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Nutanix, Inc. (NTNX)

Q3 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Thank you for standing by and welcome to the Nutanix Q3 2023 Earnings Conference Call. At this time, all participants are in listen-only mode. After the speakers' presentations, there will be a question-and-answer session. [Operator Instructions] As a reminder, today's call is being recorded.

I will now turn the conference to your host, Mr. Rich Valera, Nutanix's VP of Investor Relations. Please go ahead, sir.

Richard Valera
Vice President-Investor Relations, Nutanix, Inc.

Good afternoon and welcome to today's conference call to discuss the results of our third quarter of 2023. Joining me today are Rajiv Ramaswami, Nutanix's President and CEO; and Rukmini Sivaraman, Nutanix's CFO.

After the market closed today, Nutanix issued a press release announcing financial results for its fiscal third quarter 2023. If you'd like to read the release, please visit the Press Releases section of our IR website. We also filed our 10-Q for our second quarter fiscal 2023, which is available on the SEC's website.

During today's call, management will make forward-looking statements, including statements regarding our business plans, strategies, initiatives, vision, objectives, and outlook; including our financial guidance as well as our ability to execute thereon successfully and in timely manner; and the benefits and impact thereof on our business, operations, and financial results; our plans to implement recommendations and/or remedial measures following the completion of the Audit Committee investigation; our expectations and estimates for the resolution of the third-party software uses matter that was the subject of the investigation, including its estimated impact on our financial statements and guidance; our financial performance and targets and use of new or different performance metrics in future periods; expectations regarding profitability; our competitive position and market opportunity; the timing and impact of our current and future business model transitions; the factors driving our growth; and macroeconomic and geopolitical and industry trends, including global supply chain challenges.

These forward-looking statements involve risks and uncertainties, some of which are beyond our control which could cause the actual results to differ materially and adversely from those anticipated by these statements. For more detailed description of these and other risks and uncertainties, please refer to our SEC filings, including our annual report on Form 10-K for the fiscal year ended July 31, 2022 and our quarterly reports on Form 10-Q and fiscal quarters ended October 31, 2022 and January 31, 2023 as well as our earnings press release issued today.

These forward-looking statements apply as of today, and we undertake no obligation to revise these statements after this call. As a result, you should not rely on them as representing our views in the future. Please note, unless otherwise specifically referenced, all financial measures we use on today's call, except for revenue, are expressed on a non-GAAP basis and have been adjusted to exclude certain charges. We have provided, to the extent available, reconciliations of these non-GAAP financial measures to GAAP financial measures on our IR website and in our earnings press release.

Lastly, Nutanix will be holding its 2023 Investor Day in New York City on September 26. Please see our earnings press release for registration information. Nutanix will also be appearing at the Nasdaq Investor Conference in London on June 13, and we hope to see some of you there.

And with that, I'll turn the call over to Rajiv. Rajiv?

Rajiv Ramaswami

President, Chief Executive Officer & Director, Nutanix, Inc.

Thank you, Rich, and good afternoon, everyone. Against an uncertain macro backdrop, we delivered a solid third quarter with results that came in ahead of our guidance and saw continued strong performance in our renewals business.

With respect to the macro backdrop, in our third quarter, we continued to see businesses prioritizing their digital transformation and data center modernization initiative, with a strong focus on total cost of ownership, which plays to the strength of our platform. However, we also continue to see some increased inspection of deals by customers, which we believe is related to the more uncertain macro backdrop and this is driving a modest elongation in sales cycles. We've considered this dynamic in our outlook for the remainder of the fiscal year. Supply chain constraints with our seller partners appear to have normalized at this point and are now having minimal impact on our business.

In conjunction with the release of our fiscal third quarter earnings tonight, we also announced the conclusion of the Audit Committee investigation related to third-party software usage and the subsequent filing of our 10-Q for our fiscal second quarter. As a result of this process, we identified a material weakness in our internal control over financial reporting and are working on remedial measures to address the identified weakness and help prevent this from happening again.

We have also held the responsible employees accountable. This matter had no material impact on our historical financials and we believe it will have minimal impact going forward. While Rukmini will provide more details, we're pleased the investigation has been completed.

Taking a closer look at the third quarter, we delivered solid top line growth, including 17% year-over-year ACV billings growth, driven by continued strong performance of our renewals business. Our ongoing focus on expense management help us generate $42 million of free cash flow, continuing our strong year-to-date free cash flow performance.

Overall, I'm pleased with our financial performance in the third quarter. Our third quarter results reflect the value new and existing customers are seeing in both our core cloud platform and our solutions-based portfolio as they look to modernize while carefully managing their cost.

A good example of this is our largest deal in the quarter with a Fortune 500 semiconductor provider that was looking to accelerate its digital transformation. This customer decided to deploy their containerized manufacturing applications on Red Hat OpenShift on our Nutanix Cloud Platform to optimize their infrastructure resources and operationalize their private cloud environment in their numerous manufacturing facilities around the world. They expect this will meaningfully reduce their costs while also enabling enhanced agility in deploying new products and responding to changing market demands. We see this win as a testament to the performance, scalability, and total cost of ownership benefit delivered by our platform and our ability to expand our footprint within some of the world's largest companies.

