NETSCOUT SYSTEMS, INC.
Fourth-Quarter & Fiscal Year 2017 Financial Results Conference Call
Management's Prepared Remarks

May 4, 2017

A. Kramer: Introduction

Thank you and good morning everyone. Welcome to NETSCOUT'S fourth-quarter and fiscal year 2017 conference call for the period ended March 31, 2017. I'm joined today by:

- Anil Singhal, NetScout's co-founder, 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, which can be accessed on the investor relations section of our website at www.netscout.com. You can advance the slides in the webcast viewer to follow our commentary. We will try call out the slide number we are referencing in our remarks.

Today's agenda will be consistent with prior quarters. Our CEO, Anil Singhal, will share his perspective on our results, key trends and highlights, and our outlook for fiscal year 2018. Our COO Michael Szabados will briefly highlight notable go-to-market activities and key wins. Our CFO Jean Bua will then provide greater detail and insight into our financial results, and review our fiscal year 2018 guidance.

Slide #3: Safe Harbor Statement

Moving on to slide #3, I would like to remind everybody listening that forward-looking statements as part of this communication are made pursuant to the safe harbor provisions of

Section 21E of the Securities Exchange Act of 1934, as amended, and other federal securities laws. Investors are cautioned that statements in this conference call, which are not strictly historical statements, including but not limited to, the statements related to the financial guidance and expectations for NETSCOUT, market conditions and customer demand, and all of the other various product development, sales and marketing, expense management, integration and other initiatives planned for fiscal year 2018 and beyond, constitute forward-looking statements which involve risks and uncertainties. Actual results could differ materially from the forward-looking statements due to known and unknown risk, uncertainties, assumptions and other factors. This slide details these factors, and I strongly encourage you to review each and every single one of them. For a more detailed description of the Company's risk factors, please refer to the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2016 and subsequent Quarterly Reports on Form 10-Q, which are 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. This slide, which we also encourage you to read, provides information about the use of GAAP and non-GAAP measures because non-GAAP measures are not intended to be superior to, or a substitute for, the equivalent GAAP metric. Non-GAAP items are described and reconciled to GAAP results in today's press release and they are included at the end of the slide presentation that is made available online on our website.

As a reminder, our acquisition of the Danaher Communications Business was completed on July 14, 2015 and as such, the results for the full fiscal year 2017 are skewed in comparison with fiscal year 2016. To provide an "apples-to-apples" comparison between these two fiscal years, we have provided additional non-GAAP, pro forma details so that you can better understand the key performance trends as well as gain further context for our fiscal year 2018 guidance. Reconciliations between the GAAP and non-GAAP pro forma financials are provided in the presentation's appendix.

As we detailed in our press release today, we delivered a strong finish to the fiscal year and achieved the key financial and strategic milestones we laid out at the start of the year. We've continued to make good progress on fortifying our incumbency in key accounts and on delivering on our new product cycle. With that as a high level background, I will turn the call over to Anil to provide some further context on our non-GAAP results, recent achievements and our outlook for the coming fiscal year. Anil, please go ahead.

Anil Singhal:

Thank you, Andy. Good morning everybody and thank you for joining us. Let's begin on slide 6 with a recap of our recent results.

Slide #6: Q4 & FY'17 Results

We enjoyed a solid finish to the quarter that enabled us to achieve our fiscal year 2017 targets with non-GAAP revenue of $1.2 billion, a gross margin of 75.2 percent, an operating profit margin of 23.0 percent and diluted EPS of $1.92 per share.

Jean will review our performance in more detail, but I will share a few brief observations:

- Total revenue was essentially unchanged from the prior year's revenue on a pro forma basis.
- In the service provider vertical, exceptionally strong revenue growth within our Arbor security product area was offset by the decline in our service assurance product area. Excluding one of our tier-one service providers who delayed larger orders during the second half of the year, we were encouraged that NETSCOUT's service assurance revenue grew by double digits.
- In the enterprise, mid-single digit growth for our nGeniusONE solution and mid-teens growth at Arbor was offset by declines within the legacy Fluke enterprise product lines arising from product rationalization and the ramping of new manufacturing and distribution channels. We've put these issues behind us and expect any related impact to be minimal in fiscal year 2018.
- Overall, our cybersecurity product area was a standout performer with exceptional growth that reflected the combination of a surge in capacity expansion initiatives and

new customer wins following highly publicized, advanced distributed denial of service (DDoS) attacks and a spike in service provider spending related to a transition in product offerings.

