NETSCOUT SYSTEMS, INC.
First-Quarter Fiscal Year 2019 Financial Results Conference Call
Management's Prepared Remarks

July 26, 2018

A. Kramer: Introduction

Thank you [operator] and good morning everyone. Welcome to NETSCOUT'S first-quarter fiscal year 2019 conference call for the period ended June 30, 2018. Joining me today are:

- Anil Singhal, NETSCOUT's 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. You can advance the slides in the webcast viewer to follow our commentary. We will call out the slide number we are referencing in our remarks. Both the slides and the prepared remarks can be accessed in multiple areas within the investor relations section of our website at www.netscout.com including the IR landing page under financial results, the webcast itself and under financial information on the quarterly results page.

Our agenda is as follows: Anil Singhal will briefly review our performance, highlight key trends and recent developments, and offer his views on our outlook for fiscal year 2019. Michael Szabados will briefly review some customer wins that help highlight some of our near and longer-term growth drivers, as well as recap go-to-market highlights. Jean Bua will then review our first-quarter results and fiscal year 2019 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 on this conference call, which are not strictly historical statements, including but not limited to, the statements related to the fiscal year 2019 financial guidance for NETSCOUT; market conditions, technology trends, customers and customer demand; anticipated revenue from specific customers and specific products; share repurchase activity; and all of the other various product development, sales and marketing, expense management, cost-reduction and other initiatives planned for 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, 2018 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. We've also provided supplemental data for comparability purposes related to the reclassification of product and service revenue and the applicable costs for prior periods. That information can be found in the press release, in the appendix of the slide presentation and on the investor relations website.

Overall, we reported relatively solid EPS results despite revenue at the lower end of our plans. We made solid strategic and operational progress, and we are excited about our prospects over the coming quarters. With that said, I will now turn the call over to Anil for his prepared remarks. 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 first-quarter non-GAAP results.

Slide #6: Q1'19 Financial & Operational Highlights

We delivered a relatively solid first-quarter earnings performance with diluted EPS of 3 cents primarily due to our ongoing efforts to manage costs. Total first-quarter revenue of 206 million dollars was at the lower end of our targets primarily due to order delays with our enterprise customers. Jean will review our first-quarter results in more detail in a few moments.

Despite a slow start to the year, we continued to make good progress on multiple fronts. We continued to advance key development initiatives to enhance and expand our product portfolio. We also took tangible steps to further fortify and expand our customer relationships and validate our product strategy through our annual sales kick-off and user conference events, along with a new strategic partnership with IBM. Just as critical, we are advancing actions to proactively recalibrate our cost structure.

With that as the backdrop, I'd like to review our core strengths and how they are relevant to today's market trends, as well as key developments in the quarter.   Let's move to slide number 7 for that.

Slide #7: Core Strengths, Market Trends & Key Developments

Over the past 30-plus years, NETSCOUT has built its market and technology leadership by leveraging its extensive expertise in understanding network traffic, or wire data. Network traffic is very high-fidelity data, but until recently, it has been relatively expensive to collect it and difficult to make it actionable. Through both organic development and acquisition, our efforts have been focused on making it more affordable for customers to pervasively deploy our technology and more relevant to different stakeholders across and beyond IT operations – from network engineers to cloud architects and from chief information officers to chief security officers and senior-level executives.

To do this, we have focused our product strategy around the concept of 'smart data' – which is our patented ability to instantaneously convert high-volume network traffic into highly contextual, structured metadata at the collection point. By reshaping and expanding our offerings into a software-centric, feature-rich portfolio of 'smart data' solutions, our software-based 'smart data' instrumentation and analytics can cost-effectively address a broader range of use cases spanning network assurance, application assurance, security and big data.

Our performance over the past few years has been affected by difficult market conditions as we also managed through the challenges involved in transforming our product portfolio with increasing software content. The constrained service provider spending environment was most pronounced at our largest carrier customer who substantially reduced spending after several years of elevated purchasing. In addition, enterprise purchasing has been choppy as customers grapple with digital transformation, and the threat landscape for security continues to rapidly evolve. However, with the resizing of our business and because of the investments we have making, we believe that most of these challenges will largely bottom out within the first half of this fiscal year.

