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

October 29, 2020

Tony Piazza: Introduction

Thank you, operator, and good morning everyone. Welcome to NETSCOUT's second-quarter fiscal year 2021 conference call for the period ended September 30, 2020. Joining me today are:

- Anil Singhal, NETSCOUT's president and chief executive officer;
- 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 outlook, 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, 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 the 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 …

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 second-quarter non-GAAP results.

Slide #6: Q2'21 Financial Results

- We delivered solid earnings per share growth on lower revenue of 205.3 million dollars compared with the same quarter last year.
- Earnings per share was 38 cents in the quarter, an increase of more than 35 percent compared with the same period last year.
- Both service provider and security revenue grew in the quarter but were more than offset by a decline in spending in the U.S. federal government sector, which impacted enterprise revenue.
- The quarter benefited from our focus on cost control as well as pandemic related travel restrictions.

Let's move to slide 7 for some further perspective on the business and market trends.

Slide #7: Business Insights and Market Trends

Service Provider Customer Vertical

In the service provider vertical, revenue grew approximately 4 percent compared with the same quarter last year. We continue to work with our service provider customers on their 4G LTE evolution projects internationally and on their 5G projects domestically and in certain Asian regions.

Given that the 5G build-out is one of our catalysts for future growth, I want to provide some insight as to where we see the market right now, and how it may evolve. Currently, many North American carriers have 5G offerings utilizing their 4G networks. These services are operated on what is called a "non-standalone" 5G network. Over time, carriers and others will need to build new "stand-alone" 5G networks to support future use cases and ultimately a larger volume of traffic. These "standalone" 5G networks will be software or virtual installations given that they will be more distributed at the edge in order to deliver on the promise of enhanced bandwidth, higher-speed, and low-latency to support 5G use cases like industrial automation, telemedicine, autonomous transportation and drones, augmented and virtual reality gaming, the Internet-of-Things, etc.

Last year, we discussed a few projects we won related to radio frequency propagation modeling or calibration, which is a precursor to 5G as the providers plan out their networks based on signal data collected. From NETSCOUT's perspective, although we participate in all phases of the 5G evolution from planning, development, deployment, and monitoring, we believe that we will see the largest benefit once the "standalone" networks are deployed and traffic is flowing over the networks. Therefore, we see 5G as a bigger revenue opportunity for our next fiscal year and beyond, yet a major R&D investment now. In the short term, our 5G roadmap, investments, and leadership will be one of the key enablers for securing our incumbency and for driving our 4G user plane monitoring business.

Michael will highlight some of this quarter's service provider customer wins during his remarks.

Enterprise Customer Vertical

In the Enterprise vertical, revenue declined approximately 14 percent over the same quarter last year. This was primarily attributable to lower spending in the federal government sector in our second quarter, which declined more than 60 percent. As we have previously mentioned, despite having a solid pipeline of user-approved projects in the federal government sector, the timing and magnitude of funding for these initiatives has been challenging to predict in the current environment. Removing federal government revenue from the comparison, enterprise revenue would have grown in the low-single-digits in the quarter. Even with this quarter's decline in enterprise revenue, the vertical has grown 1 percent year-to-date as strong performance in our security offerings helped offset muted federal government spending.

In this vertical, customers continued to advance their digital transformation, cloud migrations, and security initiatives with even greater urgency as a result of the pandemic and the "new normal" of operating with remote resources and interacting with their customers in a more virtual fashion as they work to address speed, agility, and cost.

On the security front, the threat landscape continues to evolve rapidly, and the pandemic has created more opportunities for bad actors to disrupt organizations given their distributed operations. Last month, we issued our First Half 2020 Threat Intelligence Report, which highlighted how cybercriminals are exploiting the pandemic through a radical change in the DDoS attack methodology they are using. The report discussed how cybercriminals launched record-breaking DDoS attacks on online platforms and other services crucial during the pandemic and in an increasingly connected world. These attacks targeted ecommerce, education platforms, financial services, and healthcare services. These multi-vector attacks were shorter, faster, harder-hitting, and more complex. These new methodologies put pressure on security teams as they have less time to react to defend their organization's systems making their jobs much more difficult and highlighting the need to have strong DDoS detection and mitigation solutions like ours. This dynamic has certainly played an important part in the strong performance of our security solutions in the quarter and year-to-date.

