NETSCOUT SYSTEMS, INC.
Third-Quarter Fiscal Year 2018 Financial Results Conference Call
Management's Prepared Remarks

January 30, 2018

A. Kramer: Introduction

Thank you [operator] and good morning everyone. Welcome to NETSCOUT'S third-quarter fiscal year 2018 conference call for the period ended December 31, 2017. Joining me today 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

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

Our agenda is as follows: Anil Singhal, our president and CEO, will briefly review our performance and then address certain questions that have arisen since we announced our preliminary third-quarter results and revised outlook for fiscal year 2018. Michael Szabados will review customer adoption trends and major go-to-market activities. Our CFO Jean Bua will then review our third-quarter results and detail our updated fiscal year 2018 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 fiscal year 2018 financial guidance for NETSCOUT, revenue and profit growth prospects for fiscal year 2019, share repurchase activity including the ASR, market conditions and customer demand, anticipated revenue from specific customers and specific products, along with all of the other various product development, sales and marketing, expense management and other initiatives planned for the remainder of this year or into fiscal year 2019, constitute forward-looking statements which involve risks and uncertainties. Actual results could differ materially from the forward-looking statements due to known and unknown risks, uncertainties, assumptions and other factors. This slide details these factors, and I strongly encourage you to review each 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, 2017 and the 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 those and other reconciliations and supplemental detail are included at the end of the slide presentation, which is available on our website.

As we disclosed earlier this month, our third-quarter results were notably below our expectations entering the quarter. We expect further challenges to negatively impact our performance in the fourth quarter and, as a result, we've updated our full-year revenue and EPS targets accordingly. I will now turn the call over to Anil for his perspective on these and other matters. Anil …

Anil Singhal:

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

Slide #6: Q3 FY'18 Highlights

Consistent with our January 10th announcement, we reported third quarter revenue of $272 million, which was down nearly 13 percent from last year's third quarter and below our plans entering the quarter by 30 to 50 million dollars. I'll cover the shortfall against expectations in a moment. We also took steps to recalibrate our cost structure through certain one-time adjustments to variable incentive compensation. Our third-quarter diluted EPS of 69 cents per share also benefited from a lower tax rate.

We believe that many of the issues that affected third-quarter revenue are likely to impact our performance in the fourth-quarter. Accordingly, as we announced on January 10th, we've lowered our full year fiscal year 2018 revenue and EPS outlook. We've spent considerable time over the past several weeks trying to help shareholders understand the issues that are impacting our performance. Rather than follow our conventional format of highlighting key accomplishments in the quarter, I'd like to focus my commentary on answering the most common inquiries we've received.

Slide #7: Top Investor Questions

The first question asks about the biggest factors impacting NETSCOUT's Q3 FY'18 and full year FY'18 revenue. To answer this, it is important to provide some perspective.

As we've discussed previously, we entered fiscal year 2018 anticipating that one of our largest tier-one customers would further moderate its spend with us by up to 100 million dollars. This customer has adjusted its overall spending after multiple years of elevated spending to build its 4G/LTE footprint. In recent quarters, the customer has attempted to absorb excess capacity and otherwise redeploy equipment to mitigate growing OTT traffic volumes and deliver high-quality services in a very price sensitive, highly competitive marketplace. We had previously planned to offset this decline with a strong second half of the year aided in large part by solid growth in our enterprise customer segment.

Our inability to achieve our targets reflects three major factors: ongoing and significant service provider capital spending pressures, primarily in North America; lengthening enterprise sales cycles as our customers grapple with major digital transformation initiatives and related changes to their technology architectures; and funding delays for multiple large federal government projects. More than half of the total shortfall is attributable to the service provider customer segment. In the service provider market, about three-quarters of the shortfall is associated with overall lower-than-expected orders for our service assurance products primarily from tier-one providers in North America. The remainder of the shortfall is associated with delays and reduced orders for Arbor's DDoS offerings in part because attack volumes have moderated from prior years and that is enabling those customers to defer spending.

