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RDWR - Q3 2016 Radware Ltd Earnings Call

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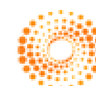

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CORPORATE PARTICIPANTS

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

Doron Abramovitch *Radware Ltd. - CFO*

Roy Zisapel *Radware Ltd. - CEO*

CONFERENCE CALL PARTICIPANTS

Jess Lubert *Wells Fargo Securities, LLC - Analyst*

Joseph Wolf *Barclays - Analyst*

Mark Kelleher *DA Davidson & Company - Analyst*

Rohit Chopra *Buckingham Research - Analyst*

Catharine Trebnick *Dougherty & Company LLC - Analyst*

PRESENTATION

Operator

Hello, and welcome. My name is Carol, and I will be your conference operator today. At this time, I would like to welcome everyone to the Radware Q3 2016 Earnings 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).

I would now like to turn the call over to Anat Earon-Heilborn, Investor Relations.

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

Thank you, Carol. Good morning, everyone, and welcome to Radware's Third Quarter 2016 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 third quarter, are 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 those 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.

Please note that management will participate in Wells Fargo Tech, Media & Telecom Conference next week, in Imperial Security Conference in December, and in Needham Growth Conference in January. All three conferences are in New York.

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

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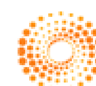

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Doron Abramovitch - *Radware Ltd. - CFO*

Good morning, everyone, and thank you for joining us on the call today. I will begin with providing an analysis of our financial results and business performance for the third quarter of 2016, and then move on to our outlook for the fourth quarter.

Q3 revenues were $46.9 million, in line with the announcement we made on October 10th, and down $1 million from Q3 last year.

Looking at the geographic breakdown, revenues from the Americas were $20 million, representing 43% of total revenues, and up 4.6% from Q3 2015. Revenues from EMEA were $12.2 million, representing 26% of the total, and down 5.1% from last year. Revenues from APAC were $14.7 million, representing 31% of total third quarter revenues, and down 8.8% from Q3 last year.

Revenues from the enterprise vertical were $33.3 million, and contributed 71% of total revenue, whereas carrier revenues were $13.6, representing 29% of the total.

As we have discussed in our preliminary announcement, our business is undergoing a shift towards an increased proportion of subscription and services sales, which led to lower-than-expected recognized revenue, despite double-digit growth in bookings and book-to-bill ratio significantly larger than 1.

This bookings growth is reflected in our total deferred revenue balance, which grew 29% from $85 million at the end of September 2015 to $110 million at the end of September 2016. Let me remind you that we calculate total deferred revenue by adding to the deferred revenue balance that is on our balance sheet the uncollected billed amounts that were offset against trade receivables and are not presented on the balance sheet. This figure is presented in the investor kit which you can find on our website.

I would like to provide you some more details on total deferred revenues in order to highlight the significance of this figure's year on year growth.

I'll start with the duration of the total deferred revenues. The average duration of the September 2016 balance was 1.77 years, compared to 1.75 years for September 2015. What this means is that the 29% year-on-year growth reflects strong business activity with only a small increase in the length of the contracts. The implication of this duration is that consistently 60% to 65% of the total deferred revenue balance is scheduled to be recognized as revenue in the next 12 months following the balance sheet date.

So, as of September 2016, approximately $68 million was scheduled to be recognized as revenues in the coming 12 months, compared to $55 million as of September 2015.

I will now move on to discuss expenses and profit, using non-GAAP figures. The differences between the GAAP and non-GAAP results for the quarter come primarily from stock-based compensation expenses, as well as from litigation costs, and amortization of intangible assets, and exchange rate fluctuations related to the balance sheet items. For a detailed GAAP to non-GAAP reconciliation, please refer to the financial tables accompanying our press release, or to the investor kit posted on our website.

Non-GAAP gross margin was 82.4% in Q3 2016, compared to 82.9% in Q3 last year, and in line with our expectations.

Our operating expenses were $38.6 million, compared with $36.7 million Q3 last year, as we continue to invest in our business in order to ensure we have the required resources to support our growth plans.

