Ladies and gentlemen, thank you for standing by, and welcome to the Radware Q4 2019 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions)

I would like to now hand the conference over to your speaker today, Anant Heilborn, VP Investor Relations of Radware. Please go ahead, Ma'am.

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

Thank you, Joanne. Good morning, everyone, and welcome to Radware’s Fourth Quarter and Full Year 2019 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 fourth 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, 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 15, 2019. 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.

I would like to remind you that on February 20, Radware will host an investor meeting in New York, where members of the executive team will provide an update on the company’s business and outlook. If you’d like to attend, please e-mail me at ir@radware.com.

With that, I will turn the call to Doron Abramovitch.
Thank you, Anat. I’m pleased to provide a review and analysis of our fourth quarter and full year results.

Revenues for the fourth quarter increased 6% year-over-year to a record $67.4 million, in line with our guidance. On a regional basis, revenues from the Americas increased 7% from Q4 '18 to $29.7 million. Revenues from Asia Pacific increased 32% year-over-year to $17.1 million, and revenues from EMEA were $20.6 million compared with $23.2 million in the previous year.

Full year revenues were $252 million and up 8% from 2018. Revenues in the Americas were 42% of total 2019 revenues and increased 4% from 2018. Revenues from Asia Pacific represented 28% of the total and increased 25% and, revenues from EMEA were down 1% year-over-year and accounted for the remaining 30%.

For the full year, revenues from the enterprise vertical represented 68% of total revenues and increased 7% from 2018, and revenues from the service providers vertical increased 10%.

Recurring revenues that include subscription and support represented approximately 63% of total 2019 revenues, similar to the 2018 level of 64%. We continue to see strong uptick and increasing proportion of subscription sales, therefore, the recurring revenues percentage is expected to remain high.

I will discuss now 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 fourth quarter was 83%. For the full year, gross margin was 83.1%, in line with our expectations and up from 82.7% in 2018. Operating expenses in Q4 were $46.4 million compared with $43.2 million in Q4 2018 and slightly above our expectations due to expenses related to end of year marketing activities and accelerated commissions as well as additional headcount.

While we continue to balance between investing in the business and controlling expenses in order to deliver operating leverage, our focus, specifically in Q4 and going into 2020, was on building the organization to execute on our 2020 plan and beyond, targeting higher growth. We have been successful in filling most of the open positions we have, and our headcount at the end of 2019 was 1,094 employees, up from 961 employees at the end of 2018. The vast majority of the additional headcount during the quarter is in line with the sales force and other field positions. Compared to the end of 2018, the addition also includes the headcount from the ShieldSquare acquisition.

Operating expenses for the full year were $176 million compared to $172 million in 2018. Operating profit and margin in Q4 2019 were $9.5 million and 14.2%, respectively.

For the full year, operating profit was $33.5 million, up 55% from $21.6 million in 2018. Operating margin increased to 13.3% from 9% in 2018. Tax expenses were $1.2 million in the quarter and $3.4 million in the full year, representing a tax rate of 10% and 8%, respectively.

For the year, tax rate was below our expectations at the beginning of the year due to changes in tax legislation in certain jurisdictions and one-off deferred tax asset creation throughout the year. We expect tax rate in 2020 to be 12% to 14%. Q4 net income was $10.9 million or $0.23 per share, diluted, in line with our expectations. Net income for the full year was $40.6 million or $0.84 per diluted share, well above net income and EPS for 2018, which was $26 million and $0.55 respectively.

Turning to the balance sheet and cash flow items. We ended the quarter with approximately $428 million in cash and financial investments. Operating cash flow in the quarter of $4 million led full year operating cash flow to be $53 million, up from $49 million in 2018. Our collection from customers continues to be strong. DSO of 31 days is in line with our expectations of DSO levels in the low 30s. During Q4, we added $20 million to our total deferred revenues to approximately $185 million and a 10% year-over-year increase. As a percentage of total deferred revenues balance, 60% is due for recognition in the next 12 months.
As for use of capital. We continue to refer our cash as a strategic asset for our growth and to apply our balanced capital allocation approach. In Q4, we increased our organic investment in the business as discussed and continue to repurchase shares. During the fourth quarter, we spent close to $6 million on repurchasing approximately 235,000 of our own shares. We intend to utilize the $15 million remaining on our share repurchase plan before expiration at the end of April.

