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

January 30, 2019

A. Kramer: Introduction

Thank you operator and good morning everyone. Welcome to NETSCOUT'S third-quarter fiscal year 2019 conference call for the period ended December 31, 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 third-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 third-quarter results, key year-to-date performance trends and our fiscal year 2019 guidance.

Slide #3: Safe Harbor Statement

Moving on to slide number 3, today's conference call will include forward-looking statements. These statements may be prefaced by words such as "anticipate," "believe," and "expect" and will cover a range of topics that are not strictly historical facts such as our financial guidance, our market opportunities and market share, key business initiatives and future product plans along with their potential impact on our financial performance. These forward-looking statements involve risks and uncertainties and actual results could differ materially from the forward-looking statements due to known and unknown risks, uncertainties, assumptions and other factors, which are described on this slide and in today's financial results press release as well as in the Company's Annual Report on Form 10-K and subsequent Quarterly Reports 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. The rationale for providing non-GAAP measures along with the limitations of relying solely on those measures is detailed on this slide and in today's press release. These measures should not be considered in isolation from or as a substitute for financial information prepared in accordance with GAAP. Additionally, as a result of the sale of the HNT tools business, we will provide certain organic non-GAAP performance trends, which removes HNT tools revenue for comparability purposes with the Company's quarterly and year-to-date fiscal year 2019. Reconciliations of all non-GAAP metrics with the applicable GAAP measure are provided in the appendix of this slide presentation, in today's earnings press release and they are on our website.

Overall, we delivered quarterly revenue and EPS at the upper end of our plans. We also made important progress in lowering costs without compromising the investments that we believe are fundamental for expanding our business. As we move into the final quarter of the year, we've refined our guidance and are focused on achieving these targets. 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 third-quarter non-GAAP results.

Slide #6: Q3'19 Financial Highlights

We generated third-quarter fiscal year 2019 revenue of 246.3 million dollars and diluted EPS of 45 cents, both of which were at the high end of our quarterly targets. Our top-line results reflected good execution in both customer segments. Excluding last year's contribution from the HNT tools business that we sold last quarter, our enterprise customer segment delivered solid organic expansion. In our service provider customer segment, revenue has remained relatively soft, although our performance this quarter was highlighted by record revenue from our calibration services that are being used by tier-one North American mobile operators to design their 5G radio access networks, a project to help one of our international customers monitor the 4G network that they are building, and sequentially stronger DDoS spending. Just as important, we have begun to realize the savings from our cost-reduction initiatives that were implemented earlier in the year. Total operating costs were down 7 percent for the year-to-date period due in part to the divestiture of the HNT tools business and headcount reductions. We advanced our restructuring activities during the quarter by combining our engineering teams, consolidating our facilities in Massachusetts, and reducing our headcount. Although market conditions remain challenging, the multiple headwinds that have affected our top line are continuing to recede and we made important progress across multiple fronts. As a result, we believe that we are well positioned to achieve our financial targets in fiscal year 2019. Let's turn to slide number 7 for some additional thoughts on key developments that help underpin our near-term and longer-term ambitions.

Slide #7: Major Q3'19 Highlights & Developments

Service Provider Customer Segment

In our service provider customer segment, our ongoing commitment to innovate and address both the nearer-term and longer-term requirements of mobile, fixed line and cable operators worldwide leaves us well positioned to navigate a fluid capital spending environment. In North America, we continued to support large tier-one operators with our calibration capabilities that are used to help design next-generation 5G radio access networks. We enjoyed a record quarter in this product area, which is not only helping us offset ongoing capital spending pressures related to existing 4G networks but it is also providing us with insight into how our customers plan to build out their next-generation architectures. In emerging markets, NETSCOUT's software-only approach and market-leading features and functionality are helping large regional carriers deliver high-quality services as they build out new 4G networks. Just as critical, we are seeing continued adoption of our nGenius Business Analytics that help carriers better understand subscriber behavior. Michael will highlight the largest deal to date that we've closed for this software. As we move forward, we continue to pursue and support 5G and NFV-related lab trials and proof-of-concepts. While we do not expect material spending on 5G-related monitoring over the next few quarters, we believe that these capabilities will position us to benefit as carriers expand their monitoring capacity in their core 4G mobile networks to handle initial 5G traffic volumes.

In DDoS, carrier spending improved sequentially and was flat on a year-over-year basis as these customers begin to gradually absorb excess capacity and spend on our newest offerings. The newest release of our Sightline platform and Threat Mitigation System provides service providers with greater visibility and clarity into their network operations, enhanced anomaly detection, and improved automation for DDoS protection.