- In terms of profitability, we delivered our second consecutive year of 200 basis points of operating margin improvement.
- We've continued to solidify our market and technological leadership in both verticals.
- We've fully integrated the key assets we acquired from Danaher and we've made excellent progress on our new product cycle. Our innovations are aimed at further elevating our value proposition to customers and helping drive substantial ROI on their technology infrastructure by protecting their networks from attack, resolving network and applications issues faster and more efficiently, advancing digital transformation initiatives with confidence, and using our data to make superior technical and business decisions. Let's move to slide number 7 to cover this progress.

Slide #7: Recent Financial Results and FY'18 Guidance

This slide helps illustrate our progress since acquiring the Danaher Communications Business nearly two years ago, and frame it against our outlook for fiscal year 2018.

Over the past two years, we expanded our operating margin by more than 400 basis points, while maintaining the revenue line and addressing a range of integration challenges. We've diligently managed our cost structure, retained key talent and invested in a major expansion of our product line through both organic innovation and by integrating various acquired assets which we've acquired. As we move into fiscal year 2018, we expect to once again improve our operating margin by another 200 basis points. We plan to achieve this largely by moving to higher software content in our products, which also bring higher gross margins.

In the service provider market, 4G/LTE technology is now a mainstream deployment, enabling a significant rise in OTT traffic from 4G subscribers that is straining their infrastructure and associated CapEx. At the same time, revenue growth is proving elusive for mobile operators, partly due to competitive "all-you-can-eat" calling and data plans and that's forcing them to limit their capital spending. This has created a headwind that all vendors have been navigating for the past couple of years, and we anticipate continued near-term spending challenges, particularly with certain tier-one service providers in the US. In such an environment, delivering a lower-priced software solution for service assurance use cases, without compromising the associated value, is becoming increasingly appealing to major service providers.

We recognized this opportunity some time ago and we have been evolving our solution for service providers through a software strategy that can help these customers maximize the utilization of their service assurance budgets while also enabling us to solidify our incumbency, gain greater top-line certainty via multi-year deals, and win new business in a price-sensitive market while substantially increasing our gross margins. Our new InfiniStreamNG platform is now available in software form and combines the best features from the legacy NETSCOUT and former TekComms platforms. We've made excellent progress thus far with this new software strategy with our carrier and cable customers on multiple fronts. Last quarter, we announced a 5-year, 75 million dollar deal with a US tier-one carrier who is using NETSCOUT technology to consolidate its service assurance vendors and gain more pervasive visibility. Yesterday, we announced another significant, multi-year agreement with Vodafone Group in Europe.

Under this multi-year agreement with Vodafone, NETSCOUT will serve as Vodafone's exclusive service assurance solutions provider across 13 countries in Europe. By working closely with Vodafone to understand its longer-term network plans, we have structured an agreement that enables them to enjoy the benefits of a standardized, repeatable service assurance solution across Europe while efficiently and pervasively deploying our InfiniStreamNG software on commercial off the shelf (COTS) servers. This milestone agreement has fortified our relationship with Vodafone and further showcases the unequivocal market appeal of our new InfiniStreamNG platform in the software-only form factor. We've already started shipping software to Vodafone under this agreement and look forward to supporting broader adoption of our solution going forward. Over the coming years, we believe that this deal will generate healthy, consistent revenue levels, accelerate sales cycles, and create new opportunities for NETSCOUT. Looking ahead, we're confident that there'll be many more service providers who will deploy our software in fiscal year 2018. Based on deals that we've already completed, we believe that the software-only version of our InfiniStreamNG could represent between 8 to 10 percent of product revenue in fiscal year 2018, and we are aggressively pursuing a range of opportunities to further expand the contribution from this platform.