In summary, we are pleased to see that the financial results of 2019 reflect our consistent execution of our strategy, and we are prepared to continue doing so in 2020.

Moving to our guidance for the first quarter and an initial outlook for the full year 2020. We expect full year 2020 revenue to grow 7% and reach $270 million. Guidance reflects our expectations that subscription bookings as a percentage of total bookings will exceed 30% in 2020. The magnitude of the impact of recognized revenues is dependent on the exact percentage and product mix. For Q1 2020, we expect revenues to be between $62 million and $64 million. Let me remind you that in Q1 2019, we had approximately $2 million of revenues pulled from Q2 2019. Excluding this anomaly, Q1 ’20 growth would have been approximately 7% as well. Gross margin will be approximately 83% and operating expenses are expected to be between $46 million and $47 million. EPS for Q1 is, therefore, expected to be $0.14 to $0.15. While EPS for Q1 is expected to be lower than Q1 ’19, we do not expect this phenomenon to continue throughout the rest of the year. For the full year, we expect EPS to be at the same level as 2019 of $0.84, reflecting our increased investment in our growth initiatives. We will provide more detailed 2020 guidance as well as our 2022 targets in our investor meeting next week.

I will now turn the call over to Roy.

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

Thank you, Doron. We are pleased with our performance in Q4. We had a record quarterly booking and revenues to close a strong year. Today, Radware is in a stronger financial, technological and competitive position than ever before. We have a broad and deep portfolio for data center and application security and delivery, which addresses the needs of private, hybrid and public cloud and is based on the industry’s most advanced algorithms and state of the art automation. We believe that with this portfolio, we are well positioned to continue to benefit from the secular growth of the cybersecurity sector. We will discuss this in more detail at our investor meeting next week. Today, I will focus mostly on Q4.

In the Americas, we were pleased to see strong business activity in the fourth quarter with some of our largest customers electing strategically rely on Radware for the data center security needs over the coming years. We are very proud of the long-lasting relationship we have with leading financial institutes, content delivery networks and e-commerce companies who are among those who selected us again in the fourth quarter. Overall booking growth in the Americas is not yet where we believe it should be, but we are encouraged by the improvements we saw in the second half of 2019.

In EMEA, we delivered very strong booking growth with record booking for the quarter and the year. The strong performance was achieved despite the market weakness we continue to witness in the U.K. and Germany.

In Asia Pacific, we believe overall, we executed well. However, for obvious reasons, we are currently somewhat hesitant with respect to the business environment. As such, we lowered our expectations for performance in Greater China in the current quarter.

On the OEM front, Q4 was another strong quarter for this channel in particular, with Cisco. In partnership with Cisco, we won a flagship deal with a leading mobile carrier. This large win for us is part of a much larger win for Cisco and as a result, garners significant visibility. Additionally, we saw many orders of varying sizes, spanning the Enterprise & Carrier verticals. Our pipeline with Cisco continues to grow and we are pleased with the continued momentum.

We are also making good progress with our global system integrator initiatives. Just last week, we announced that in the fourth quarter, we won a multimillion dollar cloud security deal with a leading multinational pharmaceutical company who is revamping all its IT services through a very high-profile project. To give some perspective on the scale of the win, the infrastructure includes over 20 data centers, hundreds of networks and...
over 2,000 applications to be protected. This win was secured in partnership with one of our growing global system integrators. And as a result, the sales cycle was relatively short.

Last month, we published our annual application and network security report. In general, only 6% of the respondents did not experience any attack in the previous year. And of the 94% that experienced an attack, almost half reported experiencing a DDoS attack, and a similar number reported a web application attack. Given that about 1/3 of them reported being attacked weekly or daily, the increasing demand for managed security services to alleviate the burden on the organization is clear.

In parallel, in the fourth -- in Q4, we continued to see strong growth in our cloud security business lines. In December alone, we blocked 134,000 DDoS attacks and 73 million web application attacks. With such attack frequency, manual operations are simply impossible. An automated detection and mitigation based on real-time algorithms like ours is critical. In addition, blocking legitimate traffic can be destructive for our customer business continuity, especially at this scale. So accuracy is key and Radware’s behavioral algorithms excel in providing superior accuracy.

