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OVERVIEW:

Company Summary

CORPORATE PARTICIPANTS

Kris Newton *NetApp Inc - Vice President, Investor Relations*

George Kurian *NetApp Inc - Chief Executive Officer, Director*

CONFERENCE CALL PARTICIPANTS

Samik Chatterjee *JPMorgan - Moderator*

PRESENTATION

Unidentified Participant

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This call is intended for JPMorgan clients only. Press participants are not permitted on this call and should disconnect now. Unless otherwise permitted by internal JPMorgan policy, members of JPMorgan Investment and Corporate Banking are not permitted on this call and should disconnect now. (Operator Instructions) And with that, I would like to turn the call over to Samik Chatterjee to begin. Please go ahead.

Samik Chatterjee - *JPMorgan - Moderator*

Yeah. Thank you, Harry, and thank you, everyone, for joining. This webinar is part of our CEO Spotlight Series that we've been doing this year. And we have the pleasure of hosting George Kurian from NetApp for this session. I do want to thank George as well as NetApp team for making this possible. I was just going through George's background related to NetApp and George as much as I knew that you've been the CEO of the company since 2015, I definitely didn't know that you were part of Cisco before that, which is another company we cover. But for the people in the audience who are not -- let's [host] with it, George has been the CEO since 2015 after joining NetApp in 2011. And prior to that, he was at Cisco and prior to that at McKinsey & Company, I believe.

So George, a long time at the role here, and we'll get into some of those questions about the longer-term view about the industry. But before I do, we also have Kris from Investor Relations here. And Kris, thank you for taking the time. And I'll hand it over to you to go through the Safe Harbor before I kick it off with questions. Thank you.

Kris Newton - *NetApp Inc - Vice President, Investor Relations*

Thanks, and thanks for having us. Today's discussion may include forward-looking statements regarding NetApp's future performance, which are subject to risk and uncertainty. Actual results may differ materially from the statements made today for a variety of reasons described in our most recent 10-K and 10-Q filed with the SEC and available on our website at netapp.com. We disclaim any obligation to update information in any forward-looking statement for any reason. Back to you, Samik.

QUESTIONS AND ANSWERS

Samik Chatterjee - *JPMorgan - Moderator*

Thank you. Okay, George, so maybe just starting with that longer term picture. Now you've been in the CEO role for 10 years-plus, I guess, what are the primary changes you've seen in the industry as well as what -- how have the customer preferences changed that NetApp has had to navigate over this last decade?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

Yes. First of all, Samik, thank you for having me and to the listeners, thanks for joining. Over the last 10 years, there have been three or four things that I would say continue to be consistent. The first is ongoing changes in the market. I think the most pronounced change over the last 10 years has been the growth of public cloud and cloud as an infrastructure pattern. We have been able to be fortunate to uniquely in the market, capitalize on the transition to public cloud. Public cloud has also driven the importance of OpEx buying as a growing pattern within the enterprise data center where people want to harmonize their operating models between public cloud and on-prem.

The second has been ongoing technology trends, which is people want to use the latest technology like flash or higher performance networking, there's a lot of new networking things like RDMA over Ethernet and other things. And so that's an ongoing set of capabilities that we see that we continue to take advantage of. We got to number one in all-flash as a result of our strength. I think. the third operationally within the client base is that more and more clients are being challenged to do more with less, especially around infrastructure. And so it has driven in addition to the push -- emerging push on AI, it has really driven the idea of unifying your data, unifying your infrastructure model into a more consistent pattern. Two other things that we've seen is the large multiline integrated system vendors, these could be Dell or HP or IBM, has lost share in the market. This continues the pattern for the 50-year history of the storage industry. First, it was IBM that was in the 1990s dominant and then lost share. Then Dell and HP have each done large-scale acquisitions and have lost share. And so that continues. And then interestingly, hyper-converged was a trend that was supposed to be a big deal and would take over the data center. It has its place in the smaller data centers; it has really not taken over the large enterprise data center. So that's really the big themes. And AI, if I look forward over the next 10 years, the ability to extract knowledge from your data assets is probably the most profoundly important theme that we see in our clients.