Non-GAAP net income this quarter was $1.6 million or $0.04 per share diluted, compared with net income of $4.8 million or $0.10 per share diluted in Q3 of last year.

The weighted average number of shares used for calculating diluted net earnings per share for the third quarter was approximately 44.1 million shares.

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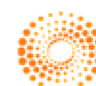

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As of September 2016, we had approximately $311 million in cash and financial investments. During the third quarter, we were restricted from conducting any stock buybacks due to the Israeli Corporate Law, but these administrative issued were resolved after the end of the quarter, and we spent $8.1 million on repurchasing approximately 626,000 of our own shares during the October. We also have $26.9 million remaining on our $40 million share repurchase plan.

We ended the quarter with 976 employees. We believe we have the right structure to support the business in its transition phase, and to continue innovate leading solutions and bring them to the market.

Moving on to our outlook for the fourth quarter, we expect revenues to be between $50 million and $51 million. Non-GAAP gross margin is expected to be between 82% and 83%. Non-GAAP operating expenses are expected to be between $40 million and $41 million. We expect non-GAAP effective tax rate to be 16%, and non-GAAP EPS is expected to be between $0.03 and $0.06 per share diluted.

Furthermore, we expect book-to-bill ratio to be significantly larger than 1 in Q4, and our total deferred revenue balance at December to increase from last year.

I will now turn the call over to Roy.

Roy Zisapel - *Radware Ltd. - CEO*

Thank you, Doron. And good morning, everyone. As we've discussed on October 10th, the shift of our business towards more subscription and service sales accelerated during the third quarter. While the shift reflects a desired strategic transition in our business model, it led to lower than expected revenues for the quarter.

We believe that the strengthening of subscription and cloud business models meet our customer needs, and at the same time create a consistent and profitable revenue stream for Radware. We therefore intend to continue our focus and investments in this area.

I would like to spend a few minutes elaborating on the strategy underlying this transition. Looking at enterprise customers, who increasingly prefer to buy fully-managed solutions that are consumed on a subscription basis, such as public cloud solutions, content delivery network, DDoS cloud scrubbing, and 24/7 monitoring and management capabilities.

This preference is a result of several technological and operational reasons that are related to the shift to the cloud from a few interlinked perspectives.

First, the industry trend to move applications to the cloud affect the entire infrastructure, and requires broader protection that encompasses the enterprise itself, as well as its cloud-based applications.

Second, protection should match the assets protected. So when the applications are in the cloud and bought in the subscription model, buying security services as a subscription is more in line with that consumption model.

Third, enterprise customers increasingly need fully-managed solutions, as they lack the expertise and the resources to manage their security solutions effectively in house. The ability to provide such management services in the cloud improves their cost effectiveness.

Last, when our solutions are deployed both on prem and in the cloud, the level of security we can deliver is stronger.

The clear trend of migrating enterprise applications to the cloud makes our solutions critical not only to such enterprise customers, but also to hosting companies and software as a service companies.

The cloud and hosting companies provide cloud services over a shared infrastructure, and an attack on one of their customers might affect thousands of others. It is critical to such hosting companies to protect their own infrastructure as part of the service they provide.

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For example, in the first quarter, we booked a 7-digit deal with a leading North American hosting service provider. Key reasons for the win were our mitigation capacity being highest in the market, with over 350 gig capacity, the needs of the customer for 100Gbps 40Gbps, and 10Gbps connectivity, and above all, our state-of-the-art security algorithms to automatically detect and block any attack based on our behavioral algorithms. Being the only vendor in the market that is able to adhere to these requirements was a clear winning factor for us.

Software companies who deliver the products in a SaaS model face similar risks to those of hosting providers. Their customers all consume the product through the shared infrastructure, and an attack on one customer can bring down the entire SaaS service.

For each of these three types of customers, enterprise, cloud infrastructure-as-a-service providers and software-as-a-service providers, our solutions are critical, and as a result, Radware is in fact a key enabler of the transition of applications to the cloud, and we participate in this transition for multiple perspectives

We have reached this position through consistent execution of our vision to provide a unified infrastructure for delivery and security of applications. In order to achieve this, our development efforts over the past years have focused on security-oriented applications, throughout both our security and applications delivery product lines. In other words, the role of our ADC offering has shifted from load balancing for the customers' datacenter, specifically to be an integral part of the comprehensive holistic portfolio that provides an end-to-end solution for applications' delivery and security.

