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CORPORATE PARTICIPANTS

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

Doron Abramovitch *Radware Ltd. - CFO*

Roy Zisapel *Radware Ltd. - Co-Founder, CEO, President & Director*

CONFERENCE CALL PARTICIPANTS

Alexander Henderson *Needham & Company, LLC, Research Division - Senior Analyst*

Andrew King

George Charles Notter *Jefferies LLC, Research Division - MD & Equity Research Analyst*

Shaul Eyal *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*

Yi Fu Lee *Oppenheimer & Co. Inc., Research Division - Associate*

PRESENTATION

Operator

Good morning, and welcome to the Radware Q2 '20 Earnings Conference Call.

I will now turn the call over to our host, Ms. Heilborn. Please go ahead with your call, ma'am.

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

Thank you, Jake. Good morning, everyone, and welcome to Radware's Second Quarter 2020 Earnings Conference Call. Joining me today are Roy Zisapel, President and Chief Executive Officer; and Doron Abramovitch, Chief Financial Officer. A copy of today's press release and financial statements as well as the investor kit for the second quarter are available in 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. These forward-looking statements are subject to various risks and uncertainties, and actual results could differ materially from Radware's current forecast and estimates. Factors that could cause or contribute to such differences include, but are not limited to, impact from the COVID-19 pandemic, 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 or furnishes from time to time with the SEC, specifically the company's last annual report on Form 20-F as filed on April 2, 2020. We undertake no commitment to revise or update any forward-looking statements in order to reflect events or circumstances after the date of such statement is made.

Please note that in August and September, management will participate in the following virtual conferences: The Oppenheimer Technology, Internet & Communications Conference, the Jefferies Semiconductor, IT Hardware & Communications Infrastructure Summit, the Colliers Institutional Investor Conference, the Jefferies Software Conference, and the Deutsche Bank's Technology Conference.

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

Roy Zisapel - *Radware Ltd. - Co-Founder, CEO, President & Director*

Thank you, Anat. We are pleased to deliver solid results for the second quarter despite the unusual circumstances we find ourselves in. Radware enjoys strong business fundamentals, and this provides us with resilience during these times. Our clear strategy, the advanced phase of our transition to subscriptions, our strong customer base, mainly centered around large enterprises, and our cash-generative business model are all key advantages that position us well at this time.

And at the heart of all these advantages, we have our broad, deep, and leading attack mitigation solution that addresses customers' critical security requirements in this very dynamic and challenging cyber threat environment.

We are extremely pleased with the results in North America. The strong booking in North America was the main driver for our second quarter book-to-bill ratio being above 1 and included multiple 7-figure deals. These large deals were, for the most part, not recognized in the second quarter revenues and resulted in record backlog for Radware as we enter the third quarter and second half of the year.

The health of our business is reflected in our annual recurring revenues, which boasted close to 10% growth compared to June 2019, driven by strong cloud and subscription results.

We attribute much of the excellent performance in North America to the success of the initiatives we discussed with you in our February investor meeting. Our focus on the sales organization structure and scope, on operational excellence, and full engagement in our growth initiatives are maturing and yielding results, and we expect them to continue to do so in the coming quarters. Moreover, we implemented successful COVID-19 go-to-market campaigns, reaching out to our existing customers and partners, and addressing their current needs in a timely and resourceful manner.

For example, a leading mobile U.S. carrier expanded its network to support unlimited data plans it offered its customers in order to enable the shift to work from home and other connectivity needs. This network expansion required a corresponding expansion of the attack mitigation capacity across their network.

Another example is an e-commerce leader to whom we proactively reached out to discuss security for remote access, VPN, and video conferencing. Following this outreach, they selected Radware cloud DDoS protection to protect their corporate services.

In Asia Pacific, we saw weaker demand, and we believe these markets currently face major disruption due to COVID-19 and lack the robustness of demand that we see in the U.S.

