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Your Enterprise Cloud Platform

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Nutanix Q1 FY2018 Earnings Transcript

November 30, 2017

Introduction and Safe Harbor

Tonya Chin, Investor Relations

Good afternoon and welcome to today's conference call to discuss the results of our first quarter of fiscal 2018. This call is also being broadcast live over the Web and can be accessed in the investor relations section of the Nutanix website. Joining me today are Dheeraj Pandey, Nutanix's CEO, and Duston Williams, Nutanix's CFO.

After the market closed today, Nutanix issued a press release announcing the financial results for its first quarter of fiscal 2018. If you would like a copy of the release, you can find it in the press releases section of the company's website.

We would like to remind you that during today's call, management will make forward-looking statements within the meaning of the safe harbor provision of federal securities laws regarding the company's anticipated future revenue, gross margin, operating expenses, net loss, loss per share, free cash flow, business plans and objectives, product sales, plans and timing for, and the impact of, our transition to focus more on software-only sales, expectations regarding product features, technology that is under development, competitive and industry dynamics, new strategic partnerships, changes in sales productivity, expectations regarding increasing software sales, future pricing of certain components of our solutions, our plans regarding how we will report the software content of our business, potential market opportunities, and other financial and business related information.

These forward-looking statements involve a number of risks and uncertainties, some of which are beyond our control, which could cause actual results to differ materially and adversely from those anticipated by these statements. These forward-looking statements apply as of today, and you should not rely on them as representing our views in the future. We undertake no obligation to update these statements after this call. For a more detailed description of these risks and uncertainties, please refer to our Quarterly Report on Form 10-Q for the third quarter of fiscal 2017, filed with the SEC on June 2, 2017, our Annual Report on form 10-K filed with the SEC on September 18, 2017 as well as our earnings release

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posted a few minutes ago on our website. Copies of these documents may be obtained from the SEC or by visiting the investor relations section of our website.

Also, please note that unless otherwise specifically referenced, all financial measures we use on this call today are expressed on a non-GAAP basis and have been adjusted to exclude certain charges. We have provided reconciliations of these non-GAAP financial measures to GAAP financial measures in the investor relations section of our website and in our earnings press release.

As a reminder, all results included in today's call and press release are using the newly adopted revenue standard, ASC 606.

Finally, Nutanix plans to attend the Raymond James 2017 Technology Investors Conference in New York City on December 4th, and the Wells Fargo Tech Summit in Deer Valley, Utah on December 6th, we hope to see you there.

Now, I'll turn it over to Dheeraj. Dheeraj?

Dheeraj:
Thank you, Tonya. Hi everyone. Thank you for joining.
Q1 marked another strong quarter for Nutanix, with billings, revenue, gross margin, and EPS performance better than our guidance and consensus. Before getting into our Q1 results, I'd like to start the call by discussing the business transformation within Nutanix.

You might have heard from us that we are increasingly taking a software-centric approach to go-to-market and financial reporting. I want to take this opportunity to zoom out and talk about the "**why**" behind our packaging and distribution strategy of the last 6 years, and the somewhat obvious "**why**" of the future software strategy. I borrow from my annual shareholder letter to set the context.

Digitization, or virtualization as we call it, has been an unstoppable phenomenon in computing. We saw this with music, photography, shopping carts, and maps, as they all converged into pure software and as digital constructs in our consumer lives. We brought that foresight to enterprise storage and compute.

And by doing so, we improved machine **productivity** by bringing data closer to applications, and also human productivity by breaking down artificial walls in IT departments. By standardizing on commodity hardware and a common operating system, we delivered economies of scale that were unprecedented in enterprise datacenters. But none of this would have been possible if we hadn't obsessively focused on product **design**. The elegance of Nutanix products is in their simplicity, and in our ability to bring a consumer-grade experience to enterprise-grade systems. We are now on a path to digitizing networking, security, and effectively the entire datacenter. This architecture -- of an undifferentiated hardware running software services (that then bring all the differentiation) -- is the only way to operate a cloud if the enterprise wants to stay in the business of computing.

