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Pure Storage, Inc. (PSTG)

Q1 2017 Earnings Call

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Tim Riitters
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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon and welcome to the Pure Storage First Quarter Fiscal 2017 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 Liz Lemon, Investor Relations. Please go ahead.

Liz Lemon

VP, Finance and Development

Good afternoon and welcome to Pure Storage's Q1 fiscal 2017 earnings call. Joining me today are 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 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 relating to our business is contained in our filings with the SEC, and we refer you to these public filings. Also, 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 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 it over to our CEO, Scott Dietzen.

Scott Dietzen

Chief Executive Officer & Director

Thanks, Liz. Good afternoon, and thank you for joining the Pure Storage first quarter earnings call, our third quarter reporting as a public company. Pure delivered another quarter of robust results. Q1 revenues were $140 million, slightly above our guidance range and up 89% from the year earlier quarter. That growth rate is well above the annual growth rate Gartner projects for the solid-state array market, meaning we are increasing share in a highly competitive environment.

We also reported significant year-over-year improvement in both gross and operating margin, as Tim Riitters, our CFO, will detail in a moment. Our balance sheet remains strong with more than $600 million in cash and zero debt. Our results continue to stand in contrast to those of many of our competitors, who sometimes attribute their declines to a slowdown in IT spending. While we agree that businesses are being careful with every IT dollar, it remains our view that the more fundamental dynamic at work is a rethinking of data center infrastructure, including the shift of flash and cloud-friendly storage and away from complex dicentric designs from the past century.

Many of our customers have found that Pure Storage pays for itself either in reduced total cost of storage ownership or by enabling them to improve their businesses to accelerated application performance or both. According to IDC, in just four short years of selling, Pure Storage has cracked the top 10 storage vendors worldwide, and we are growing approximately 10 times faster than anyone else on that list.

In the latest quarter, Pure's customer count increased by almost 300 bringing the total to more than 1,950. Pure now serves 72 of the Fortune 500, up from 66 one quarter earlier. The World Bank became a Pure customer in the quarter as did Bank of New York Mellon, which is using Pure to build its own private cloud.

SoftBank, one of Japan's largest wireless carriers chose Pure to support its cloud-based desktop-as-a-service offering, vastly boosting performance and operational efficiency. The University of Melbourne, one of the top 50 universities in the world, now uses Pure to support 1,200 virtual machines. And GMO CLOUD, Japan's largest Internet hosting company, also chose Pure for its cloud service.

Pure is gaining ground across all industry verticals, one happy customer at a time, as those institutions seek storage that provides greater performance, higher resiliency, reduced complexity, power and floor space savings and best-in-class customer service. Pure Storage remains highly differentiated in our software, our hardware, our cloud automation and our cloud-like Evergreen business model. Today, we still do not have a major competitor that has gotten any one of these right.

Q1 also marked the launch of Pure Storage's second product in FlashBlade, which was unveiled in March at our inaugural Pure//Accelerate User Conference. FlashBlade was three years in the making, and there is nothing else like it in the market.

FlashBlade, which is optimized for more capacity-oriented, scale-out file and object storage is the perfect complement to FlashArray//m. Just as FlashArray//m redefine the category of performance-optimized block storage, FlashBlade delivers the benefits of all-flash for unstructured and semi-structured, often called Big Data storage, and does so at compelling economics.

FlashBlade has been extensively tested on customer workloads over the past year. Used cases include Internet of Things, machine log analysis, security event correlation, genomics, software development, chip design, bioinformatics, machine learning and media production and transcoding. Feedback thus far on FlashBlade has been as enthusiastic as it was for the early customers of FlashArray//m.

With FlashArray//m and FlashBlade, Pure is positioned to address the full $24 billion market for data center storage and related software, enjoying a two-year to three-year lead in innovation on the major competitors. First directed availability of shipments of FlashBlade for revenue are on schedule for Q3, and we are targeting GA for later this year.

At Pure, we're often asked about the impact of the rapid growth of public cloud players like Amazon Web Services on storage. As we have remarked in the past, we see cloud as a catalyst for our business, even though we do not anticipate selling to hardcore do-it-yourselfers like AWS and Google.

Cloud continues to account for about a quarter of our business as we provide a platform for Software-as-a-Service clouds. We now count seven of IDC's top 20 SaaS companies as customers, infrastructure-as-a-service clouds and consumer clouds.

These customers, as well as many enterprises building private clouds, are doing so for a number of reasons: one, greater performance via tighter proximity between data users and systems, whereas the public cloud is big but slow, Pure-powered clouds are big and fast; two, because they see technology as a core competency, something on which they differentiate their business every day, and their specialized needs cannot be realized on infrastructure they see as least common denominator; three, to achieve cost savings at the scale of which they operate; and four, to meet data security and regulatory requirement. Although public cloud is thriving, the truth is it simply can't do it all.

Looking forward, the team at Pure is hugely excited about the road ahead. Our customer satisfaction, retention and repeat purchase statistics, we believe to be far and away the best in storage. All are the results of our highly differentiated products and service.

What's more, 100% channel go-to market model is working. In Q1, we estimate that close to 70% of our net new logos were brought to us by partners. This channel momentum, when coupled with the uncertainty the Dell-EMC merger creates for both customers and partners, is accelerating our market opportunity.

We will continue to invest in the business, so that over time, Pure can indeed play to win the number one position in this $24 billion market. At the same time, in the near term, we will continue to improve our business efficiency year-over-year to deliver on our commitment of sustained positive cash flow in the second half of calendar 2017.

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 Q1 execution, especially during a seasonally slower quarter in enterprise infrastructure, when many in storage are struggling. As promised, our continued focus is on strong top-line growth in balance with improving 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, which are available on our website at investor.purestorage.com.

