NetScout Systems, Inc.
Second-Quarter Fiscal Year 2016 Financial Results Conference Call
Management's Prepared Remarks

October 29, 2015

A. Kramer: Safe Harbor Statement and Other Details

Thank you and good morning everyone. Welcome to NetScout's fiscal year 2016 second quarter conference call for the period ended September 30, 2015. Joining me on this morning's call are:

- Anil Singhal, NetScout's co-founder, president and CEO;
- Michael Szabados, NetScout's chief operating officer; and
- Jean Bua, NetScout's executive vice president and chief financial officer

We have included a slide presentation of key financial data that accompanies the financial section of our prepared remarks. For those listeners who have dialed into the call this morning and would like to view this slide presentation, you can find it by going to our website at www.netscout.com/investors and then clicking on today's webcast. You can advance the slides in the webcast viewer to follow along with our commentary. We will try to remember to call out the slide number we are referencing in our remarks.

As you know, our Q2 results reflect the first quarter of combined operations since completing our acquisition of Danaher's Communications Business in mid-July. In terms of our agenda for today's call, Anil Singhal will first provide an overview on our second-quarter results and share his perspective on the opportunities and challenges that lie ahead. Our COO Michael Szabados will offer some insights on near-term integration activity and key drivers for customer adoption with a focus on the enterprise marketplace. CFO Jean Bua will then provide additional detail on our second-quarter financial performance as well as discuss our guidance.

Slide #3: Safe Harbor Statement and Non-GAAP Financial Metrics

Moving on to slide #3:

Safe Harbor Statement

I would like to remind everybody listening that forward-looking statements in this presentation are made pursuant to the safe harbor provisions of Section 21E of the Securities Exchange Act of 1934, as amended, and other federal securities laws. Investors are cautioned that statements in this presentation, which are not strictly historical statements, constitute forward-looking statements which involve risks and uncertainties. These include without limitation, statements relating to our financial guidance, anticipated share repurchase, integration and product development plans and expenses, adoption of our products and solutions by customers, our ability to effectively compete for service provider opportunities, being well positioned to drive top-line growth in the enterprise segment, the anticipated benefits of NetScout's acquisition of communications business lines of Danaher Corporation, and the performance of the combined company. Actual results could differ materially from the forward-looking statements. Risks and uncertainties which could cause actual results to differ include, without limitation, the other risk factors outlined in today's press release and slide presentation, and NetScout's Annual Report on Form 10-K for the fiscal year ended March 31, 2015, which is on file with the Securities and Exchange Commission and available on our website. NetScout assumes no obligation to update any forward-looking information contained in this press release or with respect to the announcements described herein.

Non-GAAP Reconciliation

Finally, I would like to remind you all that while the slide presentation includes both GAAP and Non-GAAP results, unless otherwise stated, financial information discussed on today's conference call will be on a non-GAAP basis only. Non-GAAP items are described and reconciled to GAAP results in today's press release and they are included at the end of the slide presentation that is made available online on our website. As Jean will note, the timing of the acquisition will skew period-to-period comparisons and potential discussions related to growth rates. If we do note a growth rate, we will strive to clarify the nature of the comparison.

As detailed in our press release today, NetScout reported solid second-quarter results highlighted by a two-plus month contribution from the acquired businesses. We've also made good progress in our efforts to advance the integration initiatives that are critical for driving the Company's performance.

At this point, I'd like to turn the call over to Anil and then my other colleagues to expand on these and other points. Anil, please go ahead.

Anil Singhal

Thank you Andy. Good morning to everyone listening and thank you for joining us today.

As Andy mentioned, our second quarter results reflect the two-plus month contribution of the acquired Danaher Communications Business. At a high level, our non-GAAP revenue of 281.8 million dollars reflected good execution across our company. In terms of profitability, we reported non-GAAP EPS of forty-seven cents thanks to the solid revenue performance in combination with prudent cost management and our share repurchase activity.

As we've discussed with you previously, the acquisition helps accelerate our strategic progress, enabling us to double our total addressable market to over 8 billion dollars with a broader portfolio of market-leading products, extensive domain expertise, and stronger go-to-market capabilities that can help us address the dynamic requirements of a larger, more diverse and more global customer base. With a compelling value proposition, better market access and substantially greater operational scale, we believe that the new NetScout is well positioned to create substantial value for all stakeholders as we focus on driving solid revenue growth and expanding operating margins, cash flow and earnings per share over the long term.