Service Assurance: Service Provider

In the service provider market for service assurance, our ability to deliver a software-only version of our platform for collecting network traffic is increasingly appealing to carriers with more limited capital budgets for their 4G networks. We're making tangible progress in this part of our business.

- Service provider revenue for our service assurance products stabilized in the first quarter and we believe that this trend will continue over the coming quarters.
- Adoption of the software version of our ISNG real-time information platform has continued to grow, highlighted by a sizable new deployment by a North American tier-one mobile operator in the first quarter. Michael will share further insight into this win later on the call.
- We are well positioned to benefit as major carriers begin their next investment cycle and start spending on next-generation networking technologies involving network virtualization and 5G architectures. For example, in the first quarter, we received high seven-figure orders related to 5G. Additionally, Telefonica recently certified our virtualized solutions for deployment in their next-gen lab architecture.
- Earlier this week, we announced a new partnership with IBM that highlights the intrinsic value of our smart data. Under the agreement, our ISNG software will be tightly integrated with IBM's Telecom Analytics Solution, which we believe positions us as IBM's probing platform. We are working closely with IBM to advance opportunities in which mutual customers can benefit from deploying our

software to gain timely, impactful insights into the subscriber experience using IBM's customer experience management analytics.

Service Assurance: Enterprise

In the enterprise, digital transformation is a high priority with customers as they seek to reshape the delivery of enhanced or new products and services, improve operational workflows, and lower capital and operating costs – all without sacrificing quality, performance or security. We believe that NETSCOUT is well positioned to support large enterprises and government agencies on this front by helping them manage the constantly evolving hybrid infrastructure that results from digital transformation, improve collaboration across their IT organization, consolidate the number of tools they use, and improve the end user experience. However, given the strategic importance of digital transformation, many large enterprises are moving cautiously, and this dynamic continues to impact the timing of certain projects, which contributed to the order delays we experienced in the first quarter.

Last year's launch of new offerings such as vSCOUT, vSTREAM and nGeniusPULSE extends our value proposition beyond network assurance to include application and infrastructure performance management. These new solutions are highly complementary to our core nGeniusONE analytic suite, thereby providing enterprises with a unified, consistent view into an evolving hybrid infrastructure that can span traditional data centers, private cloud and the public cloud. Michael will highlight a couple of these wins in a moment. Moving forward, we expect that sales of these new products will continue growing, especially in the second half of the fiscal year.

Security

In terms of security, our NETSCOUT Arbor unit is a leading provider of solutions for distributed denial of service, or DDoS, with a leadership position in the service provider market and an enviable high-end enterprise customer base. Arbor's carrier and ISP relationships remain very strong, although prior-year investments in capacity and a moderation in volumetric attacks are likely to continue weighing on the Arbor top line. To further enhance Arbor's value proposition and sales reach in the enterprise, we plan to substantially enhance Arbor's on-premise system and relaunch it later this quarter as Arbor Edge Defense. In addition to continued best-in-class detection of application-specific DDoS attacks, this new platform will offer new perimeter defense and reporting capabilities and better support cross-selling initiatives into our service assurance enterprise customer base.

Wire data is also very valuable to security teams, and NETSCOUT is mobilizing to capitalize on this. In addition to our investments to continue enhancing the Arbor portfolio, we are also adding new software functionality to our ISNG platform called the nGenius Packet Shaper. This new capability is designed to cost-effectively collect and filter packet data before forwarding it to other security tools that our enterprise customers use, thereby reducing the need for more security probes in the network. In addition, we are planning to release the next iteration of our advanced threat solution later this fiscal year. This product will use NETSCOUT's 'smart data' to help security teams work faster and more efficiently to identify, investigate and contain network borne advanced threats.