As Scott said, in Q1, total revenue grew 89% year-on-year to $139.9 million, which is slightly above our Q1 revenue guidance. As expected, we saw a modest Q-on-Q decline in revenue of 7%, which is seasonally typical for enterprise IT in the first quarter of the year.

Product revenue in Q1 grew 76% year-on-year, driven by strong repurchase trends and steady performance in new customer additions. Product revenue decreased 12% quarter-on-quarter to $111.7 million due to the seasonality I mentioned earlier.

Support revenue in Q1 grew 170% year-on-year and 23% Q-on-Q to $28.2 million, driven by continued revenue recognition of ongoing support contracts. Support accounted for 20% of total revenue in Q1 versus 14% in the year ago period.

Looking at Q1 from a geographic perspective, 79% of our revenue came from the U.S. and 21% from international. This compares to a 78%/22% split in the prior fiscal year.

Turning to gross margins. In Q1, total gross margins of 67.3% improved 6.8 points year-on-year and 1.3 points quarter-on-quarter. Product gross margins of 69.6% improved 5.2 points year-over-year and 1.3 points sequentially. The year-on-year improvement in product gross margin continues to be driven by a mix shift to the new higher gross margin FlashArray//m series product.

Support gross margins of 58.0% improved over 20 points year-on-year and over 4 points sequentially. This is attributed to increases in our customer base and associated deferred revenue support as well as operational efficiencies within our support organization. We continue to move consistently toward our target model of mid-60s support margins and will continue to drive efficiencies toward that goal.

Moving on to expenses. As Scott mentioned, we continue to drive operating leverage year-on-year while making consistent investments in the business. In Q1, R&D expense of $41.2 million represented 29.5% of revenue versus 37.9% of revenue in the year-ago quarter. R&D investment in absolute dollars increased 47.0% year-on-year as we continue to invest in both our FlashArray and FlashBlade products.

Sales and marketing expense of $75.1 million represented 53.7% of revenue in Q1 versus 60.6% a year ago. Sales and marketing investments grew 67.4% year-on-year. G&A expense of $18.9 million represented 13.5% of revenue in Q1 versus 15.2% a year ago. G&A spend grew 67.8% year-on-year. Total head count at the end of Q1 was over 1,500, up from over 1,300 at the end of Q4, largely attributable to our Q1 focus on sales hiring.

Turning to operating margins, we continue to be pleased with the results of our dual focus on strong growth and consistent improvement in operating leverage. For Q1, non-GAAP operating loss was $41.1 million or negative 29.4% of revenue, compared with the year-ago quarter non-GAAP operating loss of $39.4 million or negative 53.2% of revenue. This represents a 23.8-point improvement in operating margin year-on-year. Also note, our operating losses increased by $1.7 million year-on-year while we grew our revenue by nearly 90% during the same period.

Our non-GAAP net loss for the quarter was $40.8 million or negative $0.22 per share. This compares to the year ago period non-GAAP net loss of $40.3 million or negative $0.26 per share. The weighted average shares used for the per share calculations were $189.3 million and $154.9 million respectively. For those of you comparing to Q1 fiscal 2016, please note that the share count numbers used to calculate net loss per share in that period assume the conversion of all of our preferred stock as of Q1 of fiscal 2016.

Moving on to the balance sheet and cash flow, we finished the April quarter with cash and investments of $607 million reflecting a modest uplift from our Q4 ending balance. Our free cash flow was negative $17.6 million or negative 13% of revenue compared to negative free cash flow of negative $20.9 million or negative 28% of revenue in the year ago quarter. Please note that the free cash flow for the quarter included $8.7 million of cash used related to our employee stock purchase plan. Excluding this amount, free cash flow would have been negative $8.9 million or negative 6% of revenue.

Let's turn now to our guidance. As a reminder, we provide annual guidance only once at the beginning of the fiscal year which we did last quarter. We also remind investors that our full-year guidance included all product launches and contribution for the fiscal year.

For the second quarter of fiscal year 2017, we expect revenue of between $153 million and $157 million driven by several key dynamics. We are well-positioned for the rapid transition in storage where customers are choosing modern, flash and cloud solutions over legacy retrofit products. We have strong momentum in new logos, we continue to see solid repeat business trends and high customer retention rates, and we continue to deepen our channel relationships. We expect Q2 non-GAAP gross margin in the range of between 65% and 68%. We are at our long-term model for product gross margin, and we expect continued improvement in our support margins. We expect conversion to our long-term model of between 63% and 68% over the next several quarters.

Turning to operating margin, we expect Q2 non-GAAP operating margins of negative 26% to negative 30%. This guidance implies significant year-on-year improvements in operating margin and a decrease in absolute operating losses year-on-year.

As we said last quarter, investors should note that the first half of our fiscal year represent a period of seasonal investment as we hire aggressively in sales and other marketing activities and continue to invest in product innovation consistent with 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 saw in Q3 and Q4 of last year.

Moving on to cash flow, though we performed very well on free cash flow in Q1 driven by strong cash collection efforts, Q2 does tend to be a slower cash flow quarter due to the timing of cash collections and continued investments in this period.

Investors should expect lower free cash flow in Q2 versus Q1. Our long-term operating model calls for operating margins of between 15% and 20% and we continue to manage the business towards sustained, positive free cash flow in the second half of calendar year 2017. Investors will recall that in the last quarter's earnings announcement, we pulled in this date from calendar year 2018, reflecting solid leverage in our operating model as we drive revenue growth.

Finally, I'd like to remind investors that we are on plan to make fiscal year 2017 the turning point in terms of absolute losses. We encourage investors to measure our operating efficiency progress on a year-on-year basis as we march steadily and deliberately towards our long-term targets.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] At this time, we will pause momentarily to assemble our roster. And our first question will come from Brent Bracelin of Pacific Crest Securities.