In 2011-12, software-defined anything was too abstract for our customers to put their arms around. Server vendors were conflicted because they sold billions of dollars worth of hardware equipment that we, as disruptors, were digitizing into pure software. Our only route to market was to take control of our own destiny. The Nutanix appliance was born. We now had an "iPhone"-like design pattern that people could touch-and-feel, and the channel could sell. Customers loved us for bringing the web-scale culture to them in which the white-box with a robust software -- aided by a world-class customer service -- was meaningfully more delightful than their current experience of stitching together vendors and inside teams that constantly finger-pointed at each other. Over time, as our architecture gained popularity, we relaxed our opinion on our own hardware and signed OEM relationships. We built the muscle memory on a 2-hop customer service. Also, in the last 18 months, we signed large ELAs in pure software, some of which our hyperscale customers run on OCP-like server equipment. In the last 12 months, we ported our software to every major x86 server vendor, IBM Power microprocessor, ruggedized warfare servers, and even 4x4 inch Intel mini-servers for the IoT edge. We now have a meaningful competitive advantage in being the most portable operating system built for the enterprise cloud.

We've kept growing our total addressable market as we ported our software to all these platforms in the last 3 years. A software-only form factor gives us ubiquity. It also enables friction-free access of our technology to tinkerers, prospects who are at the top of the sales funnel. But the change is beyond just the product. It includes thoughtful changes to the quote-to-cash process, sales compensation, software downloads, license management, and new tools at the top of the sales funnel. These changes also prepare us well as we embrace the subscription model next year with our Xi (spelt X-i) cloud services. The company that has obsessed with an iPhone-like motif is ready to institutionalize a pure software version of its operating system. And all that without compromising customer experience and without being negligent about the boundary at which hardware and software meet.

Innovation:

Shifting gears to product. Over the past two years, we've built a multi-product portfolio. We've built our own hypervisor, AHV, which has consistently grown in market share quarter-over-quarter. We introduced AFS, a software-only scale-out filer, to remove yet another hardware silo from enterprise datacenters. We added Prism Pro and Calm for operations management and model-driven automation respectively.

At our recent .NEXT Europe customer conference in Nice, France, we continued this innovation with the announcement of the Acropolis Object Storage Service, Acropolis Compute Cloud and Nutanix App Marketplace. These services, which will be included with our software, help our customers run a growing set of cloud-native applications.

Acropolis Object Storage Service supports the growing number of applications with large, unstructured data and enables application development teams to consume storage as a high-performance, on-demand service - similar to public cloud offerings.

Complementing Object Storage Service is our new AHV-based compute service, the Acropolis Compute Cloud. This new capability will help enable enterprise customers to economically scale compute resources to better support applications like distributed analytics workloads, large scale front-end web services, Citrix XenApp deployments and other CPU-intensive workloads.

Finally, on Nutanix Calm, spelled as c-a-l-m, we announced the addition of the App Marketplace. This new marketplace service empowers IT teams to rapidly deploy fully validated applications via a self-service portal so new workloads can be deployed quickly and easily.

Xi continues to be on track for a mid-2018 release. We are making meaningful progress with Google on the go-to-market and deployment strategies around the world. On a related note, the bare-metal-as-a-service offering from the public cloud providers is a very promising breakthrough for our cloud OS, as we explore even more ubiquity for our software. Through APIs, automation, and digital delivery, bare-metal in the cloud even further commoditizes a commodity server. Alliance partnerships move from business relationships to developer relationships aided by SDKs and APIs. The next few years will be exciting in our cloud OS journey, as we forge deeper alliances with new hardware partners in the cloud.

At .NEXT, one of our most intriguing announcements was our move to the IoT edge. We laid the foundation of the IoT edge with our 4x4 mini-server form-factor port and Prism Pro software. Beyond providing an invisible IoT infrastructure, we are building an event-based message-bus application that manages data between the edge and the cloud core. Both object storage and this IoT data service are our early forays into building platform services for developers beyond traditional infrastructure for IT operators. Consumer cloud operators like Amazon and Facebook have leveraged a lot of open source to their competitive advantage. Similarly, in the last 8 years, we embraced Linux to build an elegantly simple yet enterprise-grade hypervisor and network virtualization, and also NoSQL databases to build the core metadata services of our operating system. 2018-19 will be years when we embrace open-source Apache Software Foundation services even further to deliver consumer-grade developer building blocks in Xi. Making these building blocks into hybrid services is our big bet around the future of cloud.

