Corrected Transcript

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Pure Storage, Inc. (PSTG)

Q3 2016 Earnings Call

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Tim Riitters
Chief Financial Officer

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to Pure Storage Fiscal Third Quarter 2016 Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note this event is being recorded.

I would now like to turn the conference over to [ph] Liz Lemon (00:28), Investor Relations. Please go ahead.

Unverified Participant

Good afternoon. Welcome to Pure Storage's first earnings call. Joining me today to discuss our third quarter fiscal 2016 results, our CEO, Scott Dietzen, and CFO, Tim Riitters. Before we begin, I would like to remind you that during the course of this call, management will make forward-looking statements, which are subject to various risks and uncertainties. These include statements regarding industry and technology trends, our positioning and opportunity, and our products, business and operations, including our revenue and margin guidance, operating model and growth prospects. Our actual results may differ materially from the results predicted and reported results should not be considered as an indication of future performance. A discussion of risks and uncertainties related to our business is contained in our filings with the Securities and Exchange Commission and we refer you to these filings.

Also, I'd like to remind you that during the course of this call, we may discuss some non-GAAP measures in talking about the company's performance. Reconciliations to the most directly comparable GAAP measures on a historical basis are provided in the tables and our earnings release. This conference call is being broadcast on the web and is being recorded for playback purposes. An archive of the webcast will be made available on Pure Storage's investor relations website for approximately 45 days and is the property of Pure Storage.

With that, I'll turn the call over to our CEO, Scott Dietzen.

Scott Dietzen
Chief Executive Officer & Director

Good day. I'd like to welcome everyone, particularly our new investors to Pure's quarterly earnings call. Since this is our first quarter as a public company, I'd like to take a few minutes to discuss our vision, and in particular, why Pure is different than other storage companies. I will then provide highlights from our third quarter before turning it over to our CFO, Tim Riitters, to provide more detail on our financials.

The storage industry is undergoing an unprecedented disruption due to the impact of cloud and flash memory. We saw this coming six years ago when we founded the company, and today, we are seeing the reward of our foresight and execution. We have the right market, the $24 billion spent on Tier 1 storage hardware and software, the right disruptions in flash and the cloud, and the right solution at the right time. Pure is the first successful new entrant in Tier 1 storage in over a decade, and we are growing faster than any other systems company in history that we are aware of.

Pure delivers a storage platform that transforms our customers' businesses and their IT environments, doing so via dramatic increase in performance with flash and the dramatic reduction in complexity and cost through our cloud-centric model. In our view, none of our competitors have properly embraced flash and cloud. This is why we are thriving while others in the storage space are stumbling.

So, when investor see disappointing results in storage, it's not necessarily a reflection of the health of the storage market, but rather our success in disrupting it. Pure Storage's platform is uniquely differentiated across four dimensions; software, hardware, cloud support and automation in our Evergreen business model. Evidence of that disruption can be seen in, first, our very competitive product margins, second, our certified Net Promoter Score of 79, that makes us the number one recommended technology vendor and compares to an average of 16 across all of B2B tech. Third, our very strong repeat purchase behavior on our install base, which I will update shortly. And last but not least, our best-in-class growth, not just compared to our storage predecessors, but compared to networking and security growth bellwethers like Cisco and Palo Alto Networks at a similar stage.

Customers have found our products to be substantially lower cost than performance disk, making the migration to all-flash a no-brainer. Customers have also found our platform is far more efficient versus our leading all-flash competitor. For larger configurations, we estimate that their COGS are higher than our street price, because of Pure's greater than two times better data reduction and our FlashArray//m series requiring order 6 times less CPU DRAM and interconnects.

We have helped one of our customers save more than $8 million in server consolidation on a $500,000 storage purchase. Another Pure customer saved tens of millions of dollars in inventory reduction, as a result of a 10 times acceleration in their ERP analytics that we delivered, and that was on about a $1 million storage purchase. That's just two illustrations of storage that pays for itself in terms of business value creation and cost reduction. And we are selling this highly differentiated storage platform into a $24 billion total addressable market, from traditional enterprises to the most modern cloud companies, including six of IDC's top 20 SaaS companies. Much more of this can be found on the Pure Storage website in my two most recent blog entries.

