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

May 2, 2019

A. Kramer: Introduction

Thank you operator and good morning everyone. Welcome to NETSCOUT'S fourth-quarter and full fiscal year 2019 conference call for the period ended March 31, 2019. 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 recap our fourth-quarter financial and full year results, and highlight key trends and recent developments particularly as they relate to our outlook for fiscal year 2020. Michael Szabados will cover go-to-market highlights and recent customer wins. Jean Bua will then review our fourth-quarter and full-year results in detail, and share our fiscal year 2020 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. 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.

Our fiscal year 2019 fourth-quarter results were fundamentally consistent with the preliminary numbers that we shared with the market in early April. Despite lower-than-expected revenue, we delivered a relatively strong EPS performance due to higher gross margins, lower operating costs and a lower-than-anticipated tax rate. We believe that the combination of the progress we've made in the past year along with our plans going forward will help position the Company to deliver better results in fiscal year 2020. I'll now turn the call over to Anil who will share his insights into what went well for NETSCOUT last year, and the opportunities and challenges that lie ahead.

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 quarterly and full year non-GAAP results.

Slide #6: Q4'19 and FY'19 Financial Highlights

- Today's results were fundamentally consistent with the preliminary results we reported in early April.
- Our fourth-quarter revenue of 235.2 million dollars was approximately 15 million dollars lower than we expected primarily due to delayed revenue recognition on the largest phase of a service assurance project at an international mobile operator. Unfortunately, this customer's implementation schedule progressed slower than originally planned, and we were unable to backfill this given the ongoing spending challenges facing our service provider customers. Nevertheless, excluding the since-divested HNT tools revenue from last year's fourth quarter, we generated overall organic revenue growth of 3 percent driven by an 8 percent underlying increase in the enterprise customer segment driven by strong growth in DDoS security and relatively stable service assurance revenue.
- We successfully absorbed the top-line shortfall to deliver fourth-quarter diluted EPS of 66 cents due to higher gross margins, lower operating costs and a lower tax rate.
- Despite falling short of our top-line ambitions in fiscal year 2019 with full year revenue of 911.5 million dollars, our diluted EPS of one dollar and 38 cents was above the mid-point of our original targets due in part to the proactive initiatives we implemented to reduce costs and tightly manage spending earlier in the fiscal year.

Overall, we made important progress during the past fiscal year on multiple fronts, which we believe will set the stage for generating better, more consistent results going forward. Let's move to slide 7 for some further perspective into this.

Slide #7: FY'19 Highlights

As you know, NETSCOUT's top-line has been negatively impacted over the last couple of years, largely as a result of reduced carrier spending, especially at our two largest tier-one customers. This dynamic was further compounded by integration complexity and adding disparate product lines that carried different pricing models, profitability levels and value propositions. As we move forward, we believe that that these severe headwinds have largely receded. At the same time, we are excited about our potential to benefit from new tailwinds related to our new product innovation in security and analytics, and the continued migration to increasing software content. To summarize these unique dynamics, we have:

- Stabilized revenue from our two largest service provider customers in fiscal year 2019;
- Successfully migrated most of our other tier-one operators over the past two years to our software-based platform for service assurance;
    - Service provider-related revenue for the ISNG software platform grew by nearly 40 percent and it represented nearly 30 percent of our carrier-related service assurance product revenue last year;
- Stabilized overall DDoS revenue during the second half of the year primarily due to improved enterprise traction;
- Completed major R&D projects to integrate key products and technologies that were acquired as part of the Danaher Communications Business acquisition; and
- Divested certain product lines that were unprofitable and had been in decline for

multiple years.