Another notable win in the quarter was with a leading payment solutions provider in the EMEA region who was looking to improve their IT total cost of ownership by modernizing their infrastructure and implementing a multi-cloud architecture operating across several countries. They chose our Nutanix Cloud Platform, including Nutanix Cloud Management (sic) [Nutanix Cloud Manager] to run their business-critical applications, leveraging its simplicity and built-in automation for Infrastructure as a Service. They also adopted Nutanix Database Service for managing and deploying their databases throughout their organization and Nutanix Unified Storage to service their unstructured data needs. By adopting the full Nutanix stack, this customer anticipates lowering their annual IT operating cost by 45%.

We're also seeing customers take advantage of the capabilities of Nutanix Cloud Clusters or NC2 to rapidly and efficiently optimize their workload distribution across on-prem and public clouds. An example in the third quarter was a government agency in the EMEA region that was looking to shift a variety of on-prem workloads running on Nutanix Cloud Platform to public cloud in keeping with a government cloud-first mandate. They initially chose to shift the workload to Azure using NC2 for what they thought would be a contingency plan for workload migration.

However, given the speed and simplicity afforded by NC2 for quickly transitioning workload without refactoring as well as the cost effectiveness they found running workloads on NC2 on Azure, they decided to make NC2 their primary solution for public cloud migration. This win demonstrates how our customers appreciate the ability to rapidly and seamlessly shift their workload from their private cloud to the largest public cloud providers with the consistent management, governance, and data services provided by the Nutanix Cloud Platform without the time and expense of refactoring their workload and with lower ongoing operating costs.

Moving on, in early May, we held our first in-person .NEXT user conference in almost four years and saw strong attendance and engagement from our customers and partners. In conjunction with .NEXT, we made several important product-related innovation announcements, reflecting our continued investment in the hybrid multi-cloud platform.

First, we announced new data services, including Nutanix Data Services for Kubernetes, which will bring the full power of Nutanix's enterprise class storage, snapshots, and disaster recovery to Kubernetes applications. And we introduced Multicloud Snapshot Technology, which will deliver cross-cloud data mobility by enabling snapshots directly to cloud native storage, starting with AWS' S3 object storage service.

We also announced Nutanix Central, a cloud-delivered management solution that will enable a truly universal cloud operating model by providing a single control for visibility, monitoring, and management across public cloud, on-prem, hosted or edge environments.

Finally, we introduced Project Beacon, our vision for hybrid multi-cloud Platform as a Service, a multi-year effort to deliver data-centric Platform as a Service offerings natively on Nutanix or on native public cloud. With the goal of decoupling the application and its data from the underlying infrastructure, Project Beacon aims to enable developers to build applications once and run them anywhere.

In closing, while the macro environment remains uncertain, we are encouraged that the compelling value proposition of our Cloud Platform and the strength of our business model enable us to raise our fiscal year top line outlook and bottom line outlook. We remain focused on delivering innovation for our customers now and in the future, while continuing to drive sustainable, profitable growth.

And with that, I'll hand it over to Rukmini Sivaraman. Rukmini?

Rukmini Sivaraman

Chief Financial Officer, Nutanix, Inc.

Thank you, Rajiv. Before I discuss our financial results and outlook, I would like to first provide a summary of the audit committee's completed review of our third-party software usage and the resulting implication. Upon completion of the investigation, the audit committee found that evaluation software from two of our third-party providers was used in a non-compliant manner for interoperability testing, validation, customer proof-of-concept, training and customer support over a multi-year period. In addition, the audit committee concluded that certain employees engaged in intentional misconduct to conceal use of evaluation software with respect to one of our third-party providers, in violation of our code of business conduct and ethics and other policies. We have terminated employment for certain employees who were found to be primarily responsible for the intentional misconduct.

Through the investigation, we identified a material weakness in our internal control over financial reporting. In particular, we determined that our controls did not effectively provide the information and communication necessary to identify non-compliant use of third-party software. To address this material weakness, we are implementing or will implement several remedial measures, including enhanced internal processes, enhanced training, and continuous communication regarding the importance of integrity and raising concerns in a timely manner.

We have accounted for the estimated financial impact of this issue by recording cumulative estimated expenses of $11 million as of Q2 2023, which represent the estimable amount of future payments for past non-compliant usage of software from these two vendors accrued over a multi-year period. We have accordingly also corrected the prior period financials shown in the Form 10-Q filed earlier today. We expect the incremental ongoing annual impact to operating expenses of this third-party software usage to be approximately in the low-single digit millions of dollars.

You can find additional information, including our complete Q2 2023 results and information about the estimated financial impact and remedial measures related to the third party software review, in our Form 10-Q quarterly report for Q2 2023 that we filed earlier today with the SEC. We are pleased that this investigation has been completed.

I will now provide commentary on our Q3 2023 results, followed by the outlook for Q4 2023 and the full-year 2023. Q3 was a good quarter, during which we beat all guided metrics. ACV billings in Q3 was $240 million, higher than our guidance of $220 million to $225 million, and representing a year-over-year growth of 17%. Revenue in Q3 was $449 million, higher than our guidance of $430 million to $440 million and a year-over-year growth of 11%. ARR at the end of Q3 was $1.467 billion, a year-over-year growth of 32%. New logo additions were about 430 in Q3. Average contract duration in Q3 was three years, flat quarter-over-quarter, as expected.

