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

November 1, 2018

A. Kramer: Introduction

Thank you operator and good morning everyone. Welcome to NETSCOUT'S second-quarter fiscal year 2019 conference call for the period ended September 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 second-quarter financial performance, highlight key trends and recent developments, and discuss our outlook for fiscal year 2019. Michael Szabados will briefly review recent 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 second-quarter results, key first-half performance metrics and fiscal year 2019 guidance.

Slide #3: Safe Harbor Statement

Moving on to slide number 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; expense management and related cost-reduction actions and related benefits; market conditions, technology trends, customers, customer relationships and customer demand; anticipated revenue from specific customers and specific products; and all of the other various product development, sales and marketing, and other operational 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 and subsequent Quarterly Report on Form 10-Q 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 in the presentation appendix, which is available on our website. Additionally, given the sale of the HNT Tools business, we may make references to certain pro forma or organic non-GAAP performance trends that exclude revenue or costs associated with the HNT Tool business. As a reminder, we also have 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 delivered quarterly revenue at the upper end of our plans and our diluted EPS results exceeded our targets for the targets. We also made important progress to lower costs while funding key initiatives fundamental to expanding our business. As we move into the second half of the year, we've also updated our guidance to reflect a number of factors. With that as a backdrop, 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 number 6 with a brief recap of our second-quarter non-GAAP results.

Slide #6: Q2'19 Financial & Operational Highlights

Our second-quarter fiscal year 2019 performance was solid. We delivered second-quarter diluted EPS of 25 cents on revenue of 224.0 million dollars. Our top-line performance reflected lower revenue across our service assurance and security product lines within the service provider customer segment and relatively flat revenue in our enterprise customer segment. We also delivered improved gross margins and continued to reduce costs during the second quarter, both of which contributed to the strong diluted EPS performance. Jean will review our second-quarter results in more detail in a few moments.

During the second quarter, we made important financial, operational and strategic progress. We took actions to lower our operating costs by divesting a lower margin, non-core business, restructuring key areas within our organization and continuing to manage expenses. At the same time, we continued to invest in key development projects and go-to-market initiatives that are aligned to our most promising near and longer-term growth opportunities. As we look into the second half of the fiscal year, we are seeing many of the headwinds that have affected our top line in recent quarters dissipate and believe that they will be largely behind us as we exit the year. I'd like to briefly expand on this.

- In our service provider service assurance product area, we're seeing revenue from our two largest carrier customers stabilize after substantial declines in recent years. Just as important, we believe our progress to fortify our incumbency at many of our other largest mobile operator and cable customers will contribute to improved top-line results in the second half of this year and beyond.

- In the enterprise, we took an important step to address revenue declines within the former Fluke enterprise network product lines that we acquired along with the other Danaher Communications Business assets three years ago. In mid-September, we sold the former Fluke handheld network test (HNT) Tools business. Although the remaining legacy Fluke systems products have been a modest drag on our first-half enterprise revenue, we have integrated many of the highest value capabilities from those remaining legacy offerings into our broader nGenius enterprise portfolio. Moving forward, we expect that those initiatives will help fuel growth in our nGenius enterprise offerings and more than offset any ongoing revenue erosion from the remaining legacy Fluke product lines.
- The final headwind affecting our top line is our security product area, which represented more than 20 percent of last year's total revenue. Today, these products largely consist of distributed denial of service, or DDoS, solutions. Our carrier and ISP customers have throttled back their DDoS spending over the past two years as they've absorbed excess capacity following substantial investment arising from high-profile DDoS attacks. DDoS revenue is now trending behind our original plan as service providers continue to spend cautiously on capacity. Nevertheless, we anticipate second-half DDoS revenue from service providers will outpace first-half levels, which would be consistent with historical trends.

As these headwinds dissipate and we strive to resume top-line growth, we have also taken actions to lower our operating costs and improve our gross margins, which we believe will help amplify future earnings growth. Let's turn to slide number 7 for some additional color on this.

Slide #7: Potential Earnings Power

As I alluded to at the outset of my remarks, we have taken important steps in recent months to reduce our operating costs in ways that do not impede our ability to grow, support customers or run counter to our corporate values and culture. Earlier this year, we outlined plans to reduce annual run-rate operating costs by up to 50 million dollars by adjusting headcount-related personnel costs, aggressively managing discretionary spending and selling certain non-core assets. We've made excellent progress in each of these areas and now expect to exceed our initial cost-reduction target by removing at least 70 million dollars in operating costs.