Our enterprise customer segment revenue was also notably below our plans due largely to funding delays for multiple large federal government projects and longer-than-anticipated sales cycles within our Enterprise customer base. I'd like to briefly explain each of these factors:

- Regarding the funding delays in the federal sector, we noted in October that our second-quarter government revenue was lower than expected. At that time, we were disappointed that a significant pipeline of opportunity, which we estimated to be about 50 million dollars across a variety of federal agencies, was unrealized because funding for those projects had yet to be secured due to a variety of reasons including the reprioritization of funds to aid disaster recovery activities. We moved into the third quarter with limited visibility into which unfunded projects, if any, would move forward during the second half of our fiscal year. Unfortunately, we did not see any upside from this pipeline in the third quarter, and we no longer believe it is realistic to expect any material contributions from this pipeline going forward.
- In terms of lengthening enterprise sales cycles, our enterprise customers' digital transformation initiatives and the related changes to their technology infrastructure has impacted the timing and complexion of deals involving both our traditional products and some of the newer solutions we've introduced in recent quarters.

Our enterprise revenue has also been affected, albeit to a lesser extent, by softer-than-expected orders for certain ancillary enterprise offerings. For example, the handheld tools product lines associated with the former Fluke Networks unit is likely to end this fiscal year at less than five percent of total revenue. This is a non-core, low-margin product area that lacks synergy with our enterprise sales teams since these offerings are sold through third-party distributors. Given these dynamics, we are looking at a range of options to resize our resources in this area, including potentially divesting these assets altogether.

Has there been any change in the Company's competitive position?

Investors have also inquired about whether the lower revenue outlook reflects any notable change in the competitive landscape. The short answer to that is no.

In the service provider service assurance product area, we've made good progress with the new software-only version of our InfiniStreamNG real-time information platform. We focused initially on driving deployment with international carriers where the revenue base presented limited risk and greater upside. We've made good progress thus far and this platform represented approximately 7 percent of year-to-date product revenue. Our largest carrier customers in North America have been actively qualifying this new platform and we anticipate purchasing from them to begin in fiscal year 2019. In terms of network function virtualization-related initiatives, service providers are still moving cautiously in terms of commercial traffic and actual spending. Nevertheless, we believe that we are well positioned to help carriers in this area, and one of our European customers recently selected our virtualized service assurance solutions to support a multi-year transformation of their infrastructure from physical to virtual. We expect a public endorsement of our virtualization technology by this customer over the coming weeks.

In terms of enterprise network and application assurance, we've seen sales cycles lengthen as customers advance their digital transformation projects and related changes to their IT infrastructures. Whereas prior decisions to deploy our core solutions quickly followed an upgrade or expansion of their traditional data center infrastructure, enterprises now have a broader range of infrastructure options that include private and public cloud migration, and that is extending our sales cycles. Fortunately, we have already made the necessary investments to expand our portfolio to support customers, regardless of whichever path they take.

In security, Arbor continued to win new DDoS deals with both existing and new service providers. However, spending on Arbor's solutions by North American service providers has been limited due to the combination of excess capacity and more modest attack volumes. In the enterprise, the tailwinds created by headline-grabbing DDoS attacks in the fall of 2016 have largely dissipated. That has resulted in fewer multi-million dollar enterprise wins and smaller overall deal sizes versus last year. Our initial foray into the advanced threat market has yet to deliver meaningful revenue but we've received valuable feedback from early adopter customers and prospects. We expect to introduce a new release of the solution later this spring that is aimed at taking further advantage of NETSCOUT's technology and footprint across our installed customer base.

What steps are you taking to improve your cost structure?

We took certain one-time actions during the third quarter that removed approximately 25 million dollars of costs primarily through adjusting variable incentive compensation and we expect there to be some modest benefit from this in the fourth quarter. However, these adjustments are non-recurring so those costs need to be factored into fiscal year 2019. Accordingly, we are looking at a variety of actions aimed at increasing operational efficiencies by further streamlining roles across multiple functional areas. When combined with potentially restructuring the former Fluke handheld tools business, we believe that this can further improve our profit profile, without compromising our long-term growth prospects. With that said, our R&D and sales and marketing costs also reflect our ongoing commitment to support hundreds of customers around the globe who are using legacy products from the former Tektronix and Fluke businesses. We plan to continue prudently managing these resources as we continue efforts to migrate these customers to our next-generation products while those legacy products move closer to the ends of their respective lifecycles.

