to us. US public sector is an important business to NetApp, and it's a material part of our America's business. And so, I'll just leave it there.

A

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

And Jason, just, this is Kris, really quickly. Public sector, which includes fed plus state and local governments, bounces around between 10% to 12%, 13% of total revenue.

A

Jason Ader

Analyst, William Blair & Co. LLC

That's global public sector.

Q

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

That's US public sector.

A

Jason Ader

Analyst, William Blair & Co. LLC

Oh, US, okay. US of total...

Q

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

Fed plus...

A

Jason Ader

Analyst, William Blair & Co. LLC

...revenue, not of total US revenue, right?

Q

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

Correct. Of total company revenue.

A

Jason Ader

Analyst, William Blair & Co. LLC

Okay. All right. Thanks, Kris.

Q

Operator: The next question is from Wamsi Mohan with Bank of America. Please go ahead.

Ruplu Bhattacharya

Analyst, BofA Securities, Inc.

Hi. Thanks for taking the questions. It's Ruplu filling in for Wamsi. Mike, great working with you. Congrats. I have a question for you. Are you taking any incremental cost actions, and how should we think about operating expenses as well as your investments going forward? And if you can also comment on free cash flow, is it lower sequentially in fiscal 4Q, and what would drive further strategic SSD purchases? And when would you do that, and what would be the criteria for that? Thank you.

Q

Michael J. Berry

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

So, thank you for the kind words. And I think there were three questions in there. So, first of all, hey, from an operating expense perspective, for this year, we're basically flat year-over-year. The team does a wonderful job continuing to invest in new projects. George talked about all the new products that we've rolled out and the changes also we've made in go-to-market. So, hey, we look at it every quarter, we look at it every day. We want to make sure that we get a return. So, we are scrutinizing OpEx the same today as we have in the last couple of years.

A

The second question was...

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

Cash flow.

A

Michael J. Berry

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

...cash flow. Let's talk about cash flow...

A

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

Cost action.

A

Michael J. Berry

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

...and then cost action. So, cash flow first. So, right now on an operating cash flow perspective, we're down year-over-year by about \$241 million. The driver to this is really two big things that we've talked about all year.

A

One is the payments we've made on our strategic buys. That's going to continue to be a working capital headwind for us in fiscal 2025. The other big piece is incentive payments that we made mostly in Q1. You aggregate those together, and the working capital impact is about \$300 million year-over-year. In Q4, we have some headwind from the timing of tax payments. It should increase sequentially, but we do expect to be below last year, and that's what we said in Q3 as well.

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

A

Are you planning to take cost actions?

Michael J. Berry

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

A

So, just like we talked about, we look all the time at cost as it relates – oh, I think the third one was pre-buys.

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

A

Correct.

Michael J. Berry

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

A

Yeah. So, at this point as you look at the NAND market as we've talked about, we did the strategic pre-buys when it was really a dislocated market, and it was almost a no-brainer to do it. And we benefited, and our customers did because we were able to offer great products for almost the last four quarters. At this point, we've used those up, but going forward, we'd have to see a material dislocation again to do those pre-buys. The wonderful news is my successor knows this industry really well, so he'll be able to look at it as well. But at this point, we are not expecting to do any more pre-buys, but you know what, the NAND market continues to change. So, we'll wait till Wissam gets here and he can talk about that on the next call.

Ruplu Bhattacharya

Analyst, BofA Securities, Inc.

Q

Thank you for all the detail.

Michael J. Berry

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

A

So, I think probably I answered the three questions.

Ruplu Bhattacharya

Analyst, BofA Securities, Inc.

Q

Yeah.

Michael J. Berry

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

A

Yeah?

Ruplu Bhattacharya

Analyst, BofA Securities, Inc.

Q

Yeah, Mike, thank you so much. Thanks for all the details.

Michael J. Berry

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

A

You bet. Thank you.

Operator: The next question is from Steven Fox with Fox Advisors. Please go ahead.

Steven B. Fox

Analyst, Fox Advisors LLC

Q

Hi. Good afternoon. Just following up on that, just from a competitive, dynamic standpoint, having had Mike a lot of experience with doing these pre-buys now, some of your competitors don't do them, some do them in different ways. Has that at all affected the competitive environment? And given your comments about NAND pricing going down, I guess it's all relative, but some of the NAND suppliers are talking about the bottom of inventory cycle. So, I'm curious if you see any risk that maybe you're being too optimistic on NAND pricing. Thanks.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

A

Yeah. So, let me address those two questions, right. I think, first of all, in terms of the competitive landscape, the real competitive differentiator that NetApp has is really our software and Hybrid Cloud. The percentage of our cost to a customer that comes from NAND is a small part of the total cost. And so, we have a full line-up of products with different forms of NAND. And I think that the competitive dynamic with our software strength, our Hybrid Cloud and our AI technologies gives us a real strong position in the market, and a durable competitive moat.

