NETSCOUT SYSTEMS, INC.
First-Quarter Fiscal Year 2020 Financial Results Conference Call
Management's Prepared Remarks

August 1, 2019

Anthony Piazza: Introduction

Thank you, operator, and good morning everyone. Welcome to NETSCOUT'S first-quarter fiscal year 2020 conference call for the period ended June 30, 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. 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.

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 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 also on our website.

I will now turn the call over to Anil for his prepared remarks. Anil …

Anil Singhal:

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

Slide #6: Q1'20 Financial & Operational Highlights

- Our first-quarter revenue of 186.1 million dollars was approximately 10 million dollars lower than we anticipated as we continue to see constrained spending and elongated purchasing cycles in our service provider segment.
- Despite the revenue shortfall, we delivered first quarter diluted earnings per share of 7 cents, which was in-line with our expectations as we continued to closely manage our cost structure.

Let's move to slide 7 for some further perspective on this and the trends we see in the business.

Slide #7: Business Trends

Overall, our service provider segment revenue decreased 3% compared to the first quarter of last year. We continue to see elongated purchasing cycles within some of the major North American service providers as they move toward their 5G service offerings. We were excited to see increased activity related to 5G networks this past quarter as we worked with some of our customers on their 5G initiatives. I am also happy to report that we received an 8-figure order at the beginning of our second quarter related to a Radio Frequency Propagation Modeling use case. This project is scheduled to be completed by the end of this calendar year and convert to revenue in the second half of our fiscal year. Additionally, Michael will highlight one large order we recognized as revenue in the first quarter related to a domestic 5G monitoring deal.

Within our international service provider segment, we completed the implementation and received customer approval for the large international service provider order that we had discussed over the past few quarters. This service provider operates a national LTE network that covers a significant geography. They chose us to monitor their 4G network as they disrupted their local markets and became a market leader in wireless services. We continue to see 4G related offerings throughout EMEA, Latin America, and emerging Asia Pacific countries. These offerings include services such as VoLTE.

Turning to our Enterprise segment, revenue was down about 7% on an organic basis after three quarters of consecutive organic growth. The decline was largely driven by disruption in our international enterprise sales force from the sales reorganization we announced at the beginning of our fiscal year, as discussed on last quarter's earnings call. We have reviewed the issues and have made improvements in this geography. Based on our understanding of the competitive landscape within certain international geographies, we believe we have good opportunities for growth during the remainder of the fiscal year.

Included in both our service provider and enterprise segments are our security offerings. Our overall DDoS security revenue grew modestly this quarter; in the low single digits. This growth was primarily attributable to our international service provider customers. Within the Enterprise segment, we continue to provide DDoS capabilities for a major corporation as they continue to build out their cloud provider platform.

Further, in our security product line, we just announced the availability of Arbor Threat Analytics (ATA), which we'll showcase next week at the annual Black Hat cyber security show in Las Vegas. This is our network-based threat detection and response platform, which combines NETSCOUT's unique visibility into both the internet and enterprise networks with our proven packet monitoring technology to speed detection and response in today's challenging threat landscape. We anticipate that this will be a key differentiator of our offering. This new offering will be particularly valuable to current customers who have instrumentation already in place for network and application performance management, which can now also serve cyber security use cases.

At the show, we'll also introduce Cyber Threat Horizon, a real-time, *"human readable"* threat intelligence service aimed at enterprises and ISPs looking to make better decisions faster when faced with threats and attacks. This service provides a real-time view of attack activity in a given geo or vertical segment and affords the responder a valuable context for response decisions.

Now let's move to slide number 8 to review our outlook.

Slide #8: Outlook & Summary

Despite our revenue performance in the first quarter, we remain excited about the opportunities we are seeing and our ability to capitalize on them. Accordingly, we are reiterating our guidance provided on our May 2019 earnings call.

For fiscal year 2020 our revenue target range continues to be 895 million dollars to 915 million dollars. Our revenue represents a range of less than 1% growth to approximately 2.5% growth on an organic basis compared with fiscal year 2019.

We are committed to continuing to closely manage and review our cost structure as the year progresses to deliver our diluted EPS targets within our guidance range of one dollar and 40 cents ($1.40) to one dollar and 45 cents ($1.45).

I look forward to sharing our continued progress with you over the remainder of the year.

I'll turn the call over to Michael at this point.

