NetScout Systems, Inc.
Third-Quarter Fiscal Year 2017 Financial Results Conference Call
Management's Prepared Remarks

January 31, 2017

A. Kramer: Introduction

Thank you and good morning everyone. Welcome to NetScout's fiscal year 2017 third-quarter conference call for the period ended December 31, 2016. I'm joined today by:

- 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

There is a slide presentation that accompanies our prepared remarks, which can be accessed on the investor relations section of our website at www.netscout.com. You can advance the slides in the webcast viewer to follow our commentary. We will try call out the slide number we are referencing in our remarks.

Today's agenda will be consistent with prior quarters. Our CEO, Anil Singhal, will share his perspective on our results, recent highlights, and our outlook for the remainder of fiscal year 2017. Our COO Michael Szabados will briefly highlight key wins and notable go-to-market activities. Our CFO Jean Bua will then provide greater detail and insight into our financial results, and review our fiscal year 2017 guidance.

Slide #3: Safe Harbor Statement

Moving on to slide #3, I would like to remind everybody listening that forward-looking statements as part of this communication 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 conference call, which are not strictly historical statements, including but not limited to, the statements related to the financial guidance and expectations for NetScout, market conditions and customer demand, and all of the other various product development, sales and marketing, expense management, integration and other initiatives planned for fiscal year 2017 and beyond, constitute forward-looking statements which involve risks and uncertainties. Actual results could differ materially from the forward-looking statements due to known and unknown risk, uncertainties, assumptions and other factors. This slide details these factors, and I strongly encourage you to review each and every single one of them. For a more detailed description of the Company's risk factors, please refer to the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2016 and subsequent Quarterly Reports on Form 10-Q, which are on file with the Securities and Exchange Commission. NetScout assumes no obligation to update any forward-looking information contained in this communication or with respect to the announcements described herein.

Slide #4: Non-GAAP Reconciliation

Let's turn to slide number 4, which involves non-GAAP metrics. While this 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. This slide, which we also encourage you to read, provides information about the use of GAAP and non-GAAP measures because non-GAAP measures are not intended to be superior to, or a substitute for, the equivalent GAAP metric. 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 a reminder, our acquisition of the Danaher Communications Business was completed on July 14, 2015 and as such, the 9-month results for fiscal year 2017 are skewed in comparison with the same period of fiscal year 2016. To provide an "apples-to-apples" comparison between the first three quarters of fiscal years 2016 and 2017, we have provided additional non-GAAP, pro forma details so that you can better understand the key performance trends as well as gain further context for our fiscal year 2017 guidance. Nevertheless, when we do note a growth rate, we will strive to clarify the nature of the comparison. Reconciliations between the GAAP and non-GAAP pro forma financials are provided in the presentation's appendix.

As we detailed in our press release today, NETSCOUT's third-quarter results were highlighted by revenue and EPS that were consistent with our expectations entering the quarter. We've continued to move forward with our new product cycle, and we are seeing some very positive signs of traction in the marketplace. With that as a high level background, I will turn the call over to Anil to provide some further context on our non-GAAP results and plans for the coming quarters. Anil, please go ahead.

Anil Singhal:

Thank you Andy. Good morning everybody and thank you for joining us. Let's begin on slide 6 with a recap of our recent results.

Slide #6: Q3 and First Nine Months FY'17 Performance

The table on this slide compares key non-GAAP metrics for the third quarter and the first nine months of fiscal year 2017 against the prior year periods. For the third quarter, we generated revenue of 311.4 million dollars, an operating profit of 27.1 percent and diluted EPS of 60 cents, all of which were generally consistent with our plans entering the quarter. Jean will provide a more detailed review of our performance, but I'll share several brief observations:

- Revenue declined modestly on a year-over-year basis as lower service assurance revenue more than offset another quarter of solid growth at Arbor Networks. Service assurance revenue decreased against a very strong year-ago quarter in both the enterprise and the service provider segments. Nevertheless, there were some very positive, strategic developments that I will review shortly.
- In terms of profitability, we delivered solid margin performance despite lower revenue due to product mix shifts, and efforts to balance investments in product innovation and sales and marketing initiatives with prudent cost management. The same dynamics for the third quarter are reflected in the nine-month pro forma comparison as our profitability improved despite the lower revenue.
- Overall, we are making good progress with our new product cycle, and we are seeing some very positive signs of traction with these initiatives.

Slide #7: Recent Highlights

Let's move to slide number 7 to cover recent highlights. Overall, we continued to make important progress to further elevate our value proposition with both enterprise and service provider customers, and help them advance a wide range of digital transformation initiatives, including virtualization and the cloud.