Enterprise

Within our enterprise customer segment, we delivered a solid quarter of organic growth in our service assurance product area while our enterprise DDoS product area was largely unchanged. In enterprise service assurance, we continue to differentiate ourselves in the market through the scalability, rich feature set and ability of our nGenius suite of solutions to provide large enterprises with consistent visibility into network and application performance across traditional data center and hybrid cloud environments. The investments we've made over the past two years to expand our nGenius product portfolio with cloud-based versions of our solution along with a robust active, synthetic test offering was fundamental to closing a number of large six and seven figure deals during the third quarter with existing customers who are expanding their engagements with NETSCOUT as well as new accounts. Additionally, we won several large enterprise deals that involved the software-only version of our ISNG platform. Michael will share some additional perspective on this past quarter's enterprise success.

In terms of security, we made progress in our efforts to expand beyond DDoS. We took an important step in our security product strategy in late October when 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 offers the functionality of a threat intelligence gateway, which serves as the last line of defense against outgoing threats that indicate compromised communications. In addition, we continue to invest in further expanding our enterprise security capabilities over the coming quarters. For example, we are working through the final phases of how we package and price a wide range of packet forensics that we plan to market as a new product called CyberInvestigator at our upcoming Engage user forum in April. We also expect to unveil our advanced threat analytics in the second half of this calendar year. I will spend more time detailing our go-to-market plans for our new security offerings on next quarter's conference call.

Slide #8: Outlook & Summary

Let's turn to slide number 8 for an update on our outlook and final thoughts. As you know, the past several years following our acquisition of the Danaher Communications Business have been challenging, particularly due to difficult market conditions in the telecom sector. During this time, however, we were able to double down on our commitment to the marketplace as we integrated this acquisition, and reshaped and broadened our offerings into a software-centric, feature-rich portfolio of 'smart data' solutions while also divesting non-core product lines.

Looking ahead, based on the opportunities we see over the next two months, we expect to generate revenue growth of around 4 percent in the final quarter of fiscal year 2019, which implies notably higher organic expansion. Accordingly, we plan to finish the year with annual revenue of around 925 million dollars, which is at the low end of our November guidance range. Our anticipated fourth-quarter revenue growth is predicated on sustaining our enterprise momentum and by driving stronger results in service provider service assurance. Our optimism for better service provider revenue is in part based on achieving acceptance on several moderate-sized projects where we've already shipped and deployed our solutions, and by helping other mobile operators and cable customers get their calendar year 2019 projects off to a healthy start.

With that said, we believe that it will be difficult to exceed the low end of our annual revenue targets due to ongoing capital spending pressures in the service provider market, uncertainty within the federal government after the recent shutdown, which we believe could affect the timing and magnitude of near-term spending by various agencies, and the relatively modest near-term contributions we're expecting from our newest enterprise security initiatives.

We anticipate a strong fourth-quarter EPS performance due to the combination of top-line growth, better gross margins driven by product mix, savings from our prior restructuring activities and ongoing diligence in managing costs, including carefully managing the timing of new hires. As a result, we expect to deliver fiscal year 2019 EPS in the range of $1.30 to $1.35, which is within the range of our original guidance when we began the year.

In closing, we have executed reasonably well through the first three quarters of the year and we are now looking forward to putting a successful close on fiscal year 2019. The tenacity and commitment of our team have helped propel us forward. We appreciate their efforts and move forward with confidence that we will rise to the challenges that lie ahead. That concludes my commentary and I'll now turn the call over to Michael.

Slide 10: COO Update

Michael Szabados:

Thank you Anil, and good morning everyone. Slide number 10 outlines the areas I will cover.

Customer Wins:

In the service provider market, Anil highlighted growing service provider adoption of our nGenius Business Analytics, or nBA, which allows our carrier customers to extract more value from our smart data at a granular, subscriber level and potentially augment it with other non-network data sets such as subscribers, device, geolocation and application information. As price competition in North America has intensified, domestic service providers are increasingly focused on subscriber retention, and we believe that our nBA capabilities can help carriers on this front. For example, we closed our largest nBA sale to date this past quarter with a large tier-one operator who plans to leverage its substantial investment in our technology by deploying our nBA analytics as part of a broader initiative to deliver timely, insightful and increasingly personalized customer care. This mid-seven figure deal also represents an important step in what we expect will be a multi-phased approach by this customer to leverage our next-generation software over the coming years, particularly as they look to advance their 5G and related NFV initiatives. On the 5G front, our model calibration team has also been actively working with this customer to help evolve the design of its radio access network for 5G. As the race among tier-one carriers to commercialize 5G begins to heat up, we plan to showcase our 5G service assurance capabilities at the upcoming Mobile World Congress conference next month.