In summary, overall, we are pleased with our execution in 2019, and we are further investing in our business. We are very confident in our technology and in the value we bring to our customers. We look forward to delivering on our road map and address additional cybersecurity challenges as the market evolves. We believe that the steps we are taking in all aspects of our business, put us on track to benefit from the increasing cyber threat intensity and complexity in a more prominent way, gain market share and deliver revenues and profitability growth in the coming years. We will provide more color on this at our investor meeting on February 20.

I will now open the call for Q&A.

**QUESTIONS AND ANSWERS**

*Operator*

(Operator Instructions) Your first question comes from the line of George Notter from Jefferies.

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

I’ve got a handful of questions here. Maybe you can talk to the uncollected billings number. I think $28 million to roughly $55 million sequentially. It was a pretty big jump, and we haven’t seen jumps of that size in the past. I’m kind of wondering what drove that in the quarter? And then separately, I’d love to ask about gross margins also. Coming into the quarter, you guys, I think, guided 83% to 83.5% gross margin. And you hit the low end, certainly, but the top line in Q4 was a pretty good step-up versus the year-ago and certainly versus what we’ve seen in recent quarters. I would have assumed that, that would help gross margins as well, but it sounds like it wasn’t flowing through. So I’m wondering if there’s something changing there in terms of product mix or investments in data center assets or something that’s limiting the gross margin upside. So thanks for that.

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**Doron Abramovitch** - Radware Ltd. - CFO

Okay, George. So for the first question, yes, it was quite a big or a nice number, the $54 million that is part of the total deferred. It’s -- since we had a back-ended quarter, you can assume that there was some significant deals that we issued invoices at the end of the quarter, and we didn’t collect by the end of the quarter. I can tell that most of these invoices were collected during the first quarter. So it will be part of the revenue or the deferred revenues in the next quarter.

As for the gross margin, yes, so we are -- we have two answers. Of course, when we grow our business, we do expect that the gross margin will increase. Sometimes we see it in a clear way and sometimes, there are some other issues that impact. You mentioned the product mix, if you
remember we talked about -- sometimes about where we recognize the revenues: Asia Pacific is a bit different than the North America, stuff like this. And another issue that starts to impact the gross margin is our cloud business. The cloud is a bit lower margin in some cases. So it's a mix. Sometimes we are getting benefit, sometimes we don't. This quarter, by the way, it was quite balanced. So the range that we gave is 83% to 83.5%, it made sense, and we met that it maybe the lower, but it's part of what we planned. So nothing as specific in this one as well.

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

Let me maybe add to that, that given the ramp and the strong growth of the cloud security. We are constantly in a building mode and actually even in an accelerated build mode. So the builds we've done in Q3 and early Q4, whether they are additional data centers, scaling bandwidth capacity in existing data centers and systems and people that we put into the service are impacting, but we are doing it, obviously, hand-in-hand with the bookings that we see and with the contract that we signed or about to sign. So all in all, we think it's a positive trend. And as things would ramp, obviously, there's some room for improvement also in the gross margin.

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

Got it. Okay. And then just as a follow-up, you mentioned that I guess, if I just look at the guidance for the coming year or even for Q1, I mean, it feels like you guys are going to invest in the business more aggressively ahead of the ramp in revenue. Can you talk a little bit about sort of the change in philosophy. I guess, looking backwards, I just tended just to give you guys this kind of bootstrapping the business and investing alongside top line growth, but it seems like you're pulling that forward. Is there something you're seeing in the marketplace that's sort of changing your viewpoint on the timing of investments? Or what's driving that?

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

So I think it's several things. First, if you recall some of our guidance on OpEx during '19, we were aiming a bit higher every quarter, and we were not able to fill all the positions and as a result, we came either below or on the low end of our OpEx guidance. So some of it is catching up to our 2019 plan and being very determined on doing that. Second, we do see a lot of opportunity in the market. Definitely, we're seeing some of our key strategic initiatives. I mentioned the OEMs, the global system integrators as a very positive momentum, and we want to continue to fuel those activities. And third, as we build our cloud security portfolio, and we'll talk about it more next week, we think the opportunity in front of us in security is growing, and we need to bring more talent and more capabilities to address that. So we think the market is good. We think our portfolio is good. We think our financial performance is good, and it's time to invest more.