As described previously, the percentage of orders with future start dates likely due to faster supply chain constraints continue to be an assumption in our Q3 guidance. Q3 revenue benefited approximately $5 million from the reduction in percentage of future start dates over time, as more license revenue was recognized in-quarter than was deferred, in line with the $5 million estimate we had provided on our last earnings call. As supply chain challenges faced by our server partners appear to have normalized, we expect its impact on our business to normalize as well. As a result, going forward, we will not continue to provide this quantification of revenue impact from orders with future start dates.

Non-GAAP gross margin in Q3 was 84%. Non-GAAP operating expenses in Q3 were $369 million. Non-GAAP operating margin in Q3 was 2%, including the impact of about $10 million in non-recurring tax obligations related to a portion of our employee RSUs that vested in Q3, and approximately $9 million of non-recurring legal and advisory expenses, both of which related to the third-party software review and the delay in our 10-Q filing for Q2. Excluding these onetime items, non-GAAP operating margin in Q3 would have been approximately 6%.

Non-GAAP net income in Q3 was $12 million or EPS of $0.04 per share, based on fully diluted weighted average shares outstanding of approximately 282 million shares. Billings linearity was good and DSOs were 28 days in Q3. Free cash flow in Q3 was $42 million, implying free cash flow margin of 9%.

A few additional notes on Q3 free cash flow. One, the approximately $31 million payment for the settlement of the previously outstanding securities class action litigation, which is the amount inclusive of legal fees and expenses and net of our expected recovery under our D&O insurance is now expected to be paid and settled in Q4 rather than in Q3, as previously expected. The change in timing is due to routine process.

Two, the $42 million of free cash flow in Q3 includes the impact of approximately $10 million of cash usage in Q3 for non-recurring tax obligations related to a portion of our employee RSUs that vested in March, as expected and mentioned on our last earnings call, and caused by the delay in our Q2 10-Q filing.

Three, the delay in our Q2 10-Q filing also meant that we paused our [ph] ESBP (21:23) program, delaying an estimated $20 million of net cash outflow related to [ph] ESBP (21:30), which would normally occur in Q3 to Q4.

And four, free cash flow in Q3 was also impacted by approximately $6 million of payments for non-recurring legal and advisory expenses related to the third-party software review.

We ended Q3 with cash, cash equivalents and short-term investments of $1.358 billion, up slightly from $1.311 billion in Q2 2023.

Moving on to Q4, the guidance for Q4 fiscal 2023 is as follows: ACV billings of $240 million to $250 million, revenue of $470 million to $480 million, non-GAAP gross margin of approximately 84%, and non-GAAP operating margin of 9% to 10%.

Moving on to the full-year outlook, with one quarter left, the guidance for fiscal year 2023 is as follows: ACV billings of $915 million to $925 million, a year-over-year growth of 22% at the midpoint of the range; revenue of $1.84 billion to $1.85 billion, a year-over-year growth of 17% at the midpoint; non-GAAP gross margin of approximately 84%; non-GAAP operating margin of 6% to 7%, a year-over-year improvement of over 10 points of margin at the midpoint; free cash flow of $125 million to $135 million, implying a free cash flow margin of 7% at the midpoint.

I will now provide some color on our full-year guidance. First, we have seen continued new and expansion opportunities for our solutions despite the uncertain macro environment. However, as Rajiv mentioned, and similar to last quarter, we have seen a modest elongation of sales cycles likely due to increased deal inspection.

Our fiscal year 2023 new and expansion ACV performance remains impacted by some of these macro dynamics and is performing slightly below our expectations entering the year and what we believe its longer-term potential is. We have considered this dynamic in our updated guidance.

The renewals business continues to perform well. However, it tends to be at a lower aggregate average contract duration compared to our new and expansion business. Our relative economics on renewals have also continued to improve over time, as the renewals team has improved their execution.

Second, similar to our comments last quarter, the full-year guidance assumes that contract durations would decrease slightly compared to fiscal year 2022.

Third, as stated previously, non-GAAP operating margin outlook for fiscal year 2023 is 6% to 7%. Excluding the onetime expenses related to the third-party software review, this range would have been 7% to 8%.

Finally, the updated free cash flow guidance of $125 million to $135 million includes the impact of the following non-recurring items totaling about $65 million; approximately $10 million of cash usage in Q3 for non-recurring tax obligations related to a portion of our employee RSUs vesting, which is non-recurring because it was due to the delayed filing of our 10-Q; approximately $31 million in net cash outflow expected in Q4 from the previously mentioned litigation settlement; approximately $15 million for legal and advisory fees related to the third-party software review across Q3 and Q4; and finally, an $11 million estimated payment in Q4 for the potential resolution with the third-party software vendors.

In closing, we are pleased that our Q3 results reflect our continued execution towards our stated objective of sustainable, profitable growth, and we expect to continue that focus.

With that, operator, please open the line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of Jim Fish of Piper Sandler. Your line is open.