In the enterprise, Anil relayed that we are seeing a growing number of large deals which include multiple product offerings beyond our traditional ISNG and nGeniusONE offerings. In fact, in the third quarter, we closed more than 30 deals over $500 thousand dollars and more than 85 percent of them included products like vSTREAM, vSCOUT, nGeniusPULSE and our nGenius packet broker offerings in addition to our traditional ISNG and NG1 offerings. Both new and existing customers are recognizing that only NETSCOUT has the scalability and analytical horsepower to provide them the consistent visibility into their network and application workloads across conventional data centers, private clouds and public clouds from leaders like AWS and Microsoft Azure.

We are also starting to see that our ability to deliver a software-only solution can help us win enterprise business when an appliance-based deployment would otherwise be cost prohibitive. For example, we won a two-plus-million dollar deal with a large technology company to help provide it with visibility into their market-leading unified communication and collaboration solution that is used to provide hundreds of thousands of simultaneous, real-time streaming video and audio sessions. After evaluating other competitor platforms, this customer selected NETSCOUT due to the scalability of our solution, our proven range of UCC capabilities and our ability to use a software-only approach to fit much more economically inside of its budget. As a result, this customer can proactively monitor overall service quality, and quickly identify a wide range triage technical issues that can result in video and audio jitter, latency degradation, one-way audio, frozen screens and many other problems that ultimately impact the customer experience. This initial order enables them to monitor all UCC-related customer traffic moving into and out of their two primary data centers, and we see additional opportunities moving forward to extend visibility within those data centers and out to other smaller facilities.

On the security front, we executed relatively well during the third quarter. We launched the Arbor Edge Defense solution, or AED, in late October and it is off to a good start. This product leverages our proven DDoS technology and adds comprehensive threat intelligence gateway functionality to further enhance our value proposition. In addition to dozens of our carrier customers who are reselling AED into their installed enterprise customer bases, our direct enterprise sales organization is also cross-selling AED alongside our traditional service assurance solutions. We've built a solid direct sales pipeline in relatively short order, highlighted by our third-quarter win at a regional US utility company for a combined AED-Arbor Cloud solution that is valued at close to one million dollars.

This energy provider was dealing with a steady stream of disruptive, high-volume DDoS attacks that not only impeded its ability to conduct business with clients, but also could impact its plans to migrate applications to the public cloud. The customer was looking to increase network availability by improving its perimeter protections without impacting the overall efficiency of its firewalls and other network intrusion detection and protection devices. AED and the Arbor Cloud were selected due to their proven DDoS protection capabilities, global scrubbing centers and new outbound detection capabilities. We believe that the coming quarters will be important for further expanding our business into the security market, and we'll be at the annual RSA security show in early March to help customers and prospects better understand how our solutions can help protect against an ever-expanding range of security threats.

Finally, we recently launched a new global marketing campaign called "Visibility without Borders" to help build broader awareness of NETSCOUT among C-suite executives and new buyers within the IT organization. This theme can be leveraged across all key areas of our business – for enterprises grappling with digital transformation, for carriers seeking to transform the customer experience with 5G and network function virtualization, and for businesses looking to protect the new edge and their connected world. We've reallocated marketing dollars to support a nationwide advertising campaign in both traditional business and trade media along with new media alternatives. The "Visibility without Borders" theme has also been integrated into our website and social media programs, and it will help support our presence at major events like the industry trade shows I mentioned earlier as well as our annual sales kick-off conference and Engage user forum that will be held next quarter.

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 third-quarter and year-to-date 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 an organic non-GAAP basis, which removes HNT tools revenue for the applicable period referenced. Regardless, I will be sure to note the nature of any such comparisons.

Slide 12: Q3 FY'19 and First Nine Months FY'19 Results

Slide number 12 details our results for the third quarter and first nine months of fiscal year 2019. Focusing on the quarterly performance, we reported revenue of 246.3 million dollars, which was at the higher end of our plans. Third-quarter revenue declined 9 percent on a year over year basis with the divestiture of the HNT tools business representing 4 percentage points of that decline. The remaining 5 percentage points of decline is due to a 13 percent decline in service provider offset by a 4 percent increase in enterprise. The impact of ASC 606 was immaterial to the quarter. On a comparable organic basis that excludes the HNT tools business, product revenue declined 3 percent with service revenue down 8 percent.

