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Pure Storage, Inc. (PSTG)

Q4 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

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

I would now like to turn the conference over to Liz Lemon. Please go ahead.

Liz Lemon

Investor Relations, Pure Storage, Inc.

Good afternoon and welcome to Pure Storage's Q4 and fiscal 2016 earnings call. Joining me today to discuss our 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 strategy, positioning and opportunity, and our products, business and operations, including 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 would 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 in 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 afternoon and thank you for joining the Pure Storage earnings conference call. We had another great quarter wrapping up an outstanding year of revenue growth, improvements in margin and operating efficiency and culminating in our first quarter of positive free cash flow.

We accomplished this in a rapidly evolving market that is proving difficult for competitors still prepared for the all-flash and cloud disruptions. I'm going to touch on three themes today: what is driving our record growth, the path to profitability and sustaining Pure's competitive advantage. Then I will turn the call over to our CFO, Tim Riitters to give you some more details on our financials before we move into Q&A.

Let's start with our growth. Pure Storage delivered its best ever quarter with $150 million in revenue, an increase of 128% year-over-year. Our success is being driven by increased customer adoption of our uniquely flash and cloud-friendly storage platform. With the flash memory that Pure uses now costing less than the enterprise disks that underpin the $24 billion tier 1 storage hardware and software market, there is no longer any reason for customers to purchase disk solutions.

According to Gartner, solid-state array revenue will expand by a 40% compound annual growth rate through 2019. Additionally, in 2015, Gartner named Pure as A leader in the Magic Quadrant for solid-state arrays. With Pure's growth rate well above that of the market, Pure is in an excellent position to accumulate share. Today, we are benefiting from the broad adoption of Pure Storage across industry verticals and all sizes of organizations.

We maintained our greater than 70% head-to-head proof-of-concept win rate against our biggest competitor and added more than 300 new customers in Q4. Moreover, we expanded within our install base across the public sector, healthcare, education, retail, manufacturing, financial services, tech, and entertainment industries. For each initial $1 purchase, our top 25 cohort purchased greater than $12 more of Pure Storage within their first 18 months.

Notably this quarter we grew our business with ANZ Bank and Tribune Media, while welcoming the MERCEDES AMG PETRONAS Formula One Team and the San Francisco Giants into the Pure family. Pure is now proud to serve more than 1,650 customers, an increase of over 120% over the last 12 months. That group includes 66 of the Fortune 500, up from 59 one quarter ago.

In parallel with the transition to all-flash, Pure has been focused since inception on building a storage platform and business model that enables cloud computing. While we do not anticipate selling our current product offerings to public cloud hardcore do-it-yourselfers like AWS and Google, IDC's analysis suggests that 80% of the aggregate storage market is available to Pure in 2019.

Pure has been working closely with cloud customers like LinkedIn, Intuit and Workday to dramatically lower costs and deliver better customer experiences for years. In Q4, we expanded our engagements with software-as-a-service customers Cornerstone OnDemand, [ph] Flight Steps (5:19) and Neustar. We also expanded our business with infrastructure-as-a-service providers Armor, Airware and Secure-24. To date, over a quarter of our business has been for cloud customers including software-as-a-service, infrastructure-as-a-service, and consumer clouds. Within this segment, the repeat purchase rate is approximately 50% higher than that of the rest of our customer base.

Now let's turn to financial performance. While we maintain what we believe to be the fastest growth in systems history, we are simultaneously making progress toward profitability. Both gross margin and operating margin in Q4 were up sharply from a year ago. And for the first time, we added $32 million in positive free cash flow to our balance sheet which now stands at over $600 million. We previously said that we expected to reach sustained positive cash flow by calendar 2018, and today we are pleased to pull that date forward to the second half of 2017. The business also rounded the corner on operating losses which peaked last year, will be flat this year, and then improve going forward.

Now, I'd like to close with a few words about what makes Pure unique. Our excellent top-line growth and improving operational performance have a simple explanation. We are delivering a highly differentiated storage platform that empowers our customers to transform their businesses while reducing costs. Pure continues to do all of its business through the channel. The simplicity of our platform and our Evergreen business model has attracted a high performing mix of infrastructure partners and resellers.

Our software, our hardware, our management automation, our customer-centric support and our Evergreen business model were all purpose-built for an all-flash and cloud future. Loading SSDs into 20-plus year old storage designs built for mechanical disk fails to deliver on the simplicity, elasticity and efficiency demanded by the cloud. Our recipe is working as demonstrated by our best-in-class growth, repeat purchase rates, product margins and customer satisfaction.