Slide #9: COO Update

Michael Szabados:

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

Customer Wins:

In the service provider segment, 5G continues to build momentum. In addition to the cadence of Radio Frequency Propagation Modeling deals we have been winning over the past two years, this past quarter we won a large, high seven-figure 5G core monitoring project at a Tier1 US carrier. With our solutions, this carrier can have end-to-end network visibility of their 4G and 5G networks from the core to the RAN. This win, against one of the incumbent network equipment manufacturers, demonstrates the value of our solutions and our ability to further assist our customers as they evolve. It further demonstrates the completeness of our offering for 5G and our potential for future 5G opportunities.

In the enterprise segment, we continue to attract new logos with our leading network performance monitoring capabilities. Our newer generation products have the capability of supporting speeds of up to 100Gigabit per second network segments. Additionally, our "commercial off the shelf" offering has been enticing to our enterprise customers. One example is a first quarter win from a leading German automobile manufacturer, which is a new logo for us. This automobile manufacturer purchased our solutions in order to run their network at 100 gigabits and be able to deploy our products in their "software only" form. This was a low six figure order for us and a demonstrates our ability to attract new logos.

In our security space, we won a mid-seven figure DDoS deal at a large US internet service provider or an ISP. This ISP, for whom we are the DDoS provider, completed an acquisition of a company that used a competitor's solution. The ISP wanted to standardize on a single solution as well as choose a product that could offer their large customer base DDoS protection services. This ISP's customers face a rapidly shifting threat landscape and this US-based ISP wanted to provide a scalable and robust offering to them. Accordingly, this ISP selected our solution and intends to replace the incumbent's solution with an all-NETSCOUT deployment. In the DDoS arena, we continue to leverage our core product strengths and differentiation of scalability and robustness of the Arbor Sightline and TMS portfolio. This differentiation includes our superior threat intelligence given our access to over one-third of internet traffic.

Go-to-Market Highlights

Cloud:

Following our partnering with Microsoft on the Azure VTAP offering earlier this year, we participated in Amazon's AWS VPC traffic mirroring launch at their re:inforce event in Boston in June and are working with them on ongoing field trials and roadmap collaboration. The significance of these new capabilities is that cloud traffic can now be made available for monitoring and analysis without having to deploy agents inside the workloads, thereby expanding alternatives to extend visibility to the cloud. Additionally, to meet requirements from our large US government agency customers, we are planning to expand our existing public cloud offerings to Azure Gov and AWS Gov Cloud, with targeted availabilities in the early fall.

Future Events:

Finally, in our second quarter, we plan to exhibit at VMWorld and the Black Hat cyber security show. At VMWorld, we will demonstrate our integration with VMWare's new NSX-T and VeloCloud platforms, extending IT teams' visibility to workloads running in the software defined data center and SD WAN environments. At the Black Hat show we will showcase our Arbor Threat Analytics and Cyber Threat Horizon products that Anil highlighted earlier.

That concludes my prepared remarks and I will now turn the call over to Jean.

Slide #11: CFO Review

Jean Bua:

Thank you, Michael, and good morning everyone. I will review key first-quarter metrics along with our 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 of 2018, 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 note the nature of any such comparisons.

Slide #12: Q1 FY'20 Results

Slide number 12 details our results for the first quarter of fiscal year 2020. Focusing on the quarterly performance, we reported revenue of 186.1 million dollars. First-quarter revenue declined by 10 percent on a year over year basis and 5 percent on an organic basis excluding the HNT tools business.

Our first-quarter fiscal year 2020 gross margin was 74.9 percent, relatively flat compared to the same quarter last year. Quarterly operating expenses were down by 13 percent from the prior year due primarily to lower personnel related costs resulting from reduced headcount. We reported an operating profit margin of 6.5 percent with diluted EPS of 7 cents.

Slide #13: Q1 FY'20 Revenue Trends: Customer Verticals & Geographic Mix

Turning to slide 13, I'd like to review key revenue trends for the first quarter. In the service provider customer segment, revenue declined by 3 percent with service assurance down 9 percent and DDoS security up 12 percent. In the enterprise segment revenue declined

16 percent partly due to the sale of the HNT tools business. On an organic basis, enterprise revenue declined 7 percent.