The true north for us is to provide a common IT experience in a hybrid cloud world as we try to blur the lines between owning and renting computing.

Customers:

Shifting to some Q1 KPIs now. Last quarter I shared the progress we had made in signing large deals. We continued our large deal momentum with

- 478 customers that have purchased in excess of $1 million, lifetime to date, up 74 in the first quarter, and they have collectively spent nearly $1.4 billion with us in lifetime bookings.

- Additionally, we have 206 customers that have purchased over $2 million, up 40 from last quarter, 47 customers that have purchased over $5 million, and 16 customers that have purchased over $10 million with us lifetime to date.

As we have shared in the past, customers are increasingly trusting us with their most mission-critical workloads. Our top three deals in Q1 were all in the federal vertical and together comprised more than $15m in billings. In two of those engagements, the customers went **all in** with AHV, our hypervisor, choosing to standardize on our built-in hypervisor over other virtualization offerings. The first customer, which is the largest revenue generating civilian agency in the federal government, selected Nutanix because of the inherent security and rapid time-to-value our platform provides. This customer will take advantage of our Prism Pro software edition, benefiting from reduced complexity and costs for operations and management.

The other customer, a unit within the United States Armed Forces which handles day-to-day operations around the globe, will use the Nutanix platform to support facilities that provide recreational and educational opportunities to the children and youth of soldiers and US Armed Forces civilians stationed at bases in both the US and abroad.

This quarter also saw great momentum in the healthcare vertical with seven deals greater than $1m. One such deal was with Baylor Scott & White Health, another existing customer that is using our platform to host EPIC, its electronic health records system, and power its DNA sequencing environment. In fact, using the Nutanix solution, Baylor Scott & White Health has been able to process DNA sequencing results 5x faster and at greater volume than with its previous solution.

Another great use case in the health services space is with an S&P 500 company that operates one of the largest clinical laboratory networks in the world. The company is replacing its legacy 3-tier infrastructure with Nutanix, using our platform to run a host of different workloads, including powering the lab tests for a popular privately held personal genomics and biotechnology company.

Outside of the healthcare and federal verticals, a leading entertainment provider with 17 facilities including casinos, hotels, and show theatres uses our platform to support its Bally gaming management software. To give some context on that workload, when the gaming management system goes down, the casino stops running and customers leave. It's the company's 'moneymaker' and they trust this mission critical application to Nutanix.

Another customer, an international group active in the design, manufacture and sale of watches, jewelry and watch components, which had previously committed to a VMware-centric strategy, selected our platform because of its easy-to-use and simplified management console.

In this quarter, we continued to see customers refocusing their infrastructure strategies away from public cloud-only ambitions. One such customer, a leading provider of device insurance, warranty and support services for cell phones, consumer electronics and home appliances, began adding a variety of mission critical workloads to our platform after a year long focus on evaluating and testing AWS. Cost, service-level agreements and security concerns were among the contributing factors for the shift.

We saw robust demand for our software upsells, including Prism Pro and our Ultimate software license. In Q1, Prism Pro adoption increased by over 40% **quarter over quarter**. We also had 16 Prism Pro deals in excess of $100k, including the previously mentioned largest revenue generating civilian agency in the federal government, which was one of our largest deals this quarter.

Another customer, a Fortune 100 multinational company that produces a variety of commercial, engineering, aerospace and consumer products, continues to standardize on Nutanix software, including adding Prism Pro to their 300+ Nutanix nodes so that they can execute proactive capacity planning to lower operational costs and reduce risk. This customer continues to invest in and rely on the Nutanix Enterprise Cloud Platform across their enterprise, inclusive of mission critical applications such as ERP and PLM.

One win of particular interest was a Department of Defense agency. This software-only deal coupled our software with hardware from our partner, Klas Telecom, in order to deliver a ruggedized hyperconverged solution that is roughly the same size as airline carry-on luggage. This agency plans to deploy these ruggedized Nutanix appliances across its field teams, who will operate the units on battery power to maintain communications and other critical applications in war zones.