Regarding our OEM business, our partners delivered very good results in the last quarter. Cisco booking continue to be strong and our joint pipeline continue to increase. Check Point growth trend is gaining further momentum. In fact, the second quarter was a record quarter in booking through Check Point.

Our strategic partners are instrumental in introducing Radware to new top-tier logos. Through these relationships, in the second quarter, we added companies such as the global top 10 oil and gas company, a top 3 food and beverage company and add-on orders from several tier one service providers, among others.

Our differentiated cloud offering enables acquisition of new customers through competitive displacements. The food and beverage company, I just mentioned, is an excellent example. They turned to Radware as the result of being under very persistent attacks, using an attack vector nicknamed DNS Water Torture. It is difficult to detect and mitigate the specific vector, and indeed, the wide array of multiple layers of DDoS protection and other security solutions this customer was using globally failed to mitigate the attacks, which lasted over a couple of weeks. The Radware DefensePro is capable of addressing such attacks through our unique algorithms. And as a result, our cloud DDoS service is unique in its ability to protect customers from this DNS attack and other sophisticated threats.

To conclude, while there is obviously a significant level of uncertainty going forward, taking a longer-term perspective, we are very confident in our business. We believe our cloud services and software subscriptions are set to grow rapidly on the strengths of our leading data center and application security stack. Together with continued strong performance in North America, progress with our OEM partners, and continued strong cash generation, we are well positioned for future success.

I will now turn the call to Doron.

Doron Abramovitch - *Radware Ltd. - CFO*

Thank you, Roy. In our last earnings call, we elaborated on our operational activities in the face of the COVID-19 extraordinary conditions and we were hopeful it was a one-off commentary. Unfortunately, this was not the case, and the unusual conditions still prevail. So I will briefly address the current situation.

I'm pleased to state that our organization remains resilient and productive, and our teams are committed to maintain high engagement and top-notch service. From mid-May, most of our headquarter personnel resumed working from the office, whereas most of our personnel across the regions continue to work from home. Customer service remained unaffected and equipment deliveries were also generally undisrupted.

With that, I will turn to the result of the second quarter. Revenues for the second quarter were $58.4 million, 3% below Q2 '19 and in line with our guidance. Revenues from Americas decreased 1% from last year to $27.5 million. Let me remind you that there is an element of revenue recognition timing, so our geographic revenues do not fully reflect the underlying business trends that Roy just described.

Revenues in the EMEA region increased 5% from Q2 last year to $17.7 million, and revenues from Asia Pacific decreased 17% from last year to $13.3 million.

Recurring revenues as a percentage of total revenues continued to rise in the first half to 68% as compared to 64% in the first half of 2019, reflecting growth in our subscription revenues and increasing proportion of our total subscription revenues out of the total revenues. For the second quarter, it was specifically high, reaching 71% for the first time compared to 68% for the second quarter of 2019.

The total deferred revenues balance was approximately $173 million as of the end of June. Out of the total balance, 62% or approximately $108 million are due for recognition in the next 12 months. The total deferred revenues experienced only a modest increase year-on-year, mostly because of deals that were not yet invoiced and therefore are not part of this balance and reside in our backlog. With record level of total backlog, we expect solid growth for total deferred revenues for the September quarter.

I will now discuss expenses and profit, all in non-GAAP terms. The differences between the GAAP and non-GAAP results for the quarter are detailed in our press release. Gross margin for the first quarter was 82.8%, reflecting product mix and higher proportion of subscriptions.

Operating expenses in Q2 were at the lower end of our guidance at $44.1 million, up from $43.1 million in Q2 last year. The increase is a result of higher headcount expenses, offset predominantly by lower travel expenses. We ended the quarter with 1,121 employees, up by 63 employees compared to June last year. We continue to invest in the business for the long term, but are very mindful of cost control.

Operating profit and margin in Q2 2020 were $4.3 million and 7.3% respectively. Net income for the second quarter was $6 million or $0.13 per diluted share, in line with our guidance.