An important element of our strategy to help realize NetScout's full potential involves driving tighter integration, collaboration and coordination within and across this asset base. NetScout has used this approach before with other acquisitions but it is quite different from how the acquired assets had been managed under their prior ownership. For these reasons and due to the impact of various accounting considerations related to the closing of the transaction, comparisons with the prior-year periods may not be representative and should be made with caution. Nevertheless, we will try to highlight notable performance metrics and trends in our commentary when appropriate.

Service Provider Update

In our Service Provider segment, our performance was highlighted by good traction with customers deploying our nGeniusONE solutions, along with the successful execution of a significant and exciting project with one of our Tier-1 service provider customers. This project, which involved achieving acceptance at dozens of different customer sites, was completed on schedule thanks to the diligence and hard work of our sales engineering and professional services teams. Our success this quarter helps underscore the importance of our collective capabilities in helping the world's largest and most innovative service providers seeking to differentiate their services on the overall quality, resiliency and stability of their network.

NetScout's security business, Arbor Networks, is a new and important part of our story. Arbor is recognized today as the market leader in helping both service providers and enterprises worldwide protect their networks from high-volume and application-specific distributed denial of service or DDoS attacks. During the quarter, Arbor continued to make progress fortifying its relationships with major service providers, closing a number of six and seven figure deals during the quarter.

Overall, approximately 61 percent of our total revenue came from our service provider customers, which is generally in line with our view on revenue by segment that we shared at our Investor Day event. With that said, given the large and lumpy nature of certain service provider projects, the mix is likely to vary considerably from quarter to quarter.

Enterprise Update

In our Enterprise segment, we worked diligently to address near-term customer requirements. In terms of order trends, we've seen healthy demand remain in certain verticals such as government and high tech. As Michael will highlight, we've been very pleased that a growing number of US government agencies and branches of the armed forces have standardized on nGeniusONE as part of new infrastructure initiatives and technology refresh projects. This dynamic helped partially offset softness in other verticals such as financial services as well as foreign exchange headwinds. In terms of security, Arbor continued to gain traction in the enterprise while taking important steps to further extend its market leadership by broadening its product portfolio.

We have been pleased with the overall market reception following the acquisition. While there are minimal levels of overlap between Fluke and NetScout in terms of the enterprise customer base, we did experience some disruption within certain enterprise sales and distribution channels. We do not believe that these issues will impact our performance over the long term, and we have taken and will continue to take steps to not only address those issues but to also leverage NetScout's broader product portfolio and global sales footprint. As we make further progress in refining our go-to-market approach and advancing some exciting development initiatives, we believe we will be well positioned to drive solid top-line growth in the enterprise segment moving into fiscal year 2017.

Initiatives & Opportunities Going Forward

During the past two months, I've spent considerable time with many of our largest service provider customers around the world. There is a healthy level of enthusiasm from customers about how the new NetScout can support their efforts to achieve key business objectives by improving the way they manage and protect their infrastructure.

In particular, we've received positive feedback from customers about our efforts to offer an integrated probe that can support the best-in-class troubleshooting capabilities from TekComms along with NetScout's best-of-breed monitoring, and our development activities on this front are moving forward. Nevertheless, our optimism is tempered by the fact that the service provider capital spending environment remains very fluid, and we are seeing certain service providers move cautiously to advance major new infrastructure projects in light of their broader capital spending and operational expense objectives.

Another product area where we've made good initial progress is in our packet flow switch where we have brought together our own capabilities with the VSS Monitoring operation. As some of you know, during the past three years, we have been very successful in selling our packet flow switch as a complementary accessory to our broader network monitoring solution. VSS allows us to compete much more effectively for service provider opportunities where legacy NetScout is not the primary incumbent as well as in supporting security applications for enterprise customers. We are taking steps to further integrate the development teams and refine our technology roadmaps and go-to-market plans as we focus on the platforms and capabilities required to bring the most value to our customers and prospects.