Our continued execution against this vision and market opportunity is also evident in the excellent results we posted for our third quarter. We delivered revenues of $131 million, up 167% from the year-ago quarter.

We achieved record non-GAAP total gross margin of 61.7%. Non-GAAP product gross margin of 63.1% was also up. One of the catalysts for the improved product margin was the reduced COGS of our new FlashArray//m series hardware platform, which GA-ed in the third quarter.

We posted a record non-GAAP operating margin of minus 21%, a 46 point improvement year-over-year. Indeed, over the first three quarters of this year, our revenue grew more than 1.7 times faster than our operating expenses. That is for each additional $1 of OpEx, we added more than $1.70 in revenues. As we continue to invest aggressively in sales, marketing, support and our channel to maximize growth, we will also continue to improve our operating efficiency.

We see excellent traction across a broad set of verticals, including financial services, technology, healthcare and government, just to name a few. We added over 250 new customers in the quarter to more than 1,350 total. In three short years, we have engaged 12% of the Fortune 500, up from just 6% only a year ago. And despite some customers having purchased eight figures of storage from Pure, we continue to experience broad customer diversification, with no end-customer representing over 5% of sales.

Finally, we continue to see a very strong repeat trends in our existing customer base with our top 25 customers spending an additional $9 over 18 months for every initial $1 they purchased. As you would expect with a highly differentiated product, our repeat purchase cycles tend to be well less competitive than our initial engagements.

In wrapping up my remarks, Pure Storage is in a very strong position. While the competition no doubt remains fierce, we believe it will be impossible for our big storage competitors to successfully retrofit their 15 year old to 25 year old designs for all-flash and the cloud. To date, the market has been unfolding as we expected it would, and we are profoundly excited about the road ahead for Pure Storage.

Before I turn the call over to Tim to walk through the financials, I would like to thank our customers, our partners and our investors for their loyalty. And to thank our outstandingly talented Puritans all around the world for their hard work and dedication to bring Pure Storage so far so fast.

Tim?

Tim Riitters

Chief Financial Officer

Thanks, Scott. We are very pleased with our Q3 execution, as we continue to capitalize on an outstanding opportunity. Please note that the gross margin, operating margin, OpEx, EPS and free cash flow numbers I will use are non-GAAP, unless otherwise noted. A reconciliation of these non-GAAP metrics to the GAAP comparables are available in our press release and in our earnings slide deck.

As Scott said, in Q3, total revenue grew to a record $131.4 million, an increase of 167% year-on-year. Product revenue grew a 160% year-on-year to a $113.6 million in the quarter, driven by excellent demand from both existing and new customers as our platform continues to transform the data center.

We also saw some pent-up demand for the FlashArray//m series, which we launched in June and began shipping in August, which we estimate contributed approximately $7 million in the revenues in this quarter. Importantly, even without the impact of this pent-up demand in Q3, we have exceeded revenue expectations by approximately 15%.

Support revenue grew 227% year-on-year to $17.8 million in the quarter. Support revenue accounted for 14% of total revenue in Q3, versus 11% in the same period a year ago. From a geographic perspective, in Q3, 80% of our revenue came from the U.S. and 20% from our international markets. This is the same 80-20 split that we recorded in the year-ago period. International revenue is growing well and we will continue to invest in our international operations, as we pursue market share. Q3 total gross margin of 61.7% improved three points versus the year-ago period.

Product gross margin of 63.1% improved one point year-on-year and two points sequentially, driven by mix shift to the new, higher gross margin FlashArray//m series product and offset partially by discounting of our 400 series. We had expected a temporary product gross margin dip during Q3 as we cleared 400 series inventory to make way for the new FlashArray//m series. However, we sold the 400 series at better than originally anticipated pricing, while we have some remaining 400 inventory on the balance sheet and we'll continue to sell that going forward. After Q3, the majority is now sold through.