Overall, we continued to see attractive opportunities for growth in our enterprise service assurance and cybersecurity product areas as we expand the breadth and depth of our product portfolio. By executing well on those fronts, we believe that we can drive high single-digit to low double-digit growth in the enterprise and mitigate an anticipated decline in the service provider vertical as we accelerate the transition to our software only solution with service providers. Our goal is to exit the year in an excellent position to resume top-line growth in FY19 and beyond, while continuing to enjoy further gross margin and operating margin expansion.

Slide #8: Delivering on an Exciting New Product Cycle

Moving to slide 8, NETSCOUT is focused on delivering true business assurance to our global customer base by addressing their service assurance and security assurance requirements. As a reminder, the basis of our technology platform is our patented Adaptive Service Intelligence technology, or ASI, that converts network traffic data or wire data into structured metadata or "smart data" in real time. ASI is enabling us to deliver an expanding range of analytics spanning network, application and infrastructure performance management, cybersecurity and business intelligence.

As you may recall, the first proof point of our integration effort occurred last summer when we introduced our new InfiniStreamNG real-time information platform. This platform is available in multiple form factors – from traditional appliances to software for use with COTS servers that the customer procures and in virtualized form to monitor private and public cloud environments, virtualized network functions (NFV) and traditional IT server farms.

As I've detailed, service providers are increasingly recognizing that deploying our InfiniStreamNG software can help them instrument deeper into their network infrastructure, and in the process, open new doors for us around our newest capabilities spanning NFV, IoT, video monitoring, radio access networks, and big data analytics. Our big data analytics solution, for example, will be generally available to service providers later this quarter.

In the enterprise, we are advancing three exciting new product initiatives that we believe will help us build on our momentum. First, later this month, we plan to launch new solutions that enable organizations to confidently migrate applications and workloads to private and public clouds, as well as gain increased visibility into traditional physical and virtual server farms. Second, we plan to add complementary, new capabilities for infrastructure performance management (IPM). This offering, which will be introduced within the next several months, will enable customers to leverage their nGeniusONE investments to monitor the performance of software-as-a-service applications, network devices and servers rather than spending heavily on dedicated third-party IPM tools. Third, we are also advancing product integration and cross-selling between Arbor and NETSCOUT. Later this summer, we plan to integrate our InfiniStreamNG with Arbor's Spectrum advanced threat analytics which help enterprise security teams to quickly and accurately detect and confirm hidden threats. We also plan to leverage our enterprise service assurance salesforce to market Spectrum into our installed enterprise customer base while also taking advantage of NETSCOUT's historically strong federal presence to sell both Spectrum and our DDoS solutions to government agencies.

Slide #9: Outlook

We are very excited to bring all of these new products and capabilities to the marketplace, which brings us to slide number 9 for our outlook. As we move into fiscal year 2018, we look forward to delivering another good year of improved profitability and EPS growth. More specifically, we anticipate that accelerating the transition to our new software platform will help increase gross margins by one to two percentage points and serve as the primary driver for operating margin gains in fiscal year 2018. While we are excited about the potential of our newest products, we are taking a relatively cautious view on their contributions this year since many of them have yet to be officially launched and it will likely take at least a few quarters for them to gain significant traction. Consistent with prior years, we expect to generate the majority of revenue and profits in the second half of the fiscal year.

Finally, I'd like to thank my colleagues across NETSCOUT for their efforts in fiscal year 2017 and for their unwavering commitment to delivering world-class products and support to our customers around the globe. That concludes my remarks. I'd like to turn the call to Michael at this point for his commentary.

Slide 11: COO Highlights

Michael Szabados:

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

Go-to-Market Activity:

As you may know, we begin every fiscal year with our annual Sales Kick Off event and our Engage User Conference. This year's Engage had record attendance with CIOs, CSOs, and senior-level network, cybersecurity and line-of-business professionals from over 300 organizations representing every major vertical as well as NETSCOUT distribution partners. It was invigorating to see the enthusiasm of our sales teams and our customers for our newest products that are being delivered according to the timetables that we laid out for them last year. We see our "smart data" technology becoming even more important to our customers as they advance their digital transformation projects. I will integrate some of the feedback we received from our customers at Engage as I review several notable wins.