In terms of revenue by geography, as a reminder, this is calculated on a GAAP basis and includes revenue from the HNT tools business. International revenue increased by 1% due to both of our service assurance and DDoS product offerings for service providers within Europe and Rest of World. The U.S. experienced a 16% revenue decline which was partially attributable to the disposition of the HNT tools business. We estimate that the U.S. declined about 11% on an organic basis on moderated spending by U.S. service providers. International customers represented 42% of GAAP revenue versus 38% last year. We had no customers who represented 10% or more of revenue in the quarter.

Slide #14: GAAP Balance Sheet Highlights & Free Cash Flow

Slide 14 details our balance sheet highlights and free cash flow. We ended the quarter with GAAP cash, cash equivalents, short-term marketable securities and long-term marketable securities of 443.2 million dollars, which is a decrease of 43.8 million dollars since the end of the fourth quarter. We generated free cash flow of 46.2 million dollars for the quarter. Last quarter our board approved a 50-million-dollar share repurchase tranche. We repurchased 33.2 million dollars of our common stock before the end of June with the remaining 16.8 million dollars repurchased in July. In total, we repurchased 1,946,418 shares of our common stock at an average price of 25 dollars and 69 cents ($25.69) per share. In addition to our share repurchase, we also repaid 50 million dollars of debt and at the end of the first fiscal quarter we had 500 million dollars outstanding on our 1-billion-dollar revolving credit facility.

To briefly recap other GAAP balance sheet highlights, accounts receivable, net, was 160.0 million dollars, down by 75.3 million since the end of March. DSOs were 73 days versus 88 days at the end of fiscal year 2019 and 69 days at the same time last year. The increase in the DSO's from the first quarter of this year compared with the first quarter of the prior year reflects the higher component of receivables from renewal bookings this quarter.

Finally, I would like to mention that effective April 1, 2019, NETSCOUT adopted the new Lease Accounting Standards Codification Topic 842 or ASC 842. We adopted it under the modified retrospective method and as a result did not adjust comparative periods or modify disclosures in those comparative periods. The adoption of ASC 842 resulted in the recognition of operating lease Right of Use (ROU) assets of approximately 68.2 million dollars, operating lease liabilities of approximately 83.2 million dollars and the elimination of deferred rent of approximately 15.0 million dollars. Operating leases are included in the operating lease ROU assets and lease liabilities on our balance sheet. The adoption of ASC 842 did not have a material impact on our consolidated statement of operations, consolidated statement of stockholder's equity, consolidated statement of comprehensive income (loss) or consolidated statement of cash flows. The new standard had no material impact on liquidity and had no impact on our debt-covenant compliance under our current debt agreements.

Use of Capital

I'd like to provide a brief update on our use of capital.

As discussed in the past, we plan to retain up to 300 million dollars in cash on our balance sheet for both working capital purposes and in consideration of overseas cash. In the near term, we plan to allocate 50 million dollars for stock repurchases and an additional 50 million dollars for the repayment of debt. Accordingly, we anticipate continuing to be active in the market, depending on market conditions and subject to daily trading volumes and price considerations.

Slide #15: FY'20 Guidance

Let's move to slide 15 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.

FY'20 Non-GAAP Guidance

Consistent with Anil's comments earlier, we continue to target 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 as we absorb annual merit adjustments and critical personnel replacements. We expect our non-GAAP tax rate to be at the lower end of our initial range of 23 to 25 percent. We began implementation of a tax structure that should allow us to maintain a similar non-GAAP tax rate to last year.

Assuming 78.2 million shares outstanding, we are expecting to deliver earnings growth with diluted EPS between one dollar and 40 cents ($1.40) and one dollar and 45 cents ($1.45).

Q2 FY'20

I'd also like to offer some additional color on the second quarter. As a reminder, last year's second-quarter revenue of 224.0 million dollars included 7.6 million dollars from the disposal of the HNT tools business. As we assess the timing of opportunities in front of us, we currently anticipate revenue in the range of 205 million dollars to 215 million dollars. We are planning for modest gross margin improvement in the second quarter with operating expenses in the range of seven to eight percent lower than the same quarter one year ago. Diluted EPS for the second quarter is expected to range from 25 to 27 cents.

That concludes my formal review of our financial results. Before we transition to Q&A, I'd like to quickly note that our upcoming IR conference participation is listed on slide 16.

I'll now turn the call over to the operator to start Q&A.