How much of the FY'18 revenue shortfall is the result of delayed orders that will be placed in FY'19? How has the shortfall for FY'18 impacted your growth plans in FY19?

The last two questions about order delays and our views for fiscal 2019 can be taken together. To be clear, a majority of our annual revenue shortfall is tied to opportunities that lack sufficient visibility to assume that they will materialize next year. This includes certain prospective service provider projects, the unfunded federal government pipeline and certain other enterprise opportunities associated with Arbor's DDoS and advanced threat offerings.

Although we continue to advance our planning processes for next fiscal year, it would be premature for us to offer any specific revenue guidance for fiscal year 2019 right now. Nevertheless, we are making the necessary investments that we believe can support top-line growth in fiscal year 2019. Our optimism for top-line growth is based on a few factors. First, we believe that spending from our largest tier-one service provider customers has reached a bottom that should be stable to mildly improved next year. Second, most of the product integration challenges are behind us. Third, we expect better traction from our new products, especially those that can be sold into new areas of IT and security. Additionally, we believe that our ability to deliver software-centric solutions will help us further fortify our incumbency with key service providers, move us down market to support a broader range of enterprise customers and support further gross margin improvement. The guidance we provide for fiscal year 2019 during our next conference call in May will reflect these dynamics and assumptions.

We move forward with high conviction that we are well positioned to capitalize on a range of exciting opportunities to drive future growth. We anticipate that the combination of continued gross margin improvement and our efforts to closely monitor and manage our cost structure should produce further operating leverage. Together with a lower tax rate and lower share count, this should translate into very compelling EPS growth next year. This optimism is underpinned by our plans to execute an Accelerated Share Repurchase of up to 300 million dollars in conjunction with our amended and expanded Credit Facility.

That concludes my prepared remarks and I'll turn the call over to Michael at this point.

Slide 9: COO Highlights

Michael Szabados:

Thank you Anil, and good morning everyone. Slide number 9 outlines the areas that I will cover, which I believe help convey the progress we are making with our new product cycle as well as our efforts to advance our go-to-market initiatives.

Customer Adoption Trends:

As we've discussed on prior calls during the past two-plus years, we have focused our considerable software resources and expertise on driving innovation across our product portfolio. We've extended the deployment options of our real-time information platform, the InfiniStreamNG, from a traditional appliance to software-only for commercial-off-the-shelf hardware and to an array of virtual alternatives. We've discussed on recent calls that the software-only version of the ISNG has been well received by major international carriers, and we expect a relatively sizeable deployment of our software-only platform in support of a major 4G and VoLTE rollout later this spring.

As Anil described, we are seeing longer sales cycles as our enterprise customers consider a broader range of options for deploying their existing and new applications. When our enterprise customers elect to upgrade their traditional data centers, they can extend their deployments with our appliance and software alternatives. As they move their workloads to private or public clouds, our new vScout and vStream products seamlessly expand their application monitoring coverage into the resulting hybrid cloud. Our customers consider our ability to provide them with continuity of visibility through disruptive architecture changes and workload migrations to be invaluable.

As a result, the number of evaluations and proof-of-concepts for these products has grown steadily since their launch last summer and we are engaging with new buying centers within the IT organization, such as with DevOps and cloud architecture teams, in addition to working with our traditional user base in identifying new use cases. The enthusiasm and interest we generated at last quarter's AWS re:INVENT was further validation that these solutions are highly differentiated and relevant to multiple departments within enterprise IT organizations as they plan and implement various phases of their data center transformation projects.

We are also expanding our pipeline for our nGeniusPulse software offering that is used to diagnose the root cause of issues impacting infrastructure performance and actively test software-as-a-service applications. This capability complements and amplifies the service assurance solution delivered by our core technology and eliminates any need for third party tools in the monitoring and troubleshooting workflows for our customers mission-critical applications.