At the same time, we made good progress on many other fronts such as:

- Solid execution on our product strategy;
    - We reshaped our product portfolio to focus on higher-margin, software-centric solutions;
    - We broadened our range of solutions to provide visibility across any type of infrastructure and into any service or application;
    - We now provide greater deployment flexibility ranging from appliances to software and virtual form factors; and
    - Our solutions address an expanded range of use cases – from network, application and infrastructure performance management to security and big data;
- We've begun to build sales momentum in our enterprise customer segment as customers start to move forward with digital transformation initiatives. We've reported three consecutive quarters of solid organic revenue growth in our enterprise customer segment;
- We completed the restructuring that began in the second quarter of last year;
    - We expect that these actions will generate annual run-rate savings of approximately 23 million dollars split between fiscal years 2019 and 2020;
    - By restructuring key operations, selling non-core product lines and carefully managing spending, we reduced operating costs by 9 percent in fiscal year 2019, and we believe that those actions will also help us keep costs relatively flat in the coming year; and finally,
- We recently realigned leadership roles and the overall structure for our technical, product delivery and sales organizations in order to maximize our ability to accelerate

key development initiatives and drive go-to-market effectiveness.

Slide #8: Driving Top-Line Growth in FY'20 and Beyond

Moving to slide 8, we believe that NETSCOUT's focus on providing ultra, high-definition visibility into real-time transactions embedded in network traffic is increasingly resonating with our customers who are challenged to efficiently and effectively transform and protect their infrastructures to support digital transformation without compromising their current capabilities. We recently held our annual technology and user summit, where we shared our product roadmaps for the coming year and the feedback from customers, partners and various industry analysts was very positive. As we move forward, we are focused on capitalizing on the following near and longer-term opportunities to drive top-line growth:

- In the enterprise, we see good scope for continuing to help our customers with their data center transformation initiatives, particularly as they migrate more of their application workloads to private and public cloud environments and improve overall agility;
- Security represents a promising adjacency as our value proposition expands beyond DDoS.
    - We are looking to build on the early momentum we gained with last year's launch of Arbor Edge Defense, which adds powerful new threat intelligence gateway capabilities to our proven set of enterprise DDoS capabilities;
    - We plan to launch Arbor Threat Analytics within the next couple of months. This is a new enterprise security offering that takes advantage of NETSCOUT's existing footprint inside our enterprise customers' network infrastructure. This analytic platform combines our historical strength in packet forensics with

Arbor's robust catalog of known security threats and new machine-learning capabilities, thereby enabling security teams to work faster and more efficiently to identify and investigate potential network-based security breaches.

- Combining Arbor's sales resources with our larger service assurance enterprise sales teams was the final step in completing our integration efforts. With this behind us, we move forward with improved coverage, especially in certain international markets, and have strengthened our ability to maximize cross-selling opportunities across network and security operations;
- In our service provider customer segment, we continue to fortify our incumbency in service assurance, helping carriers add capacity to support growing traffic over their 4G networks while also mining new opportunities for our nGenius business analytics and RAN optimization offerings. Just as important, we are investing to support our customers as they advance their 5G networks plans;
- To unlock new DDoS opportunities with our carrier customers, we've continued enhancing our DDoS detection capabilities in ways that can help them improve the overall efficiency of their network security infrastructure.

Slide #9: FY'20 Outlook & Summary

Let's turn to slide number 9 as I'd like to focus on our outlook for fiscal year 2020 and offer some closing thoughts. We remain bullish on the opportunities we see and confident in our ability to capitalize on them. As we've described, we believe that many of the issues that have limited our top-line results are behind us as we focus on maximizing the upside from a number of growth initiatives that are still in their early stages. As we move into fiscal year 2020, our top priority is to produce top-line growth, which is fundamental to driving operating leverage, EPS growth and stronger free cash flow. Our FY20 plan is to generate low-single digit organic revenue growth through a mid-single digit increase in product revenue, which, at the higher end of our plans, can then be converted into mid-single digit EPS growth.