Turning to the balance sheet and cash flow items, where we continue to demonstrate strength and stability. Net cash provided by operating activities was $18 million for the second quarter and $39 million for the first half of the year, up 36% from the first half of 2019.

Our free cash flow was $15.4 million for the second quarter and $34 million for the first half, up 40% compared to 2019 first half. Last 12 months free cash flow was $54.3 million.

We ended the quarter with approximately $443 million in cash and financial investments. Most of our cash is invested in highly liquid U.S. dollar, marketable securities, and deposits.

As for our use of capital, during the second quarter, we spent $5 million on repurchasing approximately 210,000 of our own shares. The remaining available capital of stock repurchase under our 2 outstanding plans is approximately $52 million. The weighted average number of our outstanding shares for the quarter was approximately 47.6 million, down by almost 1 million from the average shares for the full year of 2019.

I will move to our guidance for the third quarter of 2020. We balance our high conviction in the market opportunities, especially in the U.S. and with our strategic partners, with our belief that the global economy is fragile and the high level of uncertainty. We expect revenues to be between $60 million and $64 million. We continue to tightly monitor costs in order to deliver profitability while ensuring we still have all the required resources to seize the market opportunities when the economic environment is more supportive.

Operating expenses are, therefore, expected to be between $44 million and $45 million. We expect financial income to decline in the coming quarters, given lower yield on newer marketable securities. We expect EPS for Q3 to be between $0.16 and $0.18.

I will now open the call for Q&A.

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

Operator, can we open the call for Q&A.

QUESTIONS AND ANSWERS

Operator

We have a question from Alex Henderson with Needham.

Alexander Henderson - *Needham & Company, LLC, Research Division - Senior Analyst*

I was just hoping you could talk a little bit about the linearity during the quarter. When I look at the adjusted deferred calculus, it looks like the overall deferred was up quite nicely, but the adjustment was not consistent with prior periods. It looks like the amount of billings came in fairly late in the quarter. And, therefore, I think that goes into your comment about backlog. How big enough was that? And how much of the linearity was very heavily back-end weighted and therefore not into the -- not able to be billed?

Roy Zisapel - *Radware Ltd. - Co-Founder, CEO, President & Director*

Yes. So I think twofold. First, I think we started the quarter pretty good. And actually I think you see the result in our cash generation for the quarter. So some of the deals of April, we were actually able to collect. And then, you're right, in the sense that some of the large deals came in the end of the quarter, but some of them are also complicated from delivery point of view. So, for example, a global cloud DDoS deal, you need to set up all the centers and so on to start doing the recognition, et cetera. So I would not -- I think our linearity was pretty good. The first month was actually, I think, higher than usual for us. It was not back-end loaded too much, except for some specific deals that went to the backlog, you're right.

Alexander Henderson - *Needham & Company, LLC, Research Division - Senior Analyst*

Similarly, the Cisco momentum being strong and Check Point momentum accelerating. Does that go into your deferred at all or is that when it gets recognized by them and passed over to you at almost a 1:1 recognition to timing?

Roy Zisapel - *Radware Ltd. - Co-Founder, CEO, President & Director*

So it depends. If the deal includes, for example, support or cloud components, it would be deferred also on our end.

Alexander Henderson - *Needham & Company, LLC, Research Division - Senior Analyst*

Can you talk a little bit about your exposure to verticals that are at risk, particularly at risk and particularly adding the government, state, and local federal type end markets, please?

Roy Zisapel - *Radware Ltd. - Co-Founder, CEO, President & Director*

So fortunately now, maybe unfortunately in other times, we are not that exposed to the government verticals and specifically exposure to the U.S. federal is minimal. In other markets like travel, airline, hospitality, again, very little exposure. Our main customers in the enterprise market are coming from the financial sector, technology sector, some extent manufacturing. And of course we have the carriers, cloud providers and SaaS providers on the service provider side.

