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

May 7, 2020

Tony Piazza: Introduction

Thank you, operator, and good morning everyone. Welcome to NETSCOUT'S fourth-quarter and full fiscal year 2020 conference call for the period ended March 31, 2020. 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 some introductory comments.

Slide #6: Introductory Comments

As we are all aware, we are in unprecedented, uncertain, and challenging times as a result of the COVID-19 global pandemic. During these times, our purpose as "Guardians of the Connected World" has never been more important. Our customers depend on NETSCOUT's service assurance and security solutions to support and protect critical networks and infrastructure that connect people and support businesses around the globe. It is essential that these infrastructures continue to perform, even as they are stressed with unparalleled demand as many of us now work remotely. Accordingly, we have been effectively operating our business throughout this crisis given the critical nature of what we provide to our customers.

In-line with our "Lean but Not Mean" culture, our first priority has been the health and safety of our people, partners, customers and the communities where we live and work. Early on in this crisis, we activated our contingency plans which have allowed us to ensure the safety of our team while effectively operating the Company with most of our employees working remotely.

Finally, NETSCOUT generates significant free cash flow, as demonstrated in fiscal year 2020 where we generated more than 200 million dollars. Additionally, at the end of our fiscal year we had approximately 390 million dollars in cash, cash equivalents, and marketable securities, which represents approximately six months of our normal working capital requirements. We also have borrowing capacity on our 1-billion-dollar revolving credit facility with only 450 million dollars outstanding at our fiscal year end and no principal repayments due until the facility matures in January of 2023. Therefore, I believe that our solid balance sheet and strong financial position currently provide us the flexibility and liquidity required to weather this pandemic situation while continuing to invest in our technology and solutions to maintain our leadership position within the industry.

Let us move on to our financial results and then I will provide more insight on our business outlook and the trends we are seeing. Let's begin on slide number 7 with a brief recap of our full fiscal year 2020 non-GAAP financial results.

Slide #7: Full Fiscal Year 2020

- For fiscal year 2020, revenue was 892 million dollars and diluted earnings per share was 1 dollar and 57 cents. We delivered solid diluted earnings per share growth of 14 percent on essentially flat organic revenue, meaning excluding the divested HNT tools business, compared with the prior fiscal year.
- Revenue in our verticals was essentially flat on an organic basis as well. In the service provider vertical, revenue grew 1 percent while the enterprise vertical declined 1.4

percent.

- During the fiscal year, our "software only" product line grew approximately 35 percent compared with the prior year. "Software only" revenue as a percentage of service assurance, service provider product revenue was consistent with the prior year at approximately 30 percent. During the fiscal year, we saw "Software only" revenue grow to 30 percent of service assurance, enterprise product revenue. Last fiscal year, this was only about 10 percent.

Turning to Slide 8, I would like to briefly cover our fourth quarter financial results.

Slide #8: Fourth Quarter 2020

For our fourth quarter, revenue was 229.4 million dollars and diluted earnings per share was 50 cents. While revenue came in approximately 4 to 8 percent lower than expected, due to disruption from the COVID-19 global pandemic, there were nevertheless some highlights in the quarter, such as:

- A second quarter of consecutive revenue growth in the enterprise vertical spurred by DDoS and our government, healthcare and manufacturing customers. Michael will comment on some of these deal in his remarks.
- We also continued to see the decline in ancillary product lines such as Fluke Systems. Without the Fluke Systems decline, the enterprise vertical would have grown approximately 5% in the quarter.

Let us turn to slide 9, for some remarks on our outlook and the trends we are seeing.

Slide #9: Outlook and Trends

Looking forward to our fiscal year 2021, we believe that our unique solution set could assist our customers in dealing with some of their unexpected network and security capacity challenges in new ways throughout and after the global pandemic. Although we remain encouraged about the opportunities we see, we are also cautiously optimistic given the current uncertainty of the global economy. Accordingly, we will defer providing fiscal year 2021 guidance until there is greater visibility into the elements we do not control such as the market trends, customer purchasing behavior, and the duration and magnitude of the effects of the COVID-19 pandemic. However, I would like to share with you some insights.

Interest from our customers remains high, however, given the current economic environment, timing and funding of deals is challenging to predict. At this point, we have already received a large, eight figure order from an international service provider. We also anticipate completing the prior year's radio propagation modeling projects in the first half of this fiscal year. Given our robust functionality and the ability to sell solutions in many forms, we are a premier partner with many of the service providers on a global basis. We are 5G Ready and can support both stand-alone and non-stand-alone 5G networks, enabling us to support our customers regardless of where they are in their evolutions.

In the enterprise vertical, companies continue to advance their digital transformation and security initiatives as they work to address speed, agility, and cost. We see the potential for an acceleration of customers digital transformation/cloud migration and security initiatives given how companies are operating and some of the lessons being learned as they deal with the impacts of the global pandemic. We have already seen multiple low-seven-figure deals from some of our financial institution customers in late March and April. Michael will provide more insight on these deals this during remarks.