- Through the first half of this year, our operating expenses declined by 9 percent from the same period a year ago. In particular, personnel costs decreased by over 10 million dollars largely as a result of lower headcount tied to attrition and the management of new hires.
- As noted earlier, in September, we completed the divestiture of the HNT Tools business, which removes approximately 30 million dollars of annual operating costs. In conjunction with this sale, approximately 120 employees were transitioned from NETSCOUT to the acquirer of the HNT Tools business.
- During the second quarter, we also initiated a restructuring across various areas of the business to realign resources in ways that are aimed at prioritizing investment in growth-oriented initiatives and eliminating redundancies arising from the integration of legacy platforms, products and technologies associated with the Danaher Communications acquisition. In conjunction with these actions, we have

combined our previously separate service assurance and security engineering teams, started consolidating certain other facilities and implemented a voluntary separation program, or VSP, and other related measures. These programs are expected to result in a net reduction of approximately 145 employees by the end of this fiscal year. We expect that these actions will generate net annual run-rate savings of 22 to 24 million dollars, of which 9 to 10 million dollars will be realized in the second half of this fiscal year.

- As we move forward, we believe that we can operate a very scalable infrastructure that would require low incremental increases to our operating costs.

In addition to adjusting our operating cost structure, we have also remained focused on improving gross margins. Over the past three years, we have reshaped and expanded our product portfolio with a focus on delivering higher margin, software-centric solutions that address a broader range of customer use cases. Our progress thus far is most evident in the service provider customer segment with our service assurance solutions. Only three years ago, carriers deployed our service assurance solutions as appliances and a majority of this product revenue carried gross margins in the mid-60 percent range. Through the first half of this year, 16 of our 20 largest service providers have already deployed our platform as a software only solution, which carries gross margin of over 90 percent. The software-only ISNG platform represented 30 percent of service assurance service provider product revenue for the first half of the year, up from 16 percent one year ago. As adoption of our software only platform grows, along with other software-centric solutions for NFV, business intelligence, application performance and security, we believe that our gross margins have significant upside potential.

Slide #8: Growth Opportunities

Let's turn to slide number 8 for some further color on the key drivers for stronger revenue performance not only in the second half of this fiscal year but over the longer term as well.

Service Provider Customer Segment

In our service provider customer segment, we currently expect second-half revenue for this segment will be relatively flat to slightly higher versus last year, with higher service assurance revenue mostly offset by modestly lower DDoS revenue.

In our service assurance product area, we expect solid growth outside of the US as we benefit from new projects with top mobile operators in Eastern Europe and Asia Pacific to monitor new 4G LTE networks. Michael will highlight one of these wins shortly. In addition, as we mentioned on last quarter's call, we also anticipate meaningful contributions from our calibration offerings that are helping large tier-one operators in North America design their new 5G radio access network infrastructures. At the same time, however, we believe that larger tier-one service providers will continue to limit near-term spending on their existing 4G networks.

Longer term, we are very bullish that 5G represents an important catalyst to drive higher spending. We believe that this could benefit us as early as next fiscal year, although visibility remains limited. In addition to expanding their monitoring capacity in their core networks to handle initial 5G traffic volumes, we anticipate that carriers will ultimately evolve their infrastructure over the next few years with greater emphasis on new edge computing capabilities and NFV technology. We are well positioned to help carriers in these areas and expect that 5G field trials for our monitoring solutions will continue to ramp over the coming quarters.

In DDoS, we move forward anticipating a more gradual recovery in service provider spending than what we originally expected at the start of the year. Nevertheless, we remain optimistic about our longer-term growth prospects. As the spending environment continues to improve, we plan to capitalize by further enhancing our market-leading solutions with new automation capabilities along with more flexible pricing and deployment options. As we look out into next year, we are focused on delivering new innovations that can help our service provider customers further protect their mobility networks as well as expand the range of DDoS-based managed services that can be sold to their enterprise customers.