James E. Fish
Analyst, Piper Sandler & Co.
Q

Hey, guys. Nice quarter and congrats on getting the investigation behind you and there being fairly minimal impact, as we kind of all talked about here. Maybe just starting off on the assumptions around guide and what you guys are seeing with sales cycles. Obviously, we've talked about elongated sales cycle for some time now. We're hearing it from others in kind of the space. I guess how much have elongated sales cycle slowed or hindered that expansion rate with existing customers? And I know you're not going to give the exact, but our net retention rate's closer to essentially 120% now than where we were kind of before entering this year or as it actually gets a bit lower, just given the macro economy?

Rajiv Ramaswami
President, Chief Executive Officer & Director, Nutanix, Inc.
A

Jim, let me start with some qualitative commentary and Rukmini can give you some numbers there. So, first of all, I think you talked about NRR, and when you look at our renewals, by the way, renewals, first of all, is solid, okay? No issues, really, from the macro piece.

Now, when you look at the macro itself in terms of the impact, it impacts both new logos as well as expansion business with our existing customers. Now, the impact is similar to what we saw last quarter, which is it takes longer in terms of deals are expected more by some customers. And what we've seen is therefore, the sales cycle have gotten modestly longer.

Now, the other factor here, which is common during this kind of an environment, is that some customers [ph] if they can (28:20) tend to sweat their existing assets in the current environment, which, of course, has an impact in terms of both new and expansion business for us, they might continue to run as long as they can because they spend more money.

So if you look at that, the impact is on our FY 2023 new and expansion ACV because of these dynamics, and what I'd say overall qualitative color for that is that that new and expansion business for us is performing slightly below our expectations entering the year and also below what we believe is long-term potential. So Rukmini, do you want to add anything?

Rukmini Sivaraman
Chief Financial Officer, Nutanix, Inc.
A

Yes. And Jim, thanks for the question on NRR. And as you noted, we don't really disclose that on a quarterly basis, Jim. But what I will say is that it's sort of still in the range that I think we had talked about at our last Investor Day, in that 120%, 125% range. And so, I'll leave it at that with regards to NRR specifically.

James E. Fish
Analyst, Piper Sandler & Co.
Q

Yeah. That's helpful, Rukmini and Rajiv, appreciate that. And maybe Rajiv, for you, your favorite question, any impact yet from your vantage point with the ongoing acquisition of really your top competitor? And outside of that direct competition, I guess what are you seeing from native hyperscaler offerings and the traditional arrays? Obviously, you just alluded to some sweating of assets. Just trying to understand the competitive landscape here as you guys are still putting up solid growth. Thanks.

Rajiv Ramaswami
President, Chief Executive Officer & Director, Nutanix, Inc.

A

Yeah. I think, Jim, first of all, not a whole lot of change compared to last quarter on that. So clearly, on the Broadcom piece in terms of the acquisition, we are certainly seeing that higher level of engagement. We continue to do that with many customers around the world who are looking to look at their options to manage potential risks associated with this acquisition. Now, as we talk about our sales cycle tend to be 9 to 12 months, and so, we haven't quite seen factoring in meaningful benefit from this in FY 2023.

Now, on the other side of the equation from a competitive dynamic is the cloud native or hyperscaler piece of it. What I would say is if anything, I think our customers have gotten much more careful about what to put in the public cloud versus simply going all to the public cloud. So, we see much more focus in terms of what should I be running on-prem, what should I be using in the public cloud, how can I look at optimizing that. And that's actually playing to our strengths and certainly helping us our whole strategy around helping our customers operate in a hybrid multi-cloud world. It's helping us at this time.

Operator: Thank you. One moment, please. Our next question comes from the line of Mike Cikos of Needham. Your line is open.

Mike Cikos
Analyst, Needham & Co. LLC

Q

Hi, guys. Thanks for getting me on here and I'll echo similar comments to my peer here as far as the congrats on getting the audit committee investigation behind you and moving on to the next chapter. I wanted to highlight the strength that you guys pulled out this quarter and then the uptick in guide. Can you help us think through how the quarter played out maybe more from a linearity perspective, as each progressive month worked through the quarter? Was it building or was the outperformance snowballing over the course of the quarter or was it really more dedicated to a specific month within the quarter as far as how trends played out?

And then, my follow-up, I'll just ask it now, but good to see the slight uptick on gross margins as well. Is there anything you can do to help us wrap our heads around what's driving that uptick in gross margins and how sustainable that is as we think about the longevity of the business? Thank you again.

Rukmini Sivaraman
Chief Financial Officer, Nutanix, Inc.

A

Thank you, Mike. So first question on linearity, so linearity, I would say, was largely as expected. There wasn't any significant unusual trends compared to typical Q3, Mike. So, that's on the linearity. And then, on gross margin, what I would say is we continue to be really focused on efficiency and all of that. So in terms of, I think, how sustainable this is, I think, was your question, we think that we will be in that low-80s range, right, maybe move around a little bit. One of the things we are focused on is continuing to make sure that we are attaching professional services where it makes sense, especially for some of the newer parts of our portfolio to make sure customers are adopting them effectively and we're helping them do so. So it might move around a little bit here and there, but you saw the guide for the full year as well, which factors in all of those moving pieces at this point.