In closing, I am very pleased at how the company is evolving towards its next act. Lou Attanasio, our new Chief Revenue Officer, will play a pivotal role in our transformation to software, as he leads our growing sales force in this journey that blurs the lines between owning and renting computing. This now allows Sudheesh Nair, our President, to focus on strategic partnerships, importantly Xi and its developer-oriented services, and our largest of the large customers. I sincerely believe that we now have a dream team to do justice to our ambition.

With that, I'll turn the call over to Duston to discuss our strong Q1 financial performance.

Duston Williams:
Thank you Dheeraj.

I am pleased that our Q1 results came in a bit better than expected primarily driven by a solid quarter in our federal vertical. As a reminder, we adopted ASC 606 beginning this quarter and our results are reported under this new method of revenue recognition. Revenue for the quarter was $276 million, growing 46% from a year ago, and up 9% from the previous quarter. We billed $315 million in the quarter, representing a 32% increase from a year ago, and a 9% increase from Q4.

Our performance in our geographic regions were essentially in line with what we would expect for the first quarter of our fiscal year. As expected our OEM business, although at approximately 10% of bookings, waned a bit from the very high level we experienced in Q4. On the upside, we saw a good performance in our federal business, as well as continued strength in our APAC region. This strength was somewhat offset by seasonal declines in our North America commercial and EMEA businesses.

Once again, we were pleased to see the number of large deals in Q1 keep pace with the strong levels we experienced in Q4. We booked 15 deals >$2 million in the quarter – consistent with our strong Q4 performance. Bookings from our international regions were 37% in Q1'18, up from 34% in Q1'17.

Our gross margin for the quarter was 61.9% which was higher than our guidance and compares to 65.4% in the year ago quarter and 62.6% in the prior quarter. The Q1'18 gross margins benefited by approximately 1.5 percentage points as we purposefully eliminated more than 9% of revenue attributable to our pass-through hardware revenue. Our operating expenses were $193 million, below our guidance by $7 million, primarily due to timing of new hires and other personnel related expenses. Our non-GAAP net loss was $25 million, or a loss of $.16 cents per basic share.

Before I review the balance sheet highlights and our Q2 guidance this is a good time to take a step back for a high-level discussion on how we see our business model evolving over the next several years. Today, we are a software company – more specifically an enterprise cloud operating systems company – that up until now has delivered a majority of its software via its own branded appliance <u>and</u> recognized the associated hardware revenue. This approach made sense at the beginning as it allowed us to stand tall amongst our competitors in an emerging market, while at the same time allowing us to build out a direct sales force and brand, for what was early on, an unknown company.

It was this very same approach that yielded 60% gross margins, despite our significant software content, and which inadvertently, disguised the true nature of our company. This left many investors wondering if we were really a software company or just another storage or appliance company. And despite our best efforts to establish Nutanix as a software company, in the minds of many investors, you simply "are what your margins say you are".

Going forward, over time, Nutanix will emerge as exactly what it is – an enterprise cloud operating system company.

In conjunction with this, investors should expect the following to occur over the next few years:

1. <u>First, we will begin the migration away from pass-through hardware related revenue</u>

Beginning last quarter, we started the gradual migration away from recognizing pass-through revenue attributable to the hardware portion of our business. Today the hardware portion of our business is approximately 26% of our total billings. This transition will come in two parts – first, with

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straightforward changes which will allow us to step aside from most hardware only invoicing by enabling our legacy appliance manufacturers to begin selling the NX hardware directly to our distributors; and secondly, by simply focusing on more software-only transactions allowing our customers to then choose to run on a large number of server platforms. It's important to note that our stepping aside from the pass-through hardware does not in any way infer that customers are not ordering NX appliances. To be very clear, our customer's choices and experience will remain the same. We expect this transition to take a year or so and result in the elimination of at least 80% of all pass-through hardware related revenue.

All things being equal, the direct impact of this specific change would result in significantly higher software content, and significantly higher gross margins with no change to our growth in gross profit dollars. Probably the most important point to make here that this change will have absolutely no impact to our future growth rates of our software and support billings – that being the portion of our business today that represents 74% of our billings. Over time, we would also hope to gain additional selling leverage that naturally comes from focusing on software only transactions.