Brent Bracelin
Pacific Crest Securities

Q

Thanks for taking the question. Scott, a couple for you and then one for Tim. First, I was wondering, on the competitive front, did you notice any sort of changes in the competitive environment now that EMC is out with the all-flash VMAX and I guess now VNX?

Scott Dietzen
Chief Executive Officer & Director

A

Yeah. I would say there is a material change in the sense that EMC now seems to be leading with their disk retrofit designs built in the pre-flash mainframe era over the last century. In that competition, we continue to do supremely well. We have the best data reductions. So, we're looking at two to five times LED flash, which makes our financial dynamics dramatically better. Our hardware efficiency will often mean that their cost of goods in a competitive situation is more than our street price. We're also substantially better-performing.

And the solution appeals extremely well to next-gen datasets as we have much greater exposure to Software-as-a-Service and consumer cloud, which indicates longer term growth dynamics. And there's this level of simplicity that just doesn't come along with those legacy designs. So, we've been able to hold our competitive win rates. Against EMC, POC win rates have held up. And, we think, that market continues to bode very well for us to be able to compete.

You see this across our customer satisfaction stats, our repeat cohorts, right, our top tier of customer spend, $12 over the next 18 months for each initial dollar, our product margins are best-in-class. And our growth rates are far and away best-in-class.

Brent Bracelin
Pacific Crest Securities

Q

Fair enough. And then, second question for you is really on FlashBlade. I know it's still early access. You rattled off several workloads that you're kind of seeing beta customers use it for. But what have you learned so far and is there a sweet spot from a workload standpoint that that product is kind of well-suited for?

Scott Dietzen
Chief Executive Officer & Director

A

We've actually got an exposure to kind of all of the core, file and object-oriented workloads for the scale-out market, the capacity-oriented market, the bigger data market that we're targeting, and the feedback has been tremendous. Not only are we delivering dramatic performance acceleration, but we have the same kind of simplicity, density and total cost of ownership advantages that we are able to bring to market with FlashBlade – with FlashArray. So, we see FlashBlade as being similarly transformative and there's literally nothing else like it in the industry.

Brent Bracelin
Pacific Crest Securities

Q

Interesting. And for Tim, real quickly here on product gross margins, I know you've cited kind of a mix shift, m series is a lift there, but you are getting close to 70% kind of product gross margins in a very competitive market. So, help us understand the levers that you have and potentially could that product gross margin tick above 70%?

Tim Riitters
Chief Financial Officer

A

Brent, this is Tim. So, on product gross margins, we are very, very happy about our 69.5% gross margin for the quarter, really speaks to the differentiation that we have in the business against our competitors as you heard Scott talk about.

We continue to believe that that mid to high-60%s gross margin number, that sweet spot, because it's the right balance of having a differentiated product and yet not being too high priced and you can go and compete in any single deal that we want to. Our goal is to grow revenue and being in that mid-60s range helps us do that.

Brent Bracelin
Pacific Crest Securities

Q

Okay. Fair enough. Thank you.

Liz Lemon
VP, Finance and Development

A

Thanks, Brent. Next question.

Operator: The next question will come from Aaron Rakers of Stifel.

Aaron Rakers
Stifel, Nicolaus & Co., Inc.

Q

Yeah. Couple questions if I can as well. Thank you. So, first of all, Tim, I'd like to understand how you think about operating leverage. I know that you talked about the second half of the year to see similar operating margin leverage as what saw in fiscal 2016, but I'm just wondering exactly how you think about that. Is that a rate of revenue change relative to OpEx change or you think of it differently?

Tim Riitters
Chief Financial Officer

A

Yeah, Aaron, on the question of operating leverage, really, again, it's focused primarily on revenue but at the same time driving that year-on-year improvement both in operating margin, which as you've seen this last quarter we did very, very well. And then, also that commitment we made at the start of the year to have basically flat if not improving absolute operating losses. And so those are the two constraints that I think about the business and how we're managing the business as we continue to aspire to grow as fast as we possibly can.

Aaron Rakers
Stifel, Nicolaus & Co., Inc.

Q

And can you talk a little bit about what you're seeing from a productivity perspective? I know in some of the remarks you had stated that 70% of your new logos were brought to you through the channel. I'm just curious of what are you seeing in terms of productivity from your sales force and how does that metric, that 70% metric, compare to, let's say, what it was a year ago or last quarter?

Tim Riitters
Chief Financial Officer

A

Yeah, on productivity, Aaron, we continue to measure that very, very carefully. And I think what we've said in the past is that we watched each one of our sales cohorts or sales start classes, if you will. They are progressing right along plan. Our longest-serving cohorts are at and above target model, that long-term target model, and the newer cohorts that we brought in, and we've had some very, very successful classes, are climbing the same wrap rates, so we are on plan with that long-term productivity model. I'm very, very happy about it.

On channel, the statistics that you said, 70%, we're very pleased with that as well. Channel has always been a go -to market lever for us, and we'll continue to lever it going forward.

Aaron Rakers
Stifel, Nicolaus & Co., Inc.

Q

Okay.

Scott Dietzen
Chief Executive Officer & Director

A

And, Aaron, I might chime in. I think the merger between Dell and EMC is actually creating additional headroom for us in the channel, right? EMC has historically done about a third of their business through the channel. I mean, Dell is known for their direct sales DNA, and as we've remarked on our blog, the combined entity will have nine distinct All-Flash storage offering.

Now that combination of factors is creating confusion in the channel about which products are the long-lived ones and what the go-to market model is going to look like, and that's created a little bit of a vacuum that we've been able to fill.

Aaron Rakers
Stifel, Nicolaus & Co., Inc.