Enterprise

Within our enterprise customer segment, we have been pleased with the growth of our pipeline in recent quarters and we anticipate modest organic growth during the second half of fiscal year 2019. While a majority of our enterprise revenue is still tied to traditional network performance management and related troubleshooting use cases, we have expanded our value proposition to broaden our total addressable market. For example, our vSCOUT and vSTREAM offerings help enterprises extend visibility into application performance across their data center and hybrid cloud infrastructures. Over the past several months, two of the world's largest public cloud providers, Amazon Web Services and Microsoft Azure, have validated our capabilities by making our Application Performance Management solution available on their respective marketplaces. In addition, we've worked with Azure on their virtual network TAP initiative, which results in an agentless solution that provides mutual customers with visibility into applications and their dependencies in hybrid environments comprising both on-premises and Azure Cloud infrastructure. Michael will provide some further detail on these developments.

Looking ahead, we also believe that enterprise security has the potential to become a major growth engine and we are investing accordingly. Last week, we introduced the Arbor Edge Defense platform or AED. This solution not only helps enterprises protect against incoming DDoS attacks with proven, market-leading capabilities but it also serves as the last line of defense against outbound threats perpetuating malware and other threats. We see attractive opportunities to cross sell AED into our service assurance enterprise customer base, and we are pleased with our initial progress on this front. In addition to AED, we introduced new software features within our ISNG, now named Cyber Optimizer. Enterprises can use this packet-shaping software to cost-effectively collect and filter packet data before forwarding it to other security tools. We are also advancing plans for a security-specific version of our ISNG platform and new analytics that leverage our strength in packet forensics and an innovative approach to identifying advanced threats through anomalous network behavior.

Slide #9: Outlook & Summary

Let's turn to slide number 9 for additional perspective on our outlook and some final thoughts. We have updated our fiscal year 2019 revenue guidance to primarily reflect the sale of the HNT Tools business and a more modest second-half recovery in DDoS service provider revenue than we originally expected. Adjusting our guidance by a total of approximately 47 million dollars to account for those factors results in a new range for annual revenue between 925 million to 960 million dollars. Using the comparable accounting standard basis with the prior year and excluding revenue from the HNT Tools business, the mid-point of our updated revenue guidance would equate to relatively flat revenue versus pro forma fiscal year 2018.

The skew of revenue between the third and fourth quarters is currently difficult to forecast primarily as a result of limited visibility into the timing of revenue recognition for a small number of moderate-sized service provider service assurance projects. Accordingly, we currently anticipate third-quarter revenue in the range of 230 million to 250 million. If we are unable to achieve customer acceptance on these projects before the end of the calendar year, we would expect third-quarter revenue at the lower end of this range and revenue from those projects would likely be recognized in the fourth quarter.

In terms of our earnings performance, we remain on track to achieve our original non-GAAP diluted EPS guidance range and have further refined these targets to range from one dollar and thirty cents to one dollar and forty cents, largely due to the anticipated cost savings associated with our recent restructuring actions. Moving forward, we are focused on achieving our second-half goals and demonstrating that we can build the sales momentum necessary to achieve the long-term financial targets we outlined this past spring.

In closing, we made considerable progress this quarter and implemented significant changes across our global organization. I'd like to thank my fellow guardians at NETSCOUT for their continued support and ongoing focus on moving our business forward. That concludes my commentary and I'll turn the call over to Michael now.

Slide 11: COO Update

Michael Szabados:

Thank you Anil, and good morning everyone. Slide number 11 outlines the areas I plan to cover. As I highlight recent wins, I will also intersperse some comments about related go-to-market activities.

Customer Wins:

In the service provider market, we are seeing tier-one North American carriers aggressively plan for 5G while top regional carriers in international markets are investing in the build out of their 4G-LTE networks. We recently received a substantial seven-figure order for our ISNG software platform as part of a multi-year project with one of the largest carriers in the Asia Pacific region. This relationship has evolved and expanded over the past several years since an initial deployment of legacy hardware probes. More recently, as part of its plan to increase the speed of deployment and improve its capital efficiency while keeping pace with robust subscriber growth, the customer began rolling out our ISNG software across its network. This mobile operator is also using our packet flow software capabilities to efficiently feed traffic to our ISNG platform while also benefiting from our nGenius Business Analytics to gain greater insight into the subscriber experience. This customer's success in migrating from hardware-based probes to a scalable software solution that unlocks the power of our 'smart data' underscores the reasons why Frost & Sullivan recently recognized NETSCOUT with its Visionary Innovation Leadership Award for the global network data analytics industry.