Support gross margins of 52.8% improved 20 points year-over-year and five points sequentially. Our support gross margin continues to climb year-on-year, as the investments in support we previously made are leveraged over a larger customer base.

Moving on to expenses, as Scott mentioned, we continued to drive operating leverage year-over-year. In Q3, operating expenses were slightly lower than expected as a handful of marketing and engineering items moved into Q4. Given our pace of growth and continued investment in sales, marketing, and R&D, investors should expect some quarterly fluctuation in our operating expense rates.

R&D's expense of $34.9 million represented 27% of revenue in Q3 versus 40% a year ago. R&D investment in absolute dollars increased 79% year-over-year due to an increase in R&D head count and continued investments in the development of our next generation of FlashArray hardware and software.

Sales and marketing expense of $59.2 million, represented 45% of revenue in Q3 versus 73% a year ago. Sales and marketing investments grew 65% year-over-year, as we continue to invest aggressively in sales and marketing head count with a continued focus on sales productivity.

G&A expenses of $15 million represented a 11% of revenue versus 13% a year ago. G&A spend grew 128% year-over-year, due primarily to an increase in head count and incremental spend within legal, finance, and other professional services, as we operate as a public company. Total head count at the end of the quarter was over 1,200 up from over 1,100 at the end of Q2. Hiring was focused on sales to support our significant growth and on R&D to drive continued innovation.

Turning to operating margin. We are very pleased with the results of our continued dual focus on strong growth and operating leverage. For Q3, non-GAAP operating loss was $28.1 million or negative 21% of revenue compared with the year-ago quarter non-GAAP operating loss of $33.1 million or negative 67% of revenue. This represents a 46-point improvement in operating margin year-over-year.

Our non-GAAP net loss for the quarter was $29.1 million or negative $0.18 per share. This compares to the year-ago period's non-GAAP net loss of $33.7 million or negative $0.22 per share. The weighted average shares used for the per share calculations were $165 million and $151 million respectively. Please note that the share count numbers used to calculate net loss per share on a non-GAAP basis assume the conversion of all of our preferred stock as of the beginning of each period.

Moving on to the balance sheet and cash flow, we finished the October quarter with cash and cash equivalents of $573 million. Our free cash flow was negative $13 million or negative 10% of revenue, compared to negative free cash flow of $38.4 million or negative 78% of revenue in the year ago quarter.

I'd like to turn now to guidance. For fiscal Q4 2016, the period ended January 31, 2016, we expect revenues of $134 million to $139 million, driven by three primary factors. First, demand of our new FlashArray//m series continues to be strong and our revenue outlook is positive. Second, we continue to see increased productivity in our sales and marketing organization, as the investments we made earlier in the year continue to payoff. Third, like the storage industry in general, we expect our business to have stronger seasonality in the second-half as our business grows.

Investors should note that the incremental revenue benefit that we saw in Q3 from pent-up FlashArray//m series demand is not something we anticipate in Q4 and our revenue guidance reflects that. We expect non-GAAP gross margins in the range of 62% to 65%. Investors should expect our product margin to continue to trend upward with a long-term gross margin model of 63% to 68%. These trends are driven primarily by our mix shift towards the FlashArray//m series and the continued leverage in our support organization.

Turning to operating margin, we expect Q4 non-GAAP operating margin of negative 24% to negative 18%. This anticipated operating leverage is driven by the benefit of positive seasonal revenue trends and improving gross margins across both product and support. Our long-term operating model calls for operating margins of between 15% and 20%, and we're managing the business towards sustained positive free cash flow in calendar 2018.

We expect that the first half of next fiscal year will represent a period of seasonal investment, as we hire aggressively in sales and invest heavily in product innovation consistent with this last year. We expect this first half investment period will then be followed by a seasonally strong second half characterized by strong operating leverage, similar to what we're in the midst of right now. We therefore encourage investors to measure our operating efficiency progress on a year-on-year basis, as we plan to march steadily and deliberately toward our long-term targets.

With that, we'll open the call for questions. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question today comes from Katy Huberty of Morgan Stanley.