Operator

We have a question from Shaul Eyal with Oppenheimer.

Shaul Eyal - *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*

Congrats on the stable second quarter performance. So, Roy, can you talk to us about some of the trends you're seeing within the bot management arena? There's definitely some good acceleration taking place out there. I wanted to hear how it's impacting your business and just your overall views?

Roy Zisapel - *Radware Ltd. - Co-Founder, CEO, President & Director*

Yes. So we've entered the bot management a year ago through an acquisition, and we are very happy with the results. We are delivering the bot management solution, both as a standalone cloud solution as well as integrated with our broader cloud web application security service. The beauty of the bot management is that it solves a business problem. And you directly -- you can directly attach that to revenue of a company. So whether it's opening accounts and stealing information or whether it's attacking an inventory of a certain company or whether it's account takeovers. All of that is direct impact on the revenues of our customers. And a very good example I have is from a new customer we just signed and onboarded last quarter, they are classified, one of the largest classified sites in Europe. And what they've seen is that any ad that comes into their site, within 5 to 10 minutes appears in their competitor sites. To the point that the CTO own apartment ad that they put in, after 5 minutes was appearing in the competition sites; to tell you what is bot activity and how sophisticated it is. And then our ability to remove and block all of those bots. And the test is very easy. It was just checking, enabling us, checking the competitive sites, disabling us, checking that the assets appear again and so on. This unique strong business value proposition makes the purchase of a bot service almost straightforward.

And what we see recently is that customers are ready to invest in bot management solutions as much, if not more, than they are ready to invest in the web application security itself. So it's definitely a very good market. We're growing very nicely there. It's part of the contribution to the growth in our cloud services and in subscription. And it's very, very complementary to our complete stack of application security capabilities.

Shaul Eyal - *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*

In light of your third quarter guidance, and I think also as we think about the second half of this year, the remainder of 2020, what's the current hiring plans? And how do you feel about bringing in the right talent given what could be a changing hiring environment?

Doron Abramovitch - *Radware Ltd. - CFO*

Yes. So I will take the financial part of it and let Roy add some other comments on our hire plans. We mentioned at the beginning of the year that we plan to have roughly 1,150 employees all over. Right now, in the first half, we are in line with this plan. We started the third quarter, as I said, with high plans to continue and to be ready for the -- when the economic environment will be better to continue with this plan. So from OpEx point of view, we are in line with this one, as I said, offset by travel, so all our OpEx are in a way aligned with the initial plan.

Roy Zisapel - *Radware Ltd. - Co-Founder, CEO, President & Director*

So on the business side, as Doron mentioned, we continued with our plans pre-Corona in terms of hiring. Specifically, we are increasing resources in the field, as we shared in February. And given the results in North America, we are even allocating more headcount requisitions there. And we are trying to take advantage of the period to hire good talent as it becomes maybe a bit more available in this time. So we continue with our plans, very big focus on the field and specifically North America.

Operator

We have a question from George Notter with Jefferies.

George Charles Notter - *Jefferies LLC, Research Division - MD & Equity Research Analyst*

I guess, I wanted to ask about the difference in growth rates you're seeing in APAC relative to certainly North America, EMEA, certainly COVID is a global phenomenon. Can you talk about what you're seeing in APAC and why the types of growth rates you're putting up are so different relative to the other parts of the world?

Roy Zisapel - *Radware Ltd. - Co-Founder, CEO, President & Director*

So we think in APAC, the -- what we've seen in the market because of the, I would say, the steps that those governments have taken locally, I think the hit on the local economies was much harder than what we've seen in North America, at least to date. Going into isolation, going back, second wave, third wave, practically shut down a lot of the -- of business activity, and we've seen ongoing delays in those countries. In addition, I think internationally, the governments were less involved in funding the business community than happened in the U.S. maybe. And as a result, we've seen the business sector a lot of hesitation. It might be also that some of it is, by the way, related to our own execution, although it's hard to tell at this point. We are tracking our results as well as other vendors in the industry. And so far what we've learned is that the weakness we're seeing or the softness in demand we're seeing is -- looks like a market and not a specific Radware phenomenon.