Operator

Your next question comes from the line of Alex Henderson from Needham.

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

Yes. All right. I was wondering if you could just give us a couple of data points here to start with. You mentioned in your opening remarks, hesitant on the environment and a reduction in your estimate for Greater China. But we're not really where you're having a lot of business in Greater China. Could you tell us what portion of your business do you have there?

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

No, it's under 10% of our overall business. But you called down that market, $1 million, $1.5 million for the quarter. That's all. Nothing -- we're not dependent on that market. Having said that, it's an evolving issue, for example, mobile world Congress, I can tell you, we cut the amount... we didn't pull out like many, many other vendors, but we did cut out the number of people attending, simply because we think it will be much, much
less active. So we need to watch it. I don’t think there’s any we -- I -- my comment was more to say that we try to take that already into account in our guidance more than anything else.

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

Okay, great. So looking at the numbers that you’ve outlined for 2020. You’ve offered up a percentage from subscription at 30%. Is the subscription and support still around 63% for the full year?

Doron Abramovitch - Radware Ltd. - CFO

The recurring revenue is supposed to be this number, 63%, 64%, I mentioned that it should continue to be high. It depends on the mix of the deal. So when we guided -- when we gave the $270 million, let me remind you that is something that we mentioned 2 years ago in our investor meeting in 2018. So we still keep it. And at that time, we refer to the subscription to be part of our booking -- total booking to be 30%. So we keep this assumption, although in 2019, it was accelerated, and we mentioned that already in 2019, we reached the 30%. So overall, we kept the same number that we mentioned a couple of years ago.

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

Okay. So basically, you’re saying that the subscription percentage and the supports percentage should stay roughly the same in ’20 as in ’19?

Doron Abramovitch - Radware Ltd. - CFO

More or less, yes. It should be more or less, maybe a bit higher in terms of decision as part of our business. But overall, recurring should be more or less.

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

Okay. So Roy, you’ve indicated you’re very happy with what you’re seeing out of Cisco, you’re seeing improvement there. Cisco has been on the come for, I don’t know, is it 4 years now? Or 5 years, it’s hard to say. It seems like it’s been waiting for godot there. Clearly, Cisco would have higher margins since a lot of that’s license of product. So you’re implying that’s going to accelerate, yet you have decelerated in your guidance from 7.5% revenue growth to 7% for ’20, you’re giving guidance on subscription that’s flat. And you’re saying -- implying that you’re getting more from Cisco by the momentum, yet you’re giving guidance of flat EPS, it seems like other than the tax rate, you’re kind of stalling here relative to the progress that you’ve been doing on moving to a subscription model and moving to a more cloud driven model. The numbers don’t support a lot of evidence of meaningful improvement. Can you tell me why I’m wrong in that viewpoint?

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

Okay. You made a lot of assumptions. So I’ll try to remember them one by one and go on them. So first on Cisco, the -- initially, the contract was for software only. And then you’re right. But as I’ve mentioned in last couple of -- of calls, we’ve broadened to the portfolio with them also to include appliances and cloud services. When they sell our appliance -- when we sell our appliances and/or cloud services through them. Obviously, our gross margin is below our average gross margin for the company. So Cisco is not a net contributor for gross margin. It has other very, very substantial benefits, including visibility to business, ability to close large deals, new logos, and so on. But I would not -- I would not say that they are the ones that can increase our overall gross margin of the business. That’s one. Second, I think regarding the total annuity business as a percentage of 2020. I don’t think we’re guiding it. We said that this year, it was around 63%. We’re saying that subscriptions as a specific component. Bookings will be above 30%. I think it’s too early to determine the -- and we are not planning to give guidance specific on that. So let’s wait and see. I do agree that with the momentum we have in subscription and in cloud, et cetera, if all things being equal, they’re probably going to be a growth in the percentage
of annuity, but we're not guiding it that at this point specifically. Regarding the overall revenue, revenue guidance for the year. The more we increase subscriptions, the more we have deferred so it's not contributing to stronger growth in the revenues. It does increase our total deferred. You can see that our total deferred for this year has grown again. I think this year 10%. So all in all, we view the guidance is exactly continuing the trend. We were at 7% to 9%. We were 8% to 10%. Now we guided initially for 7%. And the only point, and I think we view that as a strong signal for our confidence is that we're pulling a lot of investment into the business to maximize the opportunity. So my viewpoint is a bit different than yours.