Regarding 5G, we see this as not only a service provider opportunity, but also as an enterprise opportunity. Enterprises and governments are focused on leveraging 5G public and private networks to operate their businesses with greater automation and precision. Our customers are offering new products and services utilizing this technology which offers high speeds and low latency. Some of the use cases for this technology are in manufacturing with automated factories, healthcare with telemedicine, transportation with smart vehicles, and other applications such as smart cites and homes, enhanced gaming and entertainment, and national defense. We also believe we are uniquely qualified and positioned to help our customers as we are one of the only companies to have service provider "scalability" and enterprise "functionality."

Finally, regarding our Arbor DDoS business, which is part of both our service provider and enterprise verticals, we also believe that this area of the business could benefit as security becomes an even greater focus during the current pandemic as bad actors attempt to take advantage of distracted companies. We continue to combine 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 a unique and valuable offering in the marketplace.

Turning toward our cost structure, we remain committed to improving our operations and maintaining cost controls such that we should be able to once again provide leverage in our earnings per share. We plan to continue to innovate and invest in our technology and solutions to ensure that we maintain our industry leadership throughout this crisis and into the future. We believe that our solid balance sheet and financial position provide us with the liquidity and flexibility necessary to weather these challenging times. At this time, we also believe it is prudent to preserve capital and we will not implement a share repurchase program for our first fiscal quarter.

Turning toward customer engagement, last week we hosted our annual technology and user summit, ENGAGE, which was virtual for the first time. This allowed the opportunity for many more of our customers and partners to attend. We had approximately 3,500 people register for the event, which was approximately 4 times more than last year. We see this as an opportunity to increase visibility of our flexible solutions, including COTS (commercial off the shelf) hardware. Michael will elaborate on our ENGAGE event during his remarks.

Finally, I would like to thank all the first responders who are working tirelessly to keep us safe, my fellow Guardians at NETSCOUT for their commitment and dedication, as well as our customers and stakeholders for their continued support.

I look forward to sharing our progress with you during fiscal year 2021.

I will now turn the call over to Michael for his remarks.

Slide #11: COO Update

Michael Szabados:

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

Customer Wins:

Starting with customer wins, we continue to make good progress with both new and existing customers. A new customer that we won during the quarter, a global leading manufacturer and marketer of beauty products, was advancing their digital transformation initiative, including moving to the cloud. The customer was experiencing performance issues and they could not address the issues with solutions which were not based on "smart data." The customer placed a low-seven-figure order to gain the full complement of our solutions for global visibility to assist in resolving performance using our packet-based rich information solutions. They are also utilizing our Visibility as a Service (VaaS) offering to accelerate and optimize the value of our solutions demonstrating the value of our packet-based visibility solutions and VaaS offering as customers advance their digital transformation and cloud migration strategies.

Within the public sector area, we also had some nice wins both domestically and internationally as we continue to assist these customers with their digital transformation initiatives as well. One of the largest cities in the Unites States decided to upgrade their education information infrastructure. They placed a low-to-mid-seven-figure order with us to deploy state-of-the-art service assurance and visibility as the foundation of their digital transformation initiatives. While not the initial trigger, scaling up remote learning is also enabled by the upgrade. This is only the start of their modernization efforts as they have more than 1,800 schools to upgrade in their city. In the international government area, we had a mid-seven-figure win to provide a system-wide augmentation and enhancement of service assurance solution at a large government agency that provides IT services to all the government agencies of that country. Both wins demonstrate the value of our incumbency with our customers, and our ability to provide them with continued value as they adapt to changes in their operations and advance their infrastructures.

In the service provider vertical, we continue to work with our Tier 1 North American carriers as they plan their 5G initial deployments. During the quarter, we delivered and recognized a significant portion of revenue from the radio frequency propagation modeling project we won earlier in the year from a Tier 1 North American carrier. We also continue to work with our international carriers as they advance their networks to 4G, LTE, and in some cases 5G.

Finally, I want to provide some insight into some of the activity we have recently seen related to the COVID-19 global pandemic. Some of these deals occurred late in the quarter while others in early April.

On the enterprise front, we have started to see some orders from our large financial institution customers, in both late March and early April, as they enhance both their visibility and security solutions by upgrading their infrastructure and adding DDoS capacity to manage higher traffic demands on their networks and elevated security threats.

In our service provider vertical, we have seen interest in upgrading technology and adding DDoS capacity within their infrastructures. One European carrier placed a low-seven-figure order to upgrade its threat mitigation infrastructure to the latest technology in one of the major countries it operates in. Another placed a mid-six-figure order to increase its capacity as traffic spiked abruptly during the pandemic with more people working remotely.

Go-to-Market Activities:

On the go-to-market front, as Anil mentioned, last week we hosted our first virtual annual technology and user forum, ENGAGE. The event has been an overwhelming success with record interest as approximately 3,500 people registered, versus approximately 900 last year, representing more than 1,000 organizations from around the globe. The registrants represented the service provider, enterprise, and government verticals as well as representation from our various partners. The event attracted strong global representation with more than half of the registrants being internationally based. We also noticed a broader array of functions attending the event, with architects, application development, and security operations represented, in addition to network engineering and operations.

