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RDWR - Preliminary Q3 2016 Radware Ltd Earnings Call

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PRESENTATION

Operator

Good morning. My name is Tanya and I will be your conference operator today. At this time, I would like to welcome everyone to the Radware Preliminary Q3 Results Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. (Operator Instructions) Thank you.

Anat Earon-Heilborn, VP, Investor Relations, you may begin your conference.

Anat Earon-Heilborn - *Radware Ltd. - VP, IR*

Thank you, Tanya and good morning everyone. We announced today preliminary results for the third quarter of 2016. Following brief prepared remarks on this announcement from Roy Zisapel, President and Chief Executive Officer and Doron Abramovitch, Chief Financial Officer, we will open the call for questions.

A copy of today's press release is available on the Investor Relations section of our website. During today's call, we may make projections or other forward-looking statements regarding future events or the future financial performance of the Company. We wish to caution you that these statements are just predictions and we undertake no obligation to update these predictions. Actual events or results may differ materially, including but not limited to, general business conditions and our ability to address changes in our industry, changes in demand for products, the timing and the amount of orders, and other risks detailed from time to time in Radware's filings. We refer you to the documents the Company files from time to time with the SEC, specifically the Company's last Form 20-F filed on April 21, 2016.

With that, I will turn the call to Doron Abramovitch.

Doron Abramovitch - *Radware Ltd. - CFO*

Thank you, Anat. As we announced in today's press release, revenues for the third quarter are expected to be approximately $47 million, down $1 million from Q3 2015 and below our guidance of $50 million to $53 million, which we provided on July 26. At this time, shortly after the quarter's end, our ability to analyze revenues is limited and we intend to provide further observations at our quarterly call scheduled for November 1.

Overall bookings for Q3 reflected double-digit growth compared to bookings in Q3 2015. The total sum of deferred revenues on our balance sheet and uncollected billed amounts that were offset against trade receivable and are not on the balance sheet, grew by approximately 30% from $85 million at the end of Q3 2015 to approximately $110 million at the end of Q3 2016.

Gross margin is expected to be approximately 82.5%, in line with our guidance. Non-GAAP operating expenses are expected to be approximately $39 million compared to our expected range of $39.5 million to $40.5 million. As a result of the above, our non-GAAP EPS is expected to be approximately $0.04 compared to our guidance of $0.07 to $0.09. We will announce our full Q3 results and provide our outlook for Q4 on November 1.

With that, I will turn the call over to Roy.

Roy Zisapel - *Radware Ltd. - President & CEO*

Thank you, Doron and good morning, everyone. As Doron mentioned, our total booking in Q3 demonstrates solid year-over-year growth. The shift of our business towards more subscription and service sales continued in the last quarter and even accelerated. This led to lower-than-expected revenues for the quarter and at the same time to strong growth in the deferred revenues balance.

We view the increasing sales of our cloud solutions and product subscriptions as a positive strategic transition in our business model. While this model has its challenges in the short term affecting the amount of revenues recognized, it provides a long-term strategic value by building an annuity-type business and a very profitable, consistent revenue stream. We continue to strengthen our sales and marketing capabilities, selectively adding resources in certain places. We are particularly focused on the opportunities available for our subscription business and cloud offering.

I remain confident in the growth prospects of Radware. We have a unique product portfolio with very strong solutions which provide genuine competitive advantages. Our capabilities are praised by industry experts and proven by our loyal installed base. With sharper execution and once the shift in our business model stabilizes, we can deliver sustained revenue growth and achieve much stronger financial results.

With that, I would like to open the discussion for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Joseph Wolf, Barclays.

Joseph Wolf - *Barclays - Analyst*

I just wanted to do a little bit of housekeeping to ask about the deferred revenue profile. If I go back now I guess there's seven quarters reported. So it was $85.3 million, $81 million, now you're saying $85 million for 3Q, and went to $101.2 million, down to $98.2 million, $98.8 million, and now we're at $110 million. And if that's correct, can you give us a little bit of a sense of how this is going to roll off in the coming quarters, meaning, do we have some sense if we look at this new number that you're giving us now of what recurring revenue could look like in 2017?

And if we're a year into the transition that was provided for the fourth quarter, is the fourth quarter of this year going to be normalized against the revenues that you reported last fourth quarter and there could be growth over the $55.3 million that was reported?