Our Satmetrix-certified net promoter score of 79 leads the industry and makes Pure one of the world's highly regarded brands. For comparison, the Apple iPhone is at a 63 on the same scale. While we continue to improve our operating efficiency, we are also continuing to invest aggressively in advancing our technology lead. In the last quarter, 27% of revenues went into research and development. Join us at our upcoming user conference, Pure//Accelerate in San Francisco in two weeks to hear more about the fruits of that labor.

Most of all, Pure's success is a reflection of the amazing team we have got, a team which believes Pure Storage Orange and has earned us 4.4 out of 5 stars on Glassdoor. Our people and our corporate culture enable us to deliver better products and better service. Our employees love Pure, our partners love Pure, and our customers love Pure. We are going to keep it that way.

And with that, I'll turn the call over to Tim and then we'll move on to Q&A. Tim?

Tim Riitters
Chief Financial Officer

Thanks, Scott. We are very pleased with Q4 and fiscal 2016 execution, which is a result of our continued focus on strong top-line growth and increasing operating leverage. 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 is available in our press release and in our earnings slide deck.

As Scott said, in Q4, total revenue grew 128% year-on-year and 14% Q-on-Q to a record $150.2 million, which represents a 10% outperformance relative to the midpoint of our Q4 guidance. For the full fiscal year 2016, total revenue grew 152% year-on-year to a record $440.3 million. Product revenue in Q4 grew 120% year-on-year and 12% quarter-on-quarter to $127.3 million. For the full fiscal year 2016, product revenue grew 143% year-on-year to a record $375.7 million driven by strong repeat purchase trends and a record quarter in new customer additions.

Support revenue in Q4 grew 185% year-on-year ,and 29% quarter-on-quarter, to $22.9 million in the quarter and accounted for 15% total revenue in Q4 versus 12% in the year-ago period. For the full fiscal year, support revenue grew 229% year-on-year to $64.6 million. Looking at fiscal year 2016 from a geographic perspective, 79% of our revenue came from the U.S. and 21% from our international markets. This compares to a 77:23 split in the prior fiscal year.

Q4 total gross margins of 66.0% improved 10 points year-on-year and four points quarter-on-quarter. For the full fiscal year 2016, total gross margin was 62.5%, a six point improvement over fiscal year 2015. Product gross margins of 68.3% improved 10 points year-over-year and five points sequentially. For the full fiscal year 2016, product gross margin was 64.7%, a 5.5% improvement over fiscal year 2015.

The improvement in product gross margin was driven by a mix shift to the new, higher gross margin FlashArray//m Series, as the 400 Series is now largely sold through. Support gross margins of 53.4% improved 17 points year-over-year and 0.6 points sequentially. For the full fiscal year 2016, support gross margins were 49.5%, a 15-point improvement over fiscal year 2015. These increases are attributable to an increase in our customer base and associated deferred support revenue, as well as the operational efficiencies within our support organization.

Moving on to expenses, as Scott mentioned, we continue to drive operating leverage year-over-year while making consistent investments in our business. In Q4, R&D expense of $41 million represented 27% of revenue versus 39% a year ago. R&D investments in absolute dollars increased 63% year-over-year, due to the increase in R&D head count and continued investments in the development of our next generation of flash hardware and software.

Sales and marketing expense of $63 million represented 42% of revenue in Q4 versus 60% a year ago. Sales and marketing investments grew 57% year-over-year, as we continue to invest aggressively in sales and marketing head count and programs, with a continued focus on sales productivity.

G&A expenses of $16 million represented 11% of revenue versus 14% a year ago. G&A spend grew 75% 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 Q4 was over 1,300, up from over 1,200 at the end of Q3. 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. Similar to Q3, in Q4 we again saw the benefits of our strategy to make investments early in the year, which are now paying off in the second half of the year. For Q4, non-GAAP operating losses were $21 million, or negative 13.9% of revenue, compared with the year-ago quarter non-GAAP operating loss of $38 million, or negative 57.5% of revenue. This represents a 43.6 point improvement in operating margin year-over-year and a 7.5 point improvement sequentially.

Our non-GAAP net loss for the quarter was $22 million, or negative $0.12 per share. This compares to the year-ago period non-GAAP net loss of $40 million or negative $0.26 per share. The weighted average shares used for the per [ph] share (14:35) calculation were 187 million and 154 million shares, respectively. For those of you comparing to Q4 fiscal 2015, please note that the share count numbers used to calculate net loss per share in that period assumed a conversion of all of our preferred stock at the beginning of Q4 fiscal 2015.

Moving on to our balance sheet and cash flow, we finished the January quarter with cash and cash equivalents of $605 million. Our free cash flow was $32 million positive, or 21% of revenue, compared to negative free cash flow of $45 million, or negative 69% of revenue, in the year-ago quarter. Our free cash flow for the current quarter included a $10 million of cash received from employee ESPP contributions. Please note that our free cash flows will continue to be impacted by employee ESPP contributions and for this reason going forward, we intend to call this out, if the impact is material.