Summary

In summary, our progress, achievements and performance in the initial quarter of combined operations reflect positively on the way we have brought our companies together. We've accomplished a lot in our first quarter together while remaining focused on addressing the needs of our customers. We've unified our sales organizations and other corporate functions. We have also rolled out our vision and plans to the senior team and the broader employee base, and we've begun to execute on those plans. On the product front, we have taken important steps to align our product portfolios, and we have kicked off several exciting product integration initiatives – all of which will be critical to driving long-term adoption by customers and prospects. While we've made good progress, we recognize that there is more work to be done in order to achieve our goals for this fiscal year and beyond.

Looking ahead, we remain confident in our strategic direction, value proposition, and in our ability to execute on a wide range of opportunities in front of us. Accordingly, we've left our non-GAAP revenue guidance for the fiscal year unchanged while adjusting our non-GAAP earnings per share outlook to reflect the net effect of accretion resulting from our year-to-date stock repurchase activity and the anticipated full-year interest expense.

I'd like to conclude by noting that the overall level of investor interest and support for our

Company has been very gratifying thus far. And finally, I want to be sure to thank the 3,100-plus individuals who are part of the new NetScout team for their hard work, focus and good execution during the past quarter.

With that said, I will now turn the call over to Michael.

Michael Szabados:

Thank you Anil and good morning everyone. It was a very busy and productive quarter for NetScout from an operational perspective. We made tangible progress in smoothly transitioning over 2,000 Danaher employees to NetScout's payroll and benefits while establishing an interim IT and Financial control infrastructure. Because of the carve-out nature of the acquired entities, we are continuing to receive transitional services from Danaher in certain areas, pending the establishment of the corresponding function at NetScout. These TSAs, which span certain facilities, select manufacturing, HR and IT services, as well as the use of the Fluke and Tektronix brands, are expected to conclude by the second quarter of our fiscal 2017. As we wind down these agreements, we expect to improve our expense base and streamline operations in a number of areas. For example, we plan to standardize our global sales organization on a common order management and sales CRM platform as we move into fiscal year 2017.

Our other near-term priorities include cross-training our sales teams on their expanded product and solution portfolios, transitioning reseller partners to NetScout, and developing demand-generation campaigns that can leverage our expanded skills and capabilities brought in through the acquisition. Our goal, whenever possible, will be to complete as much of this activity as possible during the next two quarters in order to enter fiscal year 2017 with good sales and marketing momentum. An early example of this was our announcement last week that we've aligned our go-to-market activities in the Middle East under the NetScout banner.

In terms of progress with our customers, I'd like to call several wins to your attention. These wins help underscore the unique value of NetScout's technology in helping its customers innovate with confidence in order to advance their technology projects and achieve key business and financial objectives.

First, as Anil mentioned, we've won a number of significant deals within the government market. Some of the largest Federal agencies and branches of the military in the United States continue to rely on NetScout's nGeniusONE platform to standardize the way they are managing their networks and broader IT infrastructures. In particular, we are helping a major legal agency modernize their monitoring infrastructure as they've been challenged to support a broader range of public-facing applications and rising voice and video traffic. This project encompasses deploying close to 200 InfiniStream appliances across their data centers and remote sites, enabling them to increase and assure service levels in their nation-wide, public-facing voice and video network.

With over $20 billion annually spent by companies around the world to build, maintain and expand their Unified Communications or UC infrastructures, this is an area NetScout shines due to the scalability of our solutions in combination with a range of analytics that enables enterprises to effectively monitor data, voice and video over a converged IP infrastructure, accurately measure call quality, and quickly and efficiently triage UC performance issues. During the second quarter, one of the world's largest and most innovative providers of personal technology decided to use our solutions in their key data centers to help them gain visibility into their call center and internal voice communications by deploying a combination of nGeniusONE servers, our Unified Communications modules, and Infinistream probes.

In the service provider marketplace, we are seeing leading mobile carriers offload their wireless traffic onto wifi infrastructures while cable MSOs are seeking to further monetize the expansive wifi footprints that they've have built out over the past several years. We recently closed a multi-million dollar agreement to help one of the largest cable MSOs in the U.S. monitor its wifi network with NetScout's nGeniusONE. This customer determined that our solution was a superior alternative for monitoring this infrastructure and ensuring a high quality user experience. Previously, this customer used log file collection tools and found that this approach could not deliver the breadth and depth of performance data that would allow them to confidently manage this strategic asset.