Roy Zisapel - *Radware Ltd. - President & CEO*

Okay. I'll defer some of the items to Doron, but in a high level the right metric to compare is year over year. So, you see the current figure for Q3, you have last-year figure. These should reflect, well, the growth in the deferred business and as a result of that annuity business. We cannot guarantee each quarter that there will be sequential growth, but definitely I think you see a clear phenomenon year over year. And regarding the exact guidance for Q4, we will defer that to the November call.

Doron, do you have anything to add?

Doron Abramovitch - *Radware Ltd. - CFO*

Yes. You know Joseph, we start the quarter with a much better revenue that we generate compared to last year due to the numbers that we just -- you just mentioned. The $85 million that we started Q4 2015, of course contributed some portion to Q4. And of course, now when we enter with $110 million, it's more than this. So in terms of recurring revenue, we feel much more stronger. How to modelize it, it's very difficult for me to give it because we don't disclose it. But you can imagine that getting into the quarter we now have much more confidence. Yet, as Roy mentioned, the model is quite unstabilized right now, so we cannot give a clear number for 2017 at this time.

Joseph Wolf - *Barclays - Analyst*

Okay. Maybe just as a follow-up, as the year-over-year number is the important number with this new -- with this metric and the transition to subscription, does that mean that the subscriptions are billed once a year and so the booking that you talk about, this $110 million, will be reflected in revenues in 3Q 2017, but not in any of the quarters before then or is there quarterly revenue coming off of that $110 million as well?

Doron Abramovitch - *Radware Ltd. - CFO*

In terms of (technical difficulty).

Roy Zisapel - *Radware Ltd. - President & CEO*

Doron, please.

Doron Abramovitch - *Radware Ltd. - CFO*

So, in terms of the revenue, of course it's -- now we step in with a better number and better visibility, but the unbilled number it's above that. We don't refer to this. So I prefer not to get into this. But the unbilled number right now is above the $110 million. So it's very difficult, again, to modelize it and it also relates to the duration of the contracts. So, it's much more complicated.

Roy Zisapel - *Radware Ltd. - President & CEO*

Joseph, generally our contracts are for one, two or three years and they can be billed upfront or sometimes on an annual basis. It's very rare that we are billing monthly or quarterly. However, the revenue recognition, regardless of the billing, is done pro rata across the term of the contract. So for every quarter, there is revenue contribution from this deferred balance sheet.

Joseph Wolf - *Barclays - Analyst*

All right. I'm going to pass it on to somebody else. I can imagine if you're describing it as complicated, you can understand that we view it as complicated as well. Thank you.

Operator

Alex Henderson, Needham.

Alex Henderson - *Needham & Company - Analyst*

So within the mix of business, is there more of a shift to security, is there a similar condition that we saw in the last couple of quarters in ADC? Can you give us some texture and composite within the data?

Roy Zisapel - *Radware Ltd. - President & CEO*

So definitely as we see growth in subscription that is strong, it's more related our security business. However, from a booking perspective this past quarter both lines did well and security did even a bit better, but both lines executed well. A lot of the deferral -- the growth of the deferral is coming from our security product lines, especially that relates to both product subscriptions and the cloud subscriptions.

Alex Henderson - *Needham & Company - Analyst*

If you were to take the orders that went into backlog and prorate the portion of that order that would have fallen in the current quarter, would you have been up double digits in reported revenue? In other words, if I just ignore any orders that went into backlog that would be for forward periods beyond the current quarter and just look at the demand side of the equation, what would have come in in the quarter had you not been shifting to subscription?

Roy Zisapel - *Radware Ltd. - President & CEO*

So, you assume, let's say, that this all subscription business is related to product business for the quarter, is that what you refer to?

Alex Henderson - *Needham & Company - Analyst*

I'm just trying to understand if you had not been experiencing a shift to subscription and the demand that you close -- the transactions you closed, obviously some of the subscription includes hardware that would go into other periods, but presumably that hardware would have landed in the quarter, and obviously there is services associated with those contracts, some portion of which would land in the quarter, would you have had double-digit revenue growth?

Roy Zisapel - *Radware Ltd. - President & CEO*

I don't have the exact math in front of me, but what I can tell you is that assuming the mix, so the mix was like Q3 last year, so the answer is yes, our relevant booking grew double digit, yes.