Samik Chatterjee - *JPMorgan - Moderator*

Okay. Great. So that's on the industry front. Maybe if I take that same question and lay it -- in terms of operationally. Like what were the primary -- maybe over the last decade, what were the primary aspects you focused on in the company in terms of operational transformation? And has have those delivered the results that you expected as well?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

Yeah. Maybe I'll talk about it in three ways. One is portfolio. Second is go-to-market. Third is financial and operating performance. I think on the portfolio side, listen, we continue to pivot to the growth areas of the market and do that by shifting resources from mature parts to the growth part. So I think we talk about the fact that there are four drivers that we're focused on, flash, cloud, block, and AI. And so from a portfolio perspective, we're pivoting there. Flash was a much, much, much smaller percentage of our revenues. When I started, it's now two-thirds of our hybrid cloud revenue.

The Keystone program, which is to really deliver a consumption model has grown strongly across revenue, TCV, unbilled RPO pretty much all the metrics. Cloud is 10% of our revenue, public cloud and is growing at a fast clip. It grew 33% last quarter and is very margin accretive to the overall business. And that's really the short summary of the portfolio, right, pivot to where you see growth areas of the market and do so within the disciplined operating model. On go-to-market, we decided to sharpen our focus on the biggest markets. Fairly early in my tenure, we pulled out of about 19 countries and use distributors to go-to-market. Perhaps most importantly, we struck a joint venture with Lenovo that provides us access to the China market without the operating cost structure that's required to participate in a large market like that. And then from an operating expense perspective, listen, we have been disciplined operators of the business.

We compare and contrast the first quarter as CEO, our operating margin was around 7%. I think, you'd see the most recent quarter was north of 25%. And so those would be the three buckets. From a capital return perspective, we had just started a buyback and dividend program in 2013. I became CEO in 2015. We have sustained that and expanded that over the last few years. So that's sort of the four buckets on transformation. There is always things that you want to do better, right? You got the number one in flash. We feel like we should expand our lead from that position. I think on cloud, we feel good about the fact that we've got the big three hyperscalers. There are others we want to do more with. And so you always have the aspiration to keep pushing.

Samik Chatterjee - *JPMorgan - Moderator*

No, fair. And that I was going to bring up the margin aspect and the transformation on the margin front in a bit. So we can talk about that as well. On the portfolio side, NetApp was named again as a leader in the Gartner's Magic Quadrant for enterprise storage platforms. I mean as we look at that leadership that you have today, really the question is, again, going back to the operating discipline where like you've been growing expense probably half the rate of your revenue, which basically means you've been growing at that level of low single-digit piece. How do you envision maintaining this leadership and that expense profile is more mirroring that low single-digit at profile at this point. And we are seeing more, more and more companies having to spend more to keep up with the rapid technology transformations. How do you envision maintaining your leadership in that framework?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

Yeah. I think the foundations are: one, you have a disciplined culture. I think, that we have a real focus on, are we moving our resources to the parts of the market that are growing? And then strategically, we have done one thing that is technically very hard to do, but has extraordinary leverage, right, which is we have one operating system and one platform that allows us to have enormous leverage in our business. There is literally a single-code line, one software-code line that supports our systems that supports our Keystone and that supports our penetration into all the public clouds. Not only does that give us operating leverage, but it also gives us enormous innovation capacity because you innovate once it's available everywhere. And so that's our advantage. And we've seen -- we've worked really hard to sustain that advantage with a single-code line and all of that discipline.

Samik Chatterjee - *JPMorgan - Moderator*

Got it. If I move to a different question, but more on the top line growth over the years. I mean the way -- I think we perceive it and investors perceive it is that the growth in data for customers has been consistent over the years, and that's a secular driver for the -- for your business. However, that's been a very consistent -- the increase in data has been pretty consistent. And the expectation typically has been that, that would lead to more consistent top line performance from the likes of NetApp. Relative to that, when we look at some of the top line performance that you've had, like years like 2016, you had a 10% decline. In 2022, you had a 10% increase. What drives the volatility in your performance on a year-to-date basis, even though the secular driver seems to be much more consistent and predictable from what the enterprises are seeing in terms of data growth or their storage need growth?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

It's a good question. While data growth is consistent, customers often buy periodically, especially when there are moments to take advantage of opportunities, right? So the first Trump administration's policy on benefiting investment and some tax advantages drove a lot of buying in the early 2018, 2019 time frame. 2022 was a year where clients were catching up from deferred upgrades from COVID as well as some of the constraints that the supply chain had. Conversely, there have been periods like 2016 and 2020, where buying has been more constrained. I would point out that we focus on two things. One is, we have a large part of our business that's more recurring revenues that supports the cost structure of the business. And then the second is we continue to expand the range of customers we serve and the different set of use cases in the customer so that even if there is volatility in some parts of the customer, we can get access to others.

