NETSCOUT SYSTEMS INC
Form 10-Q
October 28, 2014
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2014

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission file number 0000-26251

NETSCOUT SYSTEMS, INC.
(Exact Name of Registrant as Specified in Its Charter)

Delaware	04-2837575
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)

310 Littleton Road, Westford, MA 01886
(978) 614-4000

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES x NO ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files.) YES x NO ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	x	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
YES ¨ NO x

The number of shares outstanding of the registrant's common stock, par value $0.001 per share, as of October 22, 2014 was 41,191,313.

Table of Contents

NETSCOUT SYSTEMS, INC.
FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 2014
TABLE OF CONTENTS

Table of Contents

PART I: FINANCIAL INFORMATION
Item 1. Unaudited Financial Statements
NetScout Systems, Inc.
Consolidated Balance Sheets
(In thousands, except share and per share data)

	September 30, 2014 (Unaudited)	March 31, 2014
Assets		
Current assets:		
Cash and cash equivalents	$78,986	$102,076
Marketable securities	90,783	75,234
Accounts receivable, net of allowance for doubtful accounts of $181 and $313 at September 30, 2014 and March 31, 2014, respectively	49,786	60,518
Inventories	14,505	12,580
Prepaid income taxes	6,742	1,012
Deferred income taxes	14,372	15,846
Prepaid expenses and other current assets	9,052	11,496
Total current assets	264,226	278,762
Fixed assets, net	21,721	23,098
Goodwill	201,457	203,446
Intangible assets, net	54,465	58,513
Long-term marketable securities	47,542	41,484
Other assets	2,130	2,460
Total assets	$591,541	$607,763
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$10,193	$11,541
Accrued compensation	30,891	34,901
Accrued other	9,349	6,430
Income taxes payable	—	791
Deferred revenue	95,022	109,301
Total current liabilities	145,455	162,964
Other long-term liabilities	2,225	2,370
Deferred tax liability	2,708	2,757
Accrued long-term retirement benefits	1,584	1,581
Long-term deferred revenue	22,540	24,639
Contingent liabilities, net of current portion	4,407	4,291
Total liabilities	178,919	198,602
Commitments and contingencies (Note 11)		
Stockholders' equity:		
Preferred stock, $0.001 par value:		
5,000,000 shares authorized; no shares issued or outstanding at September 30, 2014 and March 31, 2014	—	—
Common stock, $0.001 par value:		
150,000,000 shares authorized; 50,665,227 and 49,922,959 shares issued and 41,181,526 and 41,165,784 shares outstanding at September 30, 2014 and March 31, 2014, respectively	51	50
Additional paid-in capital	287,795	273,574

Accumulated other comprehensive income	196	2,772
Treasury stock at cost, 9,483,701 and 8,757,175 shares at September 30, 2014 and March 31, 2014, respectively	(148,696)	(117,802)
Retained earnings	273,276	250,567
Total stockholders’ equity	412,622	409,161
Total liabilities and stockholders’ equity	$591,541	$607,763

The accompanying notes are an integral part of these consolidated financial statements.

1

Table of Contents

NetScout Systems, Inc.
Consolidated Statements of Operations
(In thousands, except per share data)
(Unaudited)

	Three Months Ended September 30,		Six Months Ended September 30,	
	2014	2013	2014	2013
Revenue:				
Product	$57,953	$52,357	$122,319	$95,334
Service	45,646	39,740	89,132	78,568
Total revenue	103,599	92,097	211,451	173,902
Cost of revenue:				
Product	12,939	11,810	26,705	21,583
Service	8,656	7,894	17,486	15,043
Total cost of revenue	21,595	19,704	44,191	36,626
Gross profit	82,004	72,393	167,260	137,276
Operating expenses:				
Research and development	19,241	16,638	38,008	32,603
Sales and marketing	32,196	31,559	69,468	63,759
General and administrative	11,067	7,457	19,820	14,438
Amortization of acquired intangible assets	856	857	1,718	1,711
Total operating expenses	63,360	56,511	129,014	112,511
Income from operations	18,644	15,882	38,246	24,765
Interest and other income (expense), net:				
Interest income	98	57	202	144
Interest expense	(196)	(187)	(390)	(377)
Other income (expense), net	(445)	71	(486)	101
Total interest and other income (expense), net	(543)	(59)	(674)	(132)
Income before income tax expense	18,101	15,823	37,572	24,633
Income tax expense	6,868	5,940	14,863	9,497
Net income	$11,233	$9,883	$22,709	$15,136
Basic net income per share	$0.27	$0.24	$0.55	$0.37
Diluted net income per share	$0.27	$0.24	$0.54	$0.36
Weighted average common shares outstanding used in computing:				
Net income per share - basic	41,060	41,392	41,071	41,398
Net income per share - diluted	41,652	41,950	41,732	42,004

