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PRESENTATION
Operator
Good morning, my name is Sharon and I will be your conference operator today. At this time, I would like to welcome everyone to the Radware Q3 2017 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) Thank you.

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

Anat Earon-Heilborn
Thank you, Sharon. Good morning, everyone and welcome to Radware’s Third Quarter 2017 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 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. We wish to caution you that these statements are just predictions and we undertake no obligation to update these predictions. Actual events or results may differ materially, including but not limited to general business conditions and our ability to address changes in our industry, changes in demand for products, the timing in 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 as amended on May 16, 2017.

Please note that in November, Radware will participate in the UBS Technology Conference in San Francisco and in the IDEAS Investor Conference in Dallas. In December, management will participate in the Imperial Security Conference in New York and in January in the Needham Growth Conference also in New York. Please also note the tentative earnings release date for 2018 are available in the Investor Relations website.

With that I will turn the call to Doron Abramovitch.
Thank you, Anat. Good morning, everyone and thank you for joining us on the call today. We reported strong results for the third quarter with revenues and earnings at the high end of our expectations and with continued growth in our total deferred revenues balance that provides us with the stability and confidence about our future financial performance.

Q3 revenues were $53 million, up 13% from Q3 last year. Revenues from the Americas were up 33% from last year and accounted for 50% of total revenues. Revenues from EMEA increased 13% from Q3 last year and represented 26% of total revenues and revenues from Asia Pacific were down 14% from last year and represented 24% of the total.

Our business model transition creates quarterly fluctuations in revenue recognition. We believe that the 9 months revenue growth gives a better indication of the regional trends. For the 9 months period, revenues from the Americas increased 11% from the first 9 months of 2016. Revenues from EMEA increased 7% and revenues from Asia-Pacific decreased 4%.

Next, I will discuss expenses and profit in non-GAAP terms. A detailed GAAP to non-GAAP reconciliation is presented in the financial tables accompanying our press release as well as in the Investor Kit posted on our website.

Non-GAAP gross margin was 82.1% in Q3, 2017, compared to 82.4% in Q3 last year. Our operating expenses were $42.4 million compared with $38.6 million in Q3 2016 in line with our guidance. As we discussed last quarter, the main factors behind the increase in operating expenses compared to last year are the stronger Israeli shekel, which had an impact of approximately $1.1 million. The consolidation of Seculert, which had an impact of approximately $650,000 in higher sales commissions and sales and marketing expenses related to stronger performance.

Compared to Q2 ’17, the main driver for OpEx increase is higher sales commissions and increased business activity.

Tax expenses in the quarter were $725,000 or 28% of our non-GAAP pretax income. This deviation from our normal effective tax rate is mainly a result of a one-time adjustment related to the Seculert acquisition. We expect that going forward, tax rate will remain at approximately 16%.

Non-GAAP net income in Q3 ’17 was $1.8 million or $0.04 per share diluted, compared with net income of $1.6 million or $0.04 per share diluted in Q3 2016.

Headcount at the end of September 2017 was 992 employees essentially at the same level of previous quarter.

As of September 30, 2017, we had approximately $331 million in cash and financial investments. Cash generated from operations was $5.8 million in Q3 compared with cash outflow of $1.3 million in Q3 last year.

Our operating cash flow for the last 12 months was therefore $46.7 million. Our collection in Q3 was exceptionally strong, as reflected in the DSO ratio, which was 21 days. We are pleased with our collection performance. At the same time, DSO ratio is also affected by the transition in our business model, because in our subscription business, we often collect payments ahead of revenue recognition. We believe that in time as our business transitions matures further, we will see a gradual increase in DSO ratio and expect it to be at around 35 to 40 days.

Our total deferred revenue balance continues to grow. As of the end of September, we had total deferred revenue balance of approximately $139 million, up 27% from $110 million as of the end of September 2016. The proportion of revenues due for recognition within 1 year remained stable at approximately 62%. Therefore, in the coming 12 months, we will recognize as revenue approximately $86 million out of the total deferred revenues compared with $68 million that we recognize out of the total deferred revenue a year ago.

I will conclude with our outlook for the fourth quarter of 2017. We expect Q4 revenues to be between $55 million and $57 million. Non-GAAP gross margin is expected to be approximately 82%. Non-GAAP operating expenses are expected to be between $43 million and $44 million in Q4. We expect non-GAAP effective tax rate to be 16%. Non-GAAP EPS for Q4 is expected to be between $0.06 and $0.07.