Alex Henderson - *Needham & Company - Analyst*

Right. Okay. And then within the backlog of business, how much of that should we be viewing as hardware, how much of that is sort of ongoing service contract? Is it the standard mix within that or is it more hardware than your traditional backlog would have suggested?

Roy Zisapel - *Radware Ltd. - President & CEO*

Generally, we don't carry backlog out really in a large amount. The majority is service contract and a growing portion, obviously a fast-growing portion, of that is subscription.

Alex Henderson - *Needham & Company - Analyst*

Right. But the subscription and service contracts that you're talking about include your responsibility to carry the hardware that's on -- that would have been normally recognized as revenues, yes?

Roy Zisapel - *Radware Ltd. - President & CEO*

Yes. So a product subscription is actually a product capability or sale and a cloud subscription is also -- it's not the maintenance for the cloud subscription, it's actually the product itself that we sell on a subscription basis. So this has grown significantly in this balance of deferred revenue.

Alex Henderson - *Needham & Company - Analyst*

And then just looking at the ADC market, there's been a lot of question marks around ADC based off of the idea that F5 was launching some new products. Is there any reason to think that that had any impact on the quarter? And what's your sense, are they on schedule, are they behind in terms of when getting their product out? It seems like that's running a little late to me from what I can tell, what's your sense of it?

Roy Zisapel - *Radware Ltd. - President & CEO*

So, I don't have a visibility to that. In the market we didn't see the new line of ADC appliances except for the card to the VIPRION. So, I'm not sure the appliances themselves are out.

Operator

Jess Lubert, Wells Fargo Securities.

Jess Lubert - *Wells Fargo Securities - Analyst*

I was also hoping you could provide a little bit of clarification, some other details, and maybe just let us know if the weakness you saw this quarter relative to your expectations was concentrated in any geographies and if anything stood out either from an enterprise or a service provider perspective?

Roy Zisapel - *Radware Ltd. - President & CEO*

Yes. So, as Doron mentioned, in terms of booking, we had actually very solid results. So, I cannot speak on specific weakness. We will provide the exact breakdown of revenues by geography, et cetera and obviously some geographies did better than the others. But overall, from the order intake, et cetera, the quarter was a very solid one.

I think where the shift is or where the miss in our expectation is the proportion of subscription and service business as part of our overall business, I mean, it went very strong this past quarter and I think that's where the miss came from. You can see it in bookings and you can see it in deferred, last quarter was actually a solid one.

Jess Lubert - *Wells Fargo Securities - Analyst*

And the booking strength was seen across both enterprise and service provider?

Roy Zisapel - *Radware Ltd. - President & CEO*

Yes.

Jess Lubert - *Wells Fargo Securities - Analyst*

And then, was there any contribution from Cisco in the quarter, any update with respect to how you're thinking about that relationship?

Roy Zisapel - *Radware Ltd. - President & CEO*

We started to receive the first orders from Cisco, very minimal booking because we're running a quarter of a delay in revenue recognition. In November, we are slated for very the important launch of the Cisco next-generation firewall where we're part of the FTD launch. So the amount of platforms that we are on is increasing. And I think Cisco is releasing step by step the complete product line and with that our potential for revenue generation is there. And so far we've started to win, most of the customers we are seeing through them are completely new customers in segments that we are not approaching by our own sales force. So it's a good start, but obviously we need now to see it scaling.

Operator

Catharine Trebnick, Dougherty.

Catharine Trebnick - *Dougherty & Company LLC - Analyst*

Thanks for taking my question. Hey, Roy can we just have a backtrack to a simple question? We've talked a lot about the subscription services. Are these -- can you just give a good example between who are your customers that are buying the subscription services and how their buying patterns have changed in the last 12 to 24 months?

Roy Zisapel - *Radware Ltd. - President & CEO*

So let's take a typical example. In security, it could have been a bank, and previously the bank would have acquired from us a DefensePro device to protect their on-prem data, to put it on the premise and to protect their data centers. In the last 18, 24 months, we've started to add a couple of subscriptions to this offering. The first one is the ability to mitigate attacks that are flooding the connectivity to the data center through our Cloud DDoS protection service. And the second offering is to fully manage remotely from the cloud, both the on-prem mitigation and the cloud mitigation as needed. So, we are now offering a fully-managed attack mitigation service with a very strong cloud component and an on-prem component.

All of that sales which we call attack mitigation as a service will basically go into a subscription business model and revenue deferral. So that's one example.