Q

Perfect. And then final quick question from me, the FlashBlade product, I know you talked about direct availability. Can you talk about the relative size of your direct availability or beta program? And just remind me exactly when we go into that direct availability, would you recognize revenue for that product in the fiscal third quarter? Is that the way to think about it?

Scott Dietzen
Chief Executive Officer & Director

A

Yeah. So, you can think about it, Aaron, is we're doing – order dozens of beta deployments right now across. We wanted to get pretty much every capacity-oriented workload represented, so that we were mining really great data that we could use.

Once we declare the product certified for production deployment and the customer gets the production-ready software, that would be the revenue recognition event. We are planning on directed availability that will be for select customers in the third quarter of this year, and we are striving to hit general availability before year's end.

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

Perfect.

Tim Riitters
Chief Financial Officer
A

And, Aaron, on directed availability, that's our trigger for rev rec. So, as we have directed availability units, we would trigger rev rec in those units.

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

Thank you very much.

Operator: And the next question comes from Simona Jankowski of Goldman Sachs.

Balaji Krishnamurthy
Goldman Sachs & Co.
Q

Hi. This is Balaji Krishnamurthy on Simona's behalf. So, I was wondering if you could comment on the competitive dynamics outside of EMC and Pure. The field is becoming increasingly crowded. Just yesterday, HP cited strength with its flash product and Nimble also highlighted good traction initially. So, I was hoping y ou could throw some light there as well.

Scott Dietzen
Chief Executive Officer & Director
A

Balaji, it would be our pleasure. So, the combination – all of the major players in the market are continuing to lead with what we would describe as disk era or mainframe era retrofits, right? These are technologies that were designed in the last century and are being positioned as somehow ready for flash and cloud. And yet, we are talking about a technology that we don't believe has any chance of making the leap into these modern data sets.

So, the technology that you need to pull off success has become very clear. Data reduction, we have two to five times better data reduction, that gives us far and away the best hardware efficiency in the space. You see that in our margins. But you see that in competitors not being able to compete without offering products at a loss. The technology is performance-intensive. So, if you didn't design the product like we did to support parallelism and next-generation protocols like NBME, you just can't measure up to the performance demand.

Most of all, you'll see this in our cloud footprint, right? The fact that next-generation data centers, and software-as-a-service, infrastructure-as-a-service and consumer cloud are a quarter of our business, I think that's higher than any of the other players in the storage market.

You need to have that focus on DevOps, a very simple control cloud automation. And the Evergreen business model that we pioneered. All of those things are differentiated. And the evidence for the differentiation is there in our audited and customer satisfaction scores. I mean, we're the only vendor I'm aware of that's actually publishing audited Net Promoter Scores and putting our customer satisfaction in front of the whole industry.

The repeat cohorts are the best in class. And the growth continues to be better than anyone else has done in storage history, right? The fact that in just four years, we've made it into the top 10 storage players worldwide, and the fact that we're growing on that list more than 10 times faster than pretty much anybody else on the list, that's a staggering achievement for an upstart, and it's reflective of our differentiation in a market that's been profoundly disruptive.

Balaji Krishnamurthy
Goldman Sachs & Co.

Q

That's helpful. Thanks. And just a follow-up for Tim. So on OpEx, it looks like the R&D expenses were a little below what we were expecting. It was flat sequentially even though you made a push with your new product. And on the other hand, S&M was – so S&M growth actually accelerated over the last quarter – I mean, on a YoY basis. Could you just provide some color on how you see the trajectory for both of those line items through the rest of the year?

Tim Riitters
Chief Financial Officer

A

Yeah, Balaji, on the R&D number, what you're seeing there, if you look at our CapEx number, you'll see our CapEx is up relatively notably Q-on-Q. And what's happening is as we've reached beta stage with our FlashBlade product, you're seeing the test equipment and the things that we're procuring moving into the capital, moving into the balance sheet. And so, that's why you're seeing a relatively flat quarter-on-quarter, whereas historically, we've expensed those immediately but now that we've gotten the technical feasibility. So, that's why R&D has slowed down a little bit.

On the sales and marketing side, you're seeing year-on-year leverage and, really, that's the yardstick that I take a look at. Obviously, the S&M rate is up quarter-on-quarter. That has to do with just sequential dynamics and seasonal dynamics in our business. But year-on-year, those numbers are driving – both of them are driving leverage, and that's how I think about the rest of the year as well.

Balaji Krishnamurthy
Goldman Sachs & Co.

Q

Great. Thanks.

Operator: And next, we have a question from Brian Alexander of Raymond James.

Adam Tindle
Raymond James & Associates, Inc.

Q

Yes. Thank you. This is Adam in for Brian. I just wanted to ask you a little bit more about FlashBlade. I know it's early, but would you expect FlashBlade to be adopted more by new customers or existing? And if it is for the addition of new customers, do you expect an increase in operating expenses as this ramps? And I have a follow-up, please.

Scott Dietzen
Chief Executive Officer & Director

A

So, we will see a mix with FlashBlade, both new customers and existing. If you look across the dozens of betas I mentioned, we have a nice representation both of existing and brand-new customers. But it's very much the same sales force, the same channel, the same go-to market cadence that we already have in the business. Keep in mind, we're selling the infrastructure teams, but we're also selling to line of business and we're selling to engineers that are building new products and that will be true for FlashBlade the same way it was FlashArray. So, we will be able to capitalize on the investments we've already made in our go-to market, and we think the product can grow even faster than FlashArray did as a result.

Adam Tindle
Raymond James & Associates, Inc.

Q

Okay. And on the adjusted DSOs, I think I'm calculating low-60s for the quarter. And I think your previous goal stated at the mid-50s. I wanted to understand the dynamics there, and it sounds like based on your guidance, that level is going to – that's going to continue?