In the enterprise, we are making steady progress with our initiative to provide customers with consistent visibility into their application workloads across conventional data centers, private clouds and the public cloud. Using our 'smart data' solutions, enterprises can deliver consistent and high-quality user experience before, during and after cloud migration. As Anil noted, we've established relationships to list our Application Performance Management solution on the marketplaces of both Amazon Web Services and Microsoft Azure. This sends a powerful message to customers and prospects about the operational readiness, scalability and value of our solutions. Recently, we closed another software deal, around a million dollars, with a large US Enterprise to support their planned migration to AWS. To further expand our new sales pipeline for these offerings, we're planning to participate as a "Platinum Partner" at the AWS re:Invent show toward the end of this month.

In addition, we are working closely with Azure on a Virtual Network TAP (VTAP) initiative to deliver a comprehensive network and application performance management solution to mutual customers. By leveraging the native distributed terminal access point (TAP) functionality developed by Azure and combining it with NETSCOUT technology, customers get an innovative and agentless solution to streamline the acquisition of wire data for effective monitoring and assurance in a hybrid environment. Last month, at their "Ignite" user conference we were recognized as "the NPM/APM" partner in their VTAP program.

On the security front, Anil detailed some of the progress we are making on our new product roadmaps, which was highlighted by the recent launch of Arbor Edge Defense, or AED. We have already closed our first AED sale with a new e-commerce hosting customer in North America. We are accelerating cross-selling activity for this platform and for our other security offerings to drive adoption into our service assurance enterprise customer base. A great example of our initial success on this front occurred last quarter with Banco Votorantim, one of Brazil's largest banks. This customer is rolling out nGeniousONE with multiple ISNGs, nGenius packet flow systems, our nGeniusPulse and other portable platforms as well as our DDoS solution to ensure that its mission-critical applications and services are always available to both customers and employees.

As we move forward, we are continuing to advance sales campaigns and other go-to-market initiatives that can leverage a wide array of strategic technology relationships. Our partnership with VMware is a good illustration of this. As you may recall, last quarter VMware fully certified the NSX edition of vSCOUT as "VMware Ready for Networking and Security." Since then, we have presented regularly at their regional VMUG user conferences and participated at VMworld in Vegas two months ago. We've been pleased with the interest that these activities have generated among our mutual customers, and expect similar enthusiasm when we attend at VMworld Europe next week.

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

Slide 12: CFO Review

Jean Bua:

Thank you Michael, and good morning everyone. This morning, I will review key second-quarter and first-half fiscal year 2019 metrics, along with our updated 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. In addition, due to the sale of the HNT tools business in mid-September, I will highlight certain revenue trends on a pro forma non-GAAP basis, which excludes the HNT tools revenue. Regardless, I will be sure to note when the comparisons are pro forma versus reported.

Additionally, as a reminder from last quarter, our second-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 were 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 13: Q2 and First Half FY'19 Results

Slide number 13 details our results for the second quarter and first half of fiscal year 2019. Total second-quarter revenue of 224.0 million dollars, which was at the higher end of our plans, declined 14 percent due to softness across our service provider customer segment while our enterprise customer segment posted flat top-line results. Excluding ASC 606 and the timing related to the sale of the HNT Tools business, which combined to be a net benefit to revenue of approximately 5 million dollars, revenue would have been at around the midpoint of our targets.

Despite the overall decline in revenue, our gross profit margin of 76.0 percent increased by half a percentage point. Operating expenses declined by 11 percent due primarily to lower headcount and related personnel costs. We reported an operating profit margin of 14.7 percent with diluted EPS of 25 cents. After taking into account the positive 8 cent effect associated with the adoption of ASC 606 on quarterly diluted EPS, our diluted EPS would have been at the high end of the targets that we offered last quarter.

I'd like to share a quick update on headcount. We ended the second quarter with 2,770 employees, which is down 323 people from the same quarter of the prior year. Around one-third of the change is related to transitioning the teams associated with the Fluke HNT tools divestiture in September. During the quarter, we also began implementing a VSP and other related measures, which we expect to complete by the end of this fiscal year. We anticipate that these actions will result in an additional net reduction of approximately 145 employees and generate 9 million to 10 million dollars in cost savings in the second half of this fiscal year. For fiscal year 2019, we will incur one-time cash charges associated with these programs totaling approximately 18 million dollars. The full year effect of these actions on fiscal year 2020 operating expenses will be a reduction in the range of 22 to 24 million dollars.

