NETSCOUT®

NETSCOUT SYSTEMS, INC.
First-Quarter Fiscal Year 2021 Financial Results Conference Call
Management's Prepared Remarks

July 30, 2020

Tony Piazza: Introduction

Thank you, operator, and good morning everyone. Welcome to NETSCOUT'S first-quarter fiscal year 2021 conference call for the period ended June 30, 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 fiscal year 2021 assumptions, 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 our Annual Report on Form 10-K for the year ended March 31, 2020. 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.

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 available on our website.

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

Slide #5: CEO Perspective

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 first-quarter non-GAAP results.

Slide #6: Q1'21 Financial Results

- We delivered strong earnings per share growth on a relatively consistent revenue level compared with the same quarter last year.
- Revenue was 183.8 million dollars in the quarter, approximately one percent lower than the same period last year.
- Earnings per share was 17 cents in the quarter, an increase of more than 140 percent compared to the same period last year.
- Enterprise revenue in the quarter was strong but was offset by a decline in service provider revenue due to this vertical's project-based nature.
- The quarter benefited from lower operating costs from continued cost control measures and a decrease in expenses largely attributable to lower sales and marketing cost from reduced programs, events, and travel expenditures primarily due to COVID-19 pandemic related restrictions.

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

Slide #7: Business Insights

Following our April virtual Engage Technology and User Forum, we continue to experience solid interest in our suite of solutions. NETSCOUT's trust factor is attracting enterprises to our solutions to help solve heightened pandemic challenges, such as remote work, telemedicine, digital transformation, and an expanding cyber threat landscape. Our ability to provide service assurance, with real-time, pervasive visibility and insight, and security solutions that mitigate disruption regardless of our customer's underlying infrastructure is paramount in this environment.

The pandemic and economic environment are driving varying behaviors in our customer base with some customers accelerating their investments while others are exercising caution with their purchasing decisions as they evaluate the impact within their own organizations. Overall, it appears that enterprises focused on rightsizing their networks and proactively addressed potential vulnerabilities while service providers were a bit more cautious with their spending given the environment or their organization's shifting focus.

Enterprise Customer Vertical

In the Enterprise vertical, revenue grew approximately 21 percent over the same quarter last year as customers continued to advance their digital transformation/cloud migrations and security initiatives as they work to address speed, agility, and cost. In some cases, they have been accelerating plans to address potential vulnerabilities in their networks with our solutions in-light of the current environment. We experienced strong order volume for both our service assurance and security solutions, primarily driven by the government, financial, and healthcare sectors. We were pleased to see some of the benefits of the integration of our sales force that we undertook last fiscal year as enterprise customers explored solutions across our portfolio of service assurance and security offerings and the integration allowed us to quickly address their broader requirements. Michael will highlight some of our enterprise wins during his remarks.

Service Provider Customer Vertical

Turning to the service provider vertical, revenue declined approximately 20 percent compared with the same quarter last year as carriers were cautious with their spending. As a reminder, this vertical has historically experienced inconsistent variation in revenue patterns due to its project-based nature and the timing of orders.

In this vertical, we continue to work with our service provider customers on their 4G-LTE evolutions internationally and their 5G evolutions domestically and in certain Asian regions. Michael will comment on a large order we received this quarter in the 4G international space as part of his remarks.

From a 5G perspective, NETSCOUT is 5G ready and in a position to assist carriers or enterprises with their 5G initiatives and evolutions, regardless of the stage they are at; from non-stand alone, to stand alone, to edge computing.

Although we were pleased to have seen signs of 5G acceleration last fiscal year, the current pandemic and economic environment may have changed this momentum in the short-term as organizations focus on other priorities. However, with the initial Citizens Broadband Radio Service (CBRS) spectrum auction for mid-band spectrum earlier this month, we believe this may re-accelerate the momentum of these initiatives. Overall, 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.

Finally, during the quarter, our customers continued to adopt our "software-only" form factor with "software only" revenue at 36 percent of service assurance product revenue for the quarter, which is a 28 percent increase over the same quarter last year and was driven by increased adoption in the enterprise vertical.