Michael will highlight some of our enterprise wins related to these trends during his remarks.

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

Slide #8: Outlook & Summary

Our business and operations have proven to be largely resilient as we navigate the global pandemic and macroeconomic uncertainty. This is due to our relevant solutions, trusted brand, strong customer relationships, dedicated team, and solid financial profile. That said, we are not immune from the impacts of the COVID-19 global pandemic.

As we evaluate the outlook for the remainder of the fiscal year, we remain cautious given the uncertainty around the pandemic and the resulting macro-economic environment. These dynamics have caused elongated purchasing cycles, making the timing, magnitude, and funding for deals difficult to predict, which we anticipate will negatively impact our traditionally stronger second half of the fiscal year financial results. As a result, we now expect fiscal year

2021 revenue to decline in the mid-to-upper single digits, on a percentage basis, compared with fiscal year 2020. Despite the revenue decline, we are committed to delivering annual non-GAAP earnings per share in-line with our fiscal year 2020 non-GAAP earnings per share as we continue to prudently manage our cost structure.

In closing, we are pleased with our ability to serve our customers' visibility and security needs while ensuring the safety and productivity of our team, as we execute our strategy and deliver stable results in this tough and uncharted COVID-19 environment. We appreciate the continued dedication and support of our employees and other stakeholders as we navigate the global pandemic. With long-term market trends in our favor, such as, digital transformation, cloud migration, increased cyber threats, and 5G networks, NETSCOUT is well-positioned as "Guardians of the Connected World" when we emerge from this global crisis.

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

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

Slide #10: 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, as Anil mentioned, our service provider vertical had solid growth in the quarter as we continued to see 4G expansions in our international customer base and 5G trials in North America as we await the 5G investment cycle.

A notable international 4G win in the quarter was a multi-year, eight-figure software and support deal for a major European carrier – a long standing loyal customer - that provided mid-seven figures of revenue in the quarter. The investment enables the carrier to expand their 4G capacity and positions them to transition to 5G solutions in the future.

On the 5G front, we won a low-to-mid seven figure user trial with a tier-1 North American carrier as they start to explore a "standalone" 5G network. It is still early days for North American "standalone" 5G visibility projects, but this is a good sign of progress.

Both deals demonstrate the trust in our brand, the strength and value of our solutions, and the importance of our incumbency with our loyal customer base.

In the enterprise vertical, service assurance solutions have continued to be highly relevant and are producing important new logos for us in the financial, healthcare, and other sectors.

During the quarter, one new logo and deal we won was with a large, domestic medical provider with over one-thousand beds and more than 1.5 million patient visits annually. This was a low to mid-seven-figure deal to implement our visibility platform, in a fully virtualized deployment with extensions into the cloud, for this provider's patient management system. The scale and completeness of our solution as well as the expertise of our team won us the deal over multiple competitors with only partial solutions.

On the international front, another new logo and competitive win, was a low-seven-figure deal with a major stock exchange that needed a faster and more reliable solution to triage and troubleshoot application problems. They selected our service assurance solutions because of our rich data source and strong analytical capabilities, which solved their challenges as we replaced a major competitor's solution that was falling short of their expectations.

In both of these cases, we secured these new customers as a result of our reputation as a trusted leader in service assurance with innovative and reliable solutions, but have also identified DDoS opportunities to expand these relationships as we leverage our cross-selling capabilities through our integrated sales team.

On the security front, which spans both our service provider and enterprise verticals, we continue to experience growing interest in our DDoS protection, especially as the sophistication and volume of attacks grow quickly as we outlined in our First Half 2020 Threat Intelligence Report, which Anil referenced.

During the quarter we successfully thwarted extortion attacks on large US customers, prompting even more attention on this space and on our solutions' strength. This level of protection requires on-premise deployments, such as our Arbor Edge Defense solution, both for rapid responsiveness and sophisticated layer 7 protection. The demand for our AED-based solutions has increased due to large customers redesigning their infrastructure, settling in for remote work for the long run, after the initial rush to shore up defenses when the pandemic started. This trend is exemplified in a mid-six-figure deal with a large insurance company domestically and a low-seven-figure deal with a leading international stock exchange. We are excited about our ability to provide these solutions to our customer base through a well-trained, unified, world-wide sales force.