With regard to the NAND market itself, listen, we are very, very closely aligned with all of the large suppliers of solid state technology, and in deep discussions with them. We will make strategic decisions about procurement in the way that Mike talked about. And so, we feel very, very good about our ability to understand the market. It is a dynamic market, like you said, but we are in very close dialogue with these suppliers, as we have been for many, many years.

Steven B. Fox

Analyst, Fox Advisors LLC

Q

Thank you. That's helpful.

Operator: The next question is from Krish Sankar with TD Cowen. Please go ahead.

Krish Sankar

Analyst, TD Cowen

Q

Yeah. Hi. Thanks for taking my question. George, just wanted to find out kind of like where are we in the AI in the enterprise cycle? And along the same path, the focus on enhancements to StorageGRID, which is object storage, is this also related to capitalizing on AI in the enterprise? And then, Mike, thanks for all your help. Just a clarification, is Spot completely out of the model in April quarter? Thank you.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

A

So, let me get the first one, and then Mike will get you the answer on Spot. We are starting to see the opening up of AI in the enterprise, where we are seeing clients stand up AI Centers of Excellence with AI infrastructures that combine GPU-based compute with high-performance storage infrastructures. We had several large wins in that category. We are also seeing people build out data lakes, which are applications that allow you to combine data from multiple types so that you can then normalize it and feed it into a large language model. Our AI business has performed according to our high expectations multiple quarters in a row. We are also seeing a growing number of wins in AI service providers, who are building as-a-service infrastructures for enterprise AI. And all of our differentiation around kind of multitenancy, security, AI model versioning, data mobility, all of those things come into play in all of those use cases. So, I'm pleased it's in the early innings, like we said, but our technology and our approach with customers is resonating.

Mike?

Michael J. Berry

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

A

Thanks, George. So, Krish, there is about \$9 million of cloud revenue in the Q4 guide, that's with the expected close date of early March. So, that's the difference. The \$15 million that we talked about is we expected there to be the full quarter of about 2024, and it is about a month in.

Krish Sankar

Analyst, TD Cowen

Q

Thanks, George. Thanks, Mike.

Michael J. Berry

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

A

Thank you.

Operator: The next question is from Simon Leopold with Raymond James. Please go ahead.

Simon Leopold

Analyst, Raymond James & Associates, Inc.

Q

Thank you very much. I wanted to see if you could talk about your expectations for tariffs and the risks. I know, Mike, you had mentioned some commentary on gross margins that was really in the context of NAND pricing. I'd like to get a better understanding of what you're thinking for the risk of tariffs, and if you've baked anything in. And Mike, congratulations on your retirement as well.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

A

I think you were speaking about tariffs. Listen, we have a global supply chain that has given us the ability to fulfill products to customers from multiple locations, and that is a very highly flexible supply chain. We have, as you know through the course of the past several years, removed our dependency on China to a very immaterial amount. So, any tariffs applied to products coming from China don't really affect us. We have a location in Mexico, out of which we do build product, but we have the flexibility to move those capabilities to other locations that are not tariffed in a fairly short period of time. And so, it's dynamic. We are watching the situation. We have, as you

can imagine, several contingency plans. And I'll just close by saying that we have not factored tariffs into our Q4 guide. And if tariffs applied to a wide swath of technologies that everybody in the industry uses, which is our typical approach to using industry standard commodity components, then of course it will affect the entire industry.

Simon Leopold

Analyst, Raymond James & Associates, Inc.

Thank you.

Q

Operator: The next question is from Louis Miscioscia with Daiwa Capital Markets. Please go ahead.

Louis Miscioscia

Analyst, Daiwa Capital Markets America, Inc.

Yes. Thanks. So, Louis with Daiwa. Mike, greatly appreciate all your support and help throughout the years, and best to you. So, George, you've mentioned a couple of times that it's going to take a while for AI really to contribute to give you material revenue growth. So, if you could just give us an update on that. You did just mention a minute ago that some AI inference applications are starting to ramp, but obviously didn't seem like it really helped the product revenue too much in this quarter. So, are we still 6 months out, 12 months out, or anything that you could shed light on with our guidance would be helpful?

