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RDWR.OQ - Q3 2020 Radware Ltd Earnings Call

EVENT DATE/TIME: NOVEMBER 04, 2020 / 1:30PM GMT

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Radware Q3 2020 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. If you require any further assistance, please press star 0. I'd now like to hand the conference over to Anat Earon-Heilborn, VP, Investor Relations. Please go ahead.

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

Thank you, Sharon. Good morning, everyone, and welcome to Radware's Third 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 investor kit for the third 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 forecasts 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 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 statements we've made.

Please note that management will virtually participate in the Berenberg CEO conference and the Needham Network and Security conference in November and in the Raymond James Technology Conference in December. I will now turn the call to Roy Zisapel.

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

Thank you, Anat. We are pleased to deliver another quarter of solid results. We enjoyed strong broad-based booking growth, spanning across all our geographic regions and product lines. And across all components of our data center and application security offerings. DDoS, web application firewall, BOT management and cloud workload protection. As a result, our book-to-bill was above 1, and we benefit from increasing visibility for the coming quarters despite the obvious challenges in the business environment.

With regards to our cloud solutions and product subscriptions, we saw continuous robust performance. This is reflected in our year-over-year ARR growth. For the third quarter, ARR reached $169 million, with growth rate accelerating to 12%, up from 10% in Q2. The main driver for this growth was cloud and product subscription ARR, which grew approximately 30% year-over-year.

The digital transformation is accelerating. Users move to work from home utilizing personal computers and mobile devices. At the same time, applications are moving more quickly to the cloud. These trends create an expanded attack surface. On the backdrop of this phenomena, the attack landscape continues to be very active and traffic through our cloud security infrastructure reached all-time highs. In the third quarter, the number of DDoS attacks blocked by us was more than 2.5x larger than in the second quarter, and the volume of DDoS attacks blocked more than doubled. The total number of web application attacks blocked in the third quarter increased approximately 40% sequentially over Q2.

This extensive level of attacks illustrates the need for a comprehensive security strategy that protects and secures the infrastructure and critical business applications, whether they are on-premise, in the cloud or operating in a hybrid environment. It is this increased need for our holistic security portfolio that has provided us with opportunities to expand our presence with existing customers as well as winning new business.

For example, during August, a large-scale ransom attack forced the stock exchange, which was not a Radware customer at the time, to halt trading for 3 days. Despite being protected by a competing cloud data solution, the service failed to stop certain attack vectors. We deployed our DefensePro attack mitigation appliances in a very short time, and the attack traffic was immediately blocked. As a result, we secured an order early in Q4 through our strategic partner, Cisco.

We are addressing this increased demand by further investing in our own infrastructure and operations. As we announced in late August, we recently added 3 new scrubbing centers in India, Brazil and Israel, expanding both our geographic coverage and our total capacity. We also expanded and enhanced our main security operations center, tripling its size and equipping it with state-of-the-art Monitoring & Control systems.

We continue to broaden our offering to deliver on our vision of a highly differentiated full stack application security offering, utilizing advanced algorithms across our portfolio. In June, we announced API protection capabilities, applying machine learning on API calls and providing us with a highly differentiated capability. Recently, we announced that we developed a new set of behavioral algorithms to protect against sophisticated attacks in online gaming. This meets the specific needs of this sector for protection from UDP attacks, which is the core protocol used in these applications. We believe our investment in algorithms continues to provide us with significant competitive differentiation for the effectiveness and accuracy of our security solutions.

Moving to the customers and sales front, in the third quarter, we sold several multimillion multi-solution cloud security deals, including a major win with an online trading platform we announced last month. Our OEM relationship continues to perform well and delivered record bookings for the quarter. We continue to win new customers from these relationships, including Fortune 500 logos. One such win was with a Fortune 50 leading healthcare company that selected to displace its existing security solution with Radware Cloud DDoS protection services across 6 data centers globally.

Last month, we announced our new reseller relationship with Airtel, India's largest integrated telco. Airtel is now offering Radware Cloud DDoS protection, Cloud WAF and BOT Manager cloud security services to its enterprise customers. Under this agreement, we've already secured our first joint deal and we are looking forward to securing many more.