Katy L. Huberty
Morgan Stanley & Co. LLC

Q

Thank you. And congrats on the great quarter. Revenue upside, is it entirely attributed to FlashArray//m series in the quarter? Did you also see better uptake of the discounted 400 series? And then I have a couple of follow-ups.

Tim Riitters
Chief Financial Officer

A

Katy, this is Tim. I think it's a little bit of both, primarily FlashArray//m series. FlashArray//m series is our primary selling cadence at this point in time. We were able to draw down 400s faster than we anticipated, as you heard from me, at better margins as well, but most of it was an //m phenomena.

Katy L. Huberty
Morgan Stanley & Co. LLC

Q

And is the sequential climb in gross margins driven by less 400 series discounting, or are there more efficiencies that you're gaining in the FlashArray//m series margin?

Tim Riitters
Chief Financial Officer

A

The primary reason for the gross margin landing where did was we were able to discount the 400s at a less discount rate as we moved them out this Q3. That's really the primary driver.

Katy L. Huberty
Morgan Stanley & Co. LLC

Q

But as you look at the January guidance, is the sequential uptick driven by the end of that discounting or are there additional efficiencies that you're getting in the supply chain for the FlashArray//m series?

Tim Riitters
Chief Financial Officer

A

No. That's what's happening is that you're seeing that shift to FlashArray//m series, which FlashArray//m series is a better margin product for us and so, that's the really the dynamic on the guide going forward. Really playing out as we expected in our models.

Katy L. Huberty
Morgan Stanley & Co. LLC

Q

Okay. Makes sense. And then just lastly from me, given the strong results, have you changed your hiring plans at all since the IPO?

Tim Riitters
Chief Financial Officer

A

No. We continue to invest aggressively, Katy, we'll keep watching the revenue targets and how we're performing. We're here to invest and that's really why we're guiding on an operating margin basis because as we see upside in the business, we'll continue to capture the opportunity and keep investing for what is an amazing opportunity in front of us.

Katy L. Huberty
Morgan Stanley & Co. LLC

Q

Great. Thank you.

Operator: And the next question comes from Brent Bracelin, of Pacific Crest Securities.

Brent Bracelin
Pacific Crest Securities

Q

Yeah, thanks for taking the question. A couple if I could. One, I wanted to start out with a discussion around in terms of pricing environment. What have you guys seen relative to some of your competitors in this space? Have you have seen some irrational behavior this quarter in particular? Part one.

Part two, what are the levers that you have in the quarter, in the out quarters relative to dealing with the pricing environment? Does FlashArray//m series help? Does 3 TLC Nan help? Walk us through what you have in your tool kit to try to adjust relative to the pricing environment you see out there.

Scott Dietzen
Chief Executive Officer & Director

A

Hey, Brent. And let me add, thanks to everyone who has adjusted their calendars late in order to join us on the accelerated timeline. Storage remains a fiercely competitive marketplace, but we're in such a strong position because our product is so highly differentiated relative to the competition. We do get better margins on the FlashArray//m series. We are using the most cost effective flash in the product. So and we get at least two and sometimes as much as, five times better data reduction than the products that we're competing against.

So in going up against all flash competitors, we are in a position where we can make a reasonable margin, often times when they're selling at very low margins or even below their cost. And we need to leverage that ability to continue to maintain the win rate that we've had.

Let me add, the fiercest competition is for new logos. Once Pure Storage get the footprint within the customer, their understanding of our how highly differentiated the product is, there is well understood and so repeat business is far less fiercely contested than the initial sale.

Brent Bracelin
Pacific Crest Securities

Q

Great. And then Tim, one to follow up for you on improving sales productivity. You cited that as one of the drivers for the outlook. How much of that is just productivity improvements versus the sales cycle shortening or lengthening? How should we kind of think about that relative to sales productivity versus the sales cycle in this competitive environment?