Our software innovation also extends to our packet broker offering. Earlier this year, we decoupled our packet broker software from hardware with our new PFS 5000 model. By creating an open-compute platform option for network packet brokers, we've taken a unique, disruptive approach that is starting to resonate in the marketplace. Orders for the PFS 5000 are now outpacing those for our traditional, hardware-based packet brokers and we expect that to further accelerate next month when we introduce support of inline security tools.

Go-to-Market Activity:

During the quarter, we consolidated the previously separate NETSCOUT and Arbor marketing teams to help us deliver a more unified presence to the marketplace and better align with our strategy to deliver combined service assurance and security solutions based on our smart data platform. We also anticipate higher levels of collaboration and coordination between those sales teams as we move into the next year. We expect to roll out the results and further details of this unification, along with our success stories with our new software and virtualized portfolio, at our annual Engage customer and sales meeting, making it the most exciting and impactful NETSCOUT user forum yet.

That concludes my prepared remarks and at this point, I will turn the call over to Jean.

Slide 10: CFO Review

Jean Bua:

Thank you Michael, and good morning everyone. This morning, I will review our third-quarter results, key revenue trends through the first nine months, and our revised fiscal year 2018 guidance. As a reminder, this review focuses on our non-GAAP results unless otherwise stated, and all reconciliations with our GAAP results appear in the presentation appendix.

Slide 11: Q3 FY'18 and First Nine Months FY'18 Results

Slide number 11 shows our results for the third quarter and first nine months of fiscal year 2018. Focusing on our third-quarter results, total revenue decreased by 39.3 million dollars, or 13 percent, to 272.0 million dollars.

Our overall gross margin changed by approximately 250 basis points to 80.2 percent primarily due to the one-time adjustment related to variable incentive compensation. Our total operating expenses decreased by 23.6 million dollars from the prior year largely due to the aforementioned changes in variable incentive compensation and lower sales commissions. The operating profit margin for the quarter was 30.9 percent. Recently enacted tax legislation reduced our third-quarter effective tax rate to 25 percent, which contributed to diluted earnings per share of 69 cents.

Slide 12: First Nine Months FY'18 Revenue Trends: Customer Verticals & Geographic Mix

Turning to Slide 12, I'd like to review key revenue trends through the first nine months. Revenue in our service provider customer segment declined 16 percent through the first three quarters. The decline reflects two primary factors. First, as we have discussed on prior calls, one of our large tier-one service provider customers has been moderating its purchasing over the past two years. Second, revenue for Arbor's DDoS solutions decreased by the mid-teens. These dynamics were partially offset by low single digit growth in all other service assurance service provider accounts. As Anil noted earlier, we expect that service provider capital spending pressures will continue to result in softer order volumes for our service assurance and DDoS products in the fourth quarter.

Our enterprise vertical declined by approximately 8.5 percent through the first three quarters. Enterprise revenue for legacy NETSCOUT offerings declined by mid-single digits through the first nine months. This was compounded by weakness across all other product areas. Most notably, we've continued to see erosion across the former Fluke product lines. Following a very soft third quarter, Arbor's enterprise security revenue only grew low single digits through the first nine months.

For the first nine months, the mix of revenue was 53 percent coming from service provider and 47 percent from enterprise. In terms of revenue by geography, which is calculated on a GAAP basis, our revenue in the United States declined sharply during the first three quarters largely due to the decrease in revenue from that large tier-one carrier while international revenue declined by five percent. International customers represented 40 percent of total revenue through the first nine months of this year versus 38 percent in last year's comparable period. We did not have a 10 percent revenue customer for either the third quarter or the first nine months.

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

Slide 13 details our balance sheet highlights and free cash flow. We ended the quarter with cash, cash equivalents, short-term marketable securities and long-term marketable securities of 383 million dollars, an increase of 69.6 million dollars from the end of September.

Our free cash flow for the third quarter of fiscal year 2018 was 72.0 million dollars and it was 135.9 million dollars for the first three quarters of the year. Our third-quarter free cash flow reflects favorable changes in working capital due to the collection of receivables and the lower sales volume. We currently anticipate that free cash flow for the full year will be more than 100 percent of non-GAAP net income.