In summary, while the level of macro uncertainty is high, our visibility continues to increase, supported by increased backlog and accelerating ARR growth. With the rapidly accelerated digital transformation, cloud migration and remote working initiatives, the attack surface as expanded in cyber activity is at all-time high. Our comprehensive and differentiated data center security offering addresses the critical business need for continuous data center and application security and delivery. Our focus on larger enterprises and carrier segments and leveraging our key strategic partners' market access, create for us a robust market demand for our solutions. All deals position us very well for the future.

I will now turn the call to Doron.

Doron Abramovitch - *Radware Ltd. - CFO*

Thank you, Roy. We are pleased with the results of the third quarter, which were achieved in an environment that continues to be challenging with countries and regions going in and out of lockdowns or other limitations, leading to continued uncertainty. Our organization continues to perform well under these circumstances across all functions, and we are pleased with the way our employees adapted to the operational and business environment.

Revenues for the third quarter were $62.5 million, 1% below Q3 '19 and in line with our guidance. From a geographic perspective, revenues from the Americas reflected a healthy demand environment. Q3 Americas revenues increased 24% from last year to $30.2 million, and 9-months Americas revenues increased 13%. Revenues from the EMEA region decreased 5% from Q3 last year to $18.3 million, and 9-months revenues decreased 1%. Revenues in Asia Pacific decreased 27% from last year to $14 million, and for the 9-month period decreased 25%.

Our cloud and product subscription revenues, together with maintenance revenues comprised our recurring revenues. In Q3, recurring revenues were 63% of total revenues, reflecting high product delivery. For the first 9 months of 2020, recurring revenues were 66% of total revenues compared to 64% in the first 9 months of 2019.

ARR, which normalizes primary differences in booking, invoicing and revenue recognition reached a record $169 million for September '20, increasing 12% over September '19. This growth represents the health of our underlying performance. Within the total ARR, cloud services and product subscriptions ARR grew approximately 30% year-over-year, reflecting the growth drivers for the company.

The Total Deferred Revenue balance was approximately $172 million. Out of the total balance, 63% or approximately $108 million is due for recognition in the next 12 months. We have been providing Total Deferred Revenues in the past few years as a leading indicator for future growth. We believe that ARR is more industry standard indicator that is more appropriate given the increased proportion of subscription revenues and the decreasing proportion of appliance sales. We will, therefore, stop discussing Total Deferred Revenue starting next quarter and will regularly provide ARR information.

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 third quarter was 82.2%, reflecting product mix and higher proportion of subscriptions. Let me remind you that our cloud subscriptions are actual services that are accompanied by costs, especially when we open new scrubbing centers or increasing capacity across our cloud network.

Operating expenses in Q3 were $44.5 million, up 3% from Q3 2019. The majority of the increase is a result of higher headcount expenses, including commissions, offset predominantly by lower travel expenses.

We ended the quarter with 1,125 employees, up by 54 employees compared to a year ago. Operating profit and margin in Q3 2020 were $6.9 million and 11%, respectively. Net income for the third quarter was $8.4 million or $0.18 per diluted share, at the high end of our guidance.

Turning now to the balance sheet and cash flow items. Net cash provided by operating activities was $7 million for the third quarter and $50 million for the last 12 months. During the quarter, we repurchased approximately 626,000 shares for a total of approximately $16 million. In the first 9 months of the year, we spent approximately $40 million on share buybacks. And at the end of the end of September, we had approximately $36 million available for continued purchasing. We ended the quarter with approximately $437 million in cash and financial investments. Most of our cash is invested in highly liquid U.S. dollar marketable securities and deposits.

I will move to our guidance for the fourth quarter of 2020. We expect Q4 revenues to be between $66 million and $69 million, leaving full year revenues to be between $247 million and $250 million. Q4 operating expenses are expected to be between $46 million and $47 million. We expect to see a continued impact of higher headcount costs, partially offset by lower travel expenses. In addition, in Q4 we factored a moderate FX impact. Although our financial income for Q3 2020 reflects a favorable investment portfolio performance, we will expect a decline in the coming quarters, given lower yield on newer marketable securities. We expect EPS for Q4 to be between $0.21 and $0.24, and full year EPS to be between $0.65 and $0.68.

I will now open the call for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question comes from George Notter with Jefferies.