Tim Riitters
Chief Financial Officer

A

Yes, so Brent, on the sales productivity, we're tracking at or above our targets. It's one of the metrics that, as you'd expect, we measure very, very religiously and regularly. In terms of sales cycles, we really haven't seen a shift either forward or backward. It stayed relatively stable. We did have a little bit of acceleration, as I alluded to, on the FlashArray//m series, just as we launched the product. But we're not seeing really any major shifts one way or another, in terms of the length of the sales cycle.

Brent Bracelin
Pacific Crest Securities
Q

Okay. Very helpful. Thank you.

Operator: And the next question is from Aaron Rakers of Stifel.

Aaron Rakers
Stifel, Nicolaus & Co., Inc.
Q

Yeah, thanks for taking the question. Just a follow-up on Brent's question, real quick. As you look at productivity, going into this current quarter, and then in particular into maybe the seasonally softer quarter or softer seasonal first half of the year. How has that, has your assumptions changed at all, are you assuming that productivity continues to improve from here and kind of continue what sounds to be a better than expected quarter, this quarter?

Scott Dietzen
Chief Executive Officer & Director
A

Yeah. So, Aaron, in terms of productivity, we really continue to track to our model. As you alluded to seasonality, and as we talked about earlier in the call in our opening remarks, there is seasonality in the business into the first half, so obviously we're modeling that as well. But really, we're happy in tracking to the, the productivity targets that we established before ourselves beginning the year.

Aaron Rakers
Stifel, Nicolaus & Co., Inc.
Q

And can you just – and if you can, can you elaborate a little bit on, how we should think about that seasonality into the first half of the year, particularly going into that April quarter?

Scott Dietzen
Chief Executive Officer & Director
A

Right now. Aaron in terms of a full year guide, given how fast the business is moving at this point in time, it would be premature to give any particular instance of kind of what that first half looks like. I would say just, you got to think about it as the second half is going to be stronger on a seasonal basis than the first half.

Aaron Rakers
Stifel, Nicolaus & Co., Inc.
Q

Okay. Fair enough. And then final question from me. You've recently announced some products around 3D NAND. Can you just help us understand what that means from an overall price competitiveness of your solutions going forward? How much of that changed the pricing for your FlashArray//m series product on a flash basis?

Scott Dietzen
Chief Executive Officer & Director
A

So, I would say, Aaron, rather we just see a consistent trend that flash pricing continues to drop and it's one of the best we made early on, right? When we got started, the consumer grade flash we used was four times faster than a performance disk. And now that price has fallen below at least a 15K spindle and that's raw, without the data reduction.

So we're incredibly excited about the continued scale of the consumer market that's driving down the cost of flash because that makes our products more competitive with each elapsed quarter as we continue to get that benefit. And let me say, it's not just TLC. We're also seeing continued drop in MLC pricing, as well, and we're in a position given our strategic relationships with the top flash suppliers to continue to just mix the best flash together and deliver a great product for customers.

Aaron Rakers
Stifel, Nicolaus & Co., Inc.

Q

Okay. Thank you very much. Congratulations.

Operator: And the next question comes from Brian Alexander of Raymond James.

Brian G. Alexander
Raymond James & Associates, Inc.

Q

Okay. Thanks and good morning. So Tim, if we look at the revenue guidance for the January quarter, it looks like it's going to be up about 4% sequentially at the midpoint. If we adjust for the $7 million of pent-up demand in 3Q, it's closer to 10% growth. I just wanted to clarify, is that the right way to think about guidance for the January quarter? And then as you look out to April, how should we think about revenue trends conceptually? Would you expect April to be down from January, just given seasonality in the industry?

Tim Riitters
Chief Financial Officer

A

So Brian, on the Q4 guide, you're spot on. The way we think about it is after you'd account for the pent-up demand, that guide is a sequential kind of 10% or slightly above on a Q-on-Q basis, with which, that also represents over a 100% growth year-on-year into Q4 at $0.5 billion run rate with the business right now. I think that's another really important thing to stress is that we are at $0.5 billion of revenue run rate in this business right now, which is something that the management team is really, really excited about.