Cost-Reduction Initiatives

Finally, I'd like to provide an update on our operating cost initiatives. We have been diligent about managing our cost structure. Our first-quarter operating costs declined approximately 8 percent from the prior year thanks primarily to lower headcount and related personnel costs. As we discussed last quarter, we also are in the process of advancing certain programs that we believe will further streamline our operations and boost overall efficiency. In total, we estimate that these actions will remove at least 50 million dollars of annual run-rate costs from our business, although we will not realize the full benefits of these actions in fiscal year 2019 due to the timing.

The divestiture of our handheld tools product area, which we determined is no longer core to our long-term strategy, is well underway with multiple bidders involved. As a reminder, about five percent of our workforce is involved in this area, which represented over four percent of last year's total revenue with gross margins below the NETSCOUT average and break-even operating profitability.

Another initiative involves further adjusting the size and complexion of our workforce. With the integration efforts following our acquisition of the Danaher Communications Business largely behind us, we have identified certain areas that we plan to realign. These plans have already been communicated to our workforce and will be implemented in a way that does not compromise our important initiatives, overall agility and company values. Additionally, we also plan to consolidate certain facilities. In combination, we believe that the divestiture of the tools business, the implementation of restructuring actions and careful management around new hires will enable us to reduce the size of our workforce by at least 10 percent. We will provide the specific cost-savings and related charges from these actions once they are completed.

Slide #8: Outlook & Summary

Turning to slide number 8, we move forward with continued enthusiasm about the opportunities we see to improve performance and return the business to consistent top-line growth, notably stronger profitability and robust free cash flow. Nevertheless, the first quarter represented a muted start to the year. Moving into the second quarter, there is continued uncertainty around the timing of certain enterprise deals and we see continued softness in our DDoS product area. Just as important, the bulk of our new product initiatives won't yet impact the revenue stream. For these reasons, we are taking a conservative view on our second-quarter revenue performance, which we currently expect to be in the range of 215 to 225 million dollars.

We recognize that our anticipated first-half revenue trajectory would currently put us on track to achieve the lower end of our full year revenue guidance, which would equate to relatively flat with last year on a comparable accounting basis. With that said, we are bullish about our prospects in the second half of the fiscal year. We expect seasonally stronger spending by service providers, anchored by several larger-sized projects, including some 5G-related projects. In the enterprise, we also expect better results from our enterprise service assurance products and contributions from our newest security products. Based on these dynamics, we have left our full-year non-GAAP revenue guidance unchanged at this time. Our fiscal year 2019 non-GAAP diluted EPS guidance also remains intact as we work to complete certain cost-reduction initiatives this quarter. Just as important, we believe that stronger second-half results will demonstrate that we have built the sales momentum necessary to put us on a path to achieve the long-term financial targets we shared with you last quarter.

Finally, I would like to publicly thank Jim Lico for his service on the NETSCOUT board, which will end after our upcoming Annual Meeting in September. Jim's counsel since joining our board three years ago has been very helpful, particularly in regard to the integration of the Danaher Communications Business. I know he has a very full plate as CEO of Fortive Corporation and we wish him continued success in his future endeavors.

That wraps up my comments and I'd like to turn the call over to Michael at this point.

Slide 10: COO Update

Michael Szabados:

Thank you Anil, and good morning everyone. Slide number 10 outlines my plan to highlight some recent wins and recap Engage, our annual technology and user summit.

Customer Wins:

In the service provider market, Anil highlighted the progress we've made in driving adoption of the software-only version of our ISNG platform, which enables carriers and cable operators to cost-effectively expand their monitoring coverage. With service provider capital budgets still under pressure, this strategy is helping us stabilize revenue in this important vertical. During the first quarter, a major tier-one operator in North America began deploying our ISNG software after deploying our legacy platforms to gain end-to-end visibility. This purchase, which was valued at nearly 10 million dollars, provides them ample near-term capacity to handle continued traffic and subscriber growth as they focus on upgrading key links and extending visibility to new parts of their network. From our perspective, this deal solidifies our incumbency, improves the profit profile of this account and creates new sales opportunities for our nGenius Business Analytics, NFV instrumentation and eventual 5G-related projects.

