NETSCOUT

NETSCOUT SYSTEMS, INC.
Fourth-Quarter and Full-Year Fiscal Year 2018 Financial Results Conference Call
Management's Prepared Remarks

May 3, 2018

A. Kramer: Introduction

Thank you [operator] and good morning everyone. Welcome to NETSCOUT'S fourth-quarter and year-end fiscal year 2018 conference call for the period ended March 31, 2018. Joining me today are:

- 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. Both the slides and the prepared remarks can be accessed on the investor relations section of our website at www.netscout.com. The slides can be advanced in the webcast viewer to follow our commentary. We will call out the slide number we are referencing in our remarks.

Our agenda is as follows: Anil Singhal will briefly review our performance and then address certain questions that we believe are on the minds of investors. Michael Szabados will briefly review customer adoption trends and major go-to-market highlights. Jean Bua will then review our fourth-quarter and full-year results and detail our fiscal year 2019 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 on this conference call, which are not strictly historical statements, including but not limited to, the statements related to the fiscal year 2019 financial guidance for NETSCOUT; market conditions, technology trends, customers and customer demand; anticipated revenue from specific customers and specific products; share repurchase activity; and all of the other various product development, sales and marketing, expense management and other initiatives planned for fiscal year 2019, constitute forward-looking statements which involve risks and uncertainties. Actual results could differ materially from the forward-looking statements due to known and unknown risks, uncertainties, assumptions and other factors. This slide details these factors, and I strongly encourage you to review each 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, 2017 and the 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 those and other reconciliations and supplemental detail are included at the end of the slide presentation, which is available on our website.

We reported diluted EPS that was at the higher end of the updated guidance we provided in January even though revenue was relatively weak. Despite the year's results, there were some positive developments that lead us to be optimistic about our prospects in fiscal year 2019. I will now turn the call over to Anil for his perspective on these and other matters. Anil …

Anil Singhal:

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

Slide #6: Q418 & FY'18 Highlights

We reported fourth-quarter revenue of 238.5 million dollars, and full-year revenue of 999.3 million dollars, which approached the low end of the guidance range we provided in January 2018. However, the EPS performance for both the fourth quarter and the full fiscal year, was reasonably good and at the higher end of the January guidance due to better than expected gross margins and lower operating costs, among other items. Jean will review our results in more detail later on this call.

Although we were unable to achieve our original targets in fiscal year 2018, we made important progress with our product strategy. We have radically reshaped and expanded our product portfolio over the past couple of years since acquiring the Danaher Communications Business. Three years ago, our offerings were largely appliances with varying levels of proprietary hardware with the primary use cases for our solutions being network performance, and distributed denial of service (DDoS). Today, our solutions are software-centric, feature-rich and applicable to a much larger total addressable market that spans beyond network performance and DDoS to encompass application performance, advanced threat and business intelligence.

Due to our substantial investments over the past couple of years, we move forward with optimism that we will start capitalizing on the attractive opportunities we see in fiscal year 2019. Although market conditions are still suboptimal and the transition to new accounting rules may dampen reported results in FY'19, we anticipate resuming revenue growth this year and producing gross margin improvement in the process as we see greater adoption of our software-based offerings. Related to that, we are also advancing plans that we believe will help us further recalibrate our cost structure in ways that can help us improve our underlying operating profitability without compromising our ability to capitalize on near-term and longer-term growth opportunities. With that as the backdrop, I'd like to briefly address what we believe are the most pressing questions we are likely to get from our investors. Let's move to slide number 7 for that.

Slide #7: Top Investor Questions

Question 1: Are the strongest revenue headwinds behind you?