Wins / Use Cases:

Our carrier and cable customers at Engage were impressed by the way that we've brought the former TekComms and NETSCOUT technologies together to provide a seamless user experience while enabling them to access next-generation analytics and cost-effectively expand their visibility via the software-only version of our real-time information platform. This is exemplified by our recent win with Vodafone, and I look forward to sharing details of another software-only win in the Asia Pacific region next quarter.

In the enterprise, we closed approximately three million dollars in orders during the fourth quarter with a global payments technology leader in support of multiple projects. One of this long-standing customer's orders was for consolidating their service triage tools by standardizing on our nGeniusONE platform and moving away from a dual-sourced vendor strategy that had included Riverbed's Opnet products. Another order involves the build-out of two new next-generation data centers using the latest SDN and private cloud technologies.

Customers like this one understand that they cannot afford to be blind to issues impacting the performance of mission-critical applications, regardless of whether the applications or their various components run in legacy data centers or in the private or public cloud. That's why there was genuine excitement at Engage about the upcoming launch of our new server-based ASI software instrumentation, which seamlessly extends our monitoring and diagnostic workflows from applications running on on-premises physical and virtual servers to applications running in hybrid, private and public cloud environments. There was also strong interest from customers seeking to learn more about our new infrastructure monitoring and diagnostic product, which will cost-effectively simplify and accelerate root cause analysis by adding device metrics, syslog, and synthetic test results derived from the infrastructure itself to our ASI data set.

Turning to cybersecurity, Arbor delivered an impressive close to an exceptionally strong year. One of Arbor's major highlights was winning one of its largest enterprise orders ever from a major international information services company. This order was over 5 million dollars and grew in scope as the customer recognized the need for global protection against the types of advanced DDoS attacks that have been making front-page news recently. They selected Arbor based on its extensive expertise, global coverage and proven set of products and services that safeguard against both sophisticated application-layer attacks and volumetric DDoS attacks.

At Engage, we showcased our plans to further increase the network and scrubbing capacity in our Arbor Cloud DDoS service and continue enhancing our product portfolio with more software-driven options. Our service assurance enterprise customers were also intrigued by the way we can help them leverage their investment in NETSCOUT technology by using the Arbor Spectrum analytics with our InfiniStreamNG as the source of packet data. This unique combination can make a tangible difference in finding and isolating advanced threats faster, thereby improving the effectiveness of existing security staff by up to 10 times.

In summary, we are pleased with the way we finished fiscal year 2017 and are moving forward focused on a range of sales and marketing initiatives that are aimed at maximizing the impact from this new product cycle over the longer term. That concludes my prepared remarks and I will turn the call over to Jean.

Slide 12: CFO Review

Jean Bua:

Thank you Michael and good morning everyone. This morning, I will review key fourth-quarter and full-year metrics for fiscal year 2017. After that, I will review the guidance for fiscal year 2018. As a reminder, this review will focus on our non-GAAP results, and comparisons between fiscal years 2017 and 2016 are on a pro forma basis unless otherwise noted.

Slide 13: Q4 FY'17 Results

Slide number 13 shows our results for the fourth quarter of fiscal year 2017. As we've previously discussed, we anticipated a large order from one of our service providers that moved from the third quarter of fiscal year 2017 into the fourth quarter, and then it actually moved out of fiscal year 2017. Despite that delay, our teams around the globe worked diligently to be able to achieve our annual financial targets.

For the quarter, total revenue increased 6 percent to 327.2 million dollars, our operating profit margin was 27.5 percent and our diluted earnings per share was 65 cents per share. For the quarter, income from operations grew approximately 30 percent on revenue growth of 6 percent. This performance illustrates the operating leverage that can be achieved as we execute on our strategy since we believe we have already made the necessary investments in our R&D and go-to-market teams that are focused on building our positions across all segments of our total addressable market.