Tim Riitters
Chief Financial Officer

A

So, Adam, this is Tim. On adjusted DSOs, what's happening there. That mid-50s is what I think about the number over the course of an overall year. As we've gotten to the scale that we have, we're seeing some seasonal dynamics. You heard us talk about in revenue, and there's seasonal dynamics as well on the balance sheet. And so what you're seeing there is really – if you strip out for example the change in deferreds, you would see that DSO would be much more in line with what it's been historically. I look at weighted average days to pay internally, as well as percent current, and those measures are all tracking very, very well. So, there's going to be some volatility and variability just because of seasonal dynamic but nothing fundamental in the change in the business.

Adam Tindle
Raymond James & Associates, Inc.

Q

Okay. Thank you.

Operator: The next question comes from Alex Kurtz of Sterne Agee.

Alex Kurtz
Sterne Agee

Q

Hey, guys. Just a clarification then a question. No more annual guidance, is that correct? Because I think you, guys, gave that last quarter, but you're not giving it this quarter?

Tim Riitters
Chief Financial Officer

A

Yeah, Alex. On that, we basically would help everybody with their underlying yearly models. But then, we're going to a 90-day cadence going forward. So, that, I think, absolutely correct.

Alex Kurtz
Sterne Agee

Q

Okay. And, Tim, just looking at you sales reps sort of reloading their pipeline, coming out of the difficult quarter, say, versus a year ago. How would you quantify that as far as looking out into the rest of the year and their ability to hit their quotas? Do you feel like the pipeline growth is sort of on track as we – here we are on May 25 or because of the macro, maybe it's a week or two behind where you'd like it to be?

Tim Riitters
Chief Financial Officer

A

Yeah. On pipeline, Alex, the pipeline continues to build well. We talked a little bit about productivity and where are folks our hitting and those trends are largely the same. So, I'm happy with where we're at right now.

Alex Kurtz
Sterne Agee

Q

Okay. Thanks.

Scott Dietzen
Chief Executive Officer & Director

A

But as we look forward across our performance in the second half, I mean, so much of the market is just breaking our whip, right? We're breaking through to new levels in the channel with the confusion and indecision of – from the incumbent vendors, so much of this technology is showing its edge, right? It is not able to keep pace with the innovation necessary to play in the modern dataset. and it is that differentiation, Alex, is making a huge difference in the marketplace.

Alex Kurtz
Sterne Agee

Q

Thanks, Scott.

Operator: And next, we have a question from Jason Ader of William Blair.

Jason N. Ader
William Blair & Co. LLC

Q

Yes. Thank you. I have two questions. Scott, maybe people got a little bit spoiled by the last two quarters of convincing revenue beats. So, did something change in Q1 where you weren't able to deliver the kind beat that people have become accustomed to?

Scott Dietzen
Chief Executive Officer & Director

A

Jason, we are very happy with the performance we just turned in, right? At $600 million revenue run rate, being able to grow that business at 89%, I would say, is unprecedented in storage industry history, right?

And I mean, we're playing now as one of the top 10 storage providers in the world and we are profoundly differentiated and distancing ourselves from the rest of the pack in terms of the market we are serving and growth. And I think you'd also see this differentiation in our best-in-class product margins, our customer CSAT, our competitive win rates. So, we are very happy that the business is kicking on all cylinders and we introduced the second product, right, which allows us to address with the two products, the whole of the $24 billion storage TAM, with only two products that are designed from the ground up for the all-flash and cloud-friendly future.

Jason N. Ader
William Blair & Co. LLC

Q

I guess what I'm getting at it is there are more seasonality in the business than maybe some people had anticipated. I know you have sort of a fair amount of EMC folks in the sales, old EMC folks in the sales force and obviously EMC has always been very seasonal in Q1. Maybe going forward, we should be thinking about more pronounced seasonality in Q1?

Tim Riitters
Chief Financial Officer

A

Jason, this is Tim. On seasonality, as we get to that $600 million run rate scale that Scott talked about, there is seasonality. We've seen seasonality in the business for a while. This was expected. It was consistent with our guide, so it's not, certainly not a surprise for us. And I think that's how we're modeling it going forward.

Jason N. Ader
William Blair & Co. LLC

Q

Okay. And then just a quick last one. For the second half, Tim, maybe this is for you, I know there's a big revenue ramp, kind of baked in to hit the annual target. How should we think about sequentials in Q3 and Q4? Should we expect a similar type of sequential growth in Q3 and Q4?

Tim Riitters
Chief Financial Officer

A

Well, as we talked a little bit earlier on the call, Jason, we're not offering forward-looking guidance, but I think you can do kind of the A minus B in terms of how we guided before. You typically see general deceleration year-on-year as the numbers get bigger, but I'll let you think about how you want to model that as we're not providing forward guidance.

Jason N. Ader
William Blair & Co. LLC

Q

Okay.

Operator: The next question comes from John Lucia of JMP Securities.

John A. Lucia
JMP Securities LLC

Q

Hey, guys. Thanks for taking my questions. My first question is on the cloud segment. Can you just talk about the momentum you're seeing there, it sounds like that's pretty positive? Is that growth rate still higher than the overall growth and also do you expect that to continue to increase as a percentage of the mix?

Scott Dietzen
Chief Executive Officer & Director

A

So, John, the cloud segment is about a quarter of our business, breaking out historically, and but I want to be clear, we have a strong litmus test for what we quantify as cloud. It's got to be software-as-a-service infrastructure-as-a-service across public networks or the large consumer web services, right. We count those all as next generation data center cloud opportunities.

The repeat purchase behavior we're seeing in the cloud cohort is 2x better than we're seeing in the overall business. So you should expect that to grow faster over time. And I mean, that's in line with what's happening in the market, right? If you look at IDC's forecast, you can see some of this on our blog, IDC sees cloud growing substantially faster than the rest of spend and most compellingly, software-as-a-service and consumer cloud, I believe, both growing faster than may have public cloud services like AWS. And we're very well exposed to those services in our business.