The first question is, are the strongest revenue headwinds behind us? The simple answer is yes. The most severe headwinds were in our service provider customer segment. The acquisition of the Danaher Communication Business brought us a much broader global service provider footprint but the revenue was highly concentrated with two 10 percent-plus customers. Over the last three years, those customers have declined to the mid single-digits as a percentage of total revenue as part of their efforts to reduce capital spending on their 4G network infrastructures. Combined, these two customers represented approximately 10 percent of FY18 revenue with over 40 percent of that revenue coming from a very healthy stream of recurring maintenance and support services. Looking ahead, we expect that spending from these two top service providers customers will remain relatively stable in fiscal year 2019, with improving gross margins, as they continue transitioning to our software-based platform over the coming quarters. Given the overall traffic growth over their networks and the recurring nature of our service and support revenue, we view any potential downside risk from these customers as relatively minimal and very manageable. Just as important, we have made good progress to fortify our incumbency in other service provider accounts by offering a unique solution with appealing price-to-performance characteristics.

Question 2: What is your outlook for your Service Provider customer segment?

This is a natural lead-in to the next question about the outlook for our service provider customer segment. We believe that we can stabilize revenue in this segment during fiscal year 2019 and begin growing as we move into the second half of the year as we further strengthen our competitive position. In service assurance, overall network traffic is still growing but carriers continue to carefully manage their spending, which impacted the timing and magnitude of larger projects during fiscal year 2018. Although spending pressures are likely to persist in the near term, we continue to make good progress driving adoption of the software version of our ISNG platform. For example, of our 20 largest service provider customers in fiscal year 2018, more than half are deploying the software-only version on either bare metal or virtual or both. And as I just mentioned, we expect other large North American carrier customers to migrate to our software platform during fiscal year 2019. In addition, we are seeing opportunities to capture greater wallet share with our existing customers who require cost-effective visibility into their user plane traffic.

While near-term service provider spending is likely to remain muted, we believe that spending on service assurance tools like ours will enjoy reasonable growth over the coming years with 5G and Virtualization now entering the early phases of their lifecycles with the world's largest and most innovative carriers. We have already won some small but strategically important projects with large North American operators to help them plan and design their 5G radio access networks. Michael will cover this in more detail in a moment. Additionally, we are moving into 5G lab testing and planning to support 5G field trials for our core service assurance solutions with certain tier-one customers over the coming quarters. While we are incrementally more positive about 5G as a meaningful long-term revenue catalyst for us, we do not expect substantial contributions from 5G-related projects in fiscal year 2019 and it remains hard to forecast when major investment in 5G networks will begin. Along those lines, the number of deployments, proof of concepts and trials for our network function virtualization, or NFV, monitoring solutions continues to grow. However, we anticipate that spending on these products is likely to remain relatively small this year.

Question 3: Where and why do you expect to see growth in FY'19?

The third question is, where and why do we expect to see growth in fiscal year 2019? Regardless of the accounting transition, we would expect to enjoy much better performance in our enterprise customer segment. As our enterprise customers advance their digital transformation initiatives, we are well positioned to support that transition, consolidate their tools vendors and leverage the network traffic we collect for them for multiple use cases spanning from our stronghold in network performance to application performance and security. We call this approach our "Smart Data Core," and it enables enterprises to deploy our products more pervasively, and cost effectively, by consolidating tools across multiple stakeholders within IT. Over the past several weeks, I have visited with some of our largest enterprise customers, and there is a general excitement among these customers about our direction, which we plan to share more broadly during our annual user forum, in Dallas, in 10 days.

Question 4: What new enterprise budgets will you target in FY'19?

A related question about our enterprise growth prospects is, what new enterprise budgets will we target and sell into during FY'19? Our "Smart Data Core" approach extends our reach beyond network operations as a buying center for our offerings. Last year's introduction of vSCOUT and vSTREAM enables us to extend application visibility much deeper into the application infrastructure, regardless of whether those application servers reside in a traditional data center, private cloud or public cloud environment, thus providing a natural "single pane of glass" with before and after views of performance. As a result, these solutions are increasingly relevant to DevOps and CloudOps teams. We are pleased that the NSX edition of vSCOUT was recently fully certified as "VMware Ready for Networking and Security" under VMware's NSX Partnership Program. We believe that our ability to provide this unique level of visibility into NSX environments offers our mutual customers tremendous value and will add further momentum to our sales efforts. Later on the call, Michael will highlight a recent win that involved our vSCOUT technology.