We've continued to advance key product development activities that can enable us to address important customer requirements, particularly in growth-oriented market sectors. We believe that WiFi is an attractive growth market for NetScout's technology in terms of how we can bring value to both service provider and enterprise customers. Moving forward, we are looking to leverage the wireless network design and analysis capabilities at Fluke. Fluke has continued to keep pace with the ongoing evolution of wireless standards as reflected in our announcement last week that some of Fluke's most popular portable network analysis and troubleshooting tools are now supporting the latest wireless standard.

Security is another growing market where we are much better positioned as a result of the acquisition. In particular, our Arbor Networks division has continued to take steps to extend its market leadership. Earlier this month, Arbor announced a major product initiative to further expand the breadth and depth of its DDoS capabilities. By bringing enhanced and new offerings to the marketplace, including new on-premise and cloud capabilities that provider greater deployment flexibility along with new managed services, Arbor is extremely well positioned to protect and extend its market leadership.

We are pleased with the market reception to NetScout following the completion of the acquisition. We continue to win mindshare with leading industry experts and top trade publications. For example, Ovum, a top global technology research and advisory firm, published an executive update about the growing strength at Newfield Wireless, a unit within Tektronix Communications that is focused on radio access network optimization. Last month, Network World, the foremost provider of news and insight for network and IT executives, recognized NetScout as one of the world's 25 most powerful enterprise networking companies.

In closing, we have been pleased with our initial progress in uniting over 3,100 talented individuals. As we move forward, we're focused on building on our momentum with current and prospective customers in our service provider and enterprise segments. I look forward to sharing additional news about our success on these fronts with you next quarter.

That concludes my remarks at this point; I'll turn it over to Jean for the financial review.

Slide 6: CFO Review

Jean Bua:

Thank you Michael and good morning everyone.

This morning, I will review our performance for the second quarter, and then discuss our guidance for the upcoming fiscal year. As a reminder, our results this quarter reflect the two and one half months' contribution of the acquired Danaher Communications assets. As expected, there were a number of acquisition-related items that impacted our GAAP results so our convention will be to refer to our non-GAAP results unless otherwise noted. On a related note, and consistent with our comments earlier on the call, the timing and magnitude of the acquisition will impact comparisons with the prior year periods and any other extrapolations of our second-quarter results may not be representative. When possible, we will frame our results against prior periods on a pro forma basis.

Slide 7: Income Statement

To begin our financial discussion, we will be starting with slide number 7 of our presentation which is accompanying this call. As a reminder, the slides are posted on our website.

For our second fiscal quarter, total non-GAAP revenue was 281.8 million dollars. As Anil noted, our revenue performance was driven by the completion of a large project for a tier-1 service provider, along with efforts to address the near-term demands of our broader customer base.

On a pro forma, FX-neutral basis, the revenue growth would have been approximately eight percent. We were generally pleased with the overall level of demand in a number of our core product areas, most notably in security and for nGeniusONE.

Product revenue was 181.5 million, or 64 percent of total revenue with service revenue comprising the remainder. This is generally in line with the information we shared at our Investor Day event earlier this summer.

Gross profit was 212.4 million dollars. Our gross margin percentage for the quarter was 75.4 percent, which reflects the overall product mix for the quarter.

Operating income for the quarter was 67.4 million dollars with a 23.9 percent operating income margin. This reflects the overall top-line performance of the business in combination with prudent expense management as we advanced our integration activities.

For the second quarter, we reported net income of 43.6 million dollars, or 47 cents per diluted share. Our original estimate of the tax rate for the quarter was 45 percent to 47 percent. However, the actual results reflect a tax rate of approximately 35%. The difference between the estimated tax rate and the actual tax rate resulted in eight cents of earnings per share. While we also repurchased shares this quarter, the reduction in the fully diluted share calculation was offset by the increased interest expense for the $250 million in debt. The net income margin was 15.5 percent.

In terms of our first-half non-GAAP performance, total revenue during this period was 382.6 million dollars. Product revenue for the first two quarters was 235.1 million dollars with service revenue coming in at 147.5 million dollars. For the first six months of fiscal year 2016, EPS was eighty six cents.

