REFINITIV STREETEVENTS

EDITED TRANSCRIPT

NTAP.OQ - NetApp Inc at Citi TMT Conference

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OVERVIEW:

Company Summary

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CORPORATE PARTICIPANTS

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

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

CONFERENCE CALL PARTICIPANTS

Asiya Merchant *Citi Infrastructure Investments LLC - Analyst*

PRESENTATION

Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

Hardware, tech supply chain. Welcome to Day 1 of Citi's conference. Really happy to have NetApp's CEO here. We also have Kris Newton from the Head of IR for NetApp.

And before we kick it off with some questions here, Kris has some prepared commentary.

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

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 any information in any forward-looking statement for any reason.

Back to you, Asiya.

Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

All right. Thank you, Kris. George, welcome again.

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

Thank you.

QUESTIONS AND ANSWERS

Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

I know you've been doing this for a while. So we've been asking all our customers -- all our corporates here that are presenting. You guys just reported results. When you think about how the storage markets evolved relative to, let's say, the start of the year, there were lots of demand indicators, there were puts and takes to the macro, tariffs, DeepSeek, all that stuff. As you sit here today and you kind of reflect back on how things are different relative to a few months ago when you thought about the demand outlook, help us understand how you think about demand.

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

Yes. I think, first of all, thank you for having me. With regard to change in the overall demand environment through the course of the year, not a whole lot of change. I think there are some macro drivers that are driving caution in overall enterprise IT spending. Those are geopolitical uncertainty, the continuing wars in the Middle East and in Ukraine.

a bit more clarity, but still a lot of uncertainty around tariffs and then the posture of various central banks on interest rates.

We are sharply focused on the parts of spending that are constructive. I think even in the last quarter, our enterprise business, meaning nonpublic sector business performed nicely. Those spending priorities in the enterprise are, in some ways, broadly correlated to getting ready for enterprise AI. It's unifying your data, accelerating cloud transformation, cyber resilience and modernization of your infrastructure using higher performance systems. And I think that we have taken share in all of those parts of the landscape.

Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

And then as you think looking ahead, and I know you guys put out fiscal year targets, which you reaffirmed at your last earnings just a week ago. So maybe help investors think about what are the puts and takes to that end demand?

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

I think the end demand for the full year does not assume a radical change in the economic environment overall. I think if the demand environment, the macro signals to the demand environment get more constructive, it should be an upside to the current outlook. We also think that enterprise AI is still in the early innings of a nine-inning ball game. And so if the AI opportunity in the enterprise inflects substantially, then it should be an upside. I think overall, our view is we continue to be cautious about US public sector.

I think that the second quarter of the year is historically our largest quarter for US public sector contribution. In the second half of the year, the percentage of our overall business that's US public sector should be less. And then on the other trends, we are number one in the flash market. We've taken share for several quarters. We expect to continue that pace. And our cloud business has performed strongly, where our cloud storage business grew 33% year-on-year. So those are the demand patterns that we see.

Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

Okay. And then maybe first, let's stick to the Hybrid Cloud and then you can talk on the Public Cloud. But on the Hybrid Cloud, while the macro hasn't been changed, you're continuing to see strong momentum on flash, which tends to be the pricier storage, right, relative to HDD-based storage, but there are obviously secular trends there. What -- given the macro is kind of mixed, what confidence that this is still an area that will continue to grow despite all the macro headwinds that exist out there with geopolitical uncertainty and federal pressure, et cetera?

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

We are accelerating share gains in the market. We are now number one in market share. And I think broadly speaking, the storage and data infrastructure specialists are taking share from the big integrated system vendors like Dell and HPE. There should be no change in that trajectory over the course of the year. I think the second is, as customers are beginning to think about how do I use AI in my enterprise, they need to get their data ready.

It's pretty common. I was with some of the large financial institutions here yesterday and their CIOs were telling me that the biggest challenge and opportunity they have is to organize their data to unify it so that they can use different models. And I think to get an AI-ready data infrastructure, you need to deploy flash-based systems, and we can unify that data not only on our flash systems but across the cloud. And I think those are the key things for why we feel strongly about our Hybrid Cloud position. The market is really coming to us on what we said from the beginning.

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Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

Okay. And then if you can -- if you just double-click on that a little bit, like what are these workloads that you're seeing pulling the incremental, whether its data modernized -- data storage modernization or additional storage services that are needed for AI to have AI inferencing or training? Like what workloads are customers sharing with you or you're involved in these conversations and the sustainability of that demand as we start to see maybe perhaps broader enterprise AI adoption?