In enterprise security, we see several opportunities. Within the next couple of months, we plan to introduce a substantially enhanced version of our advanced threat solution with a broader and richer set of analytics that is more tightly integrated with our ISNG and ASI technology so that we can drive cross-selling opportunities into our installed enterprise customer base. Additionally, we're planning to broaden the range of capabilities within the Arbor DDoS enterprise portfolio that are intended to further differentiate it as an edge defense platform while also complementing our advanced threat capabilities. We also plan to introduce new instrumentation that is aimed at cost-effectively collecting and filtering packet data before forwarding it other security tools that they use. This feature, which we call the nGenius Packet Shaper, will optimize our customers' spend, help them consolidate budgets and reduce their total cost of ownership.

Question 5: What steps are you taking to improve your cost structure?

The last question is about our cost structure and what we are doing to adjust it in fiscal year 2019. As we move into fiscal year 2019, we recognize that we must take steps to realign our cost structure with the near-term outlook in ways that do not impede our ability to grow and support our customers. As we look ahead, we are advancing plans for the first half of this year that range from reducing headcount-related personnel costs and aggressively managing discretionary spending to selling certain non-core assets.

In combination, we believe that implementing these plans would allow us to reduce annual run-rate operating costs by up to 50 million dollars from last year's level, although we do not expect to realize the full amount of those savings in FY'19 due to the timing associated with these initiatives. Nevertheless, we believe that these plans will deliver meaningful savings this year to help us absorb higher variable incentive compensation based on achieving certain business results and keep total operating expenses relatively flat with the prior year. As a reminder, our FY'18 expense base benefited from the elimination of variable incentive compensation since we did not achieve our targets.

A key component to accomplishing this will be managing personnel-related costs. Total headcount was down about 3 percent last year as attrition outpaced new hires. We anticipate that the size of workforce will decline at a higher rate in FY19 as we prioritize investment in our next-generation products and adjust resource levels in support of legacy products. Augmenting this activity, we recently closed one of our overseas development offices, consolidated our security and service assurance marketing teams, and plan to reduce spending on certain discretionary marketing programs for the coming year.

Additionally, we are advancing plans to divest the former Fluke Tools product area. As we discussed last quarter, this is a product area that lacks sales and marketing synergy with our broader service assurance offerings. This product area represented just over 4 percent of total revenue last year and approximately 5 percent of our workforce. We believe that selling these assets would help us improve gross margins slightly and lower operating costs. We will be in a much better position to assess the overall impact of our cost-reduction programs when we report our first-quarter results.

Slide #8: Outlook, Long-Term Targets & Summary

This brings us to slide number 8 for our outlook. To reiterate my earlier comments, I expect fiscal year 2019 will be an important year of strategic and financial progress for NETSCOUT. Based on the opportunities we see, we expect to resume top-line growth through higher product revenue over the coming quarters, which will help improve our underlying profitability. However, we are taking a very conservative view on the first quarter due in part to the anticipated impact of adopting the new accounting standard in combination with the relatively fluid timing associated with certain projects. Even if our reported top-line performance in fiscal year 2019 is somewhat muted by the accounting adjustment, we believe there is good potential to drive solid EPS expansion, along with very healthy free cash flow.

Long-Term Targets

Since the completion of the Danaher Communications Business acquisition nearly three years ago, we have navigated a much more turbulent market environment than we originally expected, to preserve our customer base, enhance our competitive position and completely reinvent ourselves as a software company. Although our performance is behind our original plans, we believe that the steps we have taken and continue to take to accelerate the shift to software, expand our reach into adjacent markets and manage our cost base will play an important role in helping us achieve some of our original operating targets. For these reasons, we believe it is time to share a new set of long-term targets.