John A. Lucia
JMP Securities LLC

Q

Okay. And then, I have a follow-up, it's kind of a follow-up to Jason's question. Pure has all these growth drivers in place, the rapid shift to all flash, disruption with incumbent vendors. Another thing, the cloud coming on. My question is why do we see product revenue growth decelerate below 80% despite these factors? Is there anything particular in the market that's affecting growth, or is this just a law of large numbers?

Scott Dietzen
Chief Executive Officer & Director

A

Yeah, John. I think it's the latter as you describe. And once you get to this side, growing a business at 80% for multiple years out, that's a challenge, right? And so, that's why you're seeing some of that deceleration. But at the end of the day, we are excited and looking forward to the second half. As you recall, our deliberate strategy is to invest at the beginning of the year where we have seasonally lower revenue, but bring in the star talent from a sales and marketing perspective to be armed and ready when it comes time to the seasonally strong second half that you see in the storage industry, and we're going to capture more than our fair share by going after it.

Scott Dietzen
Chief Executive Officer & Director

A

And I would just add, if you do compare us to other storage players, I mean, our growth looks extraordinary. I mean, 4x higher than that of the next closest independent company we're aware of. I mean, most of the incumbent businesses are flat to declining at this point. And you look at the historic metrics, it's not just storage that we're best-in-class, but we have better – very favorable compares to a Cisco or a Palo Alto Networks, that kind of performance at this scale, we're profoundly excited about.

John A. Lucia
JMP Securities LLC

Q

Okay. Thank you.

Operator: [Operator Instructions] And our next question will come from Tal Liani of Bank of America.

Tal Liani
Bank of America

Q

Hi, guys. I have a question about – so, your both competitors grew triple-digits if I look at the big one, the HP and EMC, in their flash product, they grew triple digits, I think, they said on the calls. You grew about 89%, it's very impressive, but the question is how big of an opportunity do you think in terms of – how long would you have a window of opportunity here before the competition starts to hurt you more than where it is now? Do you seen the market – for example, do you see growing competition or the impact of growing competition, and it doesn't have to be of technology the way you explained it, it could be just because they're already in the market and they're already selling to certain customers, and now they have a product. So I'm just trying to understand whether this past quarter you sensed any change in the competitive environment just because these guys have grown so much? Thanks.

Scott Dietzen
Chief Executive Officer & Director

A

Hey, Tal. So I want to reiterate, no change to the competitive climate. And we've operated throughout our history in a very, very competitive marketplace in storage, and the fact that we have been able to maintain competitive win rate is reflective of how highly differentiated the product is. We've cited these already, but our audited Net Promoter Score of 79, the repeat cohorts of $12 for every initial dollar over the next 18 months in the top tier, it's product margins and it's reflected in that growth.

Unlike the large incumbents, there's no financial engineering that we can do in moving dollars from maintenance on legacy disk arrays over to all-flash. And so, the fact that we're growing our business so quickly, the aggregate business, well, the incumbents are not seeing that growth. I would say it's reflective of the fact that they really can't compete with their products that were designed generally more than 20 years ago in this new world of flash and cloud-centric storage.

Tim Riitters
Chief Financial Officer

A

And Tal, this is Tim, the other thing, I would add, in terms of one of the things that we're excited about with the future is customer acquisition. We've talked about a revenue number, but we grew customer – new customers by nearly 130% year-on-year, and that's an acceleration from our year-on-year growth rate last quarter. So it really talks about how we think about landing those customers and really building those repeat statistics, because if you add that dynamic to the repeat statistics that Scott talked about, you really think about what the future holds. We're excited.

Tal Liani
Bank of America

Q

Got it. Another question that is related to growth, you said that you expect to reach sustained positive cash flow in second half 2017. If you grow slower, let's say, there is a negative scenario if something happens to the market or to you specifically and you grow slower than currently expected, do you have any pulls in your business model, where you can still get to positive cash flow second half despite weaker growth? I'm trying to understand whether reaching there this point is predicated on the current growth expectations that we have or not?

Tim Riitters
Chief Financial Officer

A

The short answer is we absolutely have levers, Tal, whether it be in our sales organization or beyond to manage the bottom line through various scenarios on the revenue top line.

Tal Liani
Bank of America

Q

Yeah.

Scott Dietzen
Chief Executive Officer & Director

A

Keep in mind, we've been investing for growth, right? And this is why we make these investments, we hire additional field personnel in the first half of the year in order to deliver on that productivity because the metrics are so strong and solid across the board.

Obviously, if we continue to look at all of that and if we didn't see clear line of sight to being able to maintain the tears that we've been on, then we need to manage the business to ensure meeting our targets of improved operating efficiency year-over-year because that's the commitment is to drive maximal growth within the constraint of materially improving our operating efficiency year-over-year.

Tal Liani
Bank of America

Q

Got it. Thank you.

Liz Lemon
VP, Finance and Development

A

Thanks, Tal.

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

Kathryn Lynn Huberty
Morgan Stanley & Co. LLC

Q

Yes, thanks. When you see yourselves grow high double digits and peers grow triple digits, does that embolden you to accelerate sales spend even more than maybe you had planned, or is the opposite true and more competitors in the market and higher penetration rates actually shrink the sales cycle and limit your need to have to invest ahead of demand like you have in the past?

Scott Dietzen
Chief Executive Officer & Director

A

Katy, I mean, I think the goal is to grow within the constraint of hitting our operating targets, right? We need to deliver on our sales productivity metrics and have our individual sales people be successful. We need to grow within the constraints of the ramping channel footprint. But the indicators there remain very strong, right? So we will invest prudently to capture as much of the market as we can within the constraints of those improved operating metrics.