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

Yes. When we looked at enterprise AI, we had always said that enterprise AI was in proof of concept still in 2025 that in the back half of 2025, we would see the early adopters go from proof of concepts to real implementations. And then 2026 would be where a broader number of those clients would move there. We have seen strength across public sector, manufacturing, financial services and healthcare. And many of those are related to productivity gains.

We're yet to see real scale implementations that drive revenue growth. As examples, in automotive design, it's really about how do I build digital twins, how do I create an immersive digital experience in the car? How do I -- we talked about how do you build an autonomous driving system. Those are the things in manufacturing. In financial services, we have several examples of people unifying large number of documents so that they can understand better mortgage underwriting policies.

In healthcare, for example, it's, hey, how do I do claims processing more quickly and better. There's software development across a broad range of industries and so on. What they need from an infrastructure standpoint is they need to get all of this data well organized, ensure that it's high quality, have the right guardrails on the data. Some of them create a second copy of the data and what's called a data lake via the underlying storage for a lot of the data lakes. And in other cases, they just -- they don't need a data lake, they'll just unify it on our storage system and apply the large language models to that.

Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

Okay. On the flip side, when you listen to some of the other vendors that are out there, not necessarily storage, but compute, it tends -- AI tends to be very lumpy. There are some quarters where you see this big expansion of growth and then there's always some kind of transition happening, and then growth sort of heaters down a little bit or it's just very lumpy. So help me understand like when you talk to your customers, what kind of visibility do you have? And is it as lumpy for you guys?

Or perhaps you have better visibility, perhaps it's more smoother? How are you guys thinking about it?

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

It's a much smoother curve for us. First of all, our predominant focus is enterprise AI. So we have a much broader customer base that we work with. We have a lot of experience working on enterprise AI with predictive AI for many, many years before generative AI. So we kind of understand the cycle of procurement for those kind of opportunities.

So I think the combination of, hey, much larger, broader customer base plus a more steady deployment pattern. You can see that, hey, they got to organize their data, they then have to apply cybersecurity and governance rules, then they want to generate vectorized copies of that data. So it's a more kind of predictable pattern. in the storage and enterprise AI market.

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Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

And then there's this view that AI storage or storage has not been a big beneficiary. I mean, of course, we can see the CapEx numbers from hyperscalers you can put in the enterprise neo cloud providers or enterprises like Tesla and xAI, Oracle perhaps in there as well. And then -- but when you look at storage as a percentage of server compute, it's kind of like not grown as rapidly, whether I look at industry forecast, whether I look at your fiscal year forecast as well. Help us understand like do you see something that could suddenly accelerate the trajectory of growth from AI?

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

Yes. I think the commentary you made was accurate. I think so far, most of the work in AI has been around training the foundational models and getting them to be more capable, less hallucinations, able to understand broader types of data, multimodal use cases. In training, the storage landscape is actually fairly small. It's basically used as a temporal, what they call a checkpoint, meaning if the large language model fails, it can come back to an interim stage rather than go back to the start.

And it's a pretty small amount of storage. It's almost an alternative to memory, right? For example, ChatGPT didn't create a second copy of the entire Internet's data, right. I think as you go from training to inferencing and using enterprise data, there's more storage growth. In fact, we're not the only ones who said it, but our view of the market is 80% to 90% of the storage is actually in the inferencing part of the use case than in the training part.

So most of the storage growth is going to come. I think the second thing there is the real value for people like NetApp is we have this giant installed base of data. And as clients want to use that data for AI, we have the opportunity to monetize it with a lot of software capabilities, guardrails, indexing, search, data lineage, a whole range of data services, which we will talk about and share at our upcoming customer conference.

Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

Okay. And then you talked very positively about the flash performance and you've grown your share in the flash performance. And then -- so just if you can remind investors, what's driven that? How sustainable are those market share gains? And could we see further growth in those market share gains relative to other players who are maybe catching up now with some of their offerings?