Samik Chatterjee - *JPMorgan - Moderator*

Yeah. Okay. Got it. Got it. And then another question on the way NetApp operates. I mean the value of the storage platforms is in the software or a large part of the value is there. But then you mentioned like there's a sizable amount of recurring revenue from the way you look at things based on that software capabilities. But at the same time, you don't appear to be using or relying as much on subscriptions with your enterprise customers in terms of your preferred go-to-market motion, particularly for the hybrid cloud portfolio. Like what drives that decision to look at the ongoing business with the enterprises as recurring revenue, which you have visibility to, but not really push them towards a subscription model?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

Our approach is to meet the customers where they are and to have the broadest range of options available to them. We have several elements of our business that are recurring. So support, which is about 40% of our business, is actually a recurring revenue stream. When a customer buys equipment even in a capital expenditure model, about 40% of that still goes into a recurring model. The second is cloud is all recurring, and our Keystone model is more of a recurring subscription and consumption model. So we offer and push people, hey, we have these models, do you want to buy them? At the end of the day, our view is if you force customers into a particular model, they may not go with you. They may choose an alternate vendor. And so we continue to see subscription as a percentage of recurring revenue as a percentage of our total business go up, but we also want to meet the client where they are. And many clients have a strong preference to buy a certain way.

Samik Chatterjee - *JPMorgan - Moderator*

Okay. Okay. Block storage market, you entered the market in terms of having very specific products for that use case pretty recently. What should we think about as the measure of success for NetApp in that market? And are customers choosing to stay with your unified storage? Or are you finding them -- some of them moving over to adopting specific block storage products in your portfolio?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

We have had block storage for a very long time at NetApp. We have north of 20,000 customers who use block storage with NetApp. They, as you noted, buy it as part of a unified configuration, meaning they want to have one-system architecture in a cluster, some of that to support file-based storage, some of that to support object-based storage and some of that to deploy block storage. We are, by far, the leader in unified storage. There are, however, customers where they just want a block-only offering. These could be either smaller customers that don't have such a sophisticated set of data needs. It could be departmental environments and larger customers, which look similar to a smaller customer or in the very, very large customers where they have file teams and block teams in their infrastructure organizations that are separate. So we introduced a set of block only or block optimized products. Those -- the success of those products comes from growth in our all-flash business. And so -- because those are all-flash configurations, the block-only products.

Samik Chatterjee - *JPMorgan - Moderator*

Got it. I mean, maybe another way to ask it is, are you seeing your deal sizes with existing customers go higher because they're adopting these block-specific products, which they didn't do before? Or it's it just a migration for these customers from instead of adopting the unified product to moving to block?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

We are seeing new wallet in existing customers and also new clients like mid-market clients that never bought NetApp before starting to choose us.

Samik Chatterjee - *JPMorgan - Moderator*

Got it. Great. And then -- and going back to the -- your number one position in flash and you've gained considerable share overall of the market as well in the last few years. And some of that has been C-Series. You also have the ASA series. How should we think about runway in terms of market share gains? Like if you take these two specific products separately, how should we think about how much more runway do you have in terms of market share gains?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

Listen, I think that the market share data that IDC published has us in the 25% range. So I tell our teams that 75% to go, right, in the all-flash market. Because your aspiration is to have dominant share. So there's plenty of market share gains to be had. Our aspiration when we build our financial plans is to grow at or above the market so that we maintain or grow share, right? That's the benchmark that we hold ourselves to. We really want to be gaining share. We believe we can. The C-Series and the ASA products complete the set of things that we need to address the flash market. It allows us to have price points that we couldn't have before when we only had the A-Series in the unified product portfolio. And then as we just discussed, a block-optimized offering. I think, the portfolio is in a good place. We have some exciting announcements to come on the AI front at our Insight User Conference. And I think that we feel confident about driving share gains in the flash market.

Samik Chatterjee - *JPMorgan - Moderator*

And maybe, George, just to look at it from another way, you brought up an interesting point, which is 75% more to go. Like how many of your customers adopt only one-storage vendor versus how many of your customers do you find typically working with two or more storage companies?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

I think ,what we have seen with the growing pressure on operating expenses in most of our clients, the need to have speed, agility, and security. The idea of having so many different vendors for storage is actually shrinking. They really feel like, hey, if I want leverage on my storage vendor, I can go to cloud. Cloud is my negotiation point with the on-premises infrastructure vendors. And so the pattern of I need multiple vendors for addressing my control and vendor control is starting to dissipate. We see most clients having two vendors and some who want just the simplification going to one vendor. And so we feel like there's an opportunity for us and maybe one other to grow share in the market.