Looking more closely at our fiscal year 2020 revenue target that ranges from 895 million dollars to 915 million dollars, we have built our plan around the following assumptions:

- We expect our revenue growth will be driven by higher product revenue in our enterprise customer segment as we see good opportunity to sustain the organic growth we've generated in recent quarters.
    - Although we are bullish on the long-term prospects for our new Arbor Threat Analytics, we anticipate relatively minimal contributions from this offering this year given the early summer launch and conventional sales cycles.
- We expect that the near-term service provider spending environment for both service assurance and DDoS security will remain difficult.
    - While we expect 5G to be a catalyst for better spending over the longer term, this technology turn remains in its early phase. Nevertheless, we anticipate another good year in capturing 5G calibration deals and we have recently won several initial deals for 5G radio access network monitoring with tier-one operators in North America. However, these carriers are moving cautiously to build out their 5G standalone architectures, which will ultimately require investment in new service assurance solutions.

In terms of diluted EPS guidance, we anticipate fiscal year 2020 diluted EPS in the range from one dollar and 40 cents ($1.40) to one dollar and 45 cents ($1.45) based on our plans for organic revenue growth plus:

- Further gross margin improvement as the product mix continues to shift toward software content; and
- Basically flat operating expenses compared with last year's reported operating costs;
- That will enable us to deliver EPS growth even with an anticipated increase in our tax rate.

Before I close my commentary, I wanted to provide a brief update on changes to our Board of Directors.

- Michael Szabados, who has made extensive contributions to NETSCOUT's success in senior leadership roles including the past 12 years as our COO, and Vivian Vitale, a highly respected and experienced HR leader with top technology companies, were appointed to our Board earlier this year. Michael will serve as vice chairman of the Board.
- At the same time, Vin Mullarkey, a long-standing NETSCOUT director, retired and I'd like to thank Vin for his service and support over the past two decades.

Finally, I'd like to thank my fellow Guardians around the world for their tireless efforts and dedication. I believe that we move forward having assembled a world-class, experienced team that possesses unmatched domain expertise, and is focused on the stellar execution of our plans this year. I look forward to sharing our continued progress and achievements with you over the course of the coming year, and I'll turn the call over to Michael at this point.

Slide 10: COO Update

Michael Szabados:

Thank you Anil, and good morning everyone. Slide 11 outlines the areas I will cover.

Slide 11: COO Highlights

Go-to-Market Highlights:

As Anil mentioned, we held our annual technology and user forum, Engage, last month in Nashville. It was a resounding success with 700-plus attendees spanning our service provider, enterprise, government and partner universe. Across both customer segments, digital transformation has become the common theme. We are well positioned to help our customers reduce the risks and maximize the rewards of their highest impact digital transformation initiatives that include 5G, cloud, application performance and security. I will intersperse some additional observations from Engage as I cover several notable wins from the past quarter.

Customer Wins:

In the service provider market, carrier marketing around 5G is increasing, although the infrastructure build-out and roll-out of 5G services is moving at a more measured pace. Our recent success with a tier-one U.S. service provider demonstrates our potential to leverage our 4G incumbency to win new 5G-related projects and participate in all phases of the 5G network lifecycle. In the fourth quarter, this carrier awarded us a mid-seven figure deal to help calibrate the design of its 5G radio access network (RAN). This long-standing customer is also starting to deploy our 5G-compatible RAN monitoring tools as they begin to launch new 5G-related services in limited markets.

In the enterprise, our range of integrated offerings is enabling our enterprise customers to move forward with major data center transformation and multi-cloud migration strategies. To that end, we've continued to advance our relationships with major public cloud vendors like AWS and Microsoft Azure. NETSCOUT is now an advanced technology partner at AWS and we recently achieved "co-sell ready" status with Microsoft Azure. This enables us to actively collaborate with Microsoft's sales teams to support customers who are migrating and managing applications in hybrid Azure environments.

As customers seek greater visibility into application performance, our nGeniusPULSE offering is becoming increasingly valuable. PULSE is an active transaction testing tool that complements our core portfolio of passive monitoring solutions. It is gaining traction with customers who can use it to ensure basic connectivity, manage the availability, reliability, and performance of Software as a Service applications, and monitor infrastructure performance. We are seeing good interest in this product:

- PULSE revenue nearly doubled last year off a relatively small base;
- The product is almost always sold in tandem with our core products; and
- The number of active trials continues to grow each quarter.