As you know, a key component of our strategy to increase market footprint, are OEMs and alliances. We are pleased to have successfully established relationship with market leaders in the security space, such as Check Point and Cisco, and with our progress with these partners.

Let's discuss business performance by region. In the Americas, it was a solid third quarter. The market shift to the cloud was the strongest in this region and in parallel, so is the shift from products with subscriptions for our business.

In EMEA market conditions continue to be challenging. We have a strong pipeline there, but sales cycles are long, and the pace of deal closures is slow.

In Asia Pacific, we believe we've taken the right steps, and in some countries begin to see the expected results. Given the diversified nature of this region, we expect it will take a few more quarters to return to growth.

Across our business, we continue to strengthen our sales and marketing capabilities, collectively adding resources in certain places. We are particularly focused on the opportunities available for our subscription business and cloud offerings. We aim to broaden our access to such a opportunities in order to significantly grow our business.

Looking forward, we are strongly positioned to benefit from the key long-term trends, such as the continued shift of applications to the cloud, the expectations for increased adoption of software-defined networks, and ever-evolving security threats.

The continuous evolvement of security threats was under the spotlight in recent weeks. IoT botnets attracted attention with the Mirai bot in September, and the high-profile Dyn attack 10 days ago. While Dyn itself is not a Radware customer, the October 21st DDoS attacks affected multiple carriers and service providers, including some of our customers. As far as we are aware, our solutions protected our customers successfully, and most importantly, automatically.

This success confirms the superiority of our unique behavioral protection technology which enables automatic detection, real-time creation of a dynamic fingerprint to match the attack, and mitigation and termination of the attack whether previously known or not, through advanced machine-learning capabilities.

These attacks demonstrate the security risks accompanying the proliferation of IoT, and we expect demand for our products to increase, as the amount of connected devices continue to grow.

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The DNS attack clearly demonstrate that cloud-delivered services such as DNS, require tight security protection, and real-time visibility. And companies must take a complete review of all the different components of their infrastructure, whether in-house or supplied by third parties, in order to avoid down time and failures.

I remain confident in the growth prospects of Radware. We have a unique product portfolio with very strong technologies, which provides genuine competitive advantages in a very exciting market. We believe that with sharper execution, and once the shift in our business model stabilizes, we can deliver sustained growth and strong financial results.

With that, I will open the call for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Jess Lubert, Wells Fargo Securities

Jess Lubert - *Wells Fargo Securities, LLC - Analyst*

Hi, guys. A couple of questions, perhaps you can help us understand what percentage of your business is subject to substitution from a subscription-based alternative, and where we are in that transition to subscription-based services. And in that regard, as we build out our models for next year, how we should be thinking about seasonality as we work through this transition, and to what extent you would expect to see growth throughout 2017, or if we should be thinking about that as more backend loaded.

Roy Zisapel - *Radware Ltd. - CEO*

Okay, so what we are seeing is as I've mentioned in the previous calls, is the deals that used to be product only have now significant components of subscription. As a result of that, the deferral of such deals is large. You can assume that in the ADC business, strictly load balancing, there's a smaller proportion, although growing, of subscription. While in security, we are encouraging and we are pushing our cloud security solutions very strong, to the point of every win ultimately will involve one component of subscription or more than one. So down the road, this might be a significant portion of our complete booking in a certain quarter.

Regarding seasonality, the way we are looking at our business is on a year-over-year basis, for both the product and subscription and services. Of course, with the growth of subscription and services, as part of the complete revenue recognition, those trends might get more smooth than we see them today. But at least for the short coming future, we'll still see the regular seasonality in our business, we believe.

Jess Lubert - *Wells Fargo Securities, LLC - Analyst*

Right. Historically, Q4 to Q1 you see a big sequential downtick, and then you see sequential growth through the remainder of the year with Q4 the strongest quarter. Is that the right way to think about next year? And maybe just last one from me is, we look at this transition across the different geographies. Where should we start to see the turn first? Which geographies may lag a little bit? So we can kind of see if things are progressing as you've laid out.

