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

January 30, 2020

Tony Piazza: Introduction

Thank you, operator, and good morning everyone. Welcome to NETSCOUT'S third-quarter fiscal year 2020 conference call for the period ended December 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. 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 for the year ended March 31, 2019 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 measures 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: Q3'20 Financial & Operational Highlights

- From a financial perspective, we delivered strong third-quarter fiscal year 2020 performance with both revenue and earnings per share exceeding the high-end of our expectations for the quarter.
- Revenue for the quarter increased 6 percent over the same quarter last year at 260.1 million dollars.
- The quarter benefited from year-over-year growth in both our service provider and enterprise verticals. We exceeded our expectation on revenue primarily due to the acceleration of a service provider transaction that we originally expected to occur next quarter.
- Earnings per share was 73 cents, which increased more than 60 percent compared with same quarter last year. We exceeded our earning per share expectation due to record "software only" revenue that benefited our gross margin as well as corporate tax clarifications and capital structure management initiatives that added incremental benefits in the quarter.
- From a strategic perspective, we continue to advance our product initiatives at a steady pace and have begun combining elements of our service assurance and security technologies to provide enhanced capabilities to our customers that leverage the strengths of our offerings. We believe this combination provides something unique and valuable in the marketplace.

- On our go-to-market initiatives, we continue to showcase our products at major industry events and believe that our sales force integration has stabilized, and the teams are beginning to build pipeline and gain good traction.

Let's move to slide 7 for some further perspective as we review business highlights.

Slide #7: Business Highlights

Service Provider Customer Vertical

In our service provider vertical, revenue grew 8 percent compared with the same quarter last year.

In the quarter, we recognized revenue from a tier-1 North American carrier that continues to evolve its nationwide 5G network. This is the second 5G related order from this carrier this fiscal year. Michael will elaborate further on this transaction in his remarks.

During the quarter, we also recognized revenue from a couple of large orders from international carriers that continue to evolve their 4G-LTE networks. These deals were a continuation of our relationships with these carriers that demonstrate the value of our visibility solutions and our incumbency as they evolve their networks.

Finally, as I said earlier, the service provider vertical also benefited from the acceleration of revenue associated with a transaction that we originally expected to occur next quarter. We were pleased to recognize the revenue early, but as it is timing-related, it does not alter our revenue expectation for this full fiscal year.

We see customers advancing their 4G-LTE networks in international geographies, including Latin America, Europe, the Middle East, and parts of Asia. We also continue to work closely with our North American and Asian customers as they advance their 5G initiatives. While we are pleased to see some leading carriers accelerate their 5G initiatives, we believe that 5G is a longer-term opportunity and driver of growth that will benefit our business in numerous ways, especially as edge computing becomes more mainstream. We are looking forward to showcasing our 5G service assurance solutions at Mobile World Congress in Barcelona, Spain next month.

Enterprise Customer Vertical

Turning to our Enterprise vertical, revenue grew 3 percent over the same quarter last year. Overall, in this vertical, our customers continue to advance their digital transformation and security initiatives. Michael will highlight some of these wins during his remarks which demonstrate the value of our visibility solutions as customers transition to the cloud. We also believe that the past disruption that we experienced from the international side of our sales force reorganization in this vertical is now primarily behind us.

In both verticals, our customers are adopting our "software-only" form factor and we saw record revenue in this area during the quarter with 42 percent of our service assurance product revenue coming from these "software-only" products.

Finally, we continue to advance our security initiatives and recently announced Arbor Sightline with Sentinel to deliver the next generation of DDoS visibility and protection for service providers and large enterprises. This is an example of how the combination of our service assurance and security technologies can add unique value for our customers. We will showcase this product at the RSA Conference next month in Las Vegas, Nevada. Michael will elaborate further on this during his remarks.

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

Slide #8: Outlook & Summary

We remain excited about the opportunities we are seeing and our ability to capitalize on them. With three quarters behind us, the view of our pipeline, and the radio frequency propagation modeling projects that are expected to produce revenue in the fourth quarter, we are narrowing our revenue guidance to a range of 900 million dollars to 910 million dollars, which implies a low-single digit organic growth rate over last year, and increasing our earnings per share guidance to a range of one dollar and 51 cents ($1.51) to one dollar and 56 cents ($1.56). The 6 cent increase primarily reflects benefits associated with tax reform legislation clarifications and capital structure management benefits such as recent share repurchases.

As we approach the end of our fiscal year 2020 and start to look to fiscal year 2021, we are excited about the trends we see in front of us such as 5G, digital transformation, security, and business analytics. We believe that these trends should benefit us in the future and that we should transition from dealing with the headwinds that we have experienced over the past few years to seeing growth again in the business.

I look forward to sharing our progress with you as we finish this fiscal year and look to the future.

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 vertical, we continue to gain traction in 5G as evidenced by an additional high 7-figure win for monitoring 5G deployments from the same North American service provider that placed similar orders earlier this fiscal year. The pace their buildout is strong and the continuation of orders from this provider demonstrate the value of our solutions as well as our incumbency.