Let's turn now to our guidance. For the first quarter of fiscal year 2017, the period ended April 30, 2016, we expect revenue of between $135 million and $139 million, taking into account three key factors. First, we continue to see a rapid market transition to flash, and we are experiencing excellent demand for our best in the industry all-flash platform. Second, like the storage industry in general, we expect a seasonally slower first half in terms of revenue. And third, we have factored the macroeconomic environment into our model and see a demand pipeline that supports our revenue levels.

We expect Q1 non-GAAP gross margin in the range of between 65% and 68%. We are at our long-term model for product gross margins and we expect continued improvement in our support margins. We expect convergence to our long-term model of 63% to 68% over the next several quarters.

Turning to operating margin, we expect Q1 non-GAAP operating margin of between negative 34% and negative 30%. As is seasonally normal and deliberate, we will experience sequential operating margin deleverage in Q1 as we invest in new salespeople ahead of the seasonally strong second half of the year. For the full fiscal year 2017, we expect revenues between $685 million and $725 million. Total gross margins of between 65% and 68% and operating margins on a non-GAAP basis of between negative 22% and negative 18%. Investors will note that the midpoint of this fiscal 2017 operating margin guidance implies that our operating losses year-on-year will be flat, an important inflection point in our drive to profitability.

Our long-term operating model calls for operating margins of between 15% and 20% and we are managing the business towards sustained positive free cash flow in the second half of calendar year 2017. Investors will note that we have pulled in this date from calendar year 2018 reflecting solid leverage in our operating model as we continue to drive substantial revenue growth. Investors should also note that the first half of our fiscal year represents a period of seasonal investment as we hire aggressively in sales and invest heavily in product innovation consistent with last year.

Therefore, we anticipate a sequential increase in operating expenses and a sequential dip in operating margins for Q1. 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 saw in this past year. We therefore encourage investors to measure our operating efficiency progress on a year-over-year basis as we march steadily and deliberately toward our long-term target.

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

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] And our first question comes from Tal Liani of Bank of America. Please go ahead.

Tal Liani
Bank of America Merrill Lynch
Q

Hi, guys. I know this that I'm asking probably the obvious, just by the way that the quarter goes but I still want to ask you about what Cisco said about a slowdown in January, and whether you see any change in the business environment starting the calendar year? That's number one.

And number two. When you look at the cash flow and earlier cash flow, is it just because of higher revenues or did something change in your expenses that enable a higher cash flow or getting to cash flow sooner than before? Thanks.

Scott Dietzen
Chief Executive Officer & Director
A

Hey, Tal. On the first question, I think what's going on is that the secular trends toward all-flash and the cloud model are simply dominating any mix macro environment out there. And that's why the business is continuing to perform very well. Keep in mind that the Pure Storage solution in addition to transforming customers' business actually saves the money. So we can operate very effectively in all market conditions. And I'll let Tim handle the other.

Tim Riitters
Chief Financial Officer
A

Tal, on the cash flow number, it is a combination of revenue as we throw up more revenue in the business, obviously that's going to drive more cash flow into the business, but it's also driving the operating leverage that Scott and I both talked about in our prepared remarks as well, efficiencies in our sales force and efficiencies in terms of our use of inventory as well. So it's a combination of those three things that are really driving that free cash flow number forward.

Tal Liani Q
Bank of America Merrill Lynch

Got it. Can I have a follow-p, just on the first question? Is there any vertical that is dominating strength? Can you speak about verticals and geographies? Thanks.

Scott Dietzen A
Chief Executive Officer & Director

We've historically highlighted that are our top three verticals have been financial services, tech, and healthcare. That is certainly continued. There is some fluctuation across quarters, but again we're seeing a very broad uplift across all of the verticals that we play in. What I would say, that's not a big change in the global mix in terms of how much of the business is domestic versus international; again, we're seeing a good uplift across the board.

Tal Liani Q
Bank of America Merrill Lynch

Thank you.

Liz Lemon A
Investor Relations, Pure Storage, Inc.

Thanks. Next question, please.

Operator: And our next question comes from Katy Huberty of Morgan Stanley. Please go ahead.

Kathryn Lynn Huberty Q
Morgan Stanley & Co. LLC

Thank you. Good afternoon. Congrats on the quarter. Scott, question on pricing behavior and gross margins. You beat the gross margin by a sizable amount this quarter. Given the volatility in the stock market, the scrutiny on free cash flow and profitability, is that impacting how aggressive you're willing to be in certain deals? Have you changed your pricing behavior at all? And then I have a follow-up.