Samik Chatterjee - *JPMorgan - Moderator*

And then staying with this market share thread. When I think about -- you mentioned this early on in terms of the integrated players giving up share to companies that are more focused like yours. I mean when you think about the share gains in the coming years, are there specific customer verticals that we should think of, that's more likely where maybe it's more mid-market driven that we should think about the share gains? Or in terms of competitive companies, we should be thinking more of that coming from like a Dell or HP. How would you encourage investors to think about where some of the share gains come from in the coming years?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

I think, we are focused on the biggest geographies in the world. I think, that someone like a Dell or HP has distribution reach advantages over us in the smaller markets of the world, like in Africa or some parts of Latin America. Our view was the strategy that Napoleon pursued, right, is when you fight a much bigger army, you kill the middle. And when the middle collapses, the sides have to fold into the middle and you can kill the whole army. So we concentrated our coverage in the biggest markets in the world. And we have seen that opportunity, right? I think we have taken share. We are number one in 8 or 9 of the top 12 countries in Europe. We've taken over number one in India, we are chased -- we took over number one in Australia. So we're really focused on our go-to-market. I think, with regard to the -- where should we gain more share, US obviously is the biggest market. And so we really want to gain more share here.

The second is with regard to price bands, our portfolio has historically been strong in price band 7, 8, and 9. With the C-Series and ASA, we brought more capability into price bands, 5 and 6. So we feel like there's more room to grow in those two price bands. I think those would be the quick summary of where we continue to take share. With regard to the players in the market, listen, there's lots of legacy players for whom storage is not a focus, innovation is not a focus, ability to attract, talent is not a focus, right? These could include the big-share donor, which has been Dell, but also IBM, Hitachi, HP, there's lots of opportunities to compete.

Samik Chatterjee - *JPMorgan - Moderator*

So maybe moving to the all-flash growth that you've seen, you've been reporting double-digit growth over the last year. Except the last quarter, when we did see some moderation there, and you explained that to be driven by the public cloud vertical. Should we assume that excluding public sector -- sorry, public sector, I meant, public sector, excluding public sector the double-digit momentum in all-flash is unchanged for NetApp and that you can sustain a double-digit rate if public sector spending comes back to a normal space?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

I would just say without giving you all the numbers, if you were to do the math, if public sector had been flat, our flash number would have been significantly higher than where it was. And so without giving you all the specifics, yes, we would have -- we feel very, very confident that we would have been able to have a much higher number in flash.

Samik Chatterjee - *JPMorgan - Moderator*

Okay. I'll take this one question that's come in, which is related to, again, the all-flash market. So the question from the investor is that NAND prices have increased and some of that has helped the suppliers that NAND suppliers itself in the industry, how should we think about how protected NetApp is from spot pricing of NAND? Or will the increase in NAND pricing drive some level of moderation in all-flash market growth?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

Yeah. I think probably three or four things in that area. One is we offer a broad range of products, both flash and disk-based storage. Our view is that for certain classes of workloads, disk makes, hard drives make a lot more sense, secondary storage, archive, even for media streaming, you really don't need all-flash. And so the price of flash has to be very close to the price of disk, which it isn't, right? And so that's the first thing. There are workloads for which disk is much better, right? The second is with regard to the flash pricing itself, vendors typically have passed through the pricing to customers when prices go up. And pass through the benefits when prices go down. As a reminder, only 30% -- roughly 30% of our total costs in a system that a customer buys is really NAND, right? It's -- there's a lot of software and support and other things that go into the system cost. And so the last thing is we work with our NAND suppliers to insulate ourselves at least for a period of time from spot prices. There are long-term agreements we structure, we get multiple vendors to compete for our business. And one of the advantages when you are number one in the flash market is more vendors want to be part of your bandwagon, right, more NAND vendors. So there are lots of ways that we try to manage through that.