Into the first half, as I said in the earlier call, it's just too premature to talk about, whether it's up, and if so by how much? Again, the business is moving so fast that, we look forward to talking to you guys 90 days out and giving you some more color in terms of what Q1 and beyond looks like.

Brian G. Alexander
Raymond James & Associates, Inc.

Q

Okay. And then just maybe for Scott on the FlashArray//m series, talk about customer acceptance. How is this helping you attract new customers that maybe you weren't able to reach before? I'm just trying to get a sense of how that's impacting win rates and new customer adds, particularly in the service provider space, given your prepared remarks seem to emphasize cloud quite a bit. Thanks.

Scott Dietzen
Chief Executive Officer & Director

A

So the FlashArray//m series is a more attractive product than the prior 400 series line. It's allowed us to improve density of north of a factor of two, power efficiency north of a factor of two. The larger scale data centers take their power and space very seriously because it's a significant expense. The FlashArray//m series was also designed to allow us to support our Evergreen model very cost-effectively, right. So we can swap out controllers, the CPU and DRAM complexes that drive the storage, without impact to the customer environment. And with the reduced COGS, it ultimately allows us to compete more aggressively. I do think it's been a factor in our success in cloud. One other thing I should mention is because it supports next-gen protocols like NBME, it's a future-proof design that we've been able to use to differentiate against many of our competitors.

Brian G. Alexander
Raymond James & Associates, Inc.
Q

Great. Thanks so much.

Scott Dietzen
Chief Executive Officer & Director
A

Thank you.

Operator: And next, we have a question from Simona Jankowski of Goldman Sachs.

Simona K. Jankowski
Goldman Sachs & Co.
Q

Hi, thank you very much. In terms of the pent-up demand that you referenced, was that mostly from your existing customers?

Tim Riitters
Chief Financial Officer
A

Simona, little bit of both. As Scott alluded to with the FlashArray//m series, it's really sort of attracting some new customers as well. We had some new logos that came in. We're very happy in terms of our new customer acquisition and we had some repeat business on the //m as well. So it's really a little bit of both.

Simona K. Jankowski
Goldman Sachs & Co.
Q

Thank you. And then in terms of the outlook over the next couple of years, you previously expected breakeven in around the second half of calendar 2018, is this now pulled forward, given the revenue trajectory is quite a bit faster?

Tim Riitters
Chief Financial Officer
A

It's something we will continue to take a look at. It's really not time to call a new normal, Simona. We had the benefit of a handful of unique things here on the top line that we alluded to and we had some expenses that pushed out into Q4 that I also spoke a little bit about.

But we look at it very carefully and absolutely we'll be talking about capital positive and breakeven on every call in terms of if it's time to pull in or not and I'll keep you posted.

Simona K. Jankowski
Goldman Sachs & Co.

Q

And then just lastly on the OpEx side, I heard your comments on having some push out and some projects into next quarter. How would you characterize the ability to hire in what's a pretty competitive market? Are you able to hit your targets in terms of R&D and sales head count? And then on the higher G&A number, how much of that was one-off, given the IPO process versus how much of it is the new baseline we should be thinking about?

Scott Dietzen
Chief Executive Officer & Director

A

So, Simona, on the hiring front, in general, it's always hard to hire the best talent, and we work very hard to attract order top 2%, 3% of individuals. I can say engineering is the place we have to work the hardest in Silicon Valley, but we were able to bring in that great talent.

If you look at field, we've become a destination site. If you watch our website traffic, our competitors are often our highest website visitors and its employees coming to our jobs page to see the latest postings. So, I would say in sales and marketing in particular, this is a great environment for us to attract talent, because customers love our product and it's an opportunity to maybe get on our growing storage engine.

Simona K. Jankowski
Goldman Sachs & Co.

Q

And on G&A?

Tim Riitters
Chief Financial Officer

A

And on G&A, Simona, I mean, you hit the nail on the head is that as we've become a public company, we have some new expenses in the G&A space. Over time, that rate continues to fall as we ultimately get leverage, but this last quarter and indeed this last year, it was a period of building up that G&A infrastructure to operate as a public company.

Simona K. Jankowski
Goldman Sachs & Co.