Roy Zisapel - *Radware Ltd. - CEO*

So without going into any guidance for Q1 or the rest of the year, for 2017 I would expect the same trends as we've seen before, a decline between Q1 versus Q4 numbers, and then probably an increase. As well we will provide specifics on Q1 in our next call.

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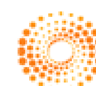

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Regarding the shift, I think as I've mentioned in my prepared remarks, the US is the furthest in the proportion of subscription. The furthest out of the total business. And I think over there we're already starting to see some signs, quite consistent growth, as well as was mentioned, it's a mix of product growth, regular product growth and the overall business growth, together with this mix shift. But I think the US is the leading indicator as far as our regions, for the business, for the new type of business mix between subscription services and products.

Jess Lubert - *Wells Fargo Securities, LLC - Analyst*

Thanks, guys.

Operator

Joseph Wolf, Barclays

Joseph Wolf - *Barclays - Analyst*

Thank you. And thank you for that extra bit of detail on the duration of the deferred. Just in terms of the growth commentary and that last comment on year-on-year comps, if I look at 4Q 2014 versus the guidance for this year, there's about a 15% decline in revenues, and about 10% from last year, 9% to 10%. Can you just talk about the subscription transition in that mix or maybe is there a way for you tell us-- you mentioned that subscriptions are accelerating-- can you tell us what percentage the subscriptions were in terms of the mix of bookings in this quarter compared to either a year ago, or even compared to 2Q?

Roy Zisapel - *Radware Ltd. - CEO*

Okay. So we're not breaking the overall deferred revenues to subscription and services. But as we've mentioned in our remarks, the big driver for the growth is coming from subscription. You can see that from our remarks that year over year these annuity-based services while maintaining roughly the same length, grew $25 million. So I feel that's a very strong point to the growth we have in subscription overall, as well as how the mix is moving from the 10%, 9-10% we mentioned reduction in recognized revenue versus the close to 30% increase in the total deferred revenue.

Joseph Wolf - *Barclays - Analyst*

Okay. I guess a question-- you mentioned cloud transition. And you've got a healthy mix of enterprise customers. Are you seeing the enterprise customers move to the public cloud, AWS or Azure type services? Is that impacting their purchasing from you? Or do you have enterprise customers that are requesting your types of services, even as they move to the public cloud?

Roy Zisapel - *Radware Ltd. - CEO*

Yes. So this is exactly what I was trying to discuss when I mentioned enterprise customers. Assuming they move to the public cloud, they still have a high need for security solutions. As they move to an Amazon or Azure or any other type of cloud, the need for our web application firewall cloud or DDoS cloud is just increasing.

So we have many customers that are either cloud only, meaning that they don't have more an on premise datacenter; or they are in a hybrid situation, meaning they have several datacenters, physical datacenters of their own plus applications in the cloud. And in that situation, they really want to have a consistent security capability across all their infrastructure. Whether it's public cloud or not - the hacker doesn't care. So when I'm protecting the company that's in both places, if they don't have a unified view of what is going on in the cyber world, they are going to lose.

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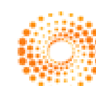

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What we are providing with our cloud solution, and as I've mentioned, there's either a cloud-only solution or hybrid cloud solution, meaning there's a component on prem, be it the public cloud or a private datacenter in our cloud security; regardless of how the customers are deploying our cloud solution, they have a consistent view across all their assets. They have a consistent detection and correlation of events. If an event is happening only in the public cloud or only in the datacenter, it's a consistent policy of mitigation and it's feeding up information regardless where the attack happens. So this is a very, very strong value proposition.

If you're going to the cloud, you absolutely need security. If you're a hybrid, you absolutely need consistent security for both, a real challenge in these specific market attacks across the datacenters.

Joseph Wolf - *Barclays - Analyst*

That was helpful. Just one last question, if you look at the DDoS events over the last couple weeks, could you just give us a rough ballpark of how many of your DDoS customers are looking at this as a preemptive solution, and how many of them are reacting and don't make that DDoS purchase decision until they've already been attacked?