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

Slide #8: Outlook & Summary

As we evaluate the outlook for the remainder of the fiscal year, we are encouraged by the opportunities we see, but remain cautiously optimistic given the continuing uncertainty around the pandemic and global economic environment, which continues to make the timing and funding of deals challenging to predict. Accordingly, we will continue to defer providing fiscal year 2021 guidance until there is a clearer outlook on the duration and magnitude of the effects of the COVID-19 global pandemic.

We remain committed to improving our operations and maintaining our disciplined cost controls so that we should be able to, once again, provide leverage in our earnings per share over fiscal year 2020.

From an operating perspective, we continue to run the Company effectively with a mix of employees working remotely, or in our facilities, as we cautiously advance through the reopening stages with all of the necessary precautions to keep our team safe. We appreciate the dedication and support of our employees and other stakeholders throughout the initial stages of this pandemic.

From a financial perspective, we will continue to prudently manage our cost structure and intend to maintain a solid financial position. We have more than 425 million dollars in cash and cash equivalents, which represents more than 6 months of normal working capital requirements. Additionally, we continue to generate solid free cash flow, and have capacity on our 1-billion-dollar revolving credit facility with 450 million dollars outstanding as of the end of the first quarter and no principal repayments required until its maturity in January of 2023. We also believe it continues to be prudent to prioritize capital preservation in the near-term and do not have plans to use our share repurchase program during our second quarter.

These actions, along with our strong financial profile and experienced team, should provide us the flexibility and liquidity required to continue to weather this global pandemic and challenging economic environment, while also allowing us to invest in our technology and solutions to maintain our leadership position within the industry.

I look forward to sharing our progress with you as the fiscal year continues to unfold.

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

Slide #9: COO Update

Michael Szabados:

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

Customer Wins:

Starting with customer wins for the quarter, one notable win within the service provider vertical, was a low 8-figure deal we did with a large international provider with close to 400 million subscribers. This deal is a continuation of our long-standing partnership with this provider featuring highly advanced use cases, especially in leveraging our subscriber intelligence in planning and marketing their services, as well as structuring their partnership relationships with OTT (over-the-top) providers and retail chains, just to name a few examples. This win demonstrates the unique role of our ASI data set in powering two business-critical functions for this operator, as well as the value of our continued relationships and incumbency with our customer base.

In the enterprise vertical, we continue to make good progress as customers evolve and accelerate their digital transformation initiatives in general and as they deal with changes in the way they operate their businesses due to the COVID-19 pandemic.

During the quarter, we closed a series of deals, amounting to low-seven-figures in total, in one of our largest and longest standing relationships with a healthcare provider customer whose digital transformation and telemedicine initiatives have drastically accelerated because of the pandemic. Our service assurance solutions are deployed at cloud connect "edges", in so called carrier neutral services facilities or co-los, to monitor and troubleshoot cloud-resident telemedicine applications whose use significantly increased with the shift to virtual doctor appointments and patient care. The funding for these deals came from the organization's emergency COVID-19 budget and demonstrates our value as technology turns occur and accelerate as well as the strength of our incumbency and long-standing relationships.

During the quarter, we also received a mid-seven-figure order from another long-standing customer, this time within the U.S. Government, that is taking the lead role in a multi-year initiative to consolidate the back office services for multiple different agencies. The objective of this major digital transformation initiative is to create a consolidated, secure, service environment, while reducing cost. We provide the strategic visibility platform for the new deployment. This win demonstrates, once again, the value of our solutions in these changing environments as well as the resiliency of our relationships and incumbency in our customer base.

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. In the quarter, we saw several low-seven-figure deals from multiple financial institution customers as they upgraded their solutions and added capacity to deal with the evolving distributed workforce and expanding threat landscape. Again, our customers come to us for the robustness of our solutions, the speed at which we can react, and the strength of our relationships.

Go-to-Market Activities:

On the go-to-market front, we continue to build out our partnership network to advance our solution deployment.