During the event we showcased our solutions that assist customers with digital transformation, security, business analytics, and 5G related initiatives that are all more critical given the recent global crisis. In addition to the three days of technical presentations, we offered virtual hand-on training sessions covering approximately 30 different subjects. Delivery of these sessions to our customers are over a two weeks period for a grand total of more than 4,000 sessions. Our plan is to continue to leverage a forum like this throughout the year to enhance our engagement with existing and prospective users and customers.

I look forward to sharing additional news of our success in our go-to-market initiatives and our customer wins in fiscal year 2021. That concludes my prepared remarks and I will now turn the call over to Jean.

Slide #13: CFO Review

Jean Bua:

Thank you, Michael, and good morning everyone. I will review key metrics for our fourth quarter and full 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 of 2018, I will highlight certain revenue trends on an organic non-GAAP basis, which removes HNT tools revenue for the applicable period referenced. I will note the nature of any such comparisons.

Slide #13: Q4 and FY'20 Financial Results

Slide number 13 details our results for our fourth quarter and full fiscal year 2020. Focusing on the quarterly performance first, revenue declined 2.5 percent over the same quarter in the prior year to 229.4 million dollars. Product revenue declined 7.2 percent and service revenue grew 2.8 percent over the prior year's quarter.

Our fourth-quarter fiscal year 2020 gross profit margin was 76.0 percent, down 3 percentage points over the same quarter last year. The lower margin was attributable to a higher volume of radio frequency propagation modeling revenue that has lower gross margins in the initial stages as well as increased variable compensation cost in the quarter. Quarterly operating expenses increased 7.3 percent from the prior year, primarily due to higher variable compensation cost and a one-time loss contingency. We reported an operating profit margin of 21.2 percent with diluted earnings per share of 50 cents.

For the full fiscal year 2020, revenue was 892.0 million dollars, which was a decline of 2.1 percent over the prior year on a reported basis. Adjusting for the divested HNT tools business, revenue was relatively flat compared with the prior year, despite the COVID-19 pandemic impact in our fourth quarter. Gross profit margin was 76.4 percent, which is consistent with the prior year. Strong "software only" sales at 29 percent of service assurance product revenue was offset by lower margin radio frequency propagation modeling services and increased compensation cost. Annual operating expenses decreased 3 percent from the prior year, primarily due to the HNT Tools divestiture, headcount management, and continued cost controls. We reported an operating profit margin of 18.3 percent with diluted earnings per share of 1 dollar and 57 cents or a 13.8 percent increase compared with the prior year.

Slide #14: FY'20 Revenue Trends: Customer Verticals

Turning to slide 14, I'd like to review key revenue trends, which exclude the divested HNT Tools business for the fiscal year 2019 comparison. For fiscal year 2020, revenue for the service provider customer vertical grew 1 percent, while the enterprise vertical declined 1.4 percent.

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

Slide #15: FY'20 Revenue Trends: Geographic Mix

Turning to slide 15, this shows our geographic revenue mix, on a GAAP basis, which includes 18 million dollars of revenue from the divested HNT tools business in fiscal year 2019. The geographical split between international and domestic revenue was relatively consistent with the prior year. Additionally, there were no customers that represented 10 percent or more of revenue for the year.

Slide #16: GAAP Balance Sheet Highlights & Free Cash Flow

Slide 16 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 389.1 million dollars, which is an increase of 42.6 million dollars since the end of the third quarter. This cash and marketable securities balance represent approximately six months of normal working capital requirements. Free cash flow generated in the quarter was 102.5 million dollars as we had strong working capital in the quarter. During the quarter, we repurchased approximately 2.0 million shares of our common stock at a cost of 50.0 million dollars or an average price of 25 dollars and 62 cents ($25.62) per share. During fiscal year 2020, we returned approximately 175 million dollars to our shareholders. Given the current economic conditions and uncertainties as a result of the COVID-19 global pandemic, our capital allocation priority has shifted to capital preservation in the near-term and we do not anticipate implementing a share repurchase program in the first quarter of fiscal year 2021.

From a debt perspective, as of the end of the fourth quarter, we had 450 million dollars outstanding on our one-billion-dollar revolving credit facility. We had approximately 1.5 times cushion against our gross leverage covenant, which could provide borrowing capacity, if required. Our revolving credit facility expires in January of 2023 and has no required principal repayments due until maturity.

To briefly recap other balance sheet highlights, accounts receivable, net, was 213.5 million dollars, down by 31.4 million dollars since the end of December. DSOs were 73 days versus 88 days at the end of fiscal year 2019 and 77 days at the end of December 2019.

Slide #17: FY'21 Commentary

Moving to slide 17.

As Anil stated in his remarks, given the rapidly evolving COVID-19 situation, the Company will defer providing full fiscal year 2021 guidance until there is a clearer outlook on the duration and magnitude of the effects of the global pandemic.

That said, I want to comment on a few capital structure items related to our first quarter of fiscal year 2021. For the quarter, we expect the tax rate to be consistent with the first quarter of the prior year at approximately 23 percent. Additionally, we expect the diluted shares outstanding for the quarter to be approximately 73 million shares.

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