Slide 14: FY'17 Full-Year Results

Turning to our full-year results on slide 14, our total revenue was comparable to the prior year's total revenue. Service revenue grew by two percent while product revenue declined by one percent. Our gross margins improved slightly as favorable shifts in product mix more than offset the impact of long lead-time projects involving lower margin, legacy products from the former TekComms product area. Operating expenses declined more than 3 percent over the prior year due mostly to reductions in personnel-related costs. Our operating margin improved by 200 basis points to 23 percent on relatively flat revenue. Our effective tax rate for the year on a non-GAAP basis was 32.6 percent, which reflects the benefit of taking advantage of certain foreign tax credits, including some for prior years that were applied retroactively. The lower effective annual tax rate contributed about two cents to our earnings per share. For the fiscal year 2017, our net income was 178.5 million dollars.

Slide 15: FY'17 Revenue Trends: Customer Verticals

Slide 15 shows our two customer verticals, Service Provider and Enterprise from a revenue performance perspective and a revenue composition perspective.

Despite the spending pressure facing many of our largest service provider customers, our overall service provider vertical remained relatively flat on a year-over-year basis. Within this vertical, our service assurance product area declined about 10 percent due to the delayed spending by one of our large tier-one providers. Excluding this service provider's revenue from both years, our service assurance portion grew by about 25 percent. Additionally, within the service provider vertical, our cybersecurity revenue increased by about 40 percent. A major driver of our cybersecurity growth was tied to a transition in product offerings. Without this product cycle transition, revenue growth would have been in line with the market growth of low double-digits as DDoS became a higher priority item for both new and existing customers following high-profile attacks this past fall.

Turning toward the enterprise vertical, overall revenue increased by about half of a percent. Within this vertical, our legacy nGeniusONE revenue grew by 5 percent. We grew 12 percent across all non-federal government and commercial sectors, including financials. This growth was partially offset by a decline in the federal sector, which is common in an election year. Our cybersecurity products grew by 14 percent due to heightened awareness of vulnerability to DDoS attacks. As previously noted, the nGeniusONE and cybersecurity growth was offset by a decline in the former Fluke product areas of about 17 percent due to both product rationalization and the transition of manufacturing and distribution channels.

Regarding the composition of the revenue, in fiscal year 2017, service provider represented 56 percent of total revenue with enterprise representing the balance. This is unchanged from the prior year.

Slide 16: FY'17 Revenue Trends – Geographic Mix

Slide 16 highlights revenue by geography, which is calculated on a GAAP basis. For fiscal year 2017, our international business represented 37 percent of total revenue versus 30 percent in the prior year. Our revenue from international markets grew about 28 percent on a year-over-year basis with all geographies contributing. This growth primarily reflects the completion of certain long lead time, legacy projects within our international service provider vertical along with higher demand from overseas operators due to the combination of 4G becoming more mainstream in certain geographies and the build out and further expansion of 4G infrastructures in emerging markets.

Slide 17: Balance Sheet Highlights, Free Cash Flow and Share Repurchase

Slide 17 details our balance sheet highlights and free cash flow. We generated free cash flow of 195.7 million dollars in fiscal year 2017. Excluding exceptional items and one-time events tied to the Danaher transaction, our normalized free cash flow was approximately $165 million for fiscal year 2017. This represents a free cash flow conversion to non-GAAP net income of about 92 percent. For the fiscal year 2018, we believe that free cash flow conversion to non-GAAP net income should be about 100 percent.

As it relates to our financial profile, with 500 million dollars of credit available on our existing facility and the higher level of cash on the balance sheet, our liquidity now stands at 965 million dollars and our gross leverage remains at the lower end of our target range.

Share Repurchase Activity

In terms of our share repurchase activity, we repurchased 21 thousand shares of our common stock this past quarter. For the second consecutive quarter, the strong, swift rise in our stock price limited our repurchase activity under the parameters that were approved by the Board and put in place shortly after announcing last quarter's results. For the year, we repurchased approximately 3.1 million shares at an average price of $25.41 for a total consideration of 80 million dollars, or roughly 45 percent of our adjusted free cash flow.