Q

Great. Thank you very much.

Operator: And our next question comes from Tal Liani of Bank of America.

Tal Liani
Bank of America

Q

Hey, guys. Two questions. First, if I adjust for the $7 million in the pent-up demand you spoke about, then the guidance for next quarter is below the seasonality we had seen last year. Last year, we had seen 32% growth of product revenues and the guidance after the adjustment is more like high-single digit or low-double digit. So if you can discuss the seasonality?

And second, after five quarters of service revenues growing as a percentage of revenues, it reversed this quarter. And the support revenue is in line with our expectations while the product revenue growth was much, much higher than our expectations. And the question is what's driving this? And is there a read-through for the adoption of Evergreen Storage, the model of Evergreen Storage? Thanks.

Tim Riitters
Chief Financial Officer

A

So, on the first question, Tal, in terms of revenue growth into Q4, the way we look at the business, whether it be on the revenue top side or operating leverage on the bottom line, it's really about how the business is growing year-on-year. And we are growing and that guide is still over 100% year-on-year, $0.5 billion revenue run rate we're at this point in time. So, we're really pleased with that. As you alluded to, if you strip out some of the one-time stuff in Q3, it's still a double-digit sequential as well, which we're pretty proud of as well.

In terms of your question on maintenance, really what you're seeing, because we had such a strong Q-on-Q growth in product revenue, that's what's really driving that shift. Really think about – the way to think about service and maintenance revenue, it's the deferral of our maintenance contracts. So based on this strong Q that we just had, we'll start having more maintenance revenue as well. So I don't think there's anything changing there. It's really a one-time phenomenon in terms of that split.

Tal Liani
Bank of America

Q

Got it. Thank you.

Operator: And next we have a question from Kirk Materne of Evercore ISI.

Kirk Materne
International Strategy & Investment Group LLC

Q

Thanks very much, and good morning. Scott, I want to follow up on your comment about the competitive environment for sort of existing customers obviously being less than for net new logos. I was just kind of curious when new or existing customers are coming back to sort of the [ph] up-sold (32:57)? Are they moving on to new workloads? Are the systems themselves getting bigger? Can you just talk about the dynamics about what's happening on that front just in terms of spreading into new workloads or just seeing the absolute size of the system sort of increase?

Scott Dietzen
Chief Executive Officer & Director

A

Hey, Kirk. So, it tends to be a bit of both. We do certainly allow people to add capacity to existing systems that scale independently, as I was talking about earlier, add performance or add capacity. But in general, we'll enter a customer environment usually with the database or VDI workload and then we expand to other workloads over time. And you gain credibility and customer trust. They see the performance improvement, the cost reduction, and they get storage that's so much simpler than anything they've had to deal in two decades, and that value proposition comes through profoundly as they continue to use the technology, right. That's how you get to a Net Promoter Score of 79, the best in all of B2B tech that we're aware of, right, when you have that kind of customer satisfaction, it's a lot easier to land and expand.

Kirk Materne
International Strategy & Investment Group LLC

Q

Great. And then Tim just a question on the deferred, obviously it keeps growing at a really phenomenal pace, in fact in front of revenue growth. I assume a lot of that just has to do with the support model and peoples uptick of Evergreen?

Tim Riitters
Chief Financial Officer
A

That's exactly it, Kirk. As we ship more, really the deferred revenue balance grows, because we have that support obligation which we'll recognize over time.

Kirk Materne
International Strategy & Investment Group LLC
Q

Right. And then just last one for Scott, you guys made some announcements around Pure1, recently just about predictive support. Can you talk about how much of – is that becoming a bigger and bigger differentiator for you relative to the competition in this kind of environment? Can you just talk about that maybe becoming something that's – is that seeping in I guess into more customer conversations? Thanks.