Slide 14: 1H FY'19 Revenue Trends: Customer Verticals & Geographic Mix

Turning to slide number 14, I'd like to review key revenue trends. Second-quarter revenue in our service provider customer segment declined by approximately 25 percent with sizeable double-digit percentage decreases in both the service assurance and DDoS product areas. In the enterprise, second-quarter revenue was relatively unchanged. On a pro forma basis excluding the HNT tools business, our enterprise service assurance revenue grew mid-single digits in the second quarter while security was flat.

In terms of first-half revenue trends, approximately 52 percent of total revenue was generated from the enterprise customer segment with the remainder from service provider. In terms of revenue by geography, which is calculated on a GAAP basis, revenue in the U.S. decreased by 10 percent with a 13 percent decline in international markets. International customers represented 38 percent of GAAP revenue versus 39 percent last year. We did not have a 10 percent revenue customer in either the second quarter or the first half of the year.

Slide 15: Balance Sheet Highlights & Free Cash Flow

Slide 15 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 452.1 million dollars. Free cash flow of 1.5 million dollars includes some one-time, non-recurring items such as transaction costs associated with the HNT tools divestiture, severance payments associated with the first phase of our headcount restructuring programs and higher capital expenditures to relocate one of our facilities. We continue to anticipate healthy free cash flow conversion for the full year in excess of 100 percent of non-GAAP net income, excluding payments associated with our headcount restructuring programs.

To briefly recap other balance sheet highlights, accounts receivable, net, were 184.2 million dollars, down by 29.2 million from the end of March. DSOs were 73 days versus 78 days at the end of fiscal year 2018 and 72 days at the same time last year. The one day increase over the prior year primarily reflects the timing of certain collections associated with international security customers with longer payment terms.

Share Repurchase Activity

I'd like to provide a brief update on our share repurchase activities. We completed our 300 million dollar Accelerated Share Repurchase (ASR) during the second quarter. In total, we repurchased 11 million, 67 thousand and 809 shares of common stock with an average price of 27 dollars and 11 cents ($27.11).

Slide 16: FY'19 Guidance

Let's move to slide 16 for guidance, which we've updated to reflect a number of items, including our results to date, the sale of the HNT Tools business, cost-reduction actions and new assumptions regarding some of the revenue risk we see primarily related to a more gradual recovery in DDoS revenue in the service provider segment. I will focus my review on our non-GAAP guidance.

FY'19 Non-GAAP Guidance

As Anil detailed earlier, our updated fiscal year 2019 revenue guidance ranges from 925 million dollars to 960 million dollars, which is a reduction of approximately 47 million dollars from our original guidance range. Of this amount, 26 million dollars is due to selling the HNT Tools business in mid-September and removing the revenue that we had otherwise anticipated from those product lines. The remaining 21 million dollars is primarily tied to lower-than-anticipated DDoS revenue in the service provider segment.

We've also updated other key assumptions around our fiscal year 2019 operating model, which are outlined on this slide. We currently anticipate full year gross margins in the 75 to 76 percent range as the benefits of ongoing adoption of our software solutions are likely to be offset by lower sales volume and product mix shifts including the ramping of new 5G calibration design projects that typically begin with lower gross margins and improve significantly over time.

We currently anticipate full year operating costs in the range of 535 to 555 million dollars. In the second half of fiscal year 2019, the sale of the HNT Tools business will remove 15 to 16 million dollars of operating expenses while the restructuring actions detailed earlier are expected to remove costs of approximately 9 to 10 million dollars. Our other assumptions regarding tax rate, interest expense, and average weighted shares outstanding are largely unchanged from last quarter. As a result, we have refined our fiscal year diluted EPS targets within our original guidance range and now expect diluted EPS between one dollar and thirty cents and one dollar forty cents.

Q3 FY'19

In terms of our near-term outlook, Anil already reviewed the dynamics that are creating a relatively wide range for third-quarter revenue between 230 million dollars to 250 million dollars. We currently anticipate third-quarter gross margins to be at least one to one and a half percentage points lower than the second quarter due primarily to the calibration projects associated with the initial phases of our customers' 5G network roll-outs. We expect that operating expenses will decline from second-quarter fiscal year 2019 levels by five to eight million dollars due largely to the previously discussed cost-reduction actions. As a result, diluted EPS for the third quarter is expected to range from 33 cents to 45 cents.

That concludes my formal review of our financial results. Before we transition to Q&A, I will mention that slide 17 details upcoming investor conferences, which we plan to augment with additional NDRs in key money centers in the U.S. I'll now turn the call over to the operator to start Q&A.