At present, we have approximately 6.8 million shares remaining on the 20 million shares authorized for repurchase. With significant cash on hand and modest debt, we believe we have sufficient resources to meet our capital deployment priorities. Returning excess cash flow to shareholders through our share repurchase activities continues to be a high priority, and we expect to be active in the market during the first fiscal quarter of fiscal year 2018. As the two-year anniversary of the Danaher Communications Business acquisition approaches, we are also working with our Board to review our financial policies which includes our share repurchase program. We appreciate the feedback and perspectives that our shareholders have shared with us on this matter.

To briefly recap other balance sheet highlights, accounts receivable, net, increased by 19 percent from the end of the last fiscal year as a result of overall product mix shifts and the timing for service renewals. DSOs were 80 days, which is unchanged from this time last year and down slightly from 83 days in the third fiscal quarter.

Slide 18: FY 2018 Guidance

Let's move to slide 18 for guidance. The reconciliation of our GAAP guidance to our non-GAAP guidance is in the appendix.

FY'18 Guidance

Based on our current pipeline of opportunities, we expect that our fiscal year 2018 revenue will be relatively unchanged from fiscal year 2017 levels. As Anil discussed, ongoing adoption of our software-only platform is expected to play an important role in improving our gross margins in fiscal year 2018 and delivering a 200-basis point improvement in operating profitability over last year to 25 percent. Correspondingly, we are targeting diluted EPS growth over last year that will range from the mid to high single digits. As a reminder and consistent with prior practices, our earnings per share guidance does not yet reflect any share repurchases. As is our practice, we will update the EPS guidance range based on the share repurchase activity.

Supporting our overall view on revenue is the expectation that we will drive strong high single-digit to low double-digit percentage growth in the enterprise customer vertical. This reflects ongoing momentum for our nGeniusONE product suite, and attractive growth prospects within our cybersecurity offerings, while taking a conservative view on the contribution from the slate of new products that are coming to market soon. We currently anticipate that this growth will be offset by an expected top-line decline in the high single-digit percentage range in our service provider vertical that primarily reflects continued near-term spending delays, particularly with certain tier-one service providers in the US.

Q1 Revenue & EPS Outlook

In terms of the phasing of quarterly revenue, we expect the majority of our revenue and profits to be generated in the second half of our fiscal year, which is consistent with the Company's historical performance. More specifically, we have traditionally generated around 45 percent of total revenue in the first half of the fiscal year. We currently anticipate a more muted start to the year with around 40 percent of fiscal year 2018 coming in the first half and a high teens contribution from our first quarter. That would translate into a year-over-year decline in the first-quarter's revenue in the high teens on a percentage change basis. This view primarily reflects two factors:

- First, the year-ago quarter included significant orders from a tier-one service provider. We expect revenue from that same customer this quarter to be lower by around 35 million to 40 million dollars as they delay larger-sized purchases. This dynamic, combined with a difficult comp at Arbor, will contribute to a tough quarter in service provider; and
- Second, although we are launching many new products within the Enterprise vertical, we anticipate that the pipelines will still be in development with initial revenue beginning to be recognized in the second half of the year.

In terms of our cost structure, we plan to maintain relatively flat operating costs across the board for the full year, and anticipate that first-quarter expenses will be down in the mid-single digit percentage range over the prior-year period. For other modeling assumptions, we expect interest and other expense to be between 10 to 12 million dollars for the year. We currently anticipate a full year tax rate between 33 percent to 34 percent.

Based on approximately 93 million shares outstanding, this would translate into a diluted EPS range for the first quarter of five to eight cents.

Slide 19: Upcoming Investor Events

That concludes my formal review of our financial results. Before we transition to Q&A, I'd like to emphasize our ongoing commitment to proactive outreach with our shareholders. Slide number 19 highlights the various investor conferences we plan to participate in over the next couple of months.

That concludes our prepared remarks this morning. Thank you again for joining us and we're now ready to answer questions. Operator, you may now begin the Q&A session.