In the enterprise market, our vSCOUT and vSTREAM offerings are positioned as a high-value platform that can help assure application performance across traditional data center, private cloud and public cloud environments. We are starting to see meaningful deals involving these offerings successfully progress through their sales funnels. Two recent wins, each worth over a million dollars, help showcase how these solutions reduce the risks inherent in digital transformation initiatives.

For example, one of the world's largest appliance manufacturers and a long-standing NETSCOUT customer for network performance, selected our vSCOUT, vSTREAM and virtual nGeniusONE offerings to aid in their cloud and virtualization transformation. This customer is using these products to extensively instrument business-critical manufacturing sites, call centers, and data centers as part of a larger project to transition from legacy infrastructure, applications and data centers to cloud-based platforms and applications. By using our solutions, this customer can baseline performance and quality of service for key applications, sites, and users before, during and after the transition to ensure business continuity and user experience. In the government sector, a large municipality's IT organization has licensed multiple thousands of vSCOUT agents and virtual nGeniusONE instances to instrument their complete infrastructure in preparation for transitioning to a multi-cloud architecture. Because our technology is cloud-agnostic, the IT teams can maintain visibility into an application's performance and their users' experience throughout the transformation.

On the security front, although revenue for the NETSCOUT Arbor DDoS revenue has been challenged in recent quarters, we continue to win new logos to build on our leadership position in the service provider market. Last quarter, BSNL, the largest provider of telephony and broadband services in India with over 160 million end users, selected NETSCOUT Arbor for DDoS detection and mitigation. Having suffered multiple network outages due to severe DDoS attacks during the past year, BSNL turned to NETSCOUT Arbor to address its need for a proven, highly scalable and robust solution. In addition to gaining the visibility and availability protection required for its massive core network, BSNL plans to monetize this protection by reselling DDoS as a value-added managed service to its enterprise customers.

Go-to-Market Activity:

In terms of go-to-market highlights, I am pleased to report that our annual Engage technology and user summit held in mid-May was a resounding success. Based on the record attendance and the feedback we received, it was our best Engage yet. Overall, attendance increased by 16 percent from last year with 700-plus IT and security professional representing NetOps, DevOps, CloudOps and SecurityOps, as well as line-of-business executives and distribution partners – not to mention some of our analysts and shareholders who joined us on the event's first day. This was a great opportunity for customers to appreciate the breadth and depth of our solutions, gain insight into our product roadmaps and new product plans, and participate in certification programs, technical tutorials and hands-on training.

That concludes my prepared remarks 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 first-quarter fiscal year 2019 metrics. After that, I will briefly recap the guidance for fiscal year 2019. 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. Additionally, our first-quarter results reflect the reclassification of certain subscription-oriented security offerings as services rather than products. Prior period revenue and related costs for those offerings have been reclassified to conform to the current period presentation for comparability purposes. That detail is available in the attached financial tables of our press release, in the appendix of our conference call slides, and it can also be downloaded from the investor relations website.

Slide 12: Q1 FY'19 Results

Slide number 12 shows our results for the first quarter of fiscal year 2019. Total revenue of 206 million dollars declined by 10 percent, which was at the lower end of our targets. The adoption of ASC 606 was not material to first-quarter revenue as the headwind associated with adopting ASC 606 was primarily offset by achieving certain milestones related to customer projects that accelerated revenue recognition in the quarter. Our gross profit margin of 74.8 percent declined by 110 basis points primarily due to lower sales volume and product mix. Operating expenses declined by 8 percent due primarily to lower headcount and related personnel costs. We reported an operating profit margin of 3.6 percent. Diluted EPS was 3 cents, reflecting the reduced headcount and a lower quarterly effective tax rate.

Slide 13: Q1 FY'19 Revenue Trends: Customer Verticals & Geographic Mix

Turning to Slide 13, I'd like to review key revenue trends. First-quarter revenue in our service provider customer segment declined by approximately 13 percent primarily due to lower carrier and ISP spending on our DDoS solutions. Consistent with Anil's earlier remarks, revenue for our service assurance products from service providers was essentially flat. Revenue in our enterprise customer segment declined by nearly 7 percent in the first quarter due primarily to continued softness in our ancillary product lines.