Our third-quarter fiscal year 2019 gross margin was 75.6 percent, or an almost 5 percentage point decrease from the same quarter last year. The third-quarter fiscal year 2018's gross margin includes a 6 million dollar reversal of incentive compensation, which represented 2 percentage points of the year-over-year change. The remaining 3 percentage point decrease related to lower overall volume as well as higher costs related to initial 5G calibration projects. Operating expenses were relatively unchanged from the prior year as the benefits from a lower overall headcount were offset by increased incentive compensation. We reported an operating profit margin of 21.4 percent with diluted EPS of 45 cents, which was at the high end of our plans entering the quarter.

I'd like to share a quick update on our restructuring activity that began last quarter. We ended the third quarter with two thousand, five hundred and ninety (2,590) employees, which is a 7 percent decrease since the end of September and a 16 percent reduction from last year at this time. In fiscal year 2019, we saved 4 million dollars in the third quarter and expect to save 6 million dollars in the fourth quarter for a total of 10 million dollars for the fiscal year 2019. In fiscal year 2020, we anticipate saving about 14 million dollars more so that on an annual run rate basis, the total savings will be about 24 million dollars. Restructuring payments related to these programs were 2 million dollars in the second quarter of this fiscal year, about 13 million dollars in the third quarter, and we anticipate an additional payment of approximately 3 million dollars in the fourth quarter for total restructuring payments of around 18 million dollars in fiscal year 2019. These payments are reflected in our free cash flow results. There are no restructuring payments associated with these programs anticipated in fiscal year 2020.

Slide 13: First Nine Months FY'19 Revenue Trends: Customer Verticals & Geographic Mix

Turning to slide number 13, I'd like to review key revenue trends. Revenue in the service provider customer segment for the first nine months has declined approximately 17 percent with relatively similar percentage-change declines in both service assurance and security. In the enterprise segment, the year-to-date revenue declined 4 percent due to the sale of the HNT tools business. On an organic basis, enterprise revenue was flat for the first nine months of the year.

In terms of other year-to-date revenue trends, approximately 51 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 8 percent with a 13 percent decline in international markets. International customers represented 39 percent of GAAP revenue versus 40 percent last year. We had one 10 percent revenue customer in the third quarter. For the year to date, there were no 10 percent revenue customers.

Slide 14: Balance Sheet Highlights & Free Cash Flow

Slide 14 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 475.8 million dollars, which is an increase of 23.7 million dollars since the end of September. We generated free cash flow of 29.4 million, which includes paying restructuring-related severance of about 13 million dollars. We continue to anticipate healthy free cash flow conversion for the full year of at least 100 percent of non-GAAP net income, excluding the headcount restructuring payments that I referenced earlier.

To briefly recap other balance sheet highlights, accounts receivable, net, were 247.7 million dollars, up by 34.3 million from the end of March. DSOs increased to 91 days versus 78 days at the end of fiscal year 2018 and 82 days at the same time last year. The increase primarily reflected an increase in multi-year renewals and the timing of renewals.

Use of Capital

I'd like to provide a brief update on our use of capital. As we move forward, we anticipate being active in the market by repurchasing around 60 million dollars of our common stock, assuming normal market conditions and subject to daily trading volumes and price considerations. We also plan to use excess cash to repay $50 million dollars that has been drawn down on our revolving line of credit. We anticipate that these actions will not have a significant effect on our net leverage.

Slide 15: FY'19 Guidance

Let's move to slide 15 for guidance, which we've updated to reflect the Company's results to date, the benefits associated with the recent restructuring actions, ongoing expense management initiatives and fourth-quarter fiscal year 2019 revenue plans. I will focus my review on our non-GAAP guidance.

FY'19 Non-GAAP Guidance

As Anil stated earlier, we are currently targeting fiscal year 2019 revenue of around 925 million dollars, which would be the lower end of our prior range. This would imply fourth-quarter revenue right around the third-quarter level. Other key assumptions around our fiscal year 2019 operating model have been updated and are outlined on this slide. We currently anticipate full year gross margins in the 76 percent range, which implies healthier fourth-quarter gross margins resulting from a more favorable product mix.

We currently anticipate full year operating costs in the range of 535 to 545 million dollars.

Our tax rate assumption is unchanged from the prior quarter and we've refined our anticipated interest expense and average weighted shares outstanding. As a result, we now expect diluted EPS between one dollar and 30 cents ($1.30) and one dollar and 35 cents ($1.35). This implies fourth-quarter EPS in the range of 59 cents to 64 cents.

That concludes my formal review of our financial results. Before we transition to Q&A, I'd likely to quickly note that our IR outreach over the next couple of months includes meeting with current and prospective institutional shareholders on the West Coast, Southwest and Midwest. In addition, we'll hold investor briefing sessions at Mobile World Congress in Barcelona, Spain at the end of February. I'll now turn the call over to the operator to start Q&A.