George Charles Notter - *Jefferies LLC, Research Division - MD & Equity Research Analyst*

And then I also wanted to ask about sort of the work from home situation. If I go back, for example, last quarter, I mean, you talked about having some business that was pulled forward because of the work from home traffic. I think you mentioned a particular project or deal on your monologue earlier. And then also, I think last quarter, you also had push-outs related to airport shutdowns and things. But can you talk about sort of the puts and takes of COVID and how it impacted your business this quarter?

Roy Zisapel - *Radware Ltd. - Co-Founder, CEO, President & Director*

Yes. So I think, first, we saw some impact on the geographic levels. We just discussed Asia Pacific. That's one. Second, we didn't see as much the immediate build-out of infrastructure needs, like we've seen in Q1, like in remote access, build-out or scale-in I need immediately to scale everything I had. That has lessened. What we did see is that people are starting to treat the remote access and VPN as a much more strategic asset than before.

So if, for example, I mentioned this e-commerce leader, obviously, they were focusing on protecting their production platforms all the time. And while remote access was important to secure, it was not as much -- as critical as it is now. So now we're seeing almost the second wave. It's not the infrastructure build-out as much as this is a significant and critical asset that I have to secure very well, and we're starting to see projects initiated from the risk of availability of enabling work from home and protecting this infrastructure. So that's what we're starting to see. Projects that stalled in Q1, I must tell you, I don't know any one of these that was relieved. They are more tied to those segments that are -- that might be problematic. And together with our partners, what we've done, we've shifted a lot of the marketing campaigns, the messaging into securing this work from home environment and approaching the existing customers first, ours and our partners to address these needs.

Operator

We have a question from Andrew King with Colliers.

Andrew King

So I just wanted to dig in a little bit into the mix of new versus expanded sales and how that has been trending over the last few quarters given the COVID-19 impact.

Roy Zisapel - *Radware Ltd. - Co-Founder, CEO, President & Director*

So I think we are in a very unique situation. In general, COVID-19 tells you, you need to focus on your existing customers. It's hard to get introduced to a new customer, starting the engagement, building the trust when everyone is keeping social distancing. However, what we are doing, beyond approaching our existing customers and focusing on that, the fact that we have so large OEM partners with so many customers mean to us that their existing customers are actually new logos to us. And if you've seen my prepared remarks, I mentioned that even during COVID-19 environment, we are able to land extremely large companies, Fortune 100, Fortune 50 and so on by leveraging our OEM partners and them being incumbent in those customers. So we didn't see a big change. We have some drop in Q2 -- in revenues from new customers. We have a very small drop in the number of new customers we were able to sign, but still, year-over-year, for example, the number of new customers has increased, and we are leveraging those OEM relationships to gain more and more new customers even in this environment.

Andrew King

And then just looking at the competitive landscape, specifically within the ADC market. Recently, F5 has been sort of shifting their focus to applications. And A10 has been shifting their focus to 5G. Can you talk a little bit about how that changes the competitive dynamics in that $2 billion market?

Roy Zisapel - *Radware Ltd. - Co-Founder, CEO, President & Director*

Yes. In the market itself, I see less of this 5G focus or security focus by A10 or security focus by F5. I think still the majority of the revenues are coming from ADC deployments in the enterprise market for F5 and in the carrier market for A10. So I don't think the market for us has changed significantly. We are already, I think, for 3 or 4 years, when we were discussing the ADC market, we explained that we pivoted it to security applications around encryption and around the encrypted attack, around application security. And over there, I think that the trends are a bit more resilient. That plus the move of the -- of some of our ADC offerings to subscriptions, I think, are positioning us well. However, obviously, ADC is a less resilient market in COVID-19 versus security because people are deferring infrastructure investments.