Scott Dietzen A
Chief Executive Officer & Director

Hey, Katy. No, I would say what's going on with product gross margin is really the transition to the m hardware line that we launched last year that is our purpose-built hardware specifically for flash. That product line enjoys a lower set of COGS and that has allowed us to deliver a higher product gross margin, even as we've continued to support this really explosive growth in the business. I would not say anything has changed on the overall competitive pricing front.

Kathryn Lynn Huberty Q
Morgan Stanley & Co. LLC

Okay. And then you talked about the price competitiveness of flash against disk in primary storage. When do you have the opportunity to have the same phenomenon play out in the secondary storage market? When can the TAM expand because of the declining NAND flash prices and your compression/dedupe technology?

Scott Dietzen
Chief Executive Officer & Director

A

So we're not there yet on raw purchase cost, but if you look at total cost of ownership, NAND is starting to encroach on the cost of a slower, more capacity-oriented disk. I think we will see a lot of opportunity in the years ahead to see that capacity-oriented workload start to transition to flash. I mean, we did see it in both, the two independent storage leaders in the market, the CEO of EMC Storage business as well as NetApp, made the remark that 2016 was the year that all primary data should go on flash. And that feels to us like a really strong endorsement of the founding thesis of the company.

Kathryn Lynn Huberty
Morgan Stanley & Co. LLC

Q

Great. Thank you.

Liz Lemon
Investor Relations, Pure Storage, Inc.

A

Next question, please.

Operator: And our next question comes from Aaron Rakers of the Stifel, Nicolaus. Please go ahead.

Aaron Rakers
Stifel, Nicolaus & Co., Inc.

Q

Yeah, thanks. Two questions, if I can, as well. First, I wanted to ask about what you're seeing in terms of the hiring side. Prior to the IPO, you talked about kind of the progression of quota bearing head. And I'm just curious of – has that changed at all? Have you accelerated those plans? If so, how much have you accelerated the plans of investment as we look into fiscal 2017?

Tim Riitters
Chief Financial Officer

A

So Aaron, this is Tim. We continue to be very focused on investing for the long haul, and the hire that we're doing are reflecting that. We ended the year essentially on plan where we wanted to be and we've got a very strong pipeline of candidates coming in. Our go-to-market leadership under Dave Hatfield and his leaders have had an excellent pipeline and track record and are driving that going forward. So we're excited about it.

Aaron Rakers
Stifel, Nicolaus & Co., Inc.

Q

Okay. And then as a follow-up, I know that you guys are hosting your Accelerate Conference here in a couple of weeks; sounds like there's going to be some interesting product announcements coming out of that. I'm curious have you factored in any hesitation or impact of product announcements into your guidance for the April quarter?

Scott Dietzen
Chief Executive Officer & Director

A

So I would say our R&D pipeline has been factored into the guidance that we have shared with you. And for any interested in getting more of the news, we'd love to have you come join us at the Accelerate Conference in mid-March.

Aaron Rakers
Stifel, Nicolaus & Co., Inc.

Q

Thanks.

Liz Lemon
Investor Relations, Pure Storage, Inc.

A

Next question.

Operator: And our next question comes from Steve Milunovich of UBS. Please go ahead.

Steven M. Milunovich
UBS Securities LLC

Q

Great. Thank you very much. Regarding your comments about cloud, a couple things. First of all you sort of separated the consumer cloud, Apple and Facebook, from the hyperscalers like AWS and Google. Does that mean that you are selling to folks like Apple and Facebook? And then second, you said you're not expecting to sell to Amazon and Google with your, quote, current offerings. Does that mean that you think that there's a product down the road that you could offer to them that they'd be interested in?

Scott Dietzen
Chief Executive Officer & Director

A

Hey, so a little more color on what's going on with cloud. We did some work with IDC. And they were looking forward on how they ultimately see the cloud market shaking out, and we've been upfront since IPO that the hardcore do-it-yourselfers like Amazon and Google, who are building their own storage, are likely to continue to do so, but the IDC analysis was interesting in that, by 2019, they said that only reflects about 20% of the global data center spend in the market, and in particular, that the software-as-a-service market, and the consumer cloud market – and by consumer cloud, we mean large consumer web properties like LinkedIn, Facebook and Apple, and large software-as-a-service properties such as Workday and Salesforce, that segment of the cloud market is going to be the larger than the public cloud infrastructure represented by AWS and Google and Azure. So that is the market that we are highly exposed to today. We remarked that it was about a quarter of our business now, and growing significantly faster than the rest of our business. That doesn't count the cloud model adoption that's happening inside of our customer and user data center, right, so all data center aspires to the simple management, low cost, and easy elasticity that the cloud model affords.