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

NetScout Systems, Inc.
Consolidated Statements of Comprehensive Income
(In thousands)
(Unaudited)

	Three Months Ended September 30,		Six Months Ended September 30,	
	2014	2013	2014	2013
Net income	$11,233	$9,883	$22,709	$15,136
Other comprehensive income:				
Cumulative translation adjustments	(1,675)	928	(2,107)	1,219
Changes in market value of investments:				
Changes in unrealized (losses) gains	(23)	39	21	4
Total net change in market value of investments	(23)	39	21	4
Changes in market value of derivatives:				
Changes in market value of derivatives, net of (benefits) taxes of ($360), $76, ($272) and $1	(603)	124	(467)	2
Reclassification adjustment for net gains (losses) included in net income, net of taxes (benefits) of $51, $71, ($14) and $103	81	113	(23)	186
Total net change in market value of derivatives	(522)	237	(490)	188
Other comprehensive (loss) income	(2,220)	1,204	(2,576)	1,411
Comprehensive income	$9,013	$11,087	$20,133	$16,547

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

NetScout Systems, Inc.
Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

	Six Months Ended September 30, 2014	2013
Cash flows from operating activities:		
Net income	22,709	15,136
Adjustments to reconcile net income to cash provided by operating activities, net of the effects of acquisitions:		
Depreciation and amortization	9,753	9,512
Loss on disposal of fixed assets	—	37
Deal related compensation expense and accretion charges	76	73
Share-based compensation expense associated with equity awards	7,797	6,742
Net change in fair value of contingent and contractual liabilities	(9)	(278)
Deferred income taxes	1,760	1,823
Other losses (gains)	85	(7)
Changes in assets and liabilities		
Accounts receivable	10,684	18,271
Inventories	(2,871)	(4,946)
Prepaid expenses and other assets	(3,367)	(340)
Accounts payable	(1,226)	(1,511)
Accrued compensation and other expenses	672	(5,881)
Income taxes payable	(791)	(114)
Deferred revenue	(16,282)	(11,416)
Net cash provided by operating activities	28,990	27,101
Cash flows from investing activities:		
Purchase of marketable securities	(57,790)	(43,750)
Proceeds from maturity of marketable securities	36,204	33,383
Purchase of fixed assets	(4,016)	(6,355)
Purchase of intangible assets	(92)	(153)
Decrease in deposits	101	38
Net cash used in investing activities	(25,593)	(16,837)
Cash flows from financing activities:		
Issuance of common stock under stock plans	67	315
Payment of contingent consideration	—	(841)
Treasury stock repurchases	(30,894)	(16,349)
Excess tax benefit from share-based compensation awards	4,033	1,733
Net cash used in financing activities	(26,794)	(15,142)
Effect of exchange rate changes on cash and cash equivalents	307	(135)
Net decrease in cash and cash equivalents	(23,090)	(5,013)
Cash and cash equivalents, beginning of period	102,076	99,930
Cash and cash equivalents, end of period	$78,986	$94,917
Supplemental disclosures:		
Cash paid for income taxes	$15,587	$7,922
Non-cash transactions:		
Transfers of inventory to fixed assets	$940	$1,781
Additions to property, plant and equipment included in accounts payable	$120	$(64)

Gross decrease in contractual liability relating to fair value adjustment	$(49)	$(98)
Gross increase (decrease) in contingent consideration liability relating to fair value adjustment	$40	$(180)
Issuance of common stock under employee stock plans	$2,760	$2,230

The accompanying notes are an integral part of these consolidated financial statements.