For the first quarter, revenue was evenly split between our service provider customer segment and the enterprise customer segment. In terms of revenue by geography, which is calculated on a GAAP basis, the aforementioned declines contributed to a decrease in revenue in the United States of 8 percent and a decline of 11 percent in our International revenue. International customers represented 38 percent of GAAP revenue versus 39 percent last year. We did not have a 10 percent revenue customer in the first quarter.

Slide 14: Balance Sheet Highlights & Free Cash Flow

Slide 14 details our balance sheet highlights and free cash flow. During the past three years, we have made considerable progress in our efforts to improve the overall efficiency of our balance sheet and optimize our capital structure. We ended the quarter with cash, cash equivalents, short-term marketable securities and long-term marketable securities of 459.1 million dollars, an increase of 11.3 million dollars from the end of March. Free cash flow for the quarter was 19.1 million dollars, which reflects favorable changes in working capital tied principally to the collection of receivables and lower cash taxes. This was partially offset by higher capital spending, of which approximately 4 million dollars is associated with a facility relocation. Our portion of the facility relocation is anticipated to be approximately 8 million dollars with the remaining 4 million dollars expected to be recorded in the second quarter. We will receive incentive reimbursements offsetting the relocation costs over a multi-year period through our cash flow from operating activities.

To briefly recap other balance sheet highlights, accounts receivable, net, were 165.3 million dollars, down by 48.1 million from the end of March. DSOs were 69 days versus 78 days at the end of fiscal year 2018 and 71 days at the same time last year.

Share Repurchase Activity

I'd like to provide a brief update on our share repurchase activities. We expect to complete our 300 million dollar Accelerated Share Repurchase (ASR) later this quarter. When the ASR agreement was signed in early February, we received an initial delivery of 7.4 million shares of common stock. Once the repurchase activity is completed, the share count will be further reduced by the number of shares actually repurchased, excluding the number of shares reflected in the initial reduction.

Slide 15: FY'19 Guidance

Let's move to slide 15 for guidance, which is fundamentally unchanged from the original guidance we issued in May. Although I typically focus my guidance commentary on our anticipated non-GAAP performance, I would like to point out that our GAAP guidance for fiscal year 2019 was updated to reflect that we recorded a non-cash intangible asset impairment charge of 35.9 million dollars in the first quarter of fiscal year 2019 related to the handheld tools product area as we moved forward with activities related to the divestiture of this asset.

Q2 & FY'19 Non-GAAP Guidance

FY'19

Turning to our non-GAAP guidance, Anil has already discussed the opportunities and challenges we see in both our enterprise and service provider customer segments. With three quarters still left in the year and consistent with his commentary, we have left our full-year non-GAAP guidance unchanged at this time. Our full-year revenue guidance ranges from a low single-digit decline to low single-digit growth on a percentage change basis over fiscal year 2018. In terms of our diluted EPS for the coming year, we expect diluted EPS guidance ranging from a 20 percent decline to low double-digit percentage growth over last year's diluted EPS of one dollar and forty-one cents per diluted share. Other key assumptions are outlined on this slide.

Q2 FY'19

We currently expect that our first-half revenue skew will likely be in the low to mid forty percent range of the full fiscal year 2019 guidance. As a result, we anticipate second-quarter revenue in the range of 215 to 225 million dollars, which would represent a mid-teens percentage point decline from the prior year. This guidance includes an anticipated revenue reduction of approximately 7 million dollars in deferred revenue that cannot be recognized under ASC 606. We anticipate second-quarter operating expenses to be between 7 to 8 percent lower than the same quarter one year ago. Diluted EPS for the second quarter is expected to range from 10 to 17 cents.

That concludes my formal review of our financial results. Before we transition to Q&A, I will mention that slide 16 details two upcoming investor conferences that we plan to attend. I'll now turn the call over to the operator to start Q&A.