Operator

We have a question from Yi Fu Lee with Oppenheimer.

Yi Fu Lee - *Oppenheimer & Co. Inc., Research Division - Associate*

Congrats on the consistent execution. I have two quick questions; one quick one for Roy and a follow-up financial questions for Doron. For Roy, on the -- we've seen elevated threats throughout the first half due to the COVID environment, elevated phishing scams, ransomware breaches, DDoS attacks. How does this, I guess, threat environment translate into Radware's product offering? How -- in your conversations with CTOs around the world how mission critical is, I guess, Radware holistic platform in this threat environment? Can you elaborate on that?

Roy Zisapel - *Radware Ltd. - Co-Founder, CEO, President & Director*

I think it's extremely critical. It's very clear to the very large enterprises we're dealing with and that's (inaudible) really protecting at the very high level and that especially now, their business is at a high risk. Talking only on the very large SaaS providers of the world that rely on us to protect the data centres. It's binary. They have to (inaudible) in order to protect revenue. Even if you take the manufacturing companies I've mentioned, today, a lot of the activity, the promotions, a lot of the direct customer relationship, shipments around the world, all of this (inaudible) channel and obviously protecting that (inaudible). So the fact that today, if you have an application, whether it resides in a public cloud (inaudible) or on your private cloud, we can protect - in the public cloud, the workload itself, we can protect the kubernetes environment your application is built on. We can front end with web security, protection, your public infrastructure, and on top of that do the denial of service protection. And last but not least, if they're attacking you at the application level with automatic attacks, we have the bot security. It's really a very, very broad, I actually don't know of any company today that offers a broader application and data center security solution, and very, very deep. Each of the components that I talked about is built from the ground up dedicated to that threat with a lot of use of algorithms, machine learning, behavioral, you name it, to excel in what they do. So I think the offering is critical, but more than that, extremely effective in what it does day in and day out. And I think our customers are seeing that and telling us and other colleagues in the market about that.

Yi Fu Lee - *Oppenheimer & Co. Inc., Research Division - Associate*

On the cash flow, again, another quarter of great execution. Doron, can you discuss -- give us more color on, is it due to greater, better cash collection that's driving the outperformance in the cash flow from operation this quarter? And how should we think about the second half? And then if I could just squeeze one more in, Doron. On the Check Point relationship, it seems like there's record bookings this year. I know it's too early to tell. Like do you foresee this to translate into kind of like a Cisco relationship going forward?

Doron Abramovitch - *Radware Ltd. - CFO*

So I'll take the cash flow. So we don't guide the second half. Obviously, we gave some high-level at the beginning of the year. We are in the right direction right now with 40% approximately year-on-year growth. The main driver is the collection. Some of it is related to the nature of the business. Roy mentioned that in the first -- in this quarter, we got some 8 big deals in the U.S. So in a way, the nature of the business and the fact that some of them are big customers with a nice subscription allow us to gain some of it. But I cannot refer to the second half. The first half was very good in terms of collection issues.

Roy Zisapel - *Radware Ltd. - Co-Founder, CEO, President & Director*

Regarding your question on Check Point. So we are saying here in regards to that, all my sons, right? We can grow Cisco, and we can grow Check Point independently. I don't like to compare the level of revenues that can be achieved, one versus the other. I think each one of them can grow significantly even from this increased level. And we are working with a lot of the Check Point field to try to engage more and open up more joint accounts together. There's definitely good improvement in the last several quarters. It shows in pipeline. It's showing results. It's showing very nice wins. But there's still a lot of work to do to get it to the next level.

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

Okay. So let's conclude.

Roy Zisapel - *Radware Ltd. - Co-Founder, CEO, President & Director*

Okay, everyone. Thanks a lot for joining us today, and have a great day. Thank you.

Operator

That does conclude the call. And you may now disconnect.

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