Scott Dietzen
Chief Executive Officer & Director
A

It certainly is, Kirk, so the issue is we want to do a much better job of supporting our customers and leverage the cloud in order to be able to do that. So when we isolate an issue even in our own test environment we will run fingerprints of the operating characteristics of the array up until the issue actually occurred, and then we cross-correlate that with all of the arrays that we have in our cloud environment. And it's actually allowed us to identify issues before they happen and preempt problems in the customer environment. And we think, you're seeing that in our NPS. You're seeing it in the fact that our products never requires maintenance windows, right? And it preserves performance through operations like hardware and software upgrades. So, we are able to deliver that higher quality of service, because of the engineering that's gone into Pure1.

Kirk Materne
International Strategy & Investment Group LLC
Q

Great. Thanks very much.

Scott Dietzen
Chief Executive Officer & Director
A

Thank you.

Operator: And our last question today will come from Steve Milunovich of UBS.

Steven M. Milunovich
UBS Securities LLC
Q

Great. Thank you. You guys are really well-positioned in terms of being a pure all-flash player, not having to deal with the legacy stuff, obviously. But on the other hand, you use disruption a lot. And I would argue, you're not a disruptive company in the Clay Christensen sense. You're going right at the heart of EMC's customer base, NetApp's higher-end customer base and so forth. So I prefer the word change, and flash is a major change. But I just wonder, are you being a little too dismissive of the incumbents? Because they've got every reason in the world to really focus on the same customers you're going after and protect their base, and their flash businesses are doing quite well and yet you said it's impossible to retrofit. To what degree do they really have to retrofit in their flash product lines? In the old product lines, obviously, they have problems, but I guess, what gives you the confidence you can sustain this advantage in the all-flash arena?

Scott Dietzen
Chief Executive Officer & Director

A

So, as you look across the storage landscape, Steve, the one incumbent that's been aggressive in trying to innovate is EMC. They've make made two acquisitions in flash technology in order to be able to compete. And we believe that was an admission that their disk-based product lines were not going to be able to make the leap for these disruptions of flash and cloud. But if you look across the rest of the landscape, you literally have every other vendor trying to re-engineer their products in place for what we believe is a completely different architecture necessary for success. If I could draw a simple analogy, it would be back to Data Domain.

When Data Domain got started, they didn't choose the software from a 20-year-old physical tape library to disrupt the backup space, right? They built something new, purpose-built and designed to take advantage of mechanical disk, and it almost sounds silly to think that what they should have done is begin with a physical tape library, and yet, other than EMC, that is what the big storage incumbents are doing. They are trying to re-engineer their products in place for something that's dramatically different. And if I could highlight one other area, it's really, really hard to take something that's grown complicated and make it simple.

We manage to shed decades of accumulated complexity, and we got a multiple thousand page manual down to a folding business card in terms of what it takes to learn and operate Pure Storage. That's why we're succeeding in the cloud, right? Because we've got something that's much, much simpler to deploy and manage than the incumbent storage technology.

Steven M. Milunovich
UBS Securities LLC

Q

Okay. Thank you. And then you talked about the investment in the first half next year. Would you expect that expenses will exceed revenue in the first half?

Tim Riitters
Chief Financial Officer

A

Steve, this is Tim. And in terms of guide going forward, again, not offering up, given the hyper growth that we're in right now, to take a look at what that looks like. I just would say that we invested heavily last quarter – last year in the first half and we reaped those rewards in the second half and that's really our operating model going forward.

Steven M. Milunovich
UBS Securities LLC

Q

Okay, thank you.

Scott Dietzen
Chief Executive Officer & Director

And thank you. And thank you to everyone for joining us today. In closing, I just want to reiterate that Pure is a different kind of storage company. We have a highly differentiated platform, it's software, it's hardware, it's cloud automation and management, and it's our Evergreen business model. We don't have a large competitor that's managed to get any one of these right yet and their each multi-year efforts of engineering and changing business models is really hard.

I would cite as evidence our best-in-class margins, our best-in-class growth, our best-in-class customer satisfaction, our best-in-class repeat business metrics, and our continuing competitive win rate, 70% or above in the POCs, against our strongest industry competitor. That all adds up to just a fantastic story for our Pure Storage.

So, we thank you for your support and we'll look forward to checking back in with you in 90 days.

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