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

I guess I wanted to ask about the differential in growth rates across your Americas business. I think you said 24% year-on-year. Obviously, APAC was worse, EMEA was in the middle. I know you guys are investing fairly aggressively in North America in particular. Can you talk about those investments and how they're translating into the additional revenue growth? And does this kind of open your minds to investing more aggressively in other parts of the business as well? Any thoughts there would be great. Appreciate it.

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

So I think in general, obviously, we're very satisfied with our performance in North America. I think the investments that we've done and we shared already in February have yielded. And that coupled also with the U.S., at least from our point of view, was hit less on the business side from COVID-19 versus what we've seen internationally in lockdowns and the way also the other governments reacted on the business side. I think also in the U.S., the investments in cybersecurity and cloud are in a heightened level and have accelerated significantly, which also contributes nicely to our performance. So our plan is to continue to increase investments in North America, given the growth and given that we think the potential for us is extremely high, almost unlimited versus where we are now. And we're planning to add more resources across both our direct salesforce, our OEM, our OEM channel and the cloud reselling partners. So across all the growth drivers we're sharing as part of our strategy. As it relates to the international, I mentioned in our prepared comments that in Q3, we already saw all our geographies growing year-over-year in bookings. It's not yet in revenues, but obviously, if this trend will continue into Q4 you will start seeing that also in the P&L. So as long as the business climate in the international market stays as is, we're also optimistic that our performance there will improve.

Operator

Next question comes from Alex Henderson with Needham.

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

Great. Thank you very much. I was hoping you could talk a little bit about the U.S. business split between what I think is probably some strength at Cisco and whether that is part of what drove the acceleration and whether -- how much is more organic Radware? And I've got some follow-ups.

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

Yes. So the growth in the U.S., not only in the third quarter, but throughout the year, definitely, we're seeing Cisco ramping up significantly, as mentioned, probably every quarter. I want also to highlight the Checkpoint relationship, another record booking quarter from Checkpoint. As I've mentioned, it was a record booking quarter for all OEMS, so that is helping us. But a lot of the growth is coming also from our organic wins there.

So it's really the fruits of all the strategy taking place. And as was mentioned, we are very satisfied with the results and believe we should put more resources behind it to continue.

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

On the Cisco front, do you think the 7% RIF that they are doing will help you or hurt you as the company shifts resources and shifts focus? Any sense of whether that's a tailwind or a headwind?

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

So early to say, but definitely, the direction they're taking, the high-level strategy to focus more on applications and more on security, should help us because this is exactly the area we focus on and where we are completely complementary to their portfolio. So the high level strategy, I think, fits us very well. We need to see how the RIF affects their performance. But again, our ability to... our number in Cisco can grow significantly. The potential is huge. And we are starting to win, as I mentioned in my comments, more and more Fortune 100, Fortune 50, Fortune 500 customers with them as we're seeing increased activity with their salesforce.

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

Great. If I could ask one last question, and then I'll cede the floor, I know you don't want to give guidance past the current quarter. But strategically, the logic behind your spending and growth outlook into '21, it seems pretty clear that you had intended to accelerate spending in '20 and because of COVID slowed that somewhat. I would assume that you will see an acceleration in investment in -- as we go into '21, and then also see some T&E coming back. So should we expect the OpEx growth in '21 to put a little bit of a crimp on the operating margins in the year? Or should we assume that you're going to be, as you've historically been, more careful on the mechanics of your investments so that you continue to deliver some margin rebound?

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

Yes. So while I think we will continue to be conservative on investments, I think especially in North America and especially as it relates to our OEMs and cloud security offerings, it's the time to continue to invest. So we don't give guidance yet on all those parameters you've mentioned, but directionally, OpEx will grow, especially in these areas, in these investments because we see very good returns. I think ARR is a good directional parameter to follow, and we want to put more support behind this growth.

Operator

Next question comes from Yi Fu Lee with Oppenheimer.

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

I hope everybody is safe and healthy. Roy, can I just ask, maybe start with you first, a more broad-based macro question? We've seen Americas growing fairly healthy at 24% year-over-year. But can you give us more color? Were there any pull-forwards from the June lockdown that we're seeing with other vendors in America? And also, some commentary, Roy, on maybe the EMEA. Because we're hearing second wave lockdown in let's say the U.K. And also, anything on the timing of APAC? And then I have a quick follow-up for Doron as well.