Samik Chatterjee - *JPMorgan - Moderator*

Okay. Moving to public cloud and maybe outline for us what is your vision for NetApp's position in the public cloud storage market where you're a leader but you've also sort of tried to be in FinOps before you decided to exit using the spot -- get out -- exit the spot business. I mean, how do you envision NetApp look like in the public cloud in a few years from today and beyond first-party storage, what are the other drivers there that we need to think of?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

I think, that our primary focus is to scale our first-party and marketplace cloud storage services and to build a competitive moat around that, we build that moat in two or three ways. One way is to -- now that our infrastructure is in all the public clouds, our storage infrastructure is there. It is to add value in terms of additional software capabilities that allows us to differentiate our technology. So for example, Autonomous Ransomware Protection, compliance capabilities, multi-cloud, Multi-AZ capabilities. So there's an ongoing set of software capabilities that we bring to that platform. And the second is to integrate that platform into the software applications that the cloud providers have. This makes procurement a lot more easy for customers, right? So customers may not buy storage, they may buy a SageMaker environment or they may buy a Vertex environment for AI. And in this way, we can get consumed when they provision a Vertex or a SageMaker where they may not know what the storage is. And so that part of the journey has started. We needed to instantiate our infrastructure in all of these cloud providers. And now we're working with them to, hey, I can make your application so much better using our storage alongside your stuff. And so you'll see us make announcements of that over the course of the next 12 months, right? And we're super excited about that. And then the third is technology is great. Go-to-market is equally important to build a competitive moat. And we have a lot of engagements with the hyperscaler sales teams. We are starting to work with their professional services teams around cross-client migrations, customer success, client expansion and industry solutions. So there's lots of stuff to do, and we're excited and we continue to do that work.

Samik Chatterjee - *JPMorgan - Moderator*

And maybe this is a good opportunity for me to ask you one of the questions that came in from investors on this front. Just in terms of how to think about how competitive the market is for talent related to cloud services itself. And when we look at some of the newer competition that's coming into the industry, like the VAST and Weka's of the world and their willing intent to try to encroach on your leadership in the cloud services side. What are you finding in terms of your ability to rehire and retain talent relative to cloud services specialization?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

Yeah. I think, that we have a super strong talent pool. I think, that we have continued to evolve our talent pool as the business has evolved. So we had a group of people who started our journey in cloud. They were not the right people to scale our journey in cloud. We have really good talent to do that. I think, that NetApp's culture has been a strong point for us over 30 years, that we allow people to innovate, to experiment without fear of failure. We have people from diverse backgrounds.

We have a lot of talent from the hyperscalers at NetApp because many of them started working on the other side of the fence and then said, hey, I have more opportunity to make impact coming here. You saw the announcements of our Chief Product Officer, who was the person that built the Salesforce Genie platform was the Chief Technology Officer at Zscaler. We had a new CFO who came to us from Western Digital. So we feel good about our ability to get the talent we need for the journey -- the phase of the journey that we're in.

Samik Chatterjee - *JPMorgan - Moderator*

Yes, sounds fair. Before I move to AI questions, AI-specific questions, one more that's come in from an investor. And the question is, can George comment on whether the Big Beautiful Bill and the ability to depreciate CapEx fully in one year for tax purposes will drive any additional customer IT spend?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

We are waiting to see what the impact of the Big Beautiful Bill will be in our customers. I think, there's always three things that drive customer behavior. The first is their view of macro, which drives their overall posture on spending. And so IT is a part of that, right? And so that's the first. The second is, can they get competitive advantage? Or do they fear having the opposite happen to them if they don't make an investment. So I think that AI is the new thing. Cloud was the thing a few years ago, continues to be an important part of the consideration. Cyber is important. And so we are positioned alongside those growth drivers. And then we're waiting to see what all the impacts are as people understand it, what that posture is.

Samik Chatterjee - *JPMorgan - Moderator*

Okay. Great. Okay. So let's maybe move to AI. Maybe starting with what you're seeing from your enterprise customers and more specifically in terms of what their requirements are as they're thinking about their -- how their AI infrastructure will look? What are you hearing from them in terms of what their storage needs might be? What drives your confidence that you have the right portfolio to address that?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

Yeah. I think, broadly speaking, in the AI journey, the first phase of the AI journey, which is still ongoing, was primarily about, I want to get core technology built, right? This was in the AI, in the Generative AI world, really the large-language models. And that work is ongoing. And that's where the bulk of the AI investments have been made. The second phase of the journey was I want to integrate AI into the consumer applications, right? This is, hey, I'm going to make AI smart search like Google, I'm going to integrate that with AI capabilities and maps and so on. And it's similar to how iPhones happened, right? iPhones happened in the consumer market and then came to the enterprise.