Recently we announced our collaboration with Oracle to help customers gain end-to-end visibility for service assurance and security of mission-critical applications and services across their hybrid cloud infrastructures. Our vSTREAM and virtual nGeniusONE are now available from the Oracle Cloud Marketplace, offering Oracle Cloud customers best-in-class application visibility and the ability to leverage authentic information contained in application and network traffic for real-time telemetry. This "Smart Data" enables IT teams to gain consistent visibility and perform monitoring and troubleshooting of their critical services, regardless of the application or underlying infrastructure, with the ability to provide the deep forensics needed for faster and more efficient responses.

During the quarter we also signed a multi-year OEM private label deal with a major software infrastructure company that will be using our "Smart Data" as their virtual probe software solution.

Finally, on the sales front, with the integration of our sales teams behind us from last fiscal year's integration initiative, we are gaining traction with some of our cross-selling initiatives as we have seen some existing enterprise service assurance customers starting to purchase security products such as AED or Arbor Edge Defense. Our enterprise customers' elevated interest in on-premises advanced DDOS protection is sparked by the growing dependency on virtual private networks as the main vehicle to connect employees working from home. The integration of our sales teams in the prior year has allowed us to respond to this opportunity rapidly, with clear ownership and training in place when the pandemic hit.

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 first quarter. 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.

Slide #12: Q1 FY'21 Results

Slide number 12 details our results for our first quarter of fiscal year 2021. Revenue declined 1.2 percent over the same quarter in the prior year to 183.8 million dollars. Product revenue declined 5.3 percent and service revenue grew 1.5 percent over the prior year's quarter.

Our first-quarter fiscal year 2021 gross profit margin was 74.6 percent, slightly lower than the same quarter last year. Our "software only" sales were 36 percent of service assurance product revenue as compared to 25 percent in the same quarter of the prior year. Quarterly operating expenses decreased 8.3 percent from the same quarter in the prior year primarily due to continued cost controls and reduced cost for sales and marketing programs, events, and travel primarily due to COVID-19 pandemic related restrictions. We reported an operating profit margin of 11.2 percent compared with 6.5 percent and diluted earnings per share of 17 cents compared with 7 cents in the same quarter in the prior year.

Slide #13: Q 1 FY'21 Revenue Trends: Customer Verticals

Turning to slide 13, I'd like to review key revenue trends for the first quarter. In the enterprise customer vertical, revenue grew 21 percent while the service provider customer vertical declined 20.4 percent.

Approximately 57 percent of total revenue was generated from the enterprise vertical with the remainder from the service provider vertical.

Slide #14: Q 1 FY'21 Revenue Trends: Geographic Mix

Turning to slide 14, this shows our geographic revenue mix, on a GAAP basis. The geographic split between domestic and international was consistent with the same period in the prior year. Additionally, there were no customers that represented 10 percent or more of revenue in the quarter.

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, and short-term and long-term marketable securities of 426.5 million dollars, which is an increase of 37.4 million dollars since the end of the fourth quarter of our last fiscal year. Our cash and marketable securities balance represents more than 6 months of normal working capital requirements. Free cash flow generated in the quarter was 38.1 million dollars. In accordance with our near-term capital preservation priority, and as Anil mentioned, given the current economic environment and uncertainties as a result of the COVID-19 pandemic, we did not repurchase any shares of our common stock during the quarter and do not plan to use our share repurchase program in the second-quarter of the fiscal year.

From a debt perspective, as of the end of the first 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, providing potential borrowing capacity if needed. Our revolving credit facility expires in January of 2023 and has no required principal repayments until maturity.

To briefly recap other balance sheet highlights, accounts receivable, net, was 138.8 million dollars, down by 74.7 million dollars since the end of March. DSOs were 57 days versus 73 days at the end of fiscal year 2020 and for the same quarter last year as well. The decrease in the DSO's in the first quarter of this year compared with the first quarter of the prior year is primarily attributable to the timing of orders within the quarter.

Let's move to slide 16 for some commentary on the full fiscal year 2021.

Slide #16: FY'21 Commentary

As Anil stated in his remarks, given the continuing evolution of the 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 related items for our second quarter of fiscal year 2021. For the quarter, we expect the tax rate to continue to be approximately 23 percent. Additionally, we expect the diluted shares outstanding for the quarter to be approximately 74 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 17.

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