I want to be clear that we're not counting that in our cloud cohort as we talk about the growth in the business. So the short story is, we expect cloud to continue to be a hugely powerful positive trend for the business. And we are exposed to infrastructure-as-a-service through our partners in that vein, and we're highly exposed to SaaS, with six of the top 20 SaaS vendors using Pure in their infrastructure, and we're having great success in consumer cloud. But it would be inappropriate for me to name customers, other than the ones that are already public like LinkedIn, Intuit, Workday and ServiceNow.

Steven M. Milunovich
UBS Securities LLC

Q

Thank you.

Operator: And our next question comes from Simona Jankowski of Goldman Sachs. Please go ahead.

Simona K. Jankowski
Goldman Sachs & Co.

Q

Hi. Thank you very much. I wanted to follow up on some of your comments about the competitors validating basically the tipping point towards flash this year. So obviously, we saw a bunch of competitive launches in the quarter, including from EMC and then NetApp's acquisition and then Nimble. Can you address each one of those and how you think they might change the competitive landscape?

Scott Dietzen
Chief Executive Officer & Director

A

So again, we see these activities as very broad endorsement of the power of the all-flash and cloud disruption. It is interesting, if you survey Dell and EMC's portfolio, we count nine distinct all-flash storage offerings built in there. I mean, NetApp has three, it's almost like any storage solution now has to have an all-flash story to be relevant. Having that many different internally competing products ultimately doesn't, in our view, make those vendors' stories more compelling. In fact, it makes them less compelling.

Loading SSDs into 20-plus year old storage designs just does not make them a fit for the cloud, all right. You can't get to the supreme simplicity and low-cost elasticity that the cloud model requires. And in general, these vendors haven't embraced the automation and support model of the cloud, nor the business model of the cloud. So we continue to see cloud as a great accelerator for our business, in that it's going to help us continue to differentiate against these disk-era technologies attempting to look like all-flash cloud products.

Simona K. Jankowski
Goldman Sachs & Co.

Q

And relative to your full year guidance, which was quite strong, can you just comment a little bit on how much visibility you have into that, in terms of how much coverage you get from backlog, deferred, and the order pipelines?

Tim Riitters
Chief Financial Officer

A

Simona, this is Tim. And in terms of that guidance, we measure pipeline religiously, as you'd expect, in the business, have that view multiple quarters out, and that's what gives us the confidence to issue the guidance that we did. We put together what's happening, that secular flip to flash that Scott talked about, in addition to what our pipeline signals tell us, as well as just being prudent in terms of how we set guidance, right. And investors should know that, as they think about how they're modeling the business going forward.

Simona K. Jankowski
Goldman Sachs & Co.

Q

Thank you.

Tim Riitters
Chief Financial Officer

A

Thank you.

Operator: And our next question comes from Brian Alexander of Raymond James. Please go ahead.

Adam Tindle
Raymond James & Associates, Inc.

Q

Okay. Thank you. This is Adam in for Brian. Just wanted to get your thoughts on Nimble's new all-flash array and EMC's DSSD product, what surprised you about these products and where specifically do you think you have a price performance or feature advantage versus each? And then I have a follow-up.

Scott Dietzen
Chief Executive Officer & Director

A

So no specific surprises. On DSSD, I would say we've seen similar technology in this vein before. So in our view, it harkens back to Texas Memory, Violin. EMC, in fact, had something called the Project Thunder that was designed to be very, very fast, but also expensive. And there's no question. There's always going to be a niche for performance at any cost but in our view that niche is a really small outlier. And we saw in the launch with supercomputing and DOD esoteric use cases, it didn't come off as a mainstream product to us yet, but we will have to wait and see.

And on the case of Nimble, I would say they're making an effort to move up market towards more enterprise, all-flash oriented workloads, but there's a huge amount of effort that goes into the software base inside of the product to make it flash-friendly. So again, flash is such a different media. It supports much higher levels of parallelism. You completely change your architecture around things like data reduction, data layout, and then you have to reprogram the way you do data management in order to take best advantage of flash. Technologies like snapshots and replication need to be wholly redesigned to use the data reduction infrastructure to get full value. So simply loading SSDs into a storage array that was designed for mechanical disks doesn't get you to the promise land.

Adam Tindle
Raymond James & Associates, Inc.

Q

Okay. And I noticed that you mentioned that you're not seeing the demand weakness that others are. And your guidance appears to imply flat product gross margin sequentially. Question is, could you have driven more revenue with lower gross margin? And just quickly, on the cash flow breakeven what level of revenue do you need to achieve that?