What we see going on in the enterprise is really nobody is trying to build a foundation model. That's way too expensive and frankly, no advantage. I think, now what we see is the application of pretrained AI models with companies' data. And there's a variety of things they need to do to make that happen. That whole idea is called inferencing. And there's underlying terms like RAG and this is a Graph RAG and all this stuff. But just think about that as inferencing. In inferencing, having high-quality, well-organized, unified data is super important. If you look at Predictive AI, it really worked on structured data like databases or tables and things like that. Generative AI works on unstructured data, documents, videos, audio. And then Agentic AI works on unified, structured, and unstructured working together so that you could have a complete view of a business problem. We feel really good about our position in the AI market for two reasons. One is we hold a huge amount of the data that customers need to apply to their AI models, right? Because that's generated through their operational applications. So for example, you go to a hospital, we hold all the medical images, and we are the platform for Epic, for example. And so when a customer says, hey, I want to use GenAI or some advanced multimodal application to look at which patient has cancer or which patient has COVID. We are the incumbent. The second, as you will see, we have a whole range of super exciting announcements at our Insight Conference, which will give our clients the ability to extract a lot of knowledge from their data that sits on us. And so I would just tell you, come to Insight, we're going to shock the world.

Samik Chatterjee - *JPMorgan - Moderator*

Okay. Maybe just another one. I mean, we are early in this cycle, but what we've seen till date is related to AI, storage has seen less of an up demand or uplift relative to any particular compared to compute, right, which has seen much more of an uplift. I mean part of that would be that some of your enterprises might be starting their journey on AI in the public cloud. So one, like how do you think about the magnitude of benefit? And the timing of the benefit from AI to NetApp as well? Like do you expect that you're benefiting right now or more early on, the benefit is on the public cloud storage piece of your business related to maybe hybrid cloud and the on-prem infrastructure benefits later? And how do you think about the magnitude on each of them? Like where will enterprises eventually land more in terms of their AI infrastructure focus?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

Yeah. I think, first of all, the predominant build-outs of AI have really been for training, right? I think, if you look at the vast amount of compute, it's really for training foundation models, for improving the ability of foundation models, to do multimodal and a whole range of other things. I think, in aggregate, however, there will be more growth in compute than storage. I don't know whether what the long term, meaning 5 to 10 years out view. But if you look at a five-year out view for a mature business, right, like our FlexPod converged infrastructure business, which is more for enterprise applications, is typically a 50-50 split between compute network and storage, where storage is 50% of the spend, right? But that's in the mature enterprise application space. I don't know what the long tail will look like.

I think with regard to storage for enterprise AI, we want to capture it in both places. We want to capture it in cloud. We want to capture it on-prem. You're correct that some of the data science experiments are happening in public cloud, where the data science team doesn't know the IT team, they want to start on the public cloud. We have seen some of our public cloud solutions being used for AI. We have customers that spoke at our conference last year. There'll be more at our conference this year that talk about that. We also have clients in our enterprise business. We talked about 125 wins this year for Q1 compared to 50 wins last year, where it's split between data lakes, which is really how do you unify your data before you do inferencing. We had some sovereign wins for training or fine-tuning foundation models, and we had inferencing. And it was, I would just say, roughly a third, a third, a third.

Samik Chatterjee - *JPMorgan - Moderator*

Okay. Okay. Got it. One of your competitors, I guess, we can say, Dell has been talking a lot about parallel file systems, and they've talked about it in the context of Project Lightning that they're working on. Can you just make -- I just want to make sure we understand sort of where NetApp stands on that front? Why are parallel file systems important? And what is NetApp's offering on that front?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

Yeah. I think that the idea that AI has is to speed up access to data so that you can feed it to the GPUs, you parallelize access to the data. And where you -- in the disk drive, hard drive world, you had a construct called a parallel file system that essentially had a series of independent storage nodes connected into each of them paired to a compute node and this file system striped across all of them. It is a very complex technology. You have a lot of work to be done to load balance it, fail over when the system gets into trouble and you have to troubleshoot, it is supremely complex. And as a result, parallel file systems have stayed a very small part of the total market. It's typically been in the high -- sort of the legacy high-performance computing world, the labs in higher education, a few supercomputing environments.