4

Table of Contents

NetScout Systems, Inc.
Notes to Consolidated Financial Statements
(Unaudited)

NOTE 1 – BASIS OF PRESENTATION

The accompanying unaudited interim consolidated financial statements have been prepared by NetScout Systems, Inc., or NetScout or the Company. Certain information and footnote disclosures normally included in financial statements prepared under generally accepted accounting principles (GAAP) have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). In the opinion of management, the unaudited interim consolidated financial statements include all adjustments, consisting of normal recurring adjustments, necessary for a fair statement of the Company's financial position, results of operations and cash flows. The year-end consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. The results reported in these consolidated financial statements are not necessarily indicative of results that may be expected for the entire year. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements, including the notes thereto, included in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2014.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606) (ASU 2014-09), which supersedes the revenue recognition requirements in ASC 605, Revenue Recognition. ASU 2014-09 is based on the principle that revenue is recognized to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. This new guidance is effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2016 (April 1, 2017 for the Company); early adoption is not permitted. Entities have the option of using either a full retrospective or a modified approach to adopt the guidance. The Company has not determined the potential effects on the consolidated financial statements.

NOTE 2 – CONCENTRATION OF CREDIT RISK AND SIGNIFICANT CUSTOMERS

Financial instruments that potentially subject us to concentration of credit risk consist primarily of investments, trade accounts receivable and accounts payable. Our cash, cash equivalents, and marketable securities are placed with financial institutions with high credit standings.

At September 30, 2014, the Company had no indirect channel partner or direct customer which accounted for more than 10% of the accounts receivable balance. At March 31, 2014, one direct customer accounted for more than 10% of the accounts receivable balance, while no indirect channel partner accounted for more than 10% of the accounts receivable balance.

During the three months ended September 30, 2014, no direct customer or indirect channel partner accounted for more than 10% of our total revenue. During the six months ended September 30, 2014, two direct customers each accounted for more than 10% of our total revenue, while no indirect channel partner accounted for more than 10% of our total revenue. During the three months ended September 30, 2013, no direct customer or indirect channel partner accounted for more than 10% of our total revenue. During the six months ended September 30, 2013, one direct customer accounted for more than 10% of total revenue, while no indirect channel partner accounted for more than 10% of our total revenue.

Historically, the Company has not experienced any significant failure of its customers to meet their payment obligations nor does the Company anticipate material non-performance by its customers in the future; accordingly, the Company does not require collateral from its customers. However, if the Company's assumptions are incorrect, there could be an adverse impact on its allowance for doubtful accounts.

5

Table of Contents

NOTE 3 – SHARE-BASED COMPENSATION

The following is a summary of share-based compensation expense including restricted stock units and employee stock purchases made under our employee stock purchase plan (ESPP) based on estimated fair values within the applicable cost and expense lines identified below (in thousands):

	Three Months Ended September 30,		Six Months Ended September 30,	
	2014	2013	2014	2013
Cost of product revenue	$93	$68	$153	$112
Cost of service revenue	314	226	542	372
Research and development	1,490	1,263	2,516	2,159
Sales and marketing	1,235	1,163	2,198	2,008
General and administrative	1,363	1,210	2,388	2,091
	$4,495	$3,930	$7,797	$6,742

Employee Stock Purchase Plan – The Company maintains an ESPP for all eligible employees as described in the Company's Annual Report on Form 10-K for the year ended March 31, 2014. Under the ESPP, shares of the Company's common stock may be purchased on the last day of each bi-annual offering period at 85% of the fair value on the last day of such offering period. The offering periods run from March 1 through August 31 and from September 1 through February 28 of each year. During the six months ended September 30, 2014, employees purchased 59,897 shares under the ESPP and the value per share was $46.07.

NOTE 4 – CASH, CASH EQUIVALENTS AND MARKETABLE SECURITIES

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents and those investments with original maturities greater than three months to be marketable securities. Cash and cash equivalents consisted of money market instruments and cash maintained with various financial institutions at September 30, 2014 and March 31, 2014.

Marketable Securities

The following is a summary of marketable securities held by NetScout at September 30, 2014 classified as short-term and long-term (in thousands):

	Amortized Cost	Unrealized Gains (Losses)	Fair Value
Type of security:			
U.S. government and municipal obligations	$71,586	$39	$71,625
Commercial paper	15,982	5	15,987
Corporate bonds	3,170	1	3,171
Total short-term marketable securities	90,738	45	90,783
U.S. government and municipal obligations	44,651	4	44,655
Corporate bonds	2,890	(3)	2,887
Total long-term marketable securities	47,541	1	47,542
Total marketable securities	$138,279	$46	$138,325

Table of Contents

The following is a summary of marketable securities held by NetScout at March 31, 2014, classified as short-term and long-term (in thousands):