I will now turn the call over to Roy.
Thank you, Doron. We are very pleased with the performance and results for the third quarter. Revenues grew double digit compared to Q3 last year and our book-to-bill ratio was significantly larger than 1. Strong booking occurred across product lines in all geographies, with particularly strong growth in our product subscriptions and cloud business, which enjoyed new logos, cloud service expansions from existing customers and high renewal rates.

The solid performance reflects the fact that our strategy and the evolution of our solution portfolio is well aligned with our customers’ evolving needs. Demand for our cyber security solutions remains strong.

Attackers have become more sophisticated. The availability of attack tools has grown, in the variety of possible attack platforms including cloud and IoT is greater than ever. This results in an ongoing increase in attack frequency, complexity and size and requires continuing investments in protection solutions.

Cyber expertise is scarce and companies find it increasingly difficult to satisfy all those security needs in house. This leads to an increased demand for security automation and fully managed services.

Against this backdrop, we are very well positioned:

First, the core of our solutions offer unique and cyber war proven mathematical algorithms for behavioral-based detection, real-time automatic signature creation, and auto policy generation. Such capabilities are critical these days because of the frequency and speed of attacks. There is simply not enough time nor enough skilled resources to try and block each and every attack manually.

Second, Radware stands out with its comprehensive solution for datacenter attack mitigation, which includes all necessary protections such as DDoS, IPS, VAS, anti-scanning and behavioral analysis fully integrated and available, both on-premises and in the cloud.

Third, we provide a full spectrum of solution management options, including a fully managed option by our Emergency Response Team.

Fourth, we perfected our ADC solutions to provide encrypted attack protection with the lowest latency, highest scalability and the widest coverage for encrypted attack mitigation. All of these differentiators mean we are able to solve our customers’ most pressing security issues.

There are many examples from the last quarter that validate our strategy and the transformation of our solution offering we undertook approximately 2 years ago.

For instance in the third quarter, we were selected to provide cloud DDoS protection to the globally distributed data centers of a top 10 technology company. This win demonstrate that even large and highly sophisticated customers lack all of the internal resources to handle today’s cyber threats and prefer to purchase Managed Security Services from experts.

We continue to maintain and grow our technological advantages with the innovation of new solutions and services.

In September, we launched our new attack mitigation line which provides automated protection from fast moving, high volume attacks, encrypted attacks and very short duration threats. The new lines and enhanced capabilities are designed to overcome the complexity and scale of sophisticated IoT botnets. The growth in the number of connected devices that are potentially vulnerable, increases the threat surface. IoT botnets have been involved in nearly every major DDoS attacks since the Mirai attack a year ago. We believe the DefensePro is the only effective solution today against this new generation of IoT botnets.

We also see positive traction for our Cloud Malware Protection Solution, which is a relatively recent expansion of our cloud solution portfolio. It monitors and analyses all web communication and applies advanced machine learning on the data to provide real-time alerts and live feeds of newly detected malwares.
Last quarter, we won a 3-year cloud subscription extension deal from one of the world’s largest food and beverage conglomerates. This customer has tens of thousands of employees who browse the web at a scale that makes malware activity, a key cyber security risk. Despite the customer existing firewalls, web gateways, and threat intelligent solutions, during the past year, we successfully detected more than 1600 malware incidents with zero false positive. This is clear evidence as to the importance of cloud-based, big data analytics and machine learning in the fight against advanced cyber attacks.

We continue to expand our market reach. In Q3, we were pleased to see multiple wins with global Tier 1 carriers. These wins reflect a healthy mix of existing and new customers, which engage with us in expansion projects or competitive displacements. We've also seen continued business with carriers through our Nokia partnership and are excited with the way this relationship broaden our access to network virtualization project.

Our relationship with Cisco made initial contribution to Q3 revenues as expected and the pipeline continues to grow nicely. We are encouraged by the growing momentum in the Cisco relationship.

In summary, we are very pleased with the consistent execution against our expectation throughout the year, which is clearly reflected in our third quarter performance. We are confident, we are heading towards a strong end to 2017, as our Q4 guidance reflects.

We've taken our strong position in data center application security and delivery and transform it so that it directly addresses the most prominent industry trends.

From a business model perspective, we also made a strategic transition towards subscription sales. Not only that this meet our customer needs, but it also creates a consistent and profitable revenue stream of Radware. Today, we have better visibility than ever before and we are confident that our vision, technology, comprehensive offering, alignment with our customer business goals, and strong go-to-market channels and OEM relationships, all position us to deliver long-term growth. I would now open the discussion for Q&A.

QUESTIONS AND ANSWERS

Operator
(Operator Instructions) Your first question comes from Catharine Trebnick from Dougherty. Your line is open.

Your next question comes from Alexander Henderson from Needham & Company. Your line is open.