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

Yes. Can you just repeat your question on the U.S., whether there were --

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

Yes, yes. Were there any pull-through from the June lockdown? Because we've seen other vendors that in late June in America, like some states like California, they were in like lockdown, expanded lockdown measures, I would say, in June. Were there any pull-throughs from the second quarter to the third quarter that drove the very healthy year-over-year increase? And maybe some commentary on the India and APAC region would be helpful, Roy.

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

Okay. So nothing specific that I can share. And also, in our last quarterly result, it's not as we mentioned slipped deals in North America. North America performance for us for several quarters now has been strong and we continue to see very good levels of activity and win ratio coming from that theater. Regarding EMEA and APAC, over there the situation is a bit more complex as different countries behave differently. And also forecasts in these countries is changing quite dynamically as they move to second wave, third wave, new lockdowns and so on. I'm sure you follow the news from Europe in the past several weeks, which makes all the environment obviously less strong for us. Having said that, in Q3 and also our expectations for Q4 are quite good in the international theater as well. So we do see rebound of business activity. And to the point it will persist more than one quarter, maybe 2 or 3 quarters, it's definitely going to flow into the P&L. So I don't see any worsening conditions internationally. Actually, in Q3, we saw very good improvement, and we're looking forward to go back to previous business levels and beyond that as well.

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

Thanks for the macro commentary, Roy. And then, Doron, can I just follow-up with the investments in the expansion of the scrubbing centers, in particular in emerging markets like India, Brazil and the developed markets in Israel. Can you give us a little color on some of the greenfield opportunity in the emerging markets? And was Airtel partnership a big contribution to the performance in some of these regions? Anything on that would be helpful. Thanks, Doron.

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

So I'll take that on the customer side and then maybe Doron will add some comments. So first, on customers, what we see with some of our global customers is we need to cover, as I've mentioned, many datacenters across the world. When you take a global Fortune 50 or a very large manufacturing company and protect all their facilities, in many cases, they do have additional datacenters in countries such as Brazil and operations in India. And then our ability to serve them also locally is a significant competitive advantage. So the opening of these additional data centers is coming from 2 directions. One, of course, we want to serve the local markets, and many local markets today, taking data and user private information out of the country is not allowed by the regulators. So especially as it relates to local government, financial institutions and so on, you do need local facilities. In addition, the global companies, when we are signing global deals, it's becoming more and more a needed and a competitive advantage to have that global presence, and we've acted based on that. So both to our India and Brazil datacenters, we already have tenants based on these two. Specifically to India, we are also extremely encouraged by the Airtel partnership. We became their solution for cloud DDoS, Cloud WAF, Cloud Bot. And if you follow their announcements, they announced a new theme they call Airtel Secure and they named 2 strategic partners, Cisco and Radware, as part of this strategy. Airtel is the largest business, telco in India. They are very high-end in terms of security overall and cloud security specifically. And we are very enthusiastic about this partnership, and we will update you in the coming quarters about our progress. I think it's material to our APAC business.

Operator

Next question comes from Andrew King with Collier Securities.

Andrew King

So with the approaching holiday season, I just wanted to get an idea of where you see the opportunity with the Bot attack, especially with you just announcing the Bot Manager for Salesforce Commerce Cloud. [audio silence]. Can you guys hear me?

Operator

Presenters, you're connected.

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

Okay, can we get the original question?

Operator

Mr. King, please repeat your question.

Andrew King

Yes. So just with the approaching holiday season, can you guys give us a little bit more color around the opportunity with the Bot Manager and the bot attack, especially with you guys just announcing the Bot Manager for Salesforce Commerce Cloud?

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

Yes. So the bot space in general is targeting those automatic robots that are imitating real user traffic. In that sense, we are expanding our security portfolio and the problems we solve to more business-related problems, like account takeover, like page scraping and so on. The attack that we're seeing in the bot space are not, the traffic itself is not malicious. It's the intent that is malicious. And hence, the conversations are spanning both security and business for application business logic conversation. We're seeing very nice uptick for our customers of WAF and DDoS, buying also the additional bot capabilities from us. We think that our product, which is again based on machine learning and algorithms is doing extremely well. And we think that opportunity will just grow within the coming years. The market is still small, but growing quickly. And if we tie both to web application security as well as to API security, definitely, we're satisfied with our position and the growth we're seeing in that area of our business.