As flash has grown, what you can see is a much more advantageous next-gen architecture is what's called disaggregated storage, where you have the same idea of multiple compute nodes that can access in parallel storage and the storage is connected across a really high-performance network fabric to those compute nodes. And so what it does is it gives you very, very close to the performance of your -- of a parallel file system, but vastly simpler and vastly more efficient. And so I would just tell you, come to Insight. We'll talk about our approach to providing very high-scale distributed systems to clients.

Samik Chatterjee - *JPMorgan - Moderator*

Yes. Got it. And yeah, I think definitely looking forward to Insights and the announcements there. Maybe just delving a bit deeper into what the inferencing infrastructure for some of these enterprise companies look like. I mean there's always the concern that as they ramp, as enterprise companies ramp their infrastructure when they start planning around the inferencing workloads, they typically do budget in dollars and that starts to cannibalize some of the traditional storage spend. So one, maybe if you can share any other thoughts. You talked about the data lake -- is the stage there. Most enterprises are in terms of working on data lakes. But sort of where do you see the real sort of inflection in terms of storage needs coming from? And then secondarily, as we see that inflection, do you see a pullback in some of the traditional storage use cases just because of the priority towards AI?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

Yeah. I think the trade-offs that clients make are always driven by their business priorities. I think that in general, what our approach has been is, hey, it doesn't need to be an either/or. You -- just like in cloud, people had on-premises and cloud, and they used to have two different silos, and we unified them into one architecture so that you could leverage the investments around people and technology and make your operating environment more efficient, meaning less spend and more agile, meaning more flexibility, right? We are doing the same thing for AI, where we are saying, hey, to use AI with your -- the data that is continuing to grow in your operational environment, we will help you bridge that and make it much, much more efficient. So that's our pitch to clients. Hey, you don't need to have two different spends. You can take one and make it much more efficient. Data growth comes from two or three areas.

One is if a customer has truly distributed data and organizations that are just not able to work together, they usually create a data science or data analytics and AI team. And those people bring data together. It's a copy of the data, but they bring it to what's called a data lake. And a data lake essentially is the idea that you can bring multiple types of data into a single environment. You can do it with NetApp storage without having to build a data lake. You can just do it on the storage itself by marking which data you need. But if your data is not organized, you want to create a second copy. So that's one. Second is, at the time of inferencing, you have to take your core documents or videos or audio and you have to create what's called a vector and a graph, which is basically a way that a large language model can understand that data. And in some cases, this -- you're not going to do that for all of your data. You're going to do that for a subset. So let's say it's 20% of your data.

That -- when you vectorize the data, the volume is typically -- our best estimate of doing it most efficiently is five times growth. So that 20%, you will grow it. And you may not keep it forever, but you will keep it for as long as you're running the inferencing. And then the last phase, which is still early is, hey, when people generate data, how much data will they generate? It's too early for me to speculate. In general, if you look at human behavior in the past, if there's a free resource, they tend to fill it up. And so marketing will create 20 copies of slideware that they need, right, just so that they can compare it and present it. So, yeah.

Samik Chatterjee - *JPMorgan - Moderator*

Okay. Maybe the last question on the business side, just in terms of revenue drivers. Can you talk about the advantage in AI of already having a large installed base? Because I think on the unstructured data side, you and Dell have a large installed base already, but you're trying to do both, which is, one, sort of your installed base is an advantage, but you're also trying to win share by displacing some of the -- by winning with customers that are part of the Dell's installed base. So how much of an advantage is it having a large installed base? And how sticky are customers on that front? Are customers in AI trying to use their primary storage supplier across their AI use cases? Or do you see opportunities to displace some of your competition on that front?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

I think, the displacing competition is really around their operating environment, right, meaning the applications that are driving the creation of the data. And I think there, we have several advantages to go after Dell or anybody else, right? And so that's the primary displacement mechanism. In terms of the AI side, it's new wallet that we or Dell might compete in our installed base, right, or their installed base. I think there -- it's so much easier for a customer to be able to bring AI capabilities, meaning all the software capabilities we're working on to their existing data estate rather than lift and shift and copy it over. I would say that when you have a database or what's called structured data, it's easier to do that because it's much smaller volumes. A giant database is probably 10 terabytes. If you go and look at a giant file, it could be multiple times that. So the volume of data you have to move around is much, much larger in unstructured data. And therefore, it's much easier if you can do it like we are going to show to bring AI to your data rather than copy your data to your AI.