Daniel Park
This is Daniel Park on for Alex. Thanks for taking my question. So I was hoping, maybe you could touch a little bit on what’s happening in Europe, it seems like the business there continues to trend downward sequentially. Is it just a function of the transition to subscription-based model or is it some macro factors that you’re seeing there?

Roy Zisapel - Radware Ltd. - Co-Founder, CEO, President, Director and Director of Radware Inc
The year over year results we have in EMEA are up I think on a revenue basis, its a double digit up 13%. So we’re actually very satisfied with the business in EMEA and as I’ve mentioned also in my comments regarding bookings, all of our geographies went up also in booking quarter-over-quarter.

Daniel Park
One more question if I could. So, it seems like your service provider business is really accelerating, I was hoping if you could just touch a little bit more on the business there. And to see -- I mean trends that you are seeing that are -- that you expect moving forward?
Roy Zisapel - Radware Ltd. - Co-Founder, CEO, President, Director and Director of Radware Inc

Yes. So, as we mentioned, we are seeing large opportunities in the carrier and service provider market, which also includes for us the cloud. The cloud and hosting providers. As I've mentioned this past quarter specifically where a lot of activity there, some delivered by our own sales people and some acceleration through the Nokia reach. We are seeing many carriers reevaluating, following Mirai, the IoT attacks, the scale, they need to deliver managed security services to enterprise, all of that brings many of the carriers around the world to rethink their security strategy.

For us, it's a major opportunity, we are definitely coming very strong on all technology evaluations and we are replacing the incumbent vendors across the world, so we see growth in existing hardware accounts, we see a lot of activity by the carriers to reevaluate their strategy and given our strength on the technology side, and now with both Cisco and Nokia also stronger presence from the go-to-market side, we think we're very well positioned there.

Operator

Your next question comes from Ittai Kidron from Oppenheimer. Your Line is open.

Ittai Kidron - Oppenheimer & Co. Inc., Research Division - MD

Congrats guys on a good quarter. I guess I had a few questions. First, can you talk about Asia Pacific, that's a region that despite the fact that you made some management changes in, still isn't really nothing, no real big changed there. So what's going on over there? Should we not expect really any improvement in this area for a long time?

Roy Zisapel - Radware Ltd. - Co-Founder, CEO, President, Director and Director of Radware Inc

So, you're right, out of our regions, Asia Pacific is the least growing one. I think if you look at the 9 months is a better trend, because we have some fluctuations with the cloud and subscription. So it's up 4% year-over-year and definitely we are looking for more. Recently, as I've mentioned, especially in Q3, I would say the booking trend is much stronger. However, we definitely are focused on increasing the growth there. No question about it. We don't think it should -- we should look for a long-term position at the current level. We do see some improvement already in the booking and we are focused to accelerate our overall business there, that's definitely an opportunity.

Ittai Kidron - Oppenheimer & Co. Inc., Research Division - MD

And then with regards to your enterprise business, that's another area that I guess for 9 quarters in a row now, it's been declining. I mean, clearly some of that probably relates to changes in your business model and you're going through a lot of carriers and managed services type of companies. But what is it that's fundamentally flawed within your enterprise business or what -- is that just not a focus area for you guys?

Roy Zisapel - Radware Ltd. - Co-Founder, CEO, President, Director and Director of Radware Inc

No, it's actually a focus area and we had a great quarter in enterprise. However, the heat of the cloud subscription and product subscription is predominantly in these segments. So, the majority I would say, the vast majority of growth in total deferred you're seeing is coming from enterprise. When we look on our actual business performance, we are very satisfied with enterprise. However, in revenue recognition, you don't see it, because a lot of it is going to the deferred. You see growth in total deferred of almost $30 million, that's predominantly enterprise.
Ittai Kidron - Oppenheimer & Co. Inc., Research Division - MD

I guess then to tie this up Doron and just looking at your total deferred that $139 million number you gave, I don't know how to interpret this, I know if there is anything good or bad in this, maybe just nothing to read into it. But your uncollected deferred has been flat for 5 quarters after growing quite nicely for some time. How should I interpret that? What does that mean?

Doron Abramovitch - Radware Ltd. - CFO

In a way, it's not the key issue in this $139 million. I mentioned in the last few calls, it's the matter of timing. So overall I analyze it -- we analyze it on this total deferred revenues and I mentioned during the prepared remarks that it also impact our collection if you take this growth. So I suggest you will take only the $139 million and the growth and the 27% year-over-year, this is the key factor. If we are not collecting it or something like that, it's just a matter of timing, it's meaningless.

Operator

Your next question comes from Michael Kim from Imperial Capital. Your line is open.