Andrew King

Great. And then just looking at the OEM space specifically, in the past, you've really been focusing your investments into the Cisco relationship. Can you give us an idea if going forward if you're going to shift more of those resources to investments into the Nokia and Check Point relationships? Or will you stay focused on Cisco?

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

Based on the results we're seeing, and I've mentioned several quarters in a row also the other OEMS, we continue to add investments, both in Cisco, to Check Point and to Nokia. So we don't see those as mutually exclusive investments. Actually, we see Cisco and Check Point relationships at the end customers quite complementary for us. Because generally when Cisco security is the large security architecture player in a customer, it means that Check Point has a smaller role and vice versa. So generally, if you look on the Fortune 500, many of them would be either-or and not the 2 vendors together. And therefore, we can invest in parallel with both relationships and enjoy growth with them in getting better access to the end customers.

Operator

Next question comes from Tavy Rosner with Barclays.

Chris Reimer - *Barclays Bank PLC, Research Division*

Hi, this is Chris Reimer on for Tavy. I wanted to ask, following on the previous question relating to geographies, especially the decline in APAC. Can you clarify if you're seeing some long-term trends there? Or is it all just near-term volatility?

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

We think from a booking perspective, this year would be growth over last year. So as it relates to our booking, I do see already an improvement. We did suffer in the, I would say in the first half of the year and especially in Q1 I would say more. But since then, we do see recovery. Not in all countries yet, but in the, I would say in the major markets, we do see business is coming back. So I don't see that as a long term issue, and we look forward to bring back growth also on the P&L from the revenue recognition in APAC soon.

Chris Reimer - *Barclays Bank PLC, Research Division*

Okay. And just regarding your cash position, over $400 million, can you give any color? Or do you have any views on M&A?

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

Yes. So we continue to be active in the market, looking for M&A, especially as it relates to enterprise security, cloud security spaces. And we will update when we will have something specific to report, but it's definitely one of the pillars of our strategy. We think there's a good opportunity beyond the organic growth we had through M&A, and we are looking for that. In parallel to that, you can see that we've heightened our buyback and this year bought $60 million. So basically 100% of the operating cash flow and a bit more that we're utilizing for these buybacks.

Operator

Next question comes from Joshua Tilton with Berenberg.

Joshua Alexander Tilton - *Joh. Berenberg, Gossler & Co. KG, Research Division - Associate Analyst*

Just a quick one, and apologies I didn't catch this, but could you just repeat what the recurring revenue as a percentage of total revenue was in the quarter and what it was in Q3 last year?

Doron Abramovitch - *Radware Ltd. - CFO*

So this quarter, the recurring revenue was 63%. And in the first 9 months, it is 66%, up to 64% from last year.

Joshua Alexander Tilton - *Joh. Berenberg, Gossler & Co. KG, Research Division - Associate Analyst*

So the $64 million was for the first, from last year, that's on the first 9 months or just in the quarter? I just want to clarify.

Doron Abramovitch - *Radware Ltd. - CFO*

Yes. The first 9 months of 64% and now up to 66%.

Joshua Alexander Tilton - *Joh. Berenberg, Gossler & Co. KG, Research Division - Associate Analyst*

Okay. That was helpful. Did you -- by any chance, did you disclose what the percentage in the quarter was last year?

Doron Abramovitch - *Radware Ltd. - CFO*

Last year, it was around 66% to 67%. But overall, we mentioned that this year we are planning to get more than 65%. The fluctuation issue, I mentioned in my prepared comments that we had a certain large deal with the higher product component. So it drove the rev rec to be in this area of 63%. So this is why we obviously gave this for the 9 months. And here, you see the upwards trend started three year ago was 42%. And now we are obviously more than 65%. This particular quarter was a bit down. But again, because of these few deals with the product mix that drove this trend.

Operator

And at this time, I'll turn the call over to Mr. Zisapel.

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

Okay. Thank you very much, everyone, for attending, and have a great day. Thank you.

Operator

This concludes today's conference call. You may now disconnect.