Samik Chatterjee - *JPMorgan - Moderator*

Got it. Okay. Maybe now moving to -- actually, before I do that, let me take this investor question. The question is pretty short, but I'll let you sort of talk about the partnership here. The question reads, does NetApp work with Nutanix? But -- so maybe just outline the partnership you have there? How material do you think it will be?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

We have common customers with Nutanix. And I would just say stay tuned for upcoming announcements. Nothing to say at this point. But our approach is to work with all the hypervisor vendors north of us, right? So we already work with Proxmox, VMware, Hyper-V, Red Hat, OpenShift. There's a long list. And so our approach is to work with everybody. And so if we don't have something today, stay tuned.

Samik Chatterjee - *JPMorgan - Moderator*

Okay. Okay. Moving to margins. So I was looking back at the last decade and so gross margins have gone from, I think, 61% to 71%, largely over this time period that you've been CEO. But maybe talk about as you look forward, what do you think are the long-term margins that the company should be hitting maybe both on the gross margin side and more specifically in the operating margin as well, where you consistently continue to make progress pretty rapidly on that front.

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

I think the broad shifts -- maybe I can just go through the elements of gross margin. I think our cloud business, which is growing significantly faster than our on-premises business, it's 10%, but it's growing at 33% CAGR in Q1, right? So it's a fast-growing number, operates at -- it grew at 33% year-on-year in Q1. It is the first party, right? The cloud business overall reached north of 80% margin. And we said that our target range would be 80% to 85. So the mix of that business continues to push upward in terms of software. The depreciation that -- of the hardware that we put into Microsoft data centers continues to come off the P&L. And so we feel good about the trajectory of that business to get to the top end of the target range. I think, the most important thing for us to do there is to grow it, right? The second element, professional services, it's a small number, but the growth in professional services is through Keystone.

Keystone clients go through a trajectory that starts with lower margins, but as they go through their tenure, that goes up and to the right. And so you should see that business as Keystone grows as a percentage of the professional services business, the margin should move up over time. Support is a big number. It's growing in the low single digits. Its margins are north of 90%, 92.3%, I think, was the latest number, and it should continue to stay there. In terms of the product gross margins in the hybrid cloud business, our target range was mid- to upper 50s%. And our view of that is that it continues to shift towards flash, which is a higher margin than this. And we are continuing to add more software value into that portfolio. So that's kind of the puts and takes on gross margin.

Operating expense is a piece of the equation that we manage in a disciplined fashion. We have typically managed it to grow at half the rate of revenue growth. And so I think that gives you the puts and takes on gross margin and operating margin. What we operate the business as at is to really drive gross profit dollars because we have, as you can see, been super disciplined on OpEx. And so if you can drive gross profit dollars, the incremental dollars convert to income and cash flow at a very high clip.

Samik Chatterjee - *JPMorgan - Moderator*

Okay. Last one from my side. Just M&A and rank order, maybe give us the rank order in terms of where M&A sits in your priorities? And when I particularly look at the number of new companies trying to enter the market here, how do you think about the likelihood that there's a wave of consolidation in the near future to return this industry to where its usual sort of three or four large participants?

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

Yes. I think overall, we have a -- when we look at capital allocation, we said we -- dividends are the first call on capital returns. We typically run that about 40% of the total number. And then we split 30% of the total cash generation. And then the remainder, we split between returns to shareholders through buybacks or targeted M&A. Over the last few years, we have not done M&A. We've really focused on returning all of free cash flow to shareholders. Sometimes we have done more than 100%, sometimes it's around 100%. But generally, we've returned all of free cash flow to shareholders. I think that when we look at the market, the on-premises storage market, I think that it's a mature market with a lower growth rate and customers wanting to consolidate how many vendors because they just want simplification, they need to unify their data. And so that customer behavior generally tends to market consolidation over time.

Samik Chatterjee - *JPMorgan - Moderator*

Okay. Okay. All right. Great. I'll wrap it up there. This is great to get your insights in terms of the industry as well as NetApp. So thank you for the time. Kris, thank you as well, and thank you to the audience for tuning in as well. Harry, you should be okay to wrap up the call here. Thank you, George.

George Kurian - *NetApp Inc - Chief Executive Officer, Director*

Thank you, Samik. Thank you for having me.

Samik Chatterjee - *JPMorgan - Moderator*

No. Thank you.

Unidentified Participant

Thank you, everyone. This concludes today's webinar, and you may now disconnect from the call.