During the fourth quarter, a long-standing financial services customer spent over a quarter of a million dollars on nGeniusPULSE to monitor connectivity at over 150 offices, data centers and mission-critical call centers nationwide. This is just one part of a much larger deployment of NETSCOUT technology that is helping the customer baseline existing dependencies, support evolving data center requirements, and deploy a new cloud platform. We see additional opportunities to further expand the scope of our engagement as this customer is actively evaluating PULSE's WiFi monitoring capabilities.

Turning to security, we are executing on our strategy to expand beyond DDoS At Engage last month, we unveiled Arbor Threat Analytics – a new enterprise security analytics software product to detect and investigate potential security breaches using our ISNG and vStream data sources. This new security product builds on our ability to support forensic use cases with our valuable packet data that can aid security teams as they seek to understand where and how they've been infiltrated. For example, last quarter, the cybersecurity organization at a large Midwest financial services firm selected NETSCOUT to support a multi-phased project aimed at compliance with new state regulations that mandate the collection of forensic evidence for investigation into potential security breaches. The new Arbor Threat Analytics is designed to make it even easier for customers like this to benefit through:

- Easy access to our IP packet recording at scale;
- A robust threat intelligence feed that can help quickly detect known threats that have already penetrated existing defenses;
- New capabilities that rapidly identify anomalous behavior on the network; and
- Integration with third-party security information and event management platforms.

I look forward to sharing additional news of our success in expanding our customer relationship in fiscal year 2020. 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. I plan to review key fourth-quarter and full year metrics, along with our guidance for fiscal year 2020. 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 13: Q4 FY'19 and FY'19 Results

Slide number 13 details our results for the fourth quarter and full fiscal year 2019. Focusing on the quarterly performance, we reported revenue of 235.2 million dollars. Fourth-quarter revenue declined by 1 percent on a year over year basis but grew at 3 percent on an organic basis excluding the HNT tools business. Revenue in the service provider customer segment was relatively flat while our enterprise customer segment grew 8 percent organically. On a comparable organic basis, product revenue grew nearly 9 percent and service revenue decreased 2 percent.

Our fourth-quarter fiscal year 2019 gross margin was 79.0 percent, or a 2.3 percentage point increase from the same quarter last year largely due to favorable product mix shifts. Quarterly operating expenses were down by 17 percent from the prior year due to lower personnel costs primarily resulting from lower headcount. We reported an operating profit margin of 29.2 percent with diluted EPS of 66 cents, which ended up higher than our April 9th estimate due to a lower-than-expected tax rate as we finalized our year-end numbers under the first full year of implementing the new tax code.

As Anil mentioned, we completed our restructuring program during the fourth quarter. We ended the fiscal year with two thousand, five hundred and eighty-one (2,581) employees, which is a 14.5 percent reduction from a year ago. In fiscal year 2019, we saved a total of 10 million dollars from our restructuring actions, which impacted our third and fourth fiscal quarters. For fiscal year 2020, we expect an additional 13 million dollars in savings, which will impact our first and second quarters. This will result in a total run rate savings of about 23 million dollars. In total, restructuring payments were approximately 17 million dollars and that is reflected in our free cash flow results for fiscal year 2019. There are no material restructuring payments associated with these programs anticipated in fiscal year 2020.

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

Turning to slide 14, I'd like to review key revenue trends. Fiscal year 2019 revenue in the service provider customer segment declined by 13 percent with service assurance down 10 percent and DDoS security down 20 percent. In the enterprise segment, fiscal year 2019 revenue declined 4 percent due to the sale of the HNT tools business. On an organic basis, enterprise revenue grew nearly 2 percent for the year.