Slide 8: Total Revenue Composition

Slide 8 illustrates our second-quarter and first-half revenue performance for fiscal year 2016 by segment. We've modified our customary year-to-date reporting to focus on the second-quarter performance since this is the first quarterly reporting period of the combined business.

Approximately 61 percent of total quarterly revenue came from our Service Provider segment with the remainder coming from Enterprise. As Anil mentioned, the legacy TekComms business had a very strong quarter, completing a major project for a tier-1 service provider that spanned dozens of sites. It is worth noting that this business returned to positive revenue growth following five consecutive declining quarters.

In terms of some color within the segments, on a pro forma basis, we generated robust revenue growth from service provider customers as the results at TekComs were complemented by a more modest increase in revenue within the legacy NetScout service provider customer base. This growth was partially offset by a more modest revenue decline from enterprise customers due primarily to the timing of certain large enterprise orders last year, sluggish spending in certain verticals such as financial services and headwinds related to changes in foreign exchange rates, most notably with the Euro, the Brazilian Real and, to a lesser extent, the

Japanese Yen.

Slide 9: Revenue by Geography

Let's turn to slide 9 for a review of revenue by geography. For this slide, we'll focus on the quarterly revenue mix, which was 75 percent domestic and 25 percent international. As previously mentioned, the large tier-1 project skewed the mix more in favor of the U.S. Within our international second quarter revenue, Europe represented 14 percent of revenue with 5 percent for Asia and 6 percent for the rest of the world.

In terms of other revenue detail, we had one customer that represented greater than 10 percent of revenue. The majority of the revenue from this customer was associated with the large project we've referenced, although this customer did purchase products from multiple NetScout units during the quarter. We expect purchasing from this customer will continue into future quarters, but it is expected to moderate from second-quarter levels. No other customer represented more than 2 percent of revenue.

Slide 10: Balance Sheet Highlights & Free Cash Flow

Slide 10 details our balance sheet highlights and free cash flow.

We took steps during the quarter to strengthen the Company's liquidity, and increase its financial flexibility while also improving balance sheet efficiency by completing a new 5-year, 800 million dollar senior secured revolving credit facility in place in conjunction with the closing of the transaction. We drew down 250 million dollars on this line during the quarter to support the combined company's initial post-acquisition working capital needs as well as to execute on our share purchase plan. We ended the quarter with cash, short-term market securities and long-term marketable securities of $351.4 million. This puts our total liquidity at just over $900 million.

Our second-quarter fiscal year 2016 free cash flow for the quarter was a use of $8 million dollars. This reflects 2.3 million dollars in cash used by operations plus 5.7 million dollars in capital expenditures and the purchase of intangible assets. Our free cash flow this quarter was affected by the timing of remittances from Danaher for certain accounts receivables collected under our transitional services agreement and other reimbursable items totaling approximately 29 million dollars. Adjusting for this amount, our free cash flow for the quarter would have been $21 million dollars. These remittances will be transferred in the next few weeks and will be included in our third quarter cash flows. Also of note, within our cash flow this quarter was a one-time item involving the payment of 14.5 million dollars for business development-related activities such as investment banking fees and other professional services costs related to the acquisition.

Accounts receivable net of allowances was 165.1 million dollars and, is up significantly from 82.2 million dollars at the end of fiscal year 2015, which reflects the incremental receivables from the acquired businesses. Days sales outstanding was 50 days for the quarter versus a DSO of 43 days for the same period in the prior year.

Our total deferred revenue was 272.6 million dollars. Generally, the trend line across the combined company's operations was consistent with our expectations entering the quarter.

As many of you may recall, in conjunction with the recent DHR transaction, the Board authorized a 20 million share repurchase plan and there is no stated timeframe for completion. Our primary financial objective is to maximize total shareholder return and we consistently evaluate our share repurchase activities as well as other value-creating vehicles such as M&A, strategic partnerships, and dividends. Our on-going capital allocation policy incorporates detailed financial planning and analysis, and we consider multiple factors including operations, strategic business investments, prudent leverage, liquidity, free cash flow, cost of capital, market conditions and other metrics.