	Amortized Cost	Unrealized Gains (Losses)	Fair Value
Type of security:			
U.S. government and municipal obligations	$53,854	$26	$53,880
Commercial paper	14,581	—	14,581
Corporate bonds	6,772	1	6,773
Total short-term marketable securities	75,207	27	75,234
U.S. government and municipal obligations	37,875	2	37,877
Corporate bonds	3,611	(4)	3,607
Total long-term marketable securities	41,486	(2)	41,484
Total marketable securities	$116,693	$25	$116,718

Contractual maturities of the Company's marketable securities held at September 30, 2014 and March 31, 2014 were as follows (in thousands):

	September 30, 2014	March 31, 2014
Available-for-sale securities:		
Due in 1 year or less	$90,783	$75,234
Due after 1 year through 5 years	47,542	41,484
	$138,325	$116,718

NOTE 5 – FAIR VALUE MEASUREMENTS

The fair value hierarchy has three levels based on the reliability of the inputs used to determine fair value. Level 1 refers to fair values determined based on quoted prices in active markets for identical assets. Level 2 refers to fair values estimated using significant other observable inputs, and Level 3 includes fair values estimated using significant non-observable inputs. The following tables present the Company's financial assets and liabilities measured on a recurring basis using the fair value hierarchy as of September 30, 2014 and March 31, 2014 (in thousands).

	Fair Value Measurements at September 30, 2014			
	Level 1	Level 2	Level 3	Total
ASSETS:				
Cash and cash equivalents	$78,986	$—	$—	$78,986
U.S. government and municipal obligations	40,887	75,393	—	116,280
Commercial paper	—	15,987	—	15,987
Corporate bonds	6,058	—	—	6,058
Derivative financial instruments	—	103	—	103
	$125,931	$91,483	$—	$217,414
LIABILITIES:				
Contingent purchase consideration	$—	$—	$(4,407)	$(4,407)
Derivative financial instruments	—	(735)	—	(735)
	$—	$(735)	$(4,407)	$(5,142)

Table of Contents

	Fair Value Measurements at March 31, 2014			
	Level 1	Level 2	Level 3	Total
ASSETS:				
Cash and cash equivalents	$82,079	$19,997	$—	$102,076
U.S. government and municipal obligations	21,992	69,765	—	91,757
Commercial paper	—	14,581	—	14,581
Corporate bonds	10,380	—	—	10,380
Derivative financial instruments	—	368	—	368
	$114,451	$104,711	$—	$219,162
LIABILITIES:				
Contingent purchase consideration	$—	$—	$(4,291)	$(4,291)
Contingent contractual non-compliance liability	—	—	(49)	(49)
Derivative financial instruments	—	(139)	—	(139)
	$—	$(139)	$(4,340)	$(4,479)

This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value. On a recurring basis, the Company measures certain financial assets and liabilities at fair value, including marketable securities and derivative financial instruments.

The Company’s Level 1 investments are classified as such because they are valued using quoted market prices or alternative pricing sources with reasonable levels of price transparency.

The Company’s Level 2 investments are classified as such because fair value is being calculated using data from similar but not identical sources, or a discounted cash flow model using the contractual interest rate as compared to the underlying interest yield curve. The Company's derivative financial instruments consist of forward foreign exchange contracts and are classified as Level 2 because the fair values of these derivatives are determined using models based on market observable inputs, including spot prices for foreign currencies and credit derivatives, as well as an interest rate factor. The Company classifies municipal obligations as level 2 because the fair values are determined using quoted prices from markets the Company considers to be inactive. Commercial paper is classified as Level 2 because the Company uses market information from similar but not identical instruments and discounted cash flow models based on interest rate yield curves to determine fair value. For further information on the Company's derivative instruments refer to Note 8.

The Company’s contingent purchase consideration at September 30, 2014 and March 31, 2014 was classified as Level 3 in the fair value hierarchy. The contingent contractual non-compliance liability was also classified as Level 3 at March 31, 2014. As of September 30, 2014, the balance is $0. The contingent contractual obligation has been reduced to zero as NetScout has either settled those liabilities or believes that because of the passage of time that the probability of a future negative settlement is essentially zero. These liabilities are valued by probability weighting expected payment scenarios and then applying a discount based on the present value of the future cash flow streams. They are classified as Level 3 because the probability weighting of future payment scenarios is based on assumptions developed by management.