Over the next four years, I believe we can grow revenue at a compound annual growth rate in the mid-single digit range or better. With the transition to an increasingly software-centric product portfolio well underway, we believe that we can continue increasing gross margins into the low 80-percent range or better. The combination of the solid revenue growth, better gross margins, and limited expense growth should produce meaningful operating leverage to support operating profitability in the low 30-percent range or better. That type of fundamental performance along with the current tax rate and share count would result in a diluted EPS CAGR of greater than 20 percent to more than three dollars per share, along with annual free cash flow in excess of 300 million dollars.

In closing, I would like to publicly welcome two new directors who recently joined our Board. Al Grasso and Susan Spradley are both accomplished executives with very relevant experience, and we look forward to benefiting from their advice and counsel. I would also like to extend our gratitude to our shareholders for their support during the past year. Finally, I want to commend our employees for their resilience, tenacity and hard work, which underpins our commitment to our industry to serve as "Guardians of the Connected World."

That concludes my prepared remarks and I'll turn the call over to Michael at this point.

Slide 10: COO Highlights

Michael Szabados:

Thank you Anil, and good morning everyone. Slide number 10 outlines my plan to cover recent wins and a quick preview of our upcoming user conference.

Customer Adoption Trends:

As Anil mentioned, in the service provider market, many major carriers are starting to invest in new 5G network architectures. One early indicator of the potential upside from 5G spending is our radio access network calibration services, which are used to predict signal coverage, interference, and network performance, and thereby improve capital and operational efficiency. We recently closed a multi-million-dollar deal with a major North American mobile operator to calibrate 5G-related millimeter wave frequencies across several US markets. We expect healthy growth in this area over the next couple of years to support this customer and other mobile operators and web scale companies that are designing next-generation 5G and IoT networks, as well as refreshing existing 4G radio access networks in support of new frequencies.

In the enterprise market, Anil noted the opportunity we see to leverage our strength in network performance to extend into other areas of IT. Last quarter, we won a deal valued at over 1.5 million dollars with a major hotel operator, who relies on NETSCOUT technology to monitor network and application performance tied to its reservation system. This win is a vital part of a major IT initiative to consolidate and virtualize their data centers, and migrate applications to the cloud following a large acquisition. As part of this activity, this customer is using a combination of our ISNG and vSCOUT offerings to help them baseline system dependencies and achieve pervasive visibility into critical applications across an emerging hybrid cloud environment.

In the security area, Arbor has continued to set the standard for technology and market leadership in the DDoS market. Earlier this month, we announced that the Brazilian Network Information Centre (NIC.br) selected Arbor DDoS solutions to strengthen its Network Operations Center defense capabilities to protect its infrastructure against service disrupting Distributed Denial of Service (DDoS) attacks. The NIC.br is vital to Brazil's Internet infrastructure, registering all domestic .br domain addresses and designating all IP addresses for the entire country. With DDoS attacks commonplace in Brazil, the NIC.br recognized that it couldn't afford a disruption in its network resources so it turned to Arbor to enhance their detection and mitigation capabilities. Arbor's combination of robust, scalable detection and mitigation offerings are critical for quickly identifying attacks, and then rapidly and efficiently protecting the network from the attack via automation and other tools.

Go-to-Market Activity:

Finally, I'd like to briefly preview our upcoming Engage User Conference, which will be held in Dallas, Texas in two weeks. We already have nearly 800 registered attendees composed of senior-level professionals across NetOps, DevOps, CloudOps and SecurityOps, as well as line-of-business professionals from well over 300 organizations representing every major vertical as well as NETSCOUT distribution partners. With our "Smart Data" strategy resonating with enterprise and service provider customers, we expect that this year's Engage will be a high-impact event for us and we are looking forward to showcasing our current capabilities and sharing our near-term product roadmaps.