Roy Zisapel - *Radware Ltd. - CEO*

I think it varies. Of our existing customers, obviously they've taken action. But if you ask about investments in general, I think it's a question of the vertical market. I think in the financial segment, carriers, cloud and hosting -- in some verticals there's a clear call for action. And in some verticals that are less online exposed, I believe it's more of a weighted IT budget prioritizations, sometimes audit against cyber threats, et cetera, so it's more mixed.

But definitely, with attacks such as the last one, and I can tell you we have daily multiple attacks that we are blocking in our customers worldwide with our services, we are seeing the level of activity, I would say, of hackers around the world, whether it's politically motivated, financially motivated, activism; it doesn't matter what it is. It's clear that people will need to take action.

Joseph Wolf - *Barclays - Analyst*

Thank you, guys.

Operator

Mark Kelleher, DA Davidson

Mark Kelleher - *DA Davidson & Company - Analyst*

Great. Thanks for taking the question. Just first, some clarification, I didn't catch the gross margin guidance for the December quarter. Could you just repeat that?

Doron Abramovitch - *Radware Ltd. - CFO*

82.4%

Mark Kelleher - *DA Davidson & Company - Analyst*

Okay. And could you give us an update on Cisco and how that partnership is progressing?

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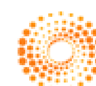

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Roy Zisapel - *Radware Ltd. - CEO*

Yes. So Cisco is progressing well. We started to receive the first orders. We are expanding the footprint, the number of appliances and product lines with Cisco that we are residing on. And now we're looking forward to growth there. But so far, so good.

Mark Kelleher - *DA Davidson & Company - Analyst*

Okay. And then on the balance sheet, just getting back to deferred revenue, it was down pretty significantly sequentially. But if you add the unbilled contracts, it was actually up pretty significantly. So is that the move to subscription? Is that what we're seeing there? Is that what that gap is?

Roy Zisapel - *Radware Ltd. - CEO*

So I think if you're asking the growth important to (inaudible)--

Mark Kelleher - *DA Davidson & Company - Analyst*

No. The unbilled contracts are pretty significant.

Roy Zisapel - *Radware Ltd. - CEO*

Can you repeat that, sorry?

Mark Kelleher - *DA Davidson & Company - Analyst*

Yes. So deferred revenue was down sequentially. But if you add the unbilled contracts, it was up pretty significantly. So the unbilled contracts are a very large portion of that. So is that what we're seeing from the switch to subscription, a lot of unbilled contracts? And if so, what's the ability of customers to cancel those contracts?

Doron Abramovitch - *Radware Ltd. - CFO*

No let me walk again through the numbers, then maybe then (inaudible). The numbers grew. Both with the deferred revenue in the balance sheet, it's from $65 million to $73 million at the (inaudible). And the total deferred revenue defined in the prepared remarks grew from $85 million to $110 million. Obviously what we consider in both these number, is something that is quite firm. We have no reason to believe it's something that supposed to be cancelled or something that is out of this equation.

Roy Zisapel - *Radware Ltd. - CEO*

One comment, Doron mentioned the year over year numbers. The total deferrals is not about unbilled contracts. It's about not collected. So those are invoiced but not collected yet. So there's no reason. There's a closed order, d , and so on. We are not even reporting contracts that may have all kind of exits for convenience clauses, et cetera. What you're seeing in the total deferred is the deferred revenues on the balance sheet plus the billed but not collected yet deferred revenues.

Mark Kelleher - *DA Davidson & Company - Analyst*

Okay. I'll follow that up a little bit more offline. Thanks.

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Operator

Rohit Chopra, Buckingham Research

Rohit Chopra - *Buckingham Research - Analyst*

Thank you. I didn't catch, Doron, the tax rate, so if you could repeat that, that's the first clarification there. And then my question is on OEM revenues. I just wanted to get a sense how Check Point is doing. And then what gives you the confidence that the Cisco relationship is going to perform better than Check Point, given Check Point's the largest pure play in security. They were selling your security solution. They're in your backyard. And it doesn't seem that they're performing well. But I just wanted to try to get a sense of what's different between Cisco, what's different between Check Point, if you don't mind.