In terms of other full-year revenue trends, total revenue was evenly split between our enterprise and service provider customer segments. In terms of revenue by geography, which is calculated on a GAAP basis and includes revenue from the HNT tools business, the U.S. experienced a 5 percent revenue decrease while international revenue declined by 12 percent.

International customers represented 39 percent of GAAP revenue versus 41 percent last year. We had no customers who represented 10% or more of revenue in either the quarter or 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 487.0 million dollars, which is an increase of 11.2 million dollars since the end of the third quarter. We generated free cash flow of 76.4 million for the quarter. In addition to repurchasing 14.5 million dollars of our common stock in the quarter, we also repaid 50 million dollars of the 600 million dollars that was outstanding on our existing credit facility. For the full year, we generated free cash flow of just over 126 million dollars, which includes the previously noted restructuring payments of 17 million dollars. Excluding the restructuring payments, our free cash flow conversion was 131 percent of non-GAAP net income and it was 116 percent conversion on the reported free cash flow.

To briefly recap other balance sheet highlights, accounts receivable, net, were 235.3 million dollars, up by 21.9 million at the end of the last fiscal year. DSOs were 88 days versus 78 days at the end of fiscal year 2018 and 91 days at the end of December. The increase from last year's level primarily reflected the timing of large maintenance renewals.

Use of Capital

I'd like to provide a brief update on our use of capital. Moving forward, we plan to retain up to 300 million dollars in cash on our balance sheet at any given point for both working capital purposes and in consideration of overseas cash. In the near term, we plan to allocate up to 100 million dollars for stock buyback and debt repayment. We anticipate being active in the market in the first quarter for share repurchases, depending on market conditions and subject to daily trading volumes and price considerations.

Slide 16: FY'20 Guidance

Let's move to slide 16 for guidance. I will focus my review on our non-GAAP guidance. As a reminder, we sold the HNT tools business in September 2018 and it contributed 18.0 million dollars to last year's revenue before the sale was completed. Accordingly, the impact of the divestiture should be taken into consideration when comparing fiscal years 2019 and 2020, especially for the first two quarters of both years. Slide 24 in the appendix details the HNT tools quarterly revenue contribution to last year's revenue.

FY'20 Non-GAAP Guidance

Consistent with Anil's comments earlier, we are currently targeting fiscal year 2020 revenue in the range of 895 to 915 million dollars, which implies low single-digit organic growth. In terms of the other key fiscal year 2020 operating model assumptions outlined on this slide, we currently anticipate further gross margin improvement as we drive adoption of our software solutions. Our plan currently calls for relatively flat operating costs compared with last year. We anticipate that savings from last year's cost-reduction actions will enable us to absorb incremental spending tied primarily to higher compensation costs associated with annual merit adjustments and critical personnel replacements, as well as additional investment in our enterprise security initiatives. We expect to deliver earnings growth despite an anticipated increase in our effective tax rate to between 23 percent and 25 percent as certain components of the new tax code are scheduled to increase. We are currently evaluating certain tax strategies that may enable us to keep the tax rate relatively flat with the prior year. Assuming 78.2 million shares outstanding, we currently expect diluted EPS between one dollar and 40 cents ($1.40) and one dollar and 45 cents ($1.45).

Q1 FY'20

I'd also like to offer some additional color on the first quarter. As a reminder, last year's first-quarter revenue of 206.0 million dollars included 10.4 million dollars from the HNT tools business. As we assess the opportunities in front of us, we currently anticipate flat to 1 percent organic revenue growth, which equates to revenue in the range of 195 million dollars to 200 million dollars. We currently anticipate that around 46 percent of our expected annual revenue will come in the first half of the year. We are planning for modest gross margin improvement in the first quarter with operating expenses in the range of six to seven percent lower than the same quarter one year ago. Diluted EPS for the first quarter is expected to range from 6 to 8 cents.

That concludes my formal review of our financial results. Before we transition to Q&A, I'd like to quickly note that our IR conference participation is listed on slide 17. I'll now turn the call over to the operator to start Q&A.