The following table sets forth a reconciliation of changes in the fair value of the Company’s Level 3 financial liabilities for the six months ended September 30, 2014 (in thousands):

	Contingent Purchase Consideration	Contingent Contractual Non-compliance Liability
Balance at beginning of period	$(4,291)	$(49)
(Increase) / decrease in fair value and accretion expense (included within research and development expense)	(116)	49
Balance at end of period	$(4,407)	$—

The Company has updated the probabilities used in the fair value calculation of the contingent liabilities at September 30, 2014 which reduced the liability by $9 thousand and is included as part of earnings for the six months ended September 30, 2014. Key assumptions include a 3.3% discount rate, and a percent weighted-probability of the settlement of the contingent contractual non-compliance liability. Deal related compensation expense, accretion charges and changes related to settlements

Table of Contents

of contractual non-compliance liabilities for the six months ended September 30, 2014 was $76 thousand and was included as part of earnings.

NOTE 6 – INVENTORIES

Inventories are stated at the lower of actual cost or net realizable value. Cost is determined by using the first in, first out (FIFO) method. Inventories consist of the following (in thousands):

	September 30, 2014	March 31, 2014
Raw materials	$8,312	$6,025
Work in process	125	161
Finished goods	6,068	6,394
	$14,505	$12,580

NOTE 7 – GOODWILL AND INTANGIBLE ASSETS

Goodwill

The Company has two reporting units: (1) Unified Service Delivery and (2) Test Optimization. As of September 30, 2014 and March 31, 2014, goodwill attributable to the Unified Service Delivery reporting unit was $199.1 million and $201.0 million, respectively. Goodwill attributable to the Test Optimization reporting unit was $2.4 million as of September 30, 2014 and March 31, 2014. Goodwill is tested for impairment at a reporting unit level at least annually, or on an interim basis if an event occurs or circumstances change that would, more likely than not, reduce the fair value of the reporting unit below its carrying value.

The change in the carrying amount of goodwill for the six months ended September 30, 2014 is due to the impact of foreign currency translation adjustments related to asset balances that are recorded in currencies other than the U.S. Dollar.

The changes in the carrying amount of goodwill for the six months ended September 30, 2014 are as follows (in thousands):

	Six Months Ended September 30, 2014
Balance at March 31, 2014	$203,446
Foreign currency translation impact	(1,989)
Balance as of September 30, 2014	$201,457

Intangible Assets

The net carrying amounts of intangible assets were $54.5 million and $58.5 million as of September 30, 2014 and March 31, 2014, respectively. Intangible assets acquired in a business combination are recorded under the acquisition method of accounting at their estimated fair values at the date of acquisition. The Company amortizes intangible assets over their estimated useful lives, except for the acquired trade name which resulted from the Network General Central Corporation (Network General) acquisition, which has an indefinite life and thus is not amortized. The carrying value of the indefinite lived trade name is evaluated for potential impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired.

During the fiscal year ended March 31, 2014, the Company acquired certain rights to Accanto Systems, S.r.l. (Accanto) software not previously purchased as part of the acquisition transaction in fiscal year 2013 for $500 thousand. This amount is included within developed technology and is being amortized using the economic benefit method and a useful life of 6.3 years.

During the fiscal year ended March 31, 2014, the Company acquired a certain technology license for $300 thousand. This amount is included within developed technology as of March 31, 2014 and is being amortized using the economic benefit method and a useful life of 3 years.

Table of Contents

Intangible assets include an indefinite lived trade name with a carrying value of $18.6 million and the following amortizable intangible assets as of September 30, 2014 (in thousands):

	Cost	Accumulated Amortization	Net
Developed technology	$31,588	$(24,670)	$6,918
Customer relationships	38,701	(15,513)	23,188
Distributor relationships	1,872	(684)	1,188
Core technology	7,421	(3,224)	4,197
Non-compete agreements	329	(329)	—
Other	861	(487)	374
	$80,772	$(44,907)	$35,865

Intangible assets include an indefinite lived trade name with a carrying value of $18.6 million and the following amortizable intangible assets as of March 31, 2014 (in thousands):

	Cost	Accumulated Amortization	Net
Developed technology	$31,946	$(23,524)	$8,422
Customer relationships	38,801	(14,046)	24,755
Distributor relationships	2,014	(568)	