Tim Riitters
Chief Financial Officer

A

So Adam, this is Tim. On the first question, we look at the gross margin portfolio every quarter. And I'll tell you we were very, very happy in terms of revenue we're able to drive. I personally look at any deal that people want to go and really focus on and we're going to do the right thing to build the business, and yet we've been able to do it at industry-leading margins which we're particularly proud of. As it relates to cash flow revenue levels, that's something that we're not talking so much about, but as you can imagine, we talked about pulling that number in and that's really the focus that we want to let people know in terms of how we think about the business going forward.

Adam Tindle
Raymond James & Associates, Inc.

Q

Okay, thanks and congrats.

Tim Riitters
Chief Financial Officer

A

Thank you.

Liz Lemon
Investor Relations, Pure Storage, Inc.

A

Thanks, Adam.

Operator: And our next question comes from Kirk Materne of Evercore ISI. Please go ahead.

Kirk Materne
Evercore

Q

Yes, thanks very much. I was wondering if you could just talk a little bit about sort of sales productivity and what you've been seeing in that area? I assume with the results you're seeing, your sales reps becoming more and more productive. But I was wondering if you could sort of talk about that qualitatively a little bit.

Scott Dietzen
Chief Executive Officer & Director

A

Yeah, Kirk. So on sales productivity, a key measure for us obviously we are very pleased with the trajectory that the sales productivity levels have been driving. They've increased year-on-year, but as you also know, we look at it on a cohort basis and each one of those cohorts is progressing very, very nicely along the ramp curve. And its signals like that that give us the confidence to continue to invest in what is a really, really strong opportunity for us, so very, very happy where we are from a sales productivity perspective.

Kirk Materne
Evercore

Q

And just sort of related to that, have you seen any – as those sales people get more productive, sales cycles I guess, shortening at all? I assume it's still a very competitive market out there. I was just curious about the sales cycles as well.

Scott Dietzen
Chief Executive Officer & Director

A

Sales cycles tend to be, have been tended to be stable over the last several quarters, so nothing really new there. But what I will say is that as we start seeing repeat business and we've got some very strong repeat trend, those sales cycles go a lot quicker. People have fallen in love with the storage and they're ready to buy more and those cycles are pleasant cycles to be in, for sure.

Kirk Materne
Evercore

Q

Okay. And last question for me, obviously deferred revenue for you all has been incredibly strong year-over-year. I assume that's all related to the support revenue bucket. Is that correct?

Scott Dietzen
Chief Executive Officer & Director

A

Yeah. There's a small amount of – a little bit of professional services but it's very, very small. The vast, vast majority of it is the maintenance to amortization, as you alluded to.

Kirk Materne
Evercore

Q

Great. Thanks very much and congrats.

Scott Dietzen
Chief Executive Officer & Director

A

Thanks.

Liz Lemon
Investor Relations, Pure Storage, Inc.

A

Thanks, Kirk.

Operator: And our next question comes from James Kisner of Jefferies. Please go ahead.

James Kisner
Jefferies LLC

Q

Hi. Thanks for taking my question. So I noted that your growth in the number of Fortune 500 customers has decelerated a bit here; still robust at 65%, but I guess was over 100% last quarter. But could you comment on how the revenue contribution from this customer group is progressing relative to rest of the business, and just comment on your progress of this customer group and penetrating it relative to SMBs?

Scott Dietzen
Chief Executive Officer & Director

A

So I don't think we're breaking out a specific revenue ramp for the Fortune 500 sector. And I think we've only provided a couple of data points, right. So from 59% in the third quarter to 66%, so I don't think we're seeing any deceleration.

James Kisner
Jefferies LLC

Q

Okay. I was looking at the growth rate in that customer group that you disclosed but I guess separately I want to clarify. I think you said the outlook accounts for the macroeconomic environments. You commented that your guidance works – your product works in any macro environment. I mean just comment qualitatively to what degree you perhaps haircut your guidance at all for the macro environment and potential slowing there? Thanks.

Tim Riitters
Chief Financial Officer

A

Also James, on guidance for the quarter and the full year, we look at – you'll see some pockets. I guess one of the pockets that I think everyone would expect, for example, is oil and gas, right. Oil and gas is an area that tends to be a little bit lighter given what's going on, but we factored in. We looked at our robust pipeline. We're happy in terms of where that's going and we squirreled that with just being prudent and cautious as we build the expectations for the year.

Scott Dietzen
Chief Executive Officer & Director

A

And again keep in mind, we've got a environment where all of the storage players are now talking about the shift to all-flash and many of them are talking about the importance of the cloud model. I mean these were the best we started with back in Pure's founding in 2009 and we are years ahead of the competition and we're benefiting from those secular trends.

James Kisner
Jefferies LLC

Q

All right. Thank you.

Liz Lemon
Investor Relations, Pure Storage, Inc.

A

Thanks, James.

Operator: And our next question comes from Tim Long of BMO Capital Markets. Please go ahead.