Q

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

We said in our prior commentary that what we are seeing clients do is put AI projects into [indiscernible] (00:49:51) and start to learn from that, and that the movement of those projects into production in the enterprise would be in the second half of calendar year 2025 or 2026. We see the same thing to be the case. It is certainly the case that we are seeing the larger clients being more facile at building AI Centers of Excellence and being able to deploy those kind of technologies into their business environment. And so, it'll take time, as we've said, to broaden. We'll keep you updated as we go through the quarters, but we feel good about our position. There are sort of really good templated wins that we are seeing across industries and across geographies, and I feel good about our progress.

A

Louis Miscioscia

Analyst, Daiwa Capital Markets America, Inc.

Okay. Thank you.

Q

Operator: The next question is from Tim Long with Barclays. Please go ahead.

Hi. This is [indiscernible] (00:50:55) for Tim Long. I was just wanting to check in on Keystone. You had another strong quarter of growth. Can you talk about customer's kind of willingness to move to as-a-service versus traditional sale? Any kind of change in customer behavior, increased interest you can mention? Thank you.

Q

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

A

We offer as-a-service models in a broad range of ways, clearly cloud, and our super-strong performance in cloud is reflective of a broad-based enthusiasm in customers for as-a-service, and the flexibility that cloud transformation gives them. We are seeing clients who are either looking to transform their IT landscape to have the same model as public cloud. Taking on Keystone, they really like our hybrid offering so that they can build an architecture that spans public and on-prem with Keystone.

The second is clients that are deploying applications that are going through an early validation, right. So, it could be like an AI application that is not yet at scale. So, they don't want to buy a full-scale infrastructure for that use case, they want to just buy kind of a flexible infrastructure model. And when they are ready, they can deploy it into a more capital expenditure kind of architecture. So, we feel good. We are focused and executing that part of our business.

Q

Thank you.

Operator: Our next question is from Ananda Baruah with Loop Capital. Please go ahead.

Ananda Baruah

Analyst, Loop Capital Markets LLC

Q

Yeah. Thanks, guys. Good afternoon. Thanks for taking the question. And Mike, yeah, I've really enjoyed working with you. We'll miss working with you. Have a great time. I guess, the question is for, could be for both of you, at the Analyst Day, guys, you talked about through 2027 an average of mid- to high-single-digit growth. Does what is going on this quarter and next quarter? Does that impact that target at all yet? And any early way to think about the flow-through to fiscal 2026, since we're all almost there as well would be helpful? Thanks a lot.

Michael J. Berry

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

A

Hey, Ananda, it's Mike. Thank you for the kind words. I will miss working with you as well. So, as we talked about last quarter, we still feel very good about the long-term targets we gave at Investor Day, and nothing that happened in Q3 has changed that in terms of the mid- to upper-single-digit growth, the margins as well as the cash flow conversion. So, we feel really good about the product line-up. George talked about that entering into 2026, all of the product momentum that we have, the go-to-market changes. So, nothing that we sit here today say that that would change, and we will hold fiscal 2026 guidance until the next call.

Ananda Baruah

Analyst, Loop Capital Markets LLC

Q

Thank you. Thanks, guys.

Operator: The next question is from Asiya Merchant with Citi. Please go ahead.

Asiya Merchant

Analyst, Citigroup Global Markets Canada, Inc.

Q

Great. Thanks for taking my call. And Mike, again, congratulations on your retirement, and enjoyed working with you. If I can just ask about the flash installed base, I mean how far along are we in terms of converting the

installed base? And net new customers, if you can tell us about the overall installed base that still has line of sight to perhaps move to the flash space? Thank you.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

A

Yeah. Thank you, Asiya. The penetration of our all-flash footprint into our installed base is now 43%. So, it's up, again, modestly every quarter, which is a reflection of both the scale of our installed base and the fact that we are growing new footprints in that installed base, so it's 43%. With regard to the kind of nature of our wins in all-flash, listen, all-flash, and Public Cloud are the two vehicles that allow us to win new customers, and the pace of new customers continues to be good.

Asiya Merchant

Analyst, Citigroup Global Markets Canada, Inc.

Q

Thank you.

Operator: The next question is from Samik Chatterjee with JPMorgan. Please go ahead.

Samik Chatterjee

Analyst, JPMorgan Securities LLC

Q

Hi. Thanks for taking my question. And Mike, we'll miss working with you. It was a good experience working with you. Maybe, George, just on the product side, you've talked about a disaggregated solution, and sort of launching that somewhere before NetApp INSIGHT this year. Maybe if you can help me with the sort of update on the progress on doing a disaggregated solution, and how do you think about on the storage side and how you think about the incremental addressable market that that product would allow you to address?