In the enterprise vertical, at a large, financial institution customer, we won a low-seven-figure service assurance deal. The opportunity arose as a result of the customer's digital transformation initiative. In this situation, we displaced an incumbent competitor at the local and regional head office locations as they standardized on the NETSCOUT solution across the enterprise. The award encompassed deploying our solutions in 13 regional head offices, more than 50 remote local offices, within the Data Centers, as well as into their East and West co-locations to support their interconnects to the cloud. Our strong product strategy and close collaboration with the network and applications teams is what secured this win for us. Our cloud capabilities and our alignment to the customer's initiatives for cloud and virtualization positioned NETSCOUT as the superior solution and lead to the decision to standardize on NETSCOUT across the enterprise.

In the security space, our Arbor DDoS solutions continue to lead in our large enterprise customer base because we can provide robust and simple to configure and adapt protection, as well as network-wide visibility during an attack, which is not the case with as-a-service alternatives.

For example, at another large financial institution, we closed an incremental expansion opportunity, in the high six figure range, demonstrating our staying power and continued critical role in a fast-evolving threat landscape. We also added a low-seven-figure deployment to our already massive install base at a major cloud player. Annual revenues from this customer continue to be strong as they expanded their business and have been a solid repeat customer for our solutions.

Go-to-Market Activities:

On the go-to-market front, we continue to participate in key industry events and will attend two major shows over the coming weeks.

We will participate in Mobile World Congress in Barcelona, where we are highlighting our 5G capabilities and will share our insights and early experience in the space. We will also participate in RSA in San Francisco, where we will focus on our new DDoS product called *Arbor Sightline with Sentinel*, which was announced last week. Combining Arbor and NETSCOUT core technologies, the product will provide ISPs with a deep understanding of the services their customers use, as well as allow them to detect a broader range of application-layer threats to enable a new breed of visibility and security value-added services.

Finally, we will host our annual Engage Technology and User Summit in Hollywood, Florida in April. We are currently in full recruitment mode and are expecting to exceed last year's record attendance. We are excited about showcasing our solutions and engaging with our customers at this event.

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 metrics for our third quarter and first nine months, or year-to-date fiscal year 2020 performance, along with our guidance for the remainder of the fiscal year. 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: Q3 and First Nine Months FY'20 Results

Slide number 12 details our results for our fiscal third quarter and year-to-date 2020 performance. Focusing on the quarterly performance, revenue grew 5.6 percent over the same quarter in the prior year to 260.1 million dollars. Product revenue grew 6.9 percent and service revenue grew 4.1 percent over the prior year's quarter.

Our third-quarter fiscal year 2020 gross profit margin was 77.8 percent, up 2.2 percentage points over the same quarter last year. Contributing to the improved margin was the strong "software only" sales at 42 percent of service assurance revenue as compared to 14 percent in the third quarter of the prior year. Quarterly operating expenses decreased 1.7 percent from the prior year, primarily due to continued cost controls and headcount management. We reported an operating profit margin of 27.3 percent with diluted earnings per share of 73 cents.

Slide #13: First Nine Months YTD FY'20 Revenue Trends: Customer Verticals

Turning to slide 13, I'd like to review key revenue trends for the first nine months of the year. For the first nine months of fiscal year 2020, the service provider customer vertical revenue grew approximately 4 percent while the enterprise vertical declined approximately 3 percent, after removing the revenue impact of the divested HNT Tools business.

Approximately 52 percent of total revenue was generated from the service provider vertical with the remainder from the enterprise.

Slide #14: First Nine Months YTD FY'20 Revenue Trends: Geographic Mix

Turning to slide 14, which shows our geographic revenue mix, on a GAAP basis. Revenue by geography was relatively consistent with the first three quarters of the prior year. Additionally, there were no customers in the quarter or the first nine months of the year that represented 10 percent or more of revenue.

Slide #15: GAAP 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 346.5 million dollars, which is an increase of 38.7 million dollars since the end of the second quarter. Free cash flow generated in the quarter was 63.2 million dollars. During the quarter, we repurchased approximately 1.0 million shares of our common stock at a cost of 25.0 million dollars or an average price of 24 dollars and 91 cents ($24.91) per share. In the first three quarters of this fiscal year, we have returned approximately 125 million dollars to our shareholders. We anticipate continuing to be active in the market, depending on market conditions and subject to daily trading volumes and price considerations.

From a debt perspective, as of the end of the third quarter, we have 450 million dollars outstanding on our one-billion-dollar revolving credit facility.

To briefly recap other balance sheet highlights, accounts receivable, net, was 244.9 million dollars, up by 42.6 million dollars since the end of September. DSOs were 77 days versus 88 days at the end of fiscal year 2019 and 91 days at the same time last year. The decrease in the DSO's in the third quarter of this year compared with the third quarter of the prior year is primarily attributable to strong collection activities.

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 prior to the completion of the sale. 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 remarks, with one quarter to go in the fiscal year, we have narrowed fiscal year 2020 revenue guidance to a range of 900 million to 910 million dollars, which implies low single-digit organic growth.

We expect our non-GAAP tax rate to be in the range of 20 to 22 percent after the issuance of regulations by the U.S. Treasury that clarified the treatment of certain items related to the Tax Cut and Jobs Act (TCJA) that was passed in December of 2017.

Assuming approximately 76 million shares outstanding, after updating for our recent share repurchase activities, we are expecting to deliver earnings growth in the high-single to low-teens range with diluted earnings per share between one dollar and 51 cents ($1.51) and one dollar and 56 cents ($1.56), compared with our prior year's performance.

That concludes my formal review of our financial results.

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