In the service provider sector, the largest carriers around the world continue to aggressively manage their capital spending as they seek to monetize the build out of their 4G/LTE networks. Nevertheless, these carriers, along with today's top cable companies, recognize that our solutions are fundamentally important for optimizing network performance, delivering high-quality services, and evolving their network architectures over the longer term. That's helped us dampen the impact of these difficult market conditions as we are successfully expanding our business at a number of service accounts both domestically and abroad.

During the quarter, we continued to build momentum with our new, real-time information platform, the InfiniStreamNG. This new platform delivers true business assurance because it supports powerful analytics to help customers with multiple use cases across service assurance, cybersecurity and business intelligence. We've been very pleased with the traction we are generating with this platform in the service provider market since its launch this past fall. We believe that our expanded capabilities, coupled with our flexible deployment options, leave us well positioned to keep pace with service providers as they implement NFV and cloud initiatives.

Existing carrier customers are finding it appealing because it protects their historical investment in the mission-critical workflows and processes associated with our various legacy platforms. In addition, by making this platform available in multiple form factors and deployment options such as virtual, software and hardware appliances, customers benefit from greater flexibility in instrumenting their networks. This quarter, we achieved some important milestones as two large, tier-one carrier customers began deployment of our InfiniStreamNG software in combination with the use of commercial-off-the-shelf (COTS) hardware.

The anticipated future revenue and profitability associated with these two software-only deals are noteworthy. In one case, we expect the annual recurring spend to be slightly ahead of what this customer had spent in the past year with obviously better margins. In the other account, our software-only form factor helped unlock a tight budget that had restricted this customer's spending on traditional appliances in prior quarters. Michael will share some more color on these wins. This COTS model is also enabling us to gain traction in cost-sensitive emerging markets where traditional appliance-based approaches are seen as too expensive. Additionally, we believe that adoption of our software-only solution will be a natural progression for many customers as they look to virtualize key parts of their wireless infrastructure.

We are also in the process of bringing our big data analytics to the service provider market. We are participating in a number of proofs-of-concept with tier one and tier two service providers around the globe as they seek to consolidate their tools vendors and leverage our robust data via export into other customer experience management (CEM) systems. To that end, we are also advancing partnership discussions with major CEM analytics providers.

In the enterprise service assurance area, our solutions are critical for managing network and application performance, and advancing digital transformation projects that are critical to their future success. Our nGeniusONE platform has delivered low single-digit growth for the year-to-date period with strength in the financial, health care and energy sectors. We are also making good progress on our cloud strategy, which is intended to help enterprises migrate certain applications and workloads to private and public clouds, even as they maintain other applications on premise for governance, regulatory and compliance reasons. Our new solutions, which we expect to launch later this spring, will enable them to maintain the unique visibility made possible by NETSCOUT technology across all of these environments to assure application performance and a high-quality user experience.

Slide #8: Outlook

Let's now turn to slide number 8 for our outlook. As we move into the last quarter of our fiscal year, we are focused on achieving our annual financial, product development and operational objectives. Although our most recent dialogues with certain customers indicate that some larger orders previously anticipated for the fourth quarter may get pushed out into fiscal year 2018, we are still expecting a good finish for the fourth quarter to close out the fiscal year.

Looking more closely into fiscal year 2018, we are excited about a range of opportunities that are well aligned with our development roadmaps across each major product area and customer segment globally. We plan to complete the balance of our highest priority development projects within the next several months. Our customers recognize that our solutions provide the business assurance capabilities needed to drive ROI on their broader infrastructure and IT investments, and gain critical, timely insights to make more informed, impactful decisions.

In security, Arbor is well positioned to further expand its DDoS franchise in the enterprise while also supporting service provider customers as they continue migrating to Arbor's newest offerings. We are also excited about the potential of Arbor's Spectrum offering for advanced threats as we plan to integrate this platform with the InfiniStreamNG later this spring. We see good growth potential in enterprise service assurance, especially as we assist customers with cloud migration; enhance our packet flow switching products for both monitoring and security applications; and bring to market a set of new, complementary capabilities that will allow us to tap into infrastructure performance management budgets. Although the service provider spending environment is expected to remain challenging over the coming quarters, we believe we are well positioned to address their near-term and longer-term requirements.

Overall, we remain cautiously optimistic about our prospects to accelerate our revenue growth in fiscal year 2018. At the same time, we are growing increasingly confident about our ability to deliver notable improvement next year in both gross and operating profit margins, regardless of the revenue trajectory. This reflects positively on the ongoing adoption of our InfiniStreamNG platform in both appliance and software-only form factors. With several key development projects winding down, we will remain vigilant in managing our current cost structure while also investing in go-to-market initiatives that support of our newest capabilities.