Timothy Patrick Long
BMO Capital Markets (United States)

Q

Thank you. Two questions, if I could. First on the OpEx efficiency, just looking at the full year, the guidance implies somewhere around a 10 point improvement compared to last year. But that's a bit slower than the improvement we've seen in the prior few. So is there something about product cycle or investment in 2017 that's maybe a little bit more intense or less beneficial to that efficiency rate in 2017? And then secondly, just give us a little update on Evergreen. You mentioned it briefly in the prepared remarks. Just curious if you can give us an update on how that's doing and what you think that's doing for differentiation and kind of adding to the repeat sales? Thank you.

Tim Riitters
Chief Financial Officer

A

So Tim, this is Tim. On your first question, we don't guide on an OpEx number. It's really a guide on a margin basis. And what we wanted to do, as you heard in our prepared remarks, is really turn the corner from an operating loss perspective. And so on an absolute basis, the implication of our guidance is that we're turning that quarter and driving more and more efficiency in the business. And I think that's how I would encourage you and the investing community to think about it in terms of going forward.

As it relates to Evergreen, we continue to see a lot of traction in Evergreen. It is our primary selling cadence. The vast majority of folks are on the Evergreen program. And it really is a game changer. As I personally talk to customers, as we hear from our sales force, this ability to interchangeably swap technology on the fly is an incredibly compelling capability that just hasn't been seen in storage, and it's one of the reasons why we're posting the results we are.

Timothy Patrick Long
BMO Capital Markets (United States)

Q

Okay. Thank you.

Liz Lemon
Investor Relations, Pure Storage, Inc.

A

Thanks, Tim.

Operator: And our next question comes from George Iwanyc of Oppenheimer. Please go ahead.

George Iwanyc
Oppenheimer & Co., Inc. (Broker)

Q

Thank you for taking my question. Following up on the sales productivity questions, can you give us a sense of how much of your sales force is currently fully ramped and which regions you're seeing the most focus on internationally?

Scott Dietzen
Chief Executive Officer & Director

A

So George on the fully ramp, we don't disclose the percentage that is fully ramped. I think again I'd just continue to point to the fact that all of those cohorts are rising very, very nicely which gives us the confidence in the business. From an international versus domestic perspective as you expect, U.S. is more mature but we're seeing good strides in the international business as well. I mean both of those both domestically and internationally growing well over 100% which we're very, very happy with given the business.

George Iwanyc
Oppenheimer & Co., Inc. (Broker)

Q

Right. Thank you.

Operator: And our next question comes from John Lucia of JMP Securities. Please go ahead.

John A. Lucia
JMP Securities LLC

Q

Hey, guys. Thanks for taking my questions. Scott, you indicated a quarter of the business to -date has been with cloud customers. As enterprises increasingly move to the cloud, where do you think that cloud business can go as a percentage of revenue over time? And then, how are the pricing dynamics with cloud customers relative to enterprise customers?

Scott Dietzen
Chief Executive Officer & Director

A

So, it depends on how you define cloud. I mean, we think all data centers are moving to a cloud model of computing. So I mean the flip answer is that it's 100%. But what's underneath that is, we expect to see continued huge growth in our cloud segment which, as I mentioned earlier, is infrastructure-as-a-service, software-as-a-service, and consumer cloud. We expect that to continue to grow faster than the rest of our customer base, roughly mimicking the growth of the overall cloud segment.

And we'll continue to see much faster growth of internal clouds, next gen data centers inside of these enterprise customers that conform to the cloud model, but those are harder to call, in terms of defining a hard and fast litmus test for what cloud is. But there's no question that everybody wants that really easy productivity, easy administration and low cost of ownership of the cloud model. And that appeal is universal across our customer base. Does that answer your question?

John A. Lucia
JMP Securities LLC
Q

Yeah. That makes sense. And then Tim, you guided for gross margins to remain in the 65% to 68% range for all of FY 2017. What gives you guys the confidence you'll be able to maintain those margins despite continued pricing pressure from the incumbents and others?

Tim Riitters
Chief Financial Officer
A

I think the short answer, it's innovation. And the engineering teams here have done tremendous job and continue to engineer both a great product and a product that is very efficient. And so, it really speaks to where we are today and where we believe we're going to be in the future, in terms of our ability to drive those cost reductions while still delivering a great service and a product to our customers.

John A. Lucia
JMP Securities LLC
Q

Okay. Thank you.

Operator: And our next question comes from Alex Kurtz of Sterne Agee. Please go ahead.

Alex Kurtz
Sterne Agee CRT
Q

Hey, guys. Can you hear me okay?

Tim Riitters
Chief Financial Officer
A

We can.