Michael Kim

You just talked about the Alteon D-line, it's relatively new, I'm just kind of curious what the early adoption has been and whether the value proposition on SSL incurs has been a strong driver behind that?

Roy Zisapel - Radware Ltd. - Co-Founder, CEO, President, Director and Director of Radware Inc

So, I think the D-Line is dual purpose for us. On one hand, it's a refresh of our ADC line and we know for many years in the ADC market, customer tend to refresh and go to the latest and greatest. So that I would say on the -- what I would call the legacy or traditional ADC line. But most importantly the D-Line is focused on security and specifically on encrypted traffic. It allows us to scale and provide the best encrypted traffic protection in conjunction with our attack mitigation line. That's number one.

Number two, we are targeting with that additional projects in SSL inspection that beforehand with the previous line, we could not effectively run on. So we are seeing more growth in ADC security applications, we are seeing very strong advantage in the attack mitigation encryption, and we enjoy ADC refresh as we have done in recent years. So all of that is good.

The last point I want to highlight - the D-line comes also with new subscriptions, specifically the Perform subscription and the Secure subscription and we're seeing higher uptake on these subscriptions than we've seen in the previous Alteon generation. So also that is a very good indication for us, it's not only the refresh of the appliances, it's the higher subscription attach rate that we are getting.

Michael Kim

And has this also been a source for competitive displacement and are you primarily saying demand from hosting companies or also enterprise or where are you seeing the demand opportunity?

Roy Zisapel - Radware Ltd. - Co-Founder, CEO, President, Director and Director of Radware Inc

So, I think it's split. In SSL inspection, we're seeing mainly new customer. In ADC refresh, it's predominantly ourS. In attack mitigation, it's a very strong complement to our attack mitigation solutions. Aside from that, as you know, FS is now in a refresh cycle and that creates many opportunities to compete on this customers and we are seeing competitive displacements as well.
Operator

(Operator Instructions) Your next question comes from George Notter from Jefferies. Your line is open.

Kyle McNealy

This is Kyle here for George. So you mentioned that Cisco OEM sales contributed to the quarter, I was wondering if you could add anything to that in terms of total customers or installed base opportunities out there, anything you can add on the attach rates and maybe what you expect trajectory to look like going forward?

Roy Zisapel - Radware Ltd. - Co-Founder, CEO, President, Director and Director of Radware Inc

So it's still early days for this cycle with Cisco. What I can share is that, that definitely bringing us to completely new customers to Radware, the mix of new customers versus customers we were targeting or existing Radware customers is very, very strong on new customers. There also the sales process is different than what we're used to. There is much less proof of concept or security discussion, they are really selling it as an add-on to the firewall.

Having said that, it's still early on. For example, this week the Cisco Global Channel Conference where they're exposing the VDP option on fire power to the worldwide channel, they gave us the slot 1 of 5 vendors across Cisco, not only Cisco Security, across all Cisco, that got to present. So, we are gaining momentum with the Cisco organization on end customers, on the channels and so on, and we do expect the ramp in Q4 and onward.

Kyle McNealy

And any color on attach rate or anything you can add there?

Doron Abramovitch - Radware Ltd. - CFO

Cisco does not share with us yet these numbers.

Kyle McNealy

And one more if I may. The deferred -- total deferred revenue balance strong year-over-year growth, but somewhat smaller than the last few quarters. I'm wondering if there is any seasonality to that, that we can expect going forward in terms of the year-over-year growth, are there certain quarters that are stronger for you for total deferred revenue? Is there anything that we -- that you should call out there?

Doron Abramovitch - Radware Ltd. - CFO

Yeah, usually the deferred revenues comes with the business itself. We have some seasonality, but in the last few quarters, we see the momentum that it's great and good in each one of the quarters, so we've got used to even sequential growth. It's not the trend that we tend to see. So, overall our view is to review also this one year-over-year. The sequential growth is something nice, but I would recommend to compare it year-over-year.

Roy Zisapel - Radware Ltd. - Co-Founder, CEO, President, Director and Director of Radware Inc

And one another comment in orders, there is a balance between the revenue growth and the deferred revenue growth. So for example, in this quarter, we've grown revenue 13%, year-over-year it was 27% on the total deferred.
So you should expect a more balanced, I would say, growth between revenues and total deferred. But again, we’re seeing strengthening demands in subscriptions, in cloud. We’re seeing the growth in deferred, we are very optimistic about this figure.

Operator

(Operator Instructions) We do not have any questions over the phone at this time. I will turn the call over to the presenters.

Roy Zisapel - Radware Ltd. - Co-Founder, CEO, President, Director and Director of Radware Inc

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

Operator

This does conclude today’s conference call. You may now disconnect.

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