Finally, I'd like to thank my colleagues across NETSCOUT for their ongoing efforts and continued perseverance as we look to close out this fiscal year on a very positive note. That concludes my remarks. I'd like to turn the call to Michael at this point for his commentary.

Slide 10: COO Highlights

Michael Szabados:

Thank you Anil and good morning everyone. Let's begin on slide number 10, which outlines the areas that I will cover.

Wins / Use Cases

In terms of customer wins, Anil noted the early traction we are gaining with our InfiniStreamNG platform. More specifically, we are seeing service providers show tangible interest in the software version of the product. During the past quarter, a major European tier-one provider began deployment of our InfiniStreamNG software. Our ability to decouple the software from our InfiniStream appliance and allow the customer to leverage its purchasing power on standard, commercial off-the-shelf (COTS) servers was critical to closing this deal. Without this option, this customer would have continued to limit their spending with us. Now, they can instrument their network more pervasively and in the process, we protected our incumbency, generated substantial revenue and made this account even more profitable.

Our flexible software approach combined with our solution strength also appeals to customers who are interested in strategic, multi-year enterprise commitments. During the third quarter, one of our long-standing North American tier-one service provider customers signed a five-year, 75 million dollar contract with us for our InfiniStreamNG software. This deal provides us with a large, recurring revenue stream that also offers upside should they require additional licenses in any given year.

In the enterprise sector, NETSCOUT closed a 5-million dollar deal with a major U.S.

banking institution to support a major data center modernization initiative involving the latest software-defined data center architectures and virtualization technologies. As a result, our technology will continue helping this customer monitor all key retail applications and quickly triage a wide range of technical issues that could disrupt high-impact, customer-facing applications for some of its fastest growing and most profitable business lines. We expect additional purchases related to this project in future quarters. We are also enthusiastic regarding our new offerings that can provide the visibility and intelligence required to help enterprises migrate their applications to private and public cloud environments with confidence. We will share more about this on our next earnings call after we unveil this offering at our upcoming Engage user conference.

Turning to cybersecurity, as Anil said, Arbor delivered another quarter of solid revenue growth. One key trend driving Arbor's growth in DDoS has been the overall frequency, size and complexity in DDoS attacks coming from IoT botnets, which are smart appliances and other Internet-connected devices that have been co-opted to launch strikes on specific websites or web services. Arbor won more than 30 new enterprise customers in the third quarter, including global gaming, software and services companies, and other industry leaders. We also took pride in a multi-million dollar agreement with a top domestic public and private cloud provider to help them roll out their services in Europe and Asia.

On a final note, we continue to focus our marketing investments to drive lead generation, advance thought leadership and broaden industry awareness. We recently published the findings from our survey of enterprise customers conducted last summer that, among other things, reinforced our efforts to build our strong, enduring relationships with thousands of organizations globally. These customers consider NETSCOUT a leader in service assurance and performance management and believe that our solutions offer compelling value as a key component of digital transformation initiatives while providing a strong value proposition in areas of operational efficiencies. We plan to showcase these solutions at a range of customer and industry events this quarter, including next month's Mobile World Congress in Spain. We are also advancing plans for our annual Engage user conference, which will be held in late April.

That wraps up my commentary and at this point, I will turn the call over to Jean.

Slide 11: CFO Review

Jean Bua:

Thank you Michael and good morning everyone. This morning, I will review key metrics for the third quarter and first nine months of fiscal year 2017. After that, I will review our guidance for the fiscal year. As we've noted, 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. Consistent with our earlier comments, the timing of our acquisition of Danaher's Communications Business impacts comparisons between the fiscal year 2017 and 2016 nine-month periods. When possible, we will frame our year-to-date results against the prior year's nine-month period on a pro forma basis. As noted earlier on the call, the appendix at the end of the slide presentation provides a reconciliation of the non-GAAP pro forma financials, along with other supplemental detail.

Slide 12: Q3 and First Nine Months FY'17 Results

To begin our financial discussion, we will start with slide number 12 of our presentation.

Revenue

For the third quarter of fiscal year 2017, total revenue declined 6.6 percent to 311.4 million dollars due in part to a large service provider's exceptionally strong ordering in the year-ago quarter that did not recur in the same volume during this past quarter. Despite this difficult comparison, our overall revenue performance was in line with the color we offered on last quarter's call.