Doron Abramovitch - *Radware Ltd. - CFO*

I will start with tax, as part of our guidance it's approximately 16%.

Rohit Chopra - *Buckingham Research - Analyst*

16%? Okay. Thank you.

Roy Zisapel - *Radware Ltd. - CEO*

And regarding the OEM performance, of course there's no guarantees. But the Cisco relationship and the Check Point relationship are going after different types of providing our solutions to the market. The Check Point relationship that we believe is progressing positively, is really supplying DDoS solutions in a separate appliance very similar to how we are selling our solutions to customers.

In that regard, they are providing us more market coverage and access to their customers, and allow us to increase our market share.

The Cisco relationship is part of the next-generation firewall market push. So Cisco is not selling an attack mitigation or a DDoS solution standalone. They're only selling this as part of their next-gen firewall. In that regard, it opens for us a channel to be offered as part of next-generation firewall deal, where not necessarily a customer is interested or can afford a dedicated DDoS-only solution.

So I think those are, again, expanding our footprint and go-to-market opportunities. We're seeing again through Cisco, an access to a set of customers that we are not able to get to by ourselves, and not through Check Point, so access to Cisco house accounts. And we are seeing also a set of opportunities that again are not focused on DDoS itself, but are a broader, I'd call it all-in-one next-generation firewall deals.

So we're actually feeling good about the mix, the opportunities that we exploit through the OEM partners. And we need to see the impact from both Check Point and Cisco.

Rohit Chopra - *Buckingham Research - Analyst*

Roy, may I ask a quick follow-up? As you look back at this past quarter, did you experience any incremental competition either on the ADC side or on the security side?

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Roy Zisapel - *Radware Ltd. - CEO*

No. Nothing specific.

Rohit Chopra - *Buckingham Research - Analyst*

Thanks, Roy. Thanks, Doron.

Operator

(Operator Instructions). Catharine Trebnick, Dougherty

Catharine Trebnick - *Dougherty & Company LLC - Analyst*

Good afternoon. Thanks for taking my question. Mine is on the Cisco relationship. What type of marketing activities are being put in place to facilitate the drive of that relationship? And then any-- is this going to be recorded in the services segment of revenue or in the product? And then finally, can you give me the product-services split? I didn't catch that on the call earlier. Thank you.

Roy Zisapel - *Radware Ltd. - CEO*

Hi, Catharine. So regarding the Cisco relationship, the marketing activity is done by Cisco. It's a Cisco product. So it's the firepower next-generation firewall, and they are pushing it through their marketing, through tradeshows to , through channel events, through internal activities and training, et cetera. So it's not a Radware product, and it's not a Radware product we sell or that our channels can sell. It's completely a Cisco product, where the Radware software is embedded.

Regarding the product recognition there, it's a software. It's a software product with accompanying maintenance contracts to it. So the maintenance goes to the services line, and the license goes to the product line.

Catharine Trebnick - *Dougherty & Company LLC - Analyst*

Okay. Thank you. And now, Doron, what was the product-services split? Thanks.

Doron Abramovitch - *Radware Ltd. - CFO*

Could you repeat the question?

Catharine Trebnick - *Dougherty & Company LLC - Analyst*

The product-- how much-- is it 70% products this quarter, 30% services?

Doron Abramovitch - *Radware Ltd. - CFO*

No, no. Sorry. We don't provide this information on a quarterly basis, only on the full year.

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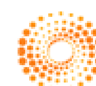

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Catharine Trebnick - *Dougherty & Company LLC - Analyst*

Okay. Thank you.

Roy Zisapel - *Radware Ltd. - CEO*

Actually we might be able to share-- Catharine, you might be referring to enterprise service provider revenues.

Catharine Trebnick - *Dougherty & Company LLC - Analyst*

Oh, no. Usually, you usually give a product/services mix. I just-- fine. Thank you.

Operator

And presenters, we have no other questions in queue at this time. I'll turn the call back to you for closing remarks.

Roy Zisapel - *Radware Ltd. - CEO*

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

Operator

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

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