Share Repurchase Activity

As detailed earlier this month and again in today's press release, we are planning to execute an Accelerated Share Repurchase of 300 million dollars later this week. Using yesterday's closing stock price of 26 dollars and 10 cents per share, the ASR would enable us to repurchase approximately 11.5 million shares. While we anticipate that it will take the banks working on our behalf between 2 to 3 quarters to execute the buyback, the accounting treatment allows us to reduce our share count by approximately 8 million shares, or approximately 70 percent of the ASR, immediately upon entering into the agreement. Once the repurchase is technically completed, the share count would be further reduced by the number of shares actually repurchased excluding the number of shares reflected in the initial reduction. Although there will be minimal benefit to our diluted EPS in fiscal year 2018, it will enable us to significantly reduce the number of our shares outstanding next year. For the third quarter, we did not repurchase any shares.

We plan to fund the ASR primarily through additional debt of 300 million dollars. We anticipate that our net leverage for the fiscal year ending 2018 will be about 1 times. To support this activity, we entered into an amended and expanded credit agreement earlier this month that upsized our existing credit facility. The agreement provides for a five-year, one billion dollar senior secured revolving credit facility, which is 25 percent larger than the original agreement, and it has better pricing and more favorable terms and conditions compared with the original agreement.

To briefly recap other balance sheet highlights, accounts receivable, net, were 249.9 million dollars, down from the end of last year. DSOs were 82 days versus 83 days at the same time last year and 80 days at the end of fiscal year 2017.

Slide 14: Guidance

Let's move to slide 14 for guidance. I will focus on the non-GAAP guidance and remind you that the reconciliation of our GAAP guidance to our non-GAAP guidance is in the appendix. Anil spent considerable time detailing the drivers associated with lowering our revenue outlook for fiscal year 2018 from the original target of approximately 1.2 billion dollars to between 1.0 billion dollars and 1.025 billion dollars.

In our service provider customer segment, we now anticipate a full-year revenue decline in the range of 22 to 25 percent from fiscal year 2017 levels due to continued capital spending pressure from tier-one carriers, primarily in North America. This is impacting the timing and magnitude of order levels for the Company's service assurance solutions and, to a lesser extent, capacity-related orders for Arbor's DDoS offerings. In the enterprise, we anticipate that fiscal year 2018 revenue will decrease between 5 to 7 percent from fiscal year 2017 levels primarily due to weaker-than-expected federal spending, longer-than-anticipated sales cycles and softer-than-expected orders for certain other enterprise offerings.

Given our revised outlook for the full year, we anticipate fourth-quarter revenue in the range of roughly 240 million and 265 million. The wider revenue range for the fourth quarter reflects some uncertainty about the timing of certain orders across both customer segments.

We currently anticipate that gross margin should increase to around 77 percent for this year, which implies that fourth-quarter gross margins are likely to decline modestly from third-quarter levels. This is primarily due to the one-time variable incentive compensation adjustment from the third quarter as well as lower sales volume. We anticipate fourth-quarter operating expenses that will increase modestly from third-quarter levels by about 13 to 15 million dollars again due to the third-quarter's adjustment related to variable compensation. Other full-year modeling assumptions including changes to the tax rate, interest expense and the diluted share count, each of which are outlined on this slide. Based on the quarterly impact of these assumptions, this would translate into fourth-quarter diluted EPS in the range of 25 to 40 cents.

That concludes my formal review of our financial results. Before we transition to Q&A, I will note that we plan to participate at a Morgan Stanley investor conference in San Francisco at the end of February and we plan to augment that with meetings in other major money centers over the coming weeks. I'll now turn the call back to Andrew Kramer before we start Q&A.

Andrew Kramer: Q&A

Thank you Jean. As we've outlined, we are moving forward focused on the opportunities that we believe can lead to improved performance in fiscal year 2019 through both top-line growth and actions to adjust our cost structure. We will plan to share more details about the coming fiscal year in early May when we report our fourth-quarter and full-year fiscal 2018 results. Operator, you may now begin the Q&A session.