And again, I want to reiterate, we are not conceding fastest growth to anyone in this market. There's no question, with a diverse product portfolio, there's more flexibility to move dollars around between buckets. We believe we're growing faster than any other player in this market. They can't all be growing faster than the aggregate Gartner data and IDC data. So the fact that we're growing materially faster than the analysts say flash is going into the data center, I think it's reflective that we're outperforming the competition.

Tim Riitters
Chief Financial Officer

A

Katy, this is...

Kathryn Lynn Huberty
Morgan Stanley & Co. LLC

Q

And...

Tim Riitters
Chief Financial Officer

A

Katy, this is Tim. One other thing on investment. We had a great quarter of hiring up nearly 200 net so – and obviously, a majority of that's focused in the sales and marketing organization, which really speaks to the app-back capability, if you will, that we are putting out into the field because of the success we've had in the business.

And that's in contrast with many that are seeing flat, if not declining employee counts as they try to manage through different things going on in their business. So we are still very, very focused on investing in our own plan in terms of what we wanted to bring sales productive capacity to bear.

Kathryn Lynn Huberty
Morgan Stanley & Co. LLC

Q

And as that relates to expanding the product portfolio, you drove a really extreme cannibalization of primary disk and 15K drives over the past year. How are you thinking about the pace of a similar cannibalization of secondary storage and 10K drives over the next couple of years? Does it happen as quickly or is the disk space business stickier in those markets?

Scott Dietzen
Chief Executive Officer & Director

A

So, Katy, I think we have the opportunity to actually drive the transition even faster. And the reason I would cite is we have much greater reach today than we did. We were ultimately constrained in the early days of FlashArray//m just in our ability to touch customers and touch channel partners. Because we are so much larger today, literally, in the top 10 storage providers in the world, we are in a position to touch a much broader part of the market far, far more quickly. And the economics are compelling. It's not just the fact that we can deliver better performance. We can deliver dramatically better density.

And customers are crying out. There was a third-party survey that was asking about – customers about whether they could get access to insights in their data. And 80% of the customers in this survey said that they would be able to increase their top line by 20 points just by mining, if they could only mine insights they have in their existing data sets.

This is what flash unleashes. Data that's stored on these large mechanical disks is effectively performance-locked. The business can't get at it in order to do anything with it. And this is the revolution that we brought to the market with FlashArray//m, and history is going to repeat with FlashBlade and it's going to do so faster.

Kathryn Lynn Huberty
Morgan Stanley & Co. LLC

Q

Interesting. Thanks for the comments.

Liz Lemon
VP, Finance and Development

A

Thanks, Katy. Next question?

Operator: Thank you. Our next question will come from Ittai Kidron of Oppenheimer.

Ittai Kidron
Oppenheimer & Co., Inc. (Broker)

Q

Thanks, Scott. You clearly are doing well in the market. You're gaining share. You're displacing your competitors. You're growing at unprecedented growth, but I like to think that you also benchmark yourself not just against your competitors, but also targets you have for yourself.

And you came just a hair above the high end of the guide, and I'd like to think that, at least internally, you thought that you can do better than the high end of the guide. And so, it'll be great if you can give us a little bit of color on what do you think did not work perfectly to plan in this quarter? Was there a region, a certain sales force, a certain competitive dynamic, whatever that may be or maybe macro, because in your prepared comments, you did talk about the difficult macro, maybe that by itself made all the impact? But if you can kind of pinpoint what actually did not work textbooks to your plan, that will be great.

Scott Dietzen
Chief Executive Officer & Director **A**

Ittai, we are extremely happy with the quarter we just turned in, right? $600 million revenue run rate, growing at 89% year-over-year, 69.6 points of product margin, the repeat business cohorts, the customer satisfaction, the channel uptick we're seeing, the net new logo increase, almost 2x the pace of net new logo acquisition from the prior quarter.

No question, we look across the boards and always think where the company could do better, because we have aspirations to be number one in a $24 billion market. But we are supremely happy with the quarter we just turned in, and we are on track to hit all of our targets.

Ittai Kidron
Oppenheimer & Co., Inc. (Broker) **Q**

You talk about your gross margin and your long-term gross margin is something that balances growth and the need to acquire new customers. Your product gross margin is, I mean, I must admit, it's very impressive, and I guess, it begs the question of, do you think that – do you think you're overpricing? Out of curiosity, do you think that if you would have priced products at a point below, it would have generated extra revenue or that will not be the case right now?

Scott Dietzen
Chief Executive Officer & Director **A**

So Ittai, we are differentiating on value that we are delivering to customers. Keep in mind, in the larger configurations, when we go up against the incumbents, we are often in a situation where our street price is actually below their cost of goods. And so, we're delivering so much value, because of our hardware efficiency, the customers are getting phenomenally better value with Pure than they can get from the competitors.

Ittai Kidron
Oppenheimer & Co., Inc. (Broker) **Q**

So why would that change then? Why should we think that your gross margins should go down into the range longer term?

Scott Dietzen
Chief Executive Officer & Director **A**

If you're talking about our gross margin occupying the range that we've set for the business, yes, that remains our long-term target. We're not asking people to change their models and say, our gross margin – our product gross margins are going to be in a new range.

I mean, keep in mind we set out to the storage on a Moore's law curve, right? Storage has not been on a Moore's law curve unlike the rest of the data center. And this is very important to customers, because it allows customer workloads to keep paced, storage to keep up with the demand of the data center and demand of the business. And we accelerate the shift to all flash by continuing to press hard on bringing the Moore's law value proposition to customers, because it's something that the mechanical disk era of products can't keep up with.

Ittai Kidron
Oppenheimer & Co., Inc. (Broker)

Q

All right. And, Tim, last...