The presentation appendix provides details on certain customer segment trends. For the first nine months, service provider represented 55 percent of total revenue with enterprise representing the balance. That is unchanged with the year-ago period. Overall, our service provider segment was down 5 percent for the quarter and through the first nine months, it was down roughly 3 percent as growth at Arbor has been more than offset by the decline in our service assurance product area. In the enterprise customer segment, year-to-date revenue is down by approximately one percent. Low single-digit growth in the nGeniusONE product line and high-single digit growth at Arbor were overshadowed by the ongoing rationalization of the former Fluke product lines that overlap within the nGeniusONE platform. With the establishment of the sales and distribution channels within the Fluke handheld tools product area, we saw a modest improvement over the same quarter a year ago. Thus far into fiscal year 2017, we have enjoyed solid nGeniusONE growth in the financial services, healthcare and energy verticals, which has been largely offset by softer government spending.

Our revenue by geography, which is calculated on a GAAP basis, was 36 percent international, which again trended higher this past quarter due to stronger orders from overseas carriers and the tougher year-over-year comparison in orders from one of our large domestic customers.

Profitability: Gross Margin & Operating Margin

Despite lower revenue, product mix shifts led to strong gross margin improvement this quarter. Our year-to-date gross margin was 75.2 percent. For the quarter, the operating margin was 27.1 percent and for the first nine months of the fiscal year, our operating margin was 21.3 percent. Our operating margin is 800 basis points higher than the same period one year ago.

Profitability: Net Income

Quarterly net income was 55.2 million dollars, or 60 cents ($0.60) per diluted share. We estimate that our international income will be higher for this fiscal year, which effects our non-GAAP tax rate. Accordingly, we saw a 1 percentage point decrease in our effective tax rate from 34.5 percent to 33.5 percent. This tax rate change contributed about two cents to our quarterly earnings per share. For the first nine months of our fiscal year, our net income was 118.0 million dollars, or one dollar and twenty seven cents ($1.27) per diluted share.

Slide 13: Balance Sheet Highlights, Free Cash Flow and Share Repurchase

Slide 13 details our balance sheet highlights and free cash flow. For the first nine months of the fiscal year, we generated free cash flow of 107.8 million dollars. This is considerably higher than the comparable reported period one year ago due to the improved profitability as well as the timing and magnitude of items related to the acquisition. Given our progress thus far, we continue to expect that free cash flow will be approximately between 80 to 90 percent of non-GAAP net income in fiscal year 2017.

As it relates to our financial profile, with 500 million dollars of credit available on our existing facility and the higher level of cash on the balance sheet, our liquidity now stands at 877 million dollars and our gross leverage remains at the lower end of our target range.

Share Repurchase Activity

In terms of our share repurchase activity, we repurchased approximately 98 thousand shares of our common stock this past quarter. This was significantly less than what we had intended to repurchase entering the quarter. The surprisingly strong rally in the US equity markets that began in early November quickly propelled NETSCOUT's stock price beyond the repurchasing parameters approved by the Board and in place to begin the quarter.

At present, we have approximately 6.8 million shares remaining on the 20 million shares authorized for repurchase. We will continue with our share repurchase program in the fourth quarter so we expect to be active in the market.

To briefly recap other balance sheet highlights, accounts receivable, net, increased by nearly 15 percent from the end of the last fiscal year as a result of overall product mix shifts and the timing for service renewals. DSOs were 83 days in comparison to 80 days in the second fiscal quarter and 71 days in the same quarter one year ago. The increase in DSOs primarily reflects the shift in geographic mix toward international customers with longer payment terms along with the timing of maintenance and support contract renewals.

Slide 14: FY 2017 Guidance

Let's move to slide 14 for guidance. The reconciliation of our GAAP guidance to our non-GAAP guidance is in the appendix.

Based on our current pipeline of opportunities, we expect that our fiscal year 2017 revenue will be approximately $1.2 billion dollars. Correspondingly, we expect that our diluted EPS will range between one dollar and eighty seven cents ($1.87) to one dollar and ninety cents ($1.90).

In terms of other modeling assumptions for our EPS guidance, we expect interest and other expense of approximately 2.5 million dollars per quarter. We currently anticipate a tax rate in the range of 33.5 percent to 34.5 percent, consistent with our updated view on our anticipated full-year tax rate. Based on approximately 92 million shares outstanding for the fourth quarter, this would translate into a diluted EPS range for the fourth quarter of sixty to sixty three cents. For the full year, we anticipate approximately 93 million shares outstanding.

That concludes my formal review of our financial results. Before we transition to Q&A, I'd like to outline our calendar for investor outreach.

- We will participate in Morgan Stanley's Technology, Media and Telecom Conference in San Francisco on March 1;
- We will augment this conference with outreach to our shareholders and prospects in New York, Chicago and the West Coast.

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.