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

Yes. I think we have built out a complete flash portfolio that combines high-performance systems and capacity flash systems on a price performance basis. And then we've also built what was called a unified systems portfolio, which we've always had, complemented that with a block storage specialized portfolio that these two address parts of the market that we could not address before and have driven strong share gains for us. I think that if you look at IDC market data, we have grown share and are the only one in the top five players in the market who have grown share for multiple for the last two or three years. I think when I look out at the competitive landscape, our opportunity to take advantage of some of the disruptions in the market for example, VMware and Broadcom disrupting the hyper-converged systems market allows us to gain share at the expense of our -- some of our competitors as well as the growth of enterprise AI, us and Dell are the large share players in unstructured data, and it's sort of our game to lose.

Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

Okay. And then remind investors again about -- when I sat at your Investor Day, you had talked a little bit more positively about your block offerings, right, which previously you haven't participated in. Why is that it's a new -- why hasn't NetApp been there before, but the opportunity is pretty sizable as you go after it. And that's been sort of the growth story underpinning some of your growth. So if you can help level set, where are you in terms of that block offering?

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How much more potential there is to continue to grow in that market?

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

Yes. We have had north of 20,000 customers who use our block storage offerings as part of a unified storage configuration, which means that you can consolidate file, block and object data on a single infrastructure. That was particularly helpful in the large enterprise where clients wanted to have a single unified platform to manage all their data. It wasn't as helpful in either smaller environments of that large enterprise and in a large number of the commercial market, which is midsized enterprise. And so we decided to build a tailored offering for that part of the market, and we're seeing good results.

It's early, but we are seeing good results there.

Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

Okay. Let me just ask the investment community here. If they have any questions. If you do, please raise your hand. We have one here, so we can get the mic to you.

Unidentified Participant

Okay. Just want to ask a little bit about the margins, gross margin progression. Maybe you could talk a little bit about product gross margin. What's going on there? Why are you confident that comes back in the back half?

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

Yes. I just want to start by saying we operate the business to drive gross profit expansion less on the margin rate because if you look at our business over a long period of time, we have been able to convert incremental gross profit dollars to earnings at a very high conversion rate, given our discipline in terms of operating performance of the operating expense. I think if you look at the four components of gross margin, company gross margin, let me start with cloud. Cloud has gone from the mid-60s gross margin rate to now we just raised our overall outlook to be in the target range of 80% to 85%. It's driven by an improving mix of software revenue growth and depreciation of some of our initial investments, particularly in the Microsoft cloud to come off our P&L.

We have every confidence that the cloud should continue to grow at a faster clip than our Hybrid Cloud business and at a higher margin rate should be able to contribute more gross profit dollars as a share of the business moving forward. In terms of professional services, that margin rate should also keep going up as our Storage as-a-Service offering, Keystone, which is a much higher contribution margin business than classic professional services grows as a percentage of the mix. Keystone grew 80% year-on-year this past quarter, and we should expect that to continue to grow as a percentage of our professional services business and overall company. Support is a big business. It's low single-digit growth, but it has very high profit margins, north of 90%, 92%.

It's just stable. No big puts and takes on that. And then on product gross margins, we said that we expect the product gross margins to trend back up in the second half of the year to our target range of mid- to upper-50s. The big puts and takes are continued shift in the overall mix to flash. It's about 2/3 of the Hybrid Cloud segment revenue, a bit higher than that in terms of the product revenue.

So that mix should shift up. The second is costs should get more beneficial to us on a year-on-year compare and even on the sequential compare. We have good line of sight into our cost structure for NAND in the second half of the year, and we should expect that to get better than it was at the start of this year.

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Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

Okay. Just on that one, George, I do hear about like NAND pricing. I mean, certainly, in our own internal city models. We talk a little bit about NAND pricing inching up. I think if you listen to NAND vendors, they do talk about as well supply-demand efficiency and better outlook after 1Q, which was pretty down.

So just help us understand how that flows through and if -- how we should correlate like product gross margins? Or is there a correlation between product gross margins and just potentially higher -- slightly higher price NAND sequentially in the back half of this year?

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

Two comments on that. First is the predominant part of our value to clients is software. NAND is about 1/3 of our total cost of goods. And so we have a large amount of software that builds on that. We have the flexibility to pass through higher prices if they go up much higher than what we have modeled, and we do so periodically.

That's been the history of the industry. And conversely, if it goes down, we pass that on to clients. Customers, importantly, budget in dollars. And so the fluctuations in prices don't really translate into more spending. It's just that they get to buy more capacity for the same dollars or less so.

And then the third thing is we have long-term agreements with suppliers that in return for predictable demand gives us assurance on the cost structures that we have.

Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

Okay. When you think about cloud, it's the Public Cloud portion of your business. It's obviously smaller than the Hybrid Cloud. It's growing at very strong rates. And I know there were some divestitures there.

Just if you can remind investors how you're thinking about the Public Cloud portion of your business? What steps are you taking to make sure growth sustains here at these levels, excluding the divestiture? And then, of course, the margins on that are very, very accretive to the rest of the business. So what's -- how sustainable are those factors that would drive both top line growth and improved margin expansion?

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

Okay. There were sort of three things that I would share with you. The first transition in our cloud business was really a move from a subscription-heavy business to a consumption-heavy business. This was similar to the hyperscalers' own models. And because we work with them when they change their model from subscription to consumption, we naturally have to follow.

As part of that transition, we are pretty much through it, right? Consumption is the de facto motion in our business. Subscription is a very small part of the business, and we end of life some of the subscription offerings. The second is we had believed that there would be synergies between some of the operational capabilities and FinOps together with storage. And the market did not develop in that direction after a few years.

So we decided last year to divest our spot portfolio. And that is part of the reason why on an as-reported basis, cloud grew 1%. But if you compare it on an apples-to-apples basis, the underlying cloud business grew at about 18% in the first quarter. The core focus of our cloud business is really what we call our first-party end marketplace cloud storage services. These are our flagship operating system embedded as a native offering, meaning developed with, sold by and supported by each of the big three hyperscalers.

And that has grown north of 40% this last year and is growing north of 33% this first calendar quarter. We have a broad range of advantages over other offerings in the cloud. And we are bringing more technology as well as expanding our go-to-market. Listen, I think broadly speaking, in cloud, we have an unhindered runway.

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Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

And just the pace of enterprise AI adoption impact Hybrid Cloud growth rates versus Public Cloud? Or is it kind of agnostic? Or just help us understand where do you see more of the AI workloads between these two segments that you have?

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

AI workloads start in the Public Cloud usually because the data science teams can spin up a workload in Amazon or Google or any of these cloud providers. We are capturing some of that with our cloud portfolio. As you scale it and depending on the industry, a lot of the data sits in the enterprise and data gravity is very, very strong, right? It's -- if you thought that the models that you apply to structured data, meaning databases or data warehouses where you copy a small amount of data every night in a batch model to a central data lake, that model just does not work for unstructured data. The volume is much, much higher the ability to copy it is just insanely low.

And so you really need to bring your AI capabilities to the data, and we'll talk more about that, a bunch of innovations that we are bringing to market that enables organizations to do that.

Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

Okay. And then sort of as you sit back, so AI can obviously be a demand driver for you guys, especially as you start to do more inferencing like you talked about, both on the Public Cloud where it maybe initiates initially and then moves on-prem. As you sit back and you think about margin expansion or profit dollar expansion as well, help us understand like could there be a scenario where you start to see margins expanding both in public and hybrid as a function of more AI inferencing? And when do you -- what's the line of sight to that?

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

I think in public, we already have a very strong margin profile. In the Hybrid Cloud world and in the Public Cloud world, I think the big driver of further margin expansion is all of the software value we bring to clients as they deploy inferencing, software value around advanced cybersecurity mechanisms on cataloging, searching and organizing your data, implementing guardrails for privacy and governance, being able to generate vectorized representations of your data on the fly without copies. That software is not just for the new data that customers are creating or the new environments that they are creating, but it can be monetized over our entire estate of data in our customers. And so that's probably the most significant multiyear opportunity for NetApp.

Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

And then how does that translate into -- does that also come with more OpEx investments? Or does it translate into better operating leverage?

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

I think we continue to remain disciplined on operating expense. I think you can see that in our track record over many years. I think that we will continue to remain disciplined about that. If there are opportunities that we can accelerate one or two things, you can see us do that both by reallocating resources, but also it might be a temporary investment. But I think in the sort of over a three-year period, you should expect us to grow OpEx less than we grow revenue.

Typically, we've grown it at half the rate of revenue, and that's productivity discipline we've installed in the company.

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Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

Right. We're asking all our companies if they internally use AI to drive some of those OpEx leverage or OpEx efficiencies that you're talking about?

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

Yes, absolutely. I mean, NetApp is a big software company. Our intellectual property is really software. We use AI to accelerate software development, have seen really strong productivity improvements there. And it allows us to deliver more payload faster.

I think the second place where we are seeing good uptick is really in our customer support business, where we can provide more advisory value to clients, but with the margin profile of our traditional support business because we continue to optimize parts of our ongoing offerings and digitize those. And then back office. So lots of different elements of back office.

Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

Okay. The competitive environment, if you can just talk a little bit about it. At one point, there's obviously pricing that has to pass through, whether its tariff related. I'm not sure that really affects NetApp as much. But just any kind of pricing pressures that you see, whether it's the underlying commodity costs that have to be passed through?

And how do you see the competitive environment? Is there pass-throughs that is affecting kind of the way you're looking at pricing in the back half and the customers' reception to those higher prices?

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

Yes. I think we are a mature industry. It's always been competitive, but the players are rational. On any given transaction, someone might be more aggressive than somebody else. But in general, it's pretty rational.

We have a sticky software platform. And so for someone to displace us is not easy, right? And on the other hand, we are trying to displace other people. So we have puts and takes in terms of our transaction volume. In terms of tariffs, as we said, and as you mentioned, Asiya, it's not a big contributor to our cost structure this year.

We said that it would be between 40 and 60 basis points as part of our guidance. And as a result, we have not raised prices. We're waiting to see whether there's a more material change in posture of the administration, and then we will take a look at what that means. And then broadly speaking, in general, as commodity cost prices change in the market, the vendors typically pass that on to customers. And as they go down, they also pass on the benefits.

So customers are quite well trained at saying, hey, this is a good time, and that's a more difficult time. And they optimize their spending.

Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

Okay. And then Dell, just in terms of what's going on in the market from a -- we have had peers like Dell talk a little bit more about Project Lightning, which are a little bit more software-defined and architectures that are also going around. So just high level, how you guys are thinking about the competitive landscape? What do you see as some of your peers coming out with? And how is NetApp positioned with that?

And within that, if you can also address something that I hear from investors about HCI, hyperconverged infrastructure, what's going on there? And how is NetApp positioned as people are -- as enterprises are looking for alternatives to VMware?

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

Yes. I think, first of all, with regard to sort of the data center evolution for AI, how the network fabric changes, how does the storage fabric change. We have some really important announcements at our customer conference where we have some state-of-the-art next-gen technologies being made available, we will be well ahead of Project Lightning or thunder or whatever. Grand announcements are to come. And so we have made that technology, we'll be ready with it, right?

I think with regard to the hyperconverged solution, listen, I think that the price of VMware being raised dramatically or them not wanting to support a class of customers like the smaller customers has caused people to revisit alternatives. We see three alternatives that customers talk to us about and that we're well positioned for. One is, hey, I want to keep VMware for compute, especially for production environments, but I want to optimize my spend. And one of the easy ones is to move storage from running on vSAN as part of a hyperconverged to using external storage. And we've already seen clients starting to do that.

It allows them to stay on VMware for a period of time while they optimize their spend and look at alternatives. The second is customers replatforming and they replatform in a bunch of different directions, right? They could replatform to Kubernetes. We are seeing a bunch of customers do that. We are seeing clients go to alternate hypervisors like Nutanix or Hyper-V or Proxmox or HPE VM Essentials.

There's just a lot of them out there. And our goal is to -- we already interoperate with a whole range of them. We will interoperate with pretty much all of them based on customer demand. And the third one is for clients who are -- especially the smaller ones who cannot negotiate directly with VMware or realize that their ability to get well-structured, consistent pricing, we are seeing them move to the hyperscalers who can guarantee pricing or some of the large service providers. We are the platform for VMware on AWS, on Azure, on Google as well as a range of other service providers.

Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

Okay. So last year -- we have a few seconds here, George, like when I talk to investors, like what do you think is underappreciated about the opportunity to invest in NetApp shares?

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

Broadly speaking, we have been working for many years to get the enterprises ready with their data for the age of AI. We talked about unifying data across data types. We talked about unifying data across the clouds, and we are incredibly well positioned now together with our large installed base to enable clients to get real value from their data. We are also, as part of that, we have the most secure storage and data -- cyber resilience of data in the planet. We are number one with modern data infrastructure with flash, and we have a growing unhindered opportunity in Public Cloud.

And I think as you look at our customer conference upcoming, we will introduce a lot of additional software capabilities that we can monetize in a broad footprint.

Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

Great. Thank you, George. I appreciate it.

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

Thank you for having us.

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Asiya Merchant - *Citi Infrastructure Investments LLC - Analyst*

Best of luck for the rest your meetings here.

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

Thank you. Thank you for having us.

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