Mike Cikos
Analyst, Needham & Co. LLC

Q

Makes a lot of sense. Thank you very much, Rukmini.

Rukmini Sivaraman
Chief Financial Officer, Nutanix, Inc.

A

Thank you, Mike.

Operator: Thank you. One moment, please. Our next question comes from the line of Pinjalim Bora of JPMorgan. Your line is open.

Pinjalim Bora
Analyst, JPMorgan Securities LLC

Q

Oh, great. Hey, guys. Congrats on the quarter and great to hear the conclusion of the investigation. Rajiv, it seems like a lot of innovation is coming out of Nutanix in the .NEXT. You talked about Project Beacon, which seems like a Holy Grail. I think VMware has kind of tried it as well. Talk to us about kind of where are the building blocks of the technology around that of multi-hybrid cloud PaaS platform, and what – where are we – how long is it going to take for us to kind of see a product launch, [ph] Rajiv (34:16)?

Rajiv Ramaswami
President, Chief Executive Officer & Director, Nutanix, Inc.

A

Yeah. So if you look at Project Beacon, just a quick recap of that is, let's say, multi-cloud Platform as a Service focused on data offerings to help companies build an app once using that set of services, and be truly able to run them anywhere, completely portable on any underlying substrate, whether it be a cloud native on any public cloud or whether it be on-prem. So, that's the quick recap of the vision.

Now, if you look at – this is clearly what we said at .NEXT, is that this is a multi-year journey for us and it happens in multiple steps. If you look at where we are, we have a foundation for that today with our Nutanix Database Service. We today offer that on-prem on a Nutanix underlying substrate and help companies manage databases in a consistent way, a variety of databases. We are on a path to make that offering available on top of native public cloud substrates. So, that will be the first step in the roadmap. And we will comment on that in terms of specific execution when we get closer to releasing it.

And then, beyond that will be other services, for example, things like messaging, streaming, caching, et cetera, that we would over time head on. Some of these could also be done in partnerships. So, we – like I said, we've started with our Nutanix Database offering and over multiple years we will get to that journey. And I also expect that there will be a broader ecosystem of people like us who are likeminded in terms of establishing this truly hybrid vision for building apps and being able to run them everywhere.

Pinjalim Bora
Analyst, JPMorgan Securities LLC

Q

Understood, understood. Thank you for that. And Rukmini, maybe my math is wrong here or maybe I'm getting the numbers wrong, it seems like there's a little bit of cautious sentiment going forward. But when I look at the guidance, I think you're raising the revenue guidance by $40 million and you beat by something like $13 million or $14 million, if I read that correctly. Help me, what gives you confidence if the macro is actually getting a little bit worse?

Rukmini Sivaraman
Chief Financial Officer, Nutanix, Inc.

A

Thank you, Pinjalim, for that question. So our guide has a few pieces, right? So, let me start with, I know your question is on revenue. But if I just start with ACV billing here for a second, we did take that guide up as well, right, from – to $915 million to $925 million, and as you point out, we took revenue up as well. So one is that we feel good, given all the caveats, right, to the point about the modest elongation of sales cycles. In some cases, as Rajiv touched upon earlier, I believe if it's a new logo, we see customers choosing to sort of sweat their assets out a little longer.

So, some of those dynamics are playing out. But I think a few things that we believe sort of bolsters that overall guidance is our renewals business, as we said from day one, from when we started the year, has continued to perform well, right? And with that mix growing over time, that helps us form a pretty strong foundation for the guide overall.

And then, the one other point I'll make is ACV billings is more of transactional sort of quarter-over-quarter number of things that are build in the quarter, but revenue obviously flows in as a waterfall over time. So, there's also the net revenue benefit we are seeing and we've talked about this each quarter this year from recognizing more license revenue, right, from the future start date orders than we were deferring, which is a boost that's seen more on the revenue side than is seen on the building side. So those are some of the things that are driving that guide, Pinjalim.

Pinjalim Bora
Analyst, JPMorgan Securities LLC

Q

Okay. Can I have one follow-up lastly? Did you bring your resumption on that start date for Q4 guidance kind of down?

Rukmini Sivaraman
Chief Financial Officer, Nutanix, Inc.

A

So, we haven't specifically divulged what those assumptions are, Pinjalim. But I think it's fair to say that overall, we have seen the supply chain dynamics normalize for our several partners. Going in, we had assumed that things would be better, right, towards the end of the year, but we hadn't assumed it would be completely normal, right? At this point, it does seem like those have largely normalized.

Pinjalim Bora
Analyst, JPMorgan Securities LLC

Q

Got it. Thank you very much.

Rukmini Sivaraman
Chief Financial Officer, Nutanix, Inc.

A

Thank you.

Operator: Thank you. One moment, please. Our next question comes from the line of George Wang of Barclays. Your line is open.

George Wang
Analyst, Barclays Capital, Inc.

Q

Hey, guys. So, congrats on the quarter and the successful completion of the investigation. I have two questions. First of all, do you have any comments on the channel partners, especially on the service providers, especially against this – the Broadcom backdrop and the VMware. Hopefully, post-merger, you guys can get them allowed from the service providers. Any thoughts on that?