2. The next modification in our business you should expect will be a gradual shift to ratable Software as a Service revenue

Once our Xi Cloud service offering takes hold, starting with services such as Disaster Recovery, we expect to see the emergence of some ratably recognized software as a service revenue.

3. And lastly, over time, we will start to position the company for increasing ratable Software as a Subscription revenue

Although not immediate and not yet quantifiable, with the introduction of both our Xi Cloud Services and Nutanix Calm, we believe we will have the option to convert some of our perpetual and term based software streams into ratably recognized subscription software.

To help incentivize and expedite this transformation, starting February 1st, 2018, our fiscal Q3'18, we will start the process of compensating our sales teams on software-only related bookings. Once this change is fully implemented, sales representatives will no longer be compensated for the pass-through hardware sales. To summarize, this transformation of our business will take place methodically and over an extended period of time. The first phase will result in more perpetual and term-based software as we begin to significantly reduce our pass-through hardware revenue, we then expect to see the emergence of ratable services revenue, followed by a gradual shift to more ratable subscription revenue over time.

As we start to shift away from pass-through hardware revenue, we will also take this opportunity to change how we report the software content of our business. The previous methodology had us reporting software as a % of total bookings with the software content comprised of OEM licenses, upsell of our editions software, and other miscellaneous software sales. What this methodology excluded was the significant software content attributable to the base operating system that was bundled into the appliance sale.

Going forward we will add the software content attributable to our base operating system into our total software metric. The base operating system is simply calculated by taking the total billings attributable to the appliance sale less the billings for the actual cost of the hardware.

As we increasingly separate ourselves from the hardware sale, the related revenue and costs of goods sold would be eliminated in equal amounts - this amount representing our actual cost of the hardware.

Under this new software-centric reporting, based on billings for Q1 2018, the splits of the business would be as follows – software and support 74% of total billings and hardware 26%. It is this 26% attributable to the pass-through hardware that will be mostly eliminated over time. We would encourage you to review the Q1 Nutanix Investor Deck located in the Investor Relations section of the corporate website for further details surrounding this new software-centric reporting and the associated historical breakouts.

So, in summary, what would Nutanix have looked like over the last twelve months if we chose not to bill any pass-through hardware related transactions? The resulting business would have been very interesting – basically yielding a $800 million pure software and support infrastructure company, with gross margins above 80% while at the same time being a market leader within a $100 billion-dollar TAM.

That's what Nutanix would have looked like over the past twelve months void of any pass-through hardware billings. This level of size, growth and gross margins compares very favorably to other software and service companies such as Splunk, Atlassian, Tableau and others.

Now let's turn to a few balance sheet highlights:

- We closed the quarter with cash and cash equivalents of $366 million, up from $349 million in Q4.
- DSOs, on a straight average, were 57 days, that was 8 days lower than the 65 days reported in the prior quarter.
- The weighted average DSO was 27 days in Q1
- We generated $10 million of cash flow from operations in Q1, which was negatively impacted by $8 million of ESPP funding.
- We used $8 million in free cash flow during the quarter. This also was negatively impacted by the $8 million of ESPP funding.

Q2 Guidance

Now I'll turn to our guidance for the second quarter.
The guidance, on a non-GAAP basis, is as follows:

- Revenue to be between $280 to $285 million;
- Gross margins between 62.5% to 63.5%

This revenue and gross margin guidance is expected to yield approximately $178 million in gross profit dollars vs. the current Q2 gross profit consensus of $173 million;

- Operating expenses of approximately $210 million;
- And a per share loss of ($.20) to ($.22), using weighted average shares outstanding of approximately 161 million.

This guidance assumes that we will eliminate approximately $12 million, or 15%, of our pass-through hardware revenue and an equal amount of hardware cost of sales during the quarter. Without this change, we would have guided to revenue in the range of $292 to $297 million with gross margins of 60 to 61%.

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Lastly, for modeling purposes, we anticipate eliminating up to two-thirds of all pass-through hardware revenue by the end of Q4'18. Additionally, we have also assumed that for every $5 to $6 million reduction in pass-through hardware revenue, gross margins should increase by about 80 to 100 basis points.

At this point Operator, if would please open the call up for questions, that would be great.

Thank you.

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