Another example can come from our ADC product line. We have similar examples in our security product line. When a company buys from us today our ADC, the appliance, and install it in the data center, there are several subscriptions that are coming with it; for example, application performance monitoring; for example, Web application firewalling et cetera, all of these we're selling as subscription where in the past we were selling them as strictly products -- product sales. So that obviously moves product recognition to the yearly subscription buckets and we're starting to see renewals of these modules, of these software modules that are running on our appliances.

So in general, we have product subscriptions both in our security product lines, weekly security updates and modules on our ADCs that I've mentioned, those we call product subscriptions. We have cloud subscriptions and the biggest ones are the DDoS cloud scrubbing and the Web application firewall cloud. And then we have also professional remote monitoring and management for our customers' implementations that we are selling on a subscription basis as well, 24/7, throughout the year, fully managed solution whether it's on-prem or the cloud. So those are the three engines behind the growth in our subscriptions.

We're seeing more and more customers that are now preferring not to buy only the products from us, but actually take a complete fully-managed deal with the cloud components and there are several good reasons for that. The first one is the lack of expertise in security in most of the enterprise customers. The second one is really the need for cloud solutions to protect you outside the enterprise, not to limit the protection only to the enterprise border especially when you are moving some of your applications in any case to a cloud like an Amazon or AZURE.

And the third is our ability, when we hold both sides of protection, both the on-prem and the cloud, to really deliver superior protection to any other solution that's either deployed on-prem separately or in the cloud. So there are very good technical reasons, there are very good personnel and expertise reasons and there are very good process reasons for a customer not only to buy our on-prem solution like in the past, but actually sign up for a more comprehensive deal that we are providing on a subscription basis.

Catharine Trebnick - *Dougherty & Company LLC - Analyst*

Okay. And then a follow-on to that, so is this more of a direct sales effort by your organization to do the subscription services or are you leveraging like Check Point et cetera?

Roy Zisapel - *Radware Ltd. - President & CEO*

So, we're doing both. So Check Point started to sell also our cloud solution as a subscription. We do also have other channels. For example, in the CDN space, Limelight is reselling our cloud solutions, and many other cloud providers. You can see some of our announcements and press releases, if you read, with those companies, you are actually going to see on their product pages that they are advertising Web application firewall cloud or a DDoS cloud that is using the Radware technology. So we're extending the footprint of resellers that -- and I would say some new type of resellers, not only the regular VAR for security and networking, but actually some of the CDN providers, some of our OEM customers, and some of our hosting and cloud customers to resell our complete solution.

Operator

Rohit Chopra, Buckingham Research.

Rohit Chopra - *Buckingham Research - Analyst*

Just a couple of questions here. I just want to know if you guys are contemplating any changes to the cost structure as you're seeing the overall environment move to more of a subscription model? That's the first question and then, Doron, specifically, have you guys thought about ratably recognizing commission to better match the shift to subscription?

Roy Zisapel - *Radware Ltd. - President & CEO*

I'll take the first question. A lot of our investments in the subscription business are already there, are already in the OpEx line. We have a complete emergency response team that monitors, tracks and mitigates attack from customer premises. The product subscriptions are obviously part of regular delivery by the Company and the managed service as well, it's built in into our OpEx. So, I don't see further changes in the cost structure apart from what I've mentioned that we're going to continue to add sales and marketing and to continue to invest there. And as we noted in our remarks, we have double-digit growth in booking and we would like it to be sustainable and we're going to continue to invest in that area.

Doron Abramovitch - *Radware Ltd. - CFO*

And as for the other question, Rohit, of course we did some modification on how we pay the commissions. And on one hand a bit more aggressive in terms of how we compensate them, but of course, on the other hand, to match how we recognize the revenue and when we pay, there is some modification and we are very alert on this one to make sure that we do the right thing. On this term, I think that we have no issue right now. On the contrary, we feel very comfortable with the commission plan and how we accrue these expenses as well.

Rohit Chopra - *Buckingham Research - Analyst*

Can I ask you a quick follow-up? Did you guys do a -- was there a big buyback in the quarter or any thoughts around that?

Doron Abramovitch - *Radware Ltd. - CFO*

I prefer not to answer this one on this call because as mentioned we are obliged to the plan, we have some -- and we will update, of course, in the next call.

Operator

There are no further questions at this time. We will conclude today's conference call. You may now disconnect.