Rajiv Ramaswami
President, Chief Executive Officer & Director, Nutanix, Inc.

A

Absolutely, George. I'll tell you, I mean, that's a rather large unpacked opportunity for us because that's [ph] a router (39:26) market that historically we have not spent a lot of time on and only recently have we really started engaging with service provider partners. In fact, and it's already bearing fruit for us, I think last quarter or the quarter before, some of the largest deals in the quarter came through the service provider channels.

So, we keep adding to our service provider sale partners. We actually have high hopes in terms of that being a strong channel for us going forward. And what I would still say is that we are still in the first innings of an – of a baseball game, to put that analogy, when it comes to our service providers in terms of building that out of market.

And to your point, I think clearly, there's a very large established service provider channel with VMware today, and they only now [ph] building out (40:11), and I think some of those channel partners [indiscernible] (40:14) they're going to be certainly more inclined to work with us more so going forward.

George Wang
Analyst, Barclays Capital, Inc.

Q

It's great. Also, Rajiv, quick follow-up, in terms of the land-and-expand, are you seeing kind of increasing attach to the [indiscernible] (40:29) stack? And especially given the kind of more mature kind of business model and the kind of – some of the additional use cases, maybe you can unpack it and kind of quantify so they – the attach kind of growing over time for the [indiscernible] (40:45) platform.

Rajiv Ramaswami
President, Chief Executive Officer & Director, Nutanix, Inc.

A

Yeah. There's no doubt. I mean, I think if you will recall, we came out with our simplified solutions-oriented product portfolio a while ago. And we are now seeing an increasing portion of our deal support coming through that new portfolio.

Now, as part of that, the very specific thing that we've seen is Nutanix Cloud Management, notably higher attach for Nutanix Cloud Management as part of what we sell today. So whenever we sell a Nutanix Cloud Infrastructure, there's a very logical attach to cloud management, and we see that certainly happening, in fact.

And then, I think on the other pieces, I think Nutanix Database Service tends to be somewhat more of a specialized sale because it is targeting database admins and developers versus the core infrastructure. So that's not as much of an attach, although we are trying to attach that more with database workflows running on our platform. And then, Unified Storage, which is the last component of our portfolio there, fairly, I think it's – is also seeing a good attach.

So, we are actually quite happy with how this revised portfolio is going and being adopted in the market and customers are certainly wanting to adopt more and more of the entire portfolio. So when people want to build a cloud, it's like, I said, very common for them to consider taking the whole thing, whole stack, which is the NCI, NCM, plus some NUS.

George Wang
Analyst, Barclays Capital, Inc.

Q

Okay. Great and thanks again. I will go back to the queue.

Operator: Thank you. One moment, please. Our next question comes from the line of Meta Marshall of Morgan Stanley. Your line is open.

Meta A. Marshall
Analyst, Morgan Stanley & Co. LLC

Q

Great. Appreciate it. Congrats on the quarter, guys. Maybe you guys have commented on kind of cloud optimization projects or data center modernization projects, clearly a theme across multiple names over the past few quarters. Just where do you think customers are on that journey of kind of figuring out what the end state of what their data centers are looking like? And does that kind of involve – you just spoke about kind of deeper adoption of the portfolio but I guess I'm just wondering does that involve kind of a deeper conversation about what Nutanix products could be used kind of upfront? So maybe just kind of a where are we in figuring out kind of their end state on hybrid cloud, and does that involve kind of more services upfront from Nutanix?

Rajiv Ramaswami
President, Chief Executive Officer & Director, Nutanix, Inc.

A

Yes, I think that's a very good question, Meta. So, in fact, I'm just – I had a conversation on this only yesterday with one of our large enterprise customer. What I would say is I think there were – five years ago, there were a set of customers who said we are going to go to the public cloud, period, the cloud-first. And now, it's much more about a cloud operating model, which is they like what the cloud offers in terms of agility, self-service, rich set of services and sometimes an OpEx model instead of a CapEx model in terms of consumption.

They like that but not necessarily a location, right? So if you just go do everything in the public cloud, they realize that cost optimization to this is a growing and important part of what they have to deal with today. So what we are seeing right now is much more discussion around this hybrid multi-cloud, people wanting to run workloads across both locations. And for us, one of the things that we are working hard to do is to actually build awareness within our customer base about the fact that we do actually have offerings that are very relevant to them in terms of enabling them to operate across all of this.

Because if you recall, our own history as a company, we started out most people – customers know of us as a HCI company, right, hyperconverged infrastructure. And we've been working hard to get our narrative out in terms of what we can do for them today. And when we talked about how we can actually help them operate across both these environments very well, very efficiently, I think the conversation becomes much more strategic with our customers and they started using more of our portfolio and certainly more of our services as well to implement some of the capabilities there. So I would say, again, for us, there's a lot of, I think, still opportunity here that this whole hybrid operation and mindset from our customers is opening up.

Meta A. Marshall
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thanks. And maybe just Rukmini, [ph] doing those (45:24) back of the envelope but it would seem as if OpEx stepped down quarter-on-quarter in the guide. Is that all just from one-time impact that you kind of saw in fiscal Q3 and so underlying OpEx is actually relatively stable or is there anything that I'm just missing there? Thanks.