That concludes my prepared remarks and at this point, I will turn the call over to Jean.

Slide 11: 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 2018. After that, I will review the guidance for fiscal year 2019. 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. All FY'17 and FY'18 results reflect revenue recognition under ASC 605 and I will cover the potential impact of adopting ASC 606 in just a moment.

Slide 12: Q4 FY'19 and Full-Year FY'19 Results

Slide number 12 shows our results for the fourth quarter of fiscal year 2018. For the quarter, total revenue decreased 27 percent to 238.5 million dollars. Our gross profit margin improved 150 basis points to 76.7 percent. The significant drop in revenue impacted operating profit margins, which declined substantially to 17.8 percent. Our diluted earnings per share was 36 cents.

Slide 13: FY'18 Revenue Trends: Customer Verticals & Geographic Mix

Turning to Slide 13, I'd like to review key revenue trends for the full year. Revenue in our service provider customer segment declined approximately 22 percent. Nearly two-thirds of the decline was attributable to the multi-year deceleration in spending by one of our large tier-one service provider customers. About 20 percent of the decline was the decrease in spending from all other service assurance provider customers and the remainder was due to a decrease in Arbor's DDoS revenue.

Our enterprise vertical declined by approximately 10 percent in fiscal year 2018. Revenue for the core NETSCOUT nGeniusONE offerings declined by approximately five percent due primarily to softness in verticals such as health care and high tech while larger verticals such as financial services and government were relatively unchanged against last year. This was compounded by a mid-teens percentage revenue decline for the ancillary products from the former Fluke Enterprise Networks area and a mid-teens revenue decline for Arbor's enterprise security products.

For the full year, the mix of revenue was 53 percent coming from service provider and 47 percent from enterprise. In terms of revenue by geography, which is calculated on a GAAP basis, our revenue in the United States declined sharply in fiscal year 2018 due primarily to weaker service provider spending led by the previously discussed decrease in revenue from that large tier-one carrier. The issues impacting spending in our service provider and enterprise customer segments also affected revenue performance outside the US. International revenue declined by 8 percent overall, with declines in each major international region. International customers represented 41 percent of GAAP revenue versus 38 percent last year. We did not have a 10 percent revenue customer in fiscal year 2018. Revenue from our single largest direct customer finished the year at just over 6 percent of total revenue.

Slide 14: Balance Sheet Highlights, Free Cash Flow and Share Repurchase

Slide 14 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 447.8 million dollars, an increase of nearly 65 million dollars from the end of December.

We delivered strong free cash flow, considering the operating results. Our free cash flow for the fourth quarter was 69.9 million dollars and 205.9 million dollars for the full year. The conversion of non-GAAP net income to free cash flow was approximately 165 percent, which was better than anticipated due primarily to favorable changes in working capital tied to the collection of receivables, lower cash taxes and lower capital spending. For next year, we would expect that free cash flow will be slightly better than 100 percent of non-GAAP net income as we anticipate increased capital spending due primarily to a facility relocation and a return to more normalized working capital levels.

Share Repurchase Activity

As detailed on last quarter's call and disclosed in our filings, we executed an Accelerated Share Repurchase (ASR) of 300 million dollars in early February. In conjunction with this activity, the banks working on our behalf immediately delivered 7.4 million shares of our common stock, which represented approximately 70 percent of the ASR when the agreement was signed. Those banks have been actively repurchasing our stock since that time, and we currently anticipate that this program will be completed by the early fall at the very latest. Once the ASR is technically completed, the share count would be further reduced by the number of shares actually repurchased, excluding the number of shares reflected in the initial reduction.

We have funded the ASR through additional debt of 300 million dollars, which is supported under our amended and expanded credit agreement that we entered into at the start of the calendar year. We have now drawn down a total of 600 million dollars on our credit facility.

We are continuing to work with our Board to finalize appropriate long-term targets for our financial profile.