Go-to-Market Activities:

On the go-to-market front, we continue to build our brand as a strategically critical partner to leading virtualization and cloud providers.

In October, we participated in the annual VMworld event as a "Technology Alliance Partner." There were more than 150 thousand participants that joined the virtual event over the 10-day duration. We presented and showcased our advanced application performance management and troubleshooting capabilities in VMWare's virtualized and AWS cloud deployments. Also, recently our AWS Migration ISV Partner Competency has been approved, meaning that AWS certifies to customers that NETSCOUT has been vetted, validated, and verified against a high-bar and that AWS will promote NETSCOUT through the AWS Sponsorship program.

On the security front, during the quarter, Omdia, a global research leader in technology, ranked NETSCOUT Arbor as the top and largest vendor in the DDoS market, highlighting our new security investments around visibility and threat analytics. Finally, as a leader in our industry, and as Anil discussed, in September we published our semi-annual Threat Intelligence Report. Our report was picked up by approximately 50 publications and translated into 5 languages as our Threat Intelligence Report is considered an industry bellwether report.

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 second quarter and first-half fiscal year 2021 metrics and our outlook. 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: Q2 and First Half FY'21 Results

Slide number 12 details our results for our second quarter and first half of fiscal year 2021. Focusing on the quarterly performance, revenue declined 5.1 percent over the same quarter in the prior year to 205.3 million dollars. Product revenue declined 10.5 percent and service revenue declined 0.3 percent over the prior year's quarter.

Our second-quarter fiscal year 2021 gross profit margin was 74.7 percent, down 1.9 percentage points over the same quarter last year due to product mix, most notably increased radio frequency propagation modeling project revenue with much lower gross margins. Our "software only" sales were 27 percent of service assurance product revenue compared with

20 percent in the second quarter of the prior year. Quarterly operating expenses decreased 15.4 percent from the prior year, primarily due to continued cost controls and pandemic related travel restrictions. We reported an operating profit margin of 19.4 percent compared with 14.6 percent in the same quarter last year. Diluted earnings per share was 38 cents compared with 28 cents in the same quarter last year.

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

Turning to slide 13, I'd like to review key revenue trends for the first half of the year. For the first six months of fiscal year 2021, the service provider customer vertical revenue declined approximately 8 percent while the enterprise vertical grew approximately 1 percent.

The service provider and enterprise verticals each contributed approximately 50 percent of total revenue for the first six months of the fiscal year.

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

Turning to slide 14, which shows our geographic revenue mix, on a GAAP basis. Revenue by geography was 58 percent in the United States and 42 percent internationally. There were no customers in the quarter or the first half 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 427.8 million dollars, which is an increase of 1.3 million dollars since the end of the first quarter. Free cash flow generated in the quarter was 8.3 million dollars. We did not repurchase shares of our common stock during the quarter.

From a debt perspective, as of the end of the second 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 169.7 million dollars, down by 43.8 million dollars since the end of March. DSOs were 65 days versus 73 days at the end of fiscal year 2020 and 79 days at the same time last year. The improvement in the DSO's in the second quarter of this year compared with the second quarter of the prior year is primarily attributable to the timing of orders within the quarter.

Slide #16: FY'21 Outlook

Let's move to slide 16 for our outlook, from a non-GAAP perspective.

FY'21 Outlook

As Anil stated in his remarks, for fiscal year 2021, we expect revenue to decline in the mid-to-upper single digits, on a percentage basis, compared with fiscal year 2020. Despite lower revenue, we anticipate delivering annual earnings per share in-line with our fiscal year 2020 earnings per share number as we continue to prudently manage our cost structure.

For the second half of the fiscal year, we anticipate that the remaining earnings per share performance should be more equally distributed between our third and fourth fiscal quarters than it was in the prior fiscal year. Given the current pandemic conditions and our cost management focus, we anticipate that our third quarter operating expenses will be in-line with our second quarter operating expense results.

I also want to comment on a few capital structure related items for fiscal year 2021. We expect the tax rate to be approximately 23 percent. Additionally, we expect the diluted shares outstanding for the year 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 upcoming IR conference participation is listed on slide 17.

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