Our target share repurchase strategy relies on three primary components: 1) The first component is compensation neutrality, which is oriented around repurchasing shares issued for employee compensation; 2) A second component is opportunistic repurchases based on market, economics, and other conditions; 3) The third component is overall prudent financial management for any excess capital. To that end, in the past three years, we have continuously repurchased shares representing the compensation neutrality portion. Additionally, in this past quarter, we repurchased 4.5M shares for a total of $176 million dollars. At this time, we are currently anticipating being active in the market during our third quarter. We continue to evaluate share repurchase opportunities and will provide more information on this topic as appropriate.

Slides 11 and 12: Guidance – FY 2016

Let's turn to our guidance for fiscal year 2016 on Slide 11.

As we outlined in today's press release, NetScout refined its fiscal year 2016 guidance that we originally issued at the end of July. Our guidance today reflects updated estimates related to the anticipated impact of the Company's share repurchase activity through the second quarter of fiscal year 2016 as well as the anticipated full-year interest expense as we seek to optimize our capital structure.

Focusing more specifically on our non-GAAP guidance for fiscal year 2016, our revenue guidance is unchanged and it ranges from one billion and fifty million dollars to 1.1 billion dollars. Our non-GAAP earnings per share guidance was adjusted to reflect the net effect of anticipated full-year 2016 interest expense of approximately 4.6 million dollars and the Company's incremental repurchase of nearly 4.5 million shares in the September quarter. As a result, we now anticipate that non-GAAP net income per diluted share will be in the range of one dollar and eighty two cents to one dollar and ninety seven cents. Our fiscal year 2016 guidance does *not* include any additional share repurchase activity at this time.

As we stated last quarter, our guidance assumes the majority of the full-year revenue and EPS guidance will be generated in the second half of the fiscal year. More specifically, we currently anticipate that the third quarter will represent approximately 28 to 30 percent of the mid-point of our full-year revenue guidance range. Based on this revenue outlook, we would expect that earnings per share for the third quarter should contribute about 20 to 22 percent of the mid-point of our full year earnings per share guidance range.

In terms of more detailed modeling assumptions, with regard to the tax rate, we anticipate a full year effective tax rate in the range of approximately 35 percent to 37 percent. As is our past practice, if additional events occur, such as the reinstatement of the R&D tax credit, we will note it in our EPS performance and factor that into EPS guidance on a go-forward basis accordingly. Given our second quarter share repurchase activity, we now expect the average weighted diluted shares outstanding for fiscal year 2016 to be just north of 99 million shares for each of the next two quarters with the average weighted diluted shares for the year being 83 million.

Within our reconciliation of GAAP earnings to non-GAAP earnings, there are a couple of items worth noting.

- First, we incurred 14.5 million dollars of business development and integration expenses, which represent investment banking fees, attorney fees and other professional fees associated with the closing of the transaction. We currently anticipate that we will continue to incur certain integration expenses going forward. At this time, we estimate that these integration expenses will be less than 4 million dollars per quarter for the next two quarters. These integration expenses represent one-time incremental costs to outside professional firms related to transitioning from certain support agreements with Danaher. As additional plans develop over the course of this year and the next, we will update our GAAP guidance accordingly.

- Secondly, the deal-related, post-combination services costs of $21.7 million dollars represent the costs of several retention programs that were put in place by Danaher for certain of Danaher's former employees. These former Danaher employees were part of the transition plan to NetScout as a result of the transaction. These programs require retention dates that span through the remainder of calendar year 2015 with one program continuing until the second quarter of the next fiscal year. Although these costs are fully reimbursable to NetScout by Danaher, under GAAP guidance, they are required to be expensed given that they relate to a period after the close hence these expenses are consider compensation under GAAP reporting requirements. We anticipate that the additional milestones related to these programs will affect the next quarter by approximately 9 million dollars and they will impact the fourth quarter by approximately 3 million dollars.

That concludes my formal review of our financial results. Before we transition to Q&A, I would like to thank all of our shareholders for their support since the closing of our acquisition and especially for helping to approve each proposal at our Annual Meeting last month by an overwhelming majority of the votes cast. Finally, NetScout will continue to be proactive in messaging our strategy and explaining our execution. To that end:

- We will be presenting at the Mizuho and RBC Conferences in New York City during the week of November 8.
- We will also attend the Nasdaq Investor Conference in London on December 1.

That concludes our prepared remarks this morning. Thank you again for joining us and we're now ready to answer questions. Operator, you may now begin the Q&A session.