Tim Riitters
Chief Financial Officer

A

[Inaudible] (53:47)

Ittai Kidron
Oppenheimer & Co., Inc. (Broker)

Q

Yeah. Tim, last...

Tim Riitters
Chief Financial Officer

A

You can go ahead. Please go ahead.

Ittai Kidron
Oppenheimer & Co., Inc. (Broker)

Q

If I may – Tim one last question. I think you talked about fiscal 2017 being a turning point for losses, I think that was the quote if I hope I got that right. Is that an annual comment or is that a quarterly comment? Meaning is 2018 as a year profitable or every quarter in 2018 is profitable?

Tim Riitters
Chief Financial Officer

A

No, Ittai. What we meant by turning the tide here in fiscal 2017, so the year we're in right now is that the guide that we provided at the beginning of the year, so the last quarter, we said that our absolute losses this year or fiscal 2017 will be no higher than the previous year. So we delivered about $140 million of operating loss last year, that's our cap that we're shooting for.

Ittai Kidron
Oppenheimer & Co., Inc. (Broker)

Q

Yeah.

Tim Riitters
Chief Financial Officer

A

As a statement on how we're doing on that, we were within $1.7 million – just under $2 million year-on-year in our absolute operating losses while still driving the business, about nearly 90%. We're very, very happy with that.

Ittai Kidron
Oppenheimer & Co., Inc. (Broker)

Q

All right. Good luck. Thank you.

Tim Riitters
Chief Financial Officer

A

Thank you.

Liz Lemon
VP, Finance and Development
A

Thank you, Ittai.

Operator: The next question comes from Rich Kugele of Needham & Company.

Rich J. Kugele
Needham & Co. LLC
Q

Thank you. Good afternoon. Just a question about average deal size, even if you are not willing to give it specifically, can you just talk about how that trended in the quarter, especially relative to sequential? And post the launch of FlashBlade, call it, let's say when it's out for more than a quarter or so, like next year, would you expect the average deal size to go up with the launch of FlashBlade, would you expect those initial deployments to be generally larger scale? Thanks.

Scott Dietzen
Chief Executive Officer & Director
A

So with respect to ASP, this is not a metric that we have historically broken out. I would say year-over-year, they are something that we look to see at least hold steady. And in a world of Moore's Law, that's actually a great outcome for us. We have not – we've built into the annual guidance for the year, our expectations around FlashBlade, but we've not stated anything about what FlashBlade's impact can be on average selling price.

I would say the way we design FlashBlade is similar to FlashArray//m. We want to have easy starter packaging with low hurdles to entry that customers can get in and try the technology out, and fall in love with it. Because we want to see that same kind of repeat purchase behavior kick in for FlashBlade that we enjoyed with FlashArray//m. Customers fall in love with your storage, and then they buy more of it than they do any of the other competitors, that's the best way to grow the business.

Rich J. Kugele
Needham & Co. LLC
Q

Okay. Thank you.

Liz Lemon
VP, Finance and Development
A

I think we have time for one last question. And then Scott, we'll hand it back to you to sum up. Okay.

Operator: Thank you. That last question will come from Eric Martinuzzi of Lake Street Capital.

Eric Martinuzzi
Lake Street Capital Markets LLC
Q

Yeah. I feel like I missed something. Did you say that you reiterated the full year revenue guidance, or you were no longer reiterating it and just getting Q2?

Tim Riitters
Chief Financial Officer
A

Eric, this is Tim. We are not reiterating the full-year guidance. We provided one-year guidance at the beginning of the year and now we're just providing quarterlies, and that's just our natural management cadence.

Liz Lemon
VP, Finance and Development

A

Yeah, to be clear, last quarter on the call, we stated very clearly that we would give it once per year and once per year only. So this is our policy.

Eric Martinuzzi
Lake Street Capital Markets LLC

Q

Okay. That's different in most companies, which is why I asked. Thanks.

Liz Lemon
VP, Finance and Development

A

Sure. Is that your only question?

Eric Martinuzzi
Lake Street Capital Markets LLC

Q

Yeah.

Operator: And this will conclude our question-and-answer session. I would like to turn the conference back over to Scott Dietzen for any closing remarks.

Scott Dietzen
Chief Executive Officer & Director

Thanks so much for joining us. Pure Storage finds ourselves uniquely well-positioned. We have a $24 billion total addressable market that is rapidly shifting to all-flash and cloud-friendly storage. The market has already come to FlashArray//m, we are increasing the benchmark to which other companies are doing their compares. We remain wholly-convinced that the mainframe area of designs from the last century that we're competing with simply cannot make the leap of the flash and cloud, it changes so much of the software, the hardware, the automation, and the business model around storage that the incumbents – of the incumbent technology, which – and the rest of that top 10 list were basically always competing with retrofits from the last century. We will be able to continue to win.

And the market is going to come to FlashBlade. FlashBlade was three years in the making much like when FlashArray//m launched, there's nothing else like it in the marketplace. And we are going to enjoy the same kind of robust differentiation around FlashBlade. That combination FlashArray//m and FlashBlade allow us to play for the entire market.

Our product lines remain hugely differentiated from the competition. We have the best customer satisfaction, the best repeat cohorts, sustained competitive win rates over year's best product margins and best-in-class growth, not just today, but in storage industry history. And we're usually enthusiastic about the road ahead. Our exposure to the cloud side of the business, but that's – cloud footprint is reflective of what all customers aspire. Everyone wants their data center to be simpler, easier to manage like cloud-oriented data centers are, and to bring down cost of ownership and bring up their performance access, so they can mine insights in their data and get just the job done for the business.

And we've got a channel that we believe is tipping towards Pure, because of our consistent excellent end-product, and because they're facing unknowns in the way that our competitors, product portfolios and business models are going to evolve over time.

So hugely excited about the rest of this year, and we will speak to you again in three months. Thanks so much for joining us.

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