Rukmini Sivaraman
Chief Financial Officer, Nutanix, Inc.

A

No, that's exactly right, Meta. The underlying OpEx, when you back out some of these one-time non-recurring items that I talked about, relatively stable. I mean, there's some moving pieces, but really small. So you are correct that if you back those out, Q3 and Q4 should be relatively stable.

Meta A. Marshall
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Perfect. Thanks.

Rukmini Sivaraman
Chief Financial Officer, Nutanix, Inc.

A

Thank you.

Operator: Thank you. One moment, please. Our next question comes from the line of Jason Ader of William Blair. Your line is open.

Jason Ader
Analyst, William Blair & Co. LLC

Q

Yeah. Thank you. Wanted to just follow-up on that last question [ph] asked you, (46:20) Rajiv. In terms of what you've seen over the last five years, let's say the kind of the pace of customers shifting workloads to the public cloud, refactoring applications, a lot of initiatives around that over the last five years, in this environment of cost optimization, have you seen enterprises sort of take a step back and say, you know what, maybe we were moving a little bit too quickly and give things a little more evaluation and thought and you talked about TCO. So maybe just kind of paint a picture for us in terms of this last, I don't know, 12 months versus what you've seen in the prior four years.

Rajiv Ramaswami
President, Chief Executive Officer & Director, Nutanix, Inc.

A

Yeah, Jason. I will say that the dialogue has definitely changed over the last year on this topic. I think there were a set of customers who said we are going to refactor. Let's go move everything to the public cloud and I think they ran into two issues, one was that it actually was pretty expensive for them to refactor in the first place. And then second, once they did refactor and ran everything into the public cloud and if they're starting to operate the scale, I mean, it's an easy on-ramp, right, in the sense that upfront, it's very easy, you like the ease of use and so forth. But then as you start using a lot of the services, then you start seeing your bill going up and you soon realize that there's a significant premium there compared to what you were doing before.

And so that consciousness is now very much – cost optimization is very much a key part of many of our customers' thinking. And so now, like I mentioned to Meta's question, there is definitely – it's not a close my eyes, let me refactor everything, move to the public cloud. That's no longer the conversation at all, right? I think it's much more about, okay, I'm going to have a process for figuring out what I'm going to go put where and, in fact, I heard one customer mention that they're establishing a target state architecture approach for every app that they have in their portfolio and they're going to then decide what to do about that app. Is it going to be running the data center? Does it makes sense to refactor it, et cetera? So I think people are being much more careful about managing their application portfolio now than they were before.

Jason Ader
Analyst, William Blair & Co. LLC

Q

Got you. And then just as a quick follow-up on that, as I think about things like NC2 and VMware and AWS, the pushback that we always got on that as well, that's great and it's an easy lift and shift, but it's sort of a stopgap, right? Ultimately, you want to have the app refactored and I guess if a customer does go that route and use NC2, what's the risk in your mind that refactoring is just sort of an inevitable step on that app and then potentially you lose the app?

Rajiv Ramaswami
President, Chief Executive Officer & Director, Nutanix, Inc.

A

Yeah. I think first of all, two points. Yes, customers can lift and shift and take it easily to the public cloud there, Jason, no doubt about it. Now, as they refactor and start creating a cloud-native version of the app, one of the things that's a little less understood about NC2 is that even in that scenario, we can actually help run that app very efficiently, right? Even for a pure cloud-native app, you can take a cloud-native app that's been fully refactored and run it on NC2 on bare metal, say, in AWS Azure, and get significant advantages both in terms of potentially cost savings but also in terms of ease of management and the ability to have one team manage your on-prem and your cloud environments with a single set of tools. So, those are sustainable.

We've also seen examples of where we can deliver depending on the application itself, quite substantial cost savings in terms of ongoing runtime costs as well. So that combination plus as we look at our future, when you look at things like Project Beacon where people can now build these cloud-native apps using a portable set of data services then they can decide where they want to land them. So for us, we don't think of NC2 as a temporary, hey, migrate and then you're out of the picture. We actually think it's migrate and operate.

And if you also look at it from a cloud provider's perspective, if you're on AWS on Amazon or in Azure, what you really care about is customers consuming your services. It doesn't matter whether they're using mechanics or not as long as those apps are running in the hyperscale environment. So there's not a – so this combination is what makes NC2 quite sticky over time.

Jason Ader
Analyst, William Blair & Co. LLC

Q

Very helpful. Thanks.

Operator: Thank you. One moment, please. Our next question comes from the line of Wamsi Mohari (sic) [Wamsi Mohan] of Bank of America. Your line is open.

Wamsi Mohan
Analyst, BofA Securities, Inc.

Q

Yes, thank you. I was wondering if you could comment on demand maybe by vertical. Did you see anything different, particularly in financial services or government or healthcare this quarter, and what trends are you seeing currently in those verticals?

Rajiv Ramaswami
President, Chief Executive Officer & Director, Nutanix, Inc.