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

But just to round out that conversation. If you're not guiding subscription and you're implying subscription's flat because you're suggesting subscription's still at 30%, then your growth rate in orders, which grew 10% is decelerating to -- comparable to your revenue growth, which is 7%, which again, sounds like a deceleration. Is this a reflection of the macro environment? Is it a reflection of a change in the business? I mean, I'm still -- I still stand by the original...

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

Yes. Alex, we're not -- we are guiding for flat subscription. Staying over 30% doesn't mean flat. I think that there's no basis to saying flat at all. We're expecting very strong growth in subscription, like we had this year, it's our fastest-growing revenue line, it's doing very substantial growth rates. We continue to see those trends. Q4 was our -- was again a record in all dimensions of cloud subscriptions and product subscriptions. So I'm saying over 30%, doesn't mean flat at all.

Operator

Your next question comes from the line of Andrew King from Dougherty & Company.

Andrew King - Dougherty & Company LLC, Research Division - Research Analyst

Just so looking at the geographic split. I want to look a little bit more into APAC. Sequentially, you guys decreased about 10%. Want to get a little bit more color into where -- what's going on there? And then also, if you could give any update as to when you would expect to see these headwinds sort of trail off in the U.K. and Germany?

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

Yes. So as we said in the previous calls, our view is -- on the regions -- is not quarterly, there will be fluctuations, especially in a certain quarter, we have a deal with a carrier, those tends to be a bit higher, bigger, and then you might see decline in revenue recognition afterwards and so on. On a yearly basis, I think APAC did pretty well. As I've mentioned, we are more conservative coming into this year. At the same time, we see very good trends in EMEA and North America. So we feel confident about the prospect there. Regarding EMEA, and U.K. and Germany. We are actually going to invest there as well. So part of our investments are going also to these markets. We think the market overall is not strong. We think the customers are hesitant. The -- what we hear from other companies and what we see from the customers is that they're not in a full investment mode, but we think those are very strong markets. I mentioned our performance in EMEA last year to be record. And we think we can gain share as well there. So we are going to invest also in these markets.

Operator

Your next question comes from the line of Tavy Rosner from Barclays.
Tavy Rosner - Barclays Bank PLC, Research Division - Head of Israel Equities Research

Most of them have been addressed already. Just you mentioned Cisco. Can you talk a little bit about Check Point and Nokia. How's the relationship going with there? Any significant change compared to last quarter?

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

So we did grow somewhat our business with Check Point. It's still a relationship that we need to take to the next level, and we are working very hard on that. It's still not where it should be. In Nokia, we do see advancements. I've mentioned, I think, last quarter that we had several bids with them ongoing and we won in Q4. I think we -- actually, the order came this quarter, we won beginning of this quarter, our first win in a very major telecom global group, together with them, displacing an incumbent. So that was a major win, and we continue to -- we have more bids. I actually approved today another bid with them in a large carrier. So that relationship is going well. I think it's a good -- they're now more focused on this integrated security and networking. And there's a bundled solution with some Nokia components, specifically the Deepfield flow and netflow detector and our mitigator in one package that Nokia is promoting together. So I think that that's a positive one.

Tavy Rosner - Barclays Bank PLC, Research Division - Head of Israel Equities Research

And then you mentioned OEM system integrator as areas of investment for next year. How does that materialize? Is it additional hires committed to selling into the system integrator? Or just like shared R&D? Or how should we think about -- is it incremental investment?

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

So some of it is definitely in field resources to cover the global system integrators in the different regions. And some is like channel managers. Technical resources to work with their architects and solution designers. So making an investment similar to what we've done in the OEMs I would say, and I think we're staring -- we started to see first fruits in second half of '19, and we look forward to do much more in 2020 and beyond.

Operator

There are no questions at this time. I will turn the call back over to the presenters.

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

Okay. Thank you very much for attending, and we look forward to seeing you next week in our Analyst Day. Thank you very much.

Operator

This concludes -- ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.