To briefly recap other balance sheet highlights, accounts receivable, net, were 213.4 million dollars, down by 80.9 million from the end of last year. DSOs were 78 days versus 80 days at the end of fiscal year 2017.

Slide 15: FY'19 Guidance

Let's move to slide 15 for guidance. My commentary will focus on the non-GAAP guidance. I'd like to remind everybody that the reconciliation of our GAAP guidance to our non-GAAP guidance is in the appendix.

ASC 606

Today's guidance reflects our adoption of ASC 606, the new revenue recognition standard, effective as of April 1, 2018. Although we anticipate that the adoption will constrain our full-year reported results, it is important to note that it will not change our customer relationships, sales practices or cash flow. We currently estimate that there is approximately 26 million of deferred revenue that would have been recognized in fiscal year 2019 under the legacy standard that will now flow through our retained earnings. Of this total, about two-thirds of the revenue is product related with a majority of it tied to orders for legacy products from the former TekComms unit. This equates to a revenue headwind of approximately 3 percent for FY'19, which directly impacts our bottom line. We currently do not anticipate any material effect of ASC 606 on our full-year sales costs.

The impact of ASC 606 will vary over the coming quarters. At present, we anticipate that the adoption of this new standard will reduce first-quarter FY'19 revenue by approximately 9-million dollars, with a reduction in revenue of over 7-million dollars anticipated in the second quarter, a reduction of nearly 6-million dollars to the third-quarter revenue and a reduction of the remaining 4 million dollars in revenue in the final quarter of the year. Using the modified retrospective approach for our reporting, we plan to break out the effect of ASC 606 on our FY'19 quarter and year-to-date results so that you are better able to assess the underlying performance against prior-year periods, which were accounted for using the legacy ASC 605 standard.

Q1 & FY'19 Non-GAAP Guidance

Anil has already reviewed the opportunities and challenges we see in both our enterprise and service provider customer segments. Taking those dynamics into account, our fiscal year 2019 revenue guidance ranges from a low single-digit decline to low single-digit growth on a percentage change basis over fiscal year 2018. On a comparable reporting basis using the legacy ASC 605 standard, this guidance range would equate to FY'19 revenue that would be roughly flat to low single-digit growth. In terms of our diluted EPS for the coming year, our revenue guidance implies EPS guidance of a 20 percent decline to low double-digit growth. On a comparable ASC 605 basis, this range would be a low single-digit decline to 30 percent growth.

Key assumptions for fiscal year 2019 are outlined on the slide. As you can see, the adoption of 606 is expected to impact reported gross and operating profit margin performance in FY'19. In terms of further color on our annual revenue guidance, we expect modest growth in product revenue, which would help offset an anticipated decline in service revenue. In terms of revenue by customer segment, it is important to keep in mind that a majority of the 606-related revenue reduction impacts orders with our service provider customer segment. Accordingly, we anticipate that service provider customer segment revenue would decline modestly on a reported basis, which we believe will be offset by growth in our enterprise customer segment.

Q1 FY'19 Outlook

I'd like to briefly cover our view into the first quarter of FY'19. Factoring in the aforementioned 9-million dollar headwind from the adoption of ASC 606, we currently anticipate that first-quarter revenue will represent approximately 21 percent of our fiscal year 2019 revenue target. This would imply a mid-single to low double-digit revenue decline on a percentage change basis from the same quarter last year. We currently anticipate that between 46 to 47 percent of our expected FY'19 revenue will come in the first half of the year, which is generally consistent with the historical trends of our business. We are planning for first-quarter operating expenses to be between three to five percent lower than the same quarter one year ago. Diluted EPS for the first quarter is expected to range from a loss of 5 cents to a positive four cents.

That concludes my formal review of our financial results. Before we transition to Q&A, I will mention that slide 16 details the investor conferences we plan to attend over the next two months. I'll now turn the call over to the operator to start Q&A.