A

Hey, Wamsi. So, yes, both financial services and healthcare are important verticals for us. I will say we have not seen any significant changes. I mean, I know people talk about what's been happening in the banking world, but we have not seen any significant changes in demand patterns. If anything, from some of the larger banks, we are seeing more engagement now with us than before and so nothing significant for us to report in terms of changes.

Wamsi Mohan
Analyst, BofA Securities, Inc.
Q

Okay. Thanks, Rajiv. And as a follow-up, I mean, your gross margin's obviously very strong, but the broader demand environment's kind of weak and there are lots of pockets in the overall market that have gotten more competitive and, frankly, increased levels of discounting across many areas of the data center. So I was wondering if you saw any of those kind of trends. And if you didn't partake, did you leave revenue on the table or billings on table?

Rajiv Ramaswami
President, Chief Executive Officer & Director, Nutanix, Inc.
A

Yeah. And, of course, as you can imagine, we look at that very closely and manage that and our ASPs have been quite steady. Part of the reason is most of our selling is a value sell. We look at – we have a team of cloud economists who actually build economic models for almost any of the significant deals we have and talk about and showcase the TCO benefits that a customer gets by using our solution. And that's how we justify the pricing.

So, yes, of course, it's a competitive environment out there, but we haven't seen anything significant yet that's impacting our gross margins.

Wamsi Mohan
Analyst, BofA Securities, Inc.
Q

Okay. Thank you. And if I could sneak one last one and can you maybe just help us think through what impact backlog drawdown is having on fiscal year 2023 and sort of what kind of a headwind that might pose for fiscal 2024?

Rukmini Sivaraman
Chief Financial Officer, Nutanix, Inc.
A

I'll take that one. Thank you for the question, Wamsi. So, I think as we said from the beginning of this fiscal year, right, both revenue growth and ACV billings have benefited from the strong backlog level with which we entered the year. And revenue specifically has also benefited from this dynamic recognition of deferred license revenue from the future start date orders as we've talked about in the past, right? So the full year results we expect will reflect a benefit from both of these, Wamsi, but this is a software company. We don't typically kind of specify or guide to backlog on anything like that. But yes, entering this year, we did have record level of backlog which is benefiting growth for this year on both revenue and ACV billings.

Wamsi Mohan
Analyst, BofA Securities, Inc.
Q

Okay. Thank you very much.

Rukmini Sivaraman
Chief Financial Officer, Nutanix, Inc.
A

Thank you.

Operator: Thank you. One moment, please. Our next question comes from Dan Bergstrom of RBC Capital Markets. Your line is open.

Daniel Bergstrom
Analyst, RBC Capital Markets LLC

Q

Hey. It's Dan Bergstrom for Matt Hedberg. Thanks for squeezing us in here. Maybe to build on a previous question on the positive outlook despite some macros, with guidance for the fourth quarter, did anything change around the level of conservatism in the outlook? Are you using a consistent approach versus the third quarter?

Rukmini Sivaraman
Chief Financial Officer, Nutanix, Inc.

A

Hi, Dan. I will take that question. We have been pretty consistent in our approach, so we haven't necessarily become more or less conservative for Q4 as related to Q3, which I believe was your question. Did I get the question correctly?

Daniel Bergstrom
Analyst, RBC Capital Markets LLC

Q

Yeah. Perfect. Thanks. And then maybe to verify on free cash flow for the fourth quarter from the prepared remarks, sounds like there's a $31 million and $20 million outflow that may have been expected in the third quarter, but will be in the fourth quarter. Is that correct?

Rukmini Sivaraman
Chief Financial Officer, Nutanix, Inc.

A

That is correct. And if I can just take a minute to maybe talk a little bit about Q4 free cash flow, right? So for the full year, we provided a guide of $125 million to $135 million and we also said that there is about $65 million of one-time outflow, right? So if you add that, you are now at a $190 million to $200 million free cash flow for the year, and that less the $150 or so million that we've already done year-to-date would be a reasonable way to think about a normalized Q4 free cash flow with some normal quarter-to-quarter adjustments.

Daniel Bergstrom
Analyst, RBC Capital Markets LLC

Q

Perfect. Thank you. Thank you.

Operator: Thank you. One moment, please. Our next question comes from the line of Erik Suppiger of JMP Securities. Your line is open.

Erik Suppiger
Analyst, JMP Securities LLC

Q

Yes. Thanks for taking the question and congrats on the quarter and the audit. With regards to the software compliance issue, can you tell us how you learned about that and are you continuing to use the software from the two vendors that you had to work with on this?

Rajiv Ramaswami
President, Chief Executive Officer & Director, Nutanix, Inc.

A

Yeah. I can take that, Erik. So, yeah, we discovered it. Management discovered it and it was discovered as part of a software project review. And yes we are continuing to use the software, but again for the non-production use cases that we talked about.

Rukmini Sivaraman
Chief Financial Officer, Nutanix, Inc.

A

And the only thing I would add is we are in contact with both of those vendors at this time and are working towards a commercial resolution.

Erik Suppiger
Analyst, JMP Securities LLC

Q

All right. Very good. Thank you.

Operator: Thank you. One moment, please. I'm showing no further question this time. Ladies and gentlemen, this does conclude today's conference. Thank you all for participating. You may now disconnect. Have a great day.