And maybe just on the same lines, one of your peer companies has talked about a hyperscaler deal, where there has been hyperscalers scale with a software solution particularly. How do you think about sort of those being in your strategic roadmap, or are those sort of deals in something that you would consider, given sort of the puts that takes about how you think your product portfolio is sort of positioned right now? Thank you.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

A

We made good progress on disaggregated storage. It is for high performance unstructured data use cases. And you'll hear more as we get towards INSIGHT. As you know, our disaggregated storage is third-generation disaggregated storage, which is the most scalable, the most-high performance, and of course the richest set of features in the industry. Many clients are using us for high-performance NAS already for AI and other use cases, but this opens up our ability to attack the other players in the NAS market, particularly the large other NAS incumbent, Dell. And so, we feel good about our opportunity there.

With regard to cloud, listen, our cloud business offers compelling value to all three large hyperscale providers. I'll point out that we've been in that market since 2019, which was the GA of the first cloud hyperscaler solution. It's a highly valuable technology to them, because it allows them to bring clients to their platforms, and it's a very high margin business for both us and them. And so, we're going to continue to drive the full stack value we have into more and more and more use cases. And we feel really good about the momentum in the hyperscaler business that we have.

Samik Chatterjee

Analyst, JPMorgan Securities LLC

Thank you.

Q

Operator: And the final question today comes from Ari Terjanian with Cleveland Research. Please go ahead.

Ari Terjanian

Analyst, Cleveland Research Co. LLC

Hi, all. Thanks for taking the question. And Mike, best of luck here. Just want to wrap on any more updates on dynamics we're seeing with VMware and Broadcom and customers contemplating new architectures, converged, hyper-converged, cloud, et cetera, and potential opportunities and challenges that that might be presenting to the business. Thank you.

Q

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

I think we are well-positioned with the VMware discussions in our clients. If they want to stay on VMware and optimize their overall VMware landscape, we have good solutions with VMware to allow customers to do that. And we're seeing some of our clients start to chase that up. We talked about, in my prepared remarks, some clients re-platforming from on-prem VMware to cloud, using a combination of VMware cloud offerings, as well as modern container-based architectures. We have very good progress with some of our clients on cloud.

A

And then, I think with regard to using on-prem alternatives, again, as we've said, we have joint solutions with Microsoft and Red Hat and others. And so, I think it's a topic that will take time to clarify where customers are headed. But we have good choices for them, regardless of where they're going.

Ari Terjanian

Analyst, Cleveland Research Co. LLC

Thank you.

Q

Operator: We're actually able to squeeze in one more question from Param Singh with Oppenheimer. Please go ahead.

Param Singh

Analyst, Oppenheimer & Co., Inc.

Yeah, yeah. Thank you for squeezing me in, and I really appreciate it. And thanks for taking my question. Now, sorry to beat a dead horse, but wanted to understand going back to the deal push-outs, what percentage of those were displacement of competitive opportunities versus replacing your existing HDD or hybrid footprint?

Q

And as you look towards your sales in the quarter and this progresses through the year, what has been the opportunity to replace cost a competitor's versus, again, your existing footprint? If you could talk about that a little bit, I'd really appreciate that.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

A

There was no specific dynamic related to the deals that pushed out that followed any pattern of competitive versus NetApp refresh. It was really tied to customers buying and procurement kind of lifecycle, and our lack of visibility into some of those, right. That we are correcting with more detailed inspection of exactly who in the customer has approved, and the various steps that our transaction typically takes to get to closure. So, I wouldn't comment that there was anything specific with regard to whether it was our footprint or competitors.

Listen, in every quarter, there are a huge number of transactions that we undertake. Some of them are refreshes of our installed footprint, some of them are competitor footprint take-out. I can just tell you, having sold flash for so many, many years, and the fact that we are 43% of our installed base penetrated with flash, should give you an indication that a preponderant part of our flash business is net-new footprint or net-new logos, right, because we're just displacing our installed base. We would be at a much, much higher percentage of penetration today.

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

All right. Thanks, Param.

A

Param Singh

Analyst, Oppenheimer & Co., Inc.

Thanks for that.

Q

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

We appreciate your question. Thank you.

A

Kris Newton

Vice President-Investor Relations, NetApp, Inc.

I'm going to pass it back to George for some final comments.

George Kurian

Chief Executive Officer & Director, NetApp, Inc.

Thank you, Kris. While we did not perform to our standards in Q3, we remained very well-positioned with customers as their supplier of choice for AI and other data-driven workloads. We are taking action to get back on track, and have already seen several deals that slipped out of Q3 close in early Q4. Our portfolio has never been stronger or more tightly aligned to IT organizations' top priorities. We enable customers to treat data as an enterprise-wide asset to stay agile and competitive in the age of AI. I am very confident in our continued ability to outgrow the market and to take share.

Operator: The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.

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