Alex Kurtz
Sterne Agee CRT
Q

So, congrats on the great numbers today. I think there's going to be a lot of focus, obviously, on the second half and how you guys ramp revenue. And I know you've touched on it earlier in one of the prior questions, but can you just dig in a little bit there around what's baked in from new sales hires helping driving that number? Any kind of large transactions, any kind of special vertical contribution, especially around the Q3 implied ramp in your business? So, anything that would sort of add to that, I think, would be helpful.

Scott Dietzen
Chief Executive Officer & Director
A

So Alex, in terms of seasonality in the business, or the revenue ramp in the business, there's really two factors at play here at Pure. So first of all, storage is just inherently a seasonal business. I think you see that in a number of our competitors, and Pure is no different. So first half, a bit slower; second half much stronger. But we make a deliberate decision, during that seasonal slow period, to invest heavily in our sales and go-to-market activities, getting the quality talent in at the beginning of the year, getting them ramped up in the Pure program, if you will, so that when that seasonal time comes along, Q3 and Q4, it's time to really sort of drive results. And so if you see those two things work in tandem, that causes that pop that you saw – candidly, this last year, this last fiscal year between Q2 and Q3, and another reason why we see it happening going forward.

Alex Kurtz
Sterne Agee CRT

Q

All right, thanks.

Operator: [Operator Instructions] Our next question comes from the Nehal Choski (sic) [Nehal Chokshi] (44:36) of Maxim Group. Please go ahead.

Nehal Sushil Chokshi
Maxim Group LLC

Q

Thanks, and congratulations on a great quarter, great guidance. Sorry, for sales and marketing investments on a non-GAAP basis, that increased $3 million Q-over-Q, is actually less than what it increased on a Q-over-Q basis from a year ago. And considering the 2X higher revenue [ph] brace, (44:59) I'm surprised it didn't increase more. Any reasons why you guys are not scaling that as fast as revenue, other than just trying to get the leverage?

Scott Dietzen
Chief Executive Officer & Director

A

Yeah, Nehal, a couple of things happening there. Number one, we had some investments in Q3. So on a comp basis Q-on-Q, it's going to look a little bit flat. And then the other thing to bear in mind, and we said this in our 10-K and 10-Q filings, our interpretation of GAAP is that we straight-line commission. So a lot of our competitors have accelerators at the end of the year, which we do as well, but we straight-line the estimated commission rate. So you're not going to see that sales and marketing pop that you might see in some other comparables.

I will tell you that now as we close the Q4 and approach our Q1, we're back in that investment mode. And the pipeline of people that we have, on the quality of talent that I see coming in, gets me really excited for what the year is in store.

Nehal Sushil Chokshi
Maxim Group LLC

Q

Okay. And then another question is that, I think a lot of the high growth companies that you guys would like to be compared against, I think reasonably so, tend to grow sales and marketing faster than R&D. In fiscal year 2016, you guys grew R&D faster than sales and marketing. Do you expect that to be the same trend for fiscal year 2017? And why do you think you guys have the reverse pace of most of your high growth peers?

Scott Dietzen
Chief Executive Officer & Director

A

We're not offering guidance on the split between sales and marketing R&D. What I will say is that we are going to invest in both of those areas we believe passionately in innovation and we also believe passionately in maximizing the number [indiscernible] (46:29) in a $24 billion market. So we're very growth focused and very investment focused and at the same time driving strong operating leverage which is indicative of the $30 million roughly of free cash flow that we threw off in the quarter, firing on both cylinders, both the top-line and the bottom-line.

Nehal Sushil Chokshi
Maxim Group LLC

Q

Okay. Great, thanks.

Operator: And ladies and gentlemen this concludes our question-and-answer session. I would like to turn the conference back over to management for any closing remarks.

Scott Dietzen

Chief Executive Officer & Director

This is Scott again. Listen, we want to thank every one of you for joining us today. In terms of takeaways, this is a market that is very rapidly tipping to all-flash and the cloud. One of the most exciting things about the IDC analysis is that by 2019, 80% of that cloud market opportunity is available to Pure. So despite the success of public cloud, there is just a huge broad cloud opportunity for us to play in going forward. Pure has far and away the best platform for all-flash and cloud and we're growing that technology lead over time.

You see it across the boards, in our best-of-class growth, the improving operating efficiency of the business, our customer satisfaction scores, our competitive win rates, our repeat business cohorts. So the market is shaping up exactly as we expected when we entered this market to disrupt it several years ago, we could not be more excited about 2016. We'll look forward to seeing some of you at Accelerate in a couple of weeks and we'll talk to the rest of you in 90 days. Thank you so much.

Liz Lemon

Investor Relations, Pure Storage, Inc.

Thank you. Bye-bye.

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