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PRESENTATION

Operator

Welcome to the Radware conference call discussing third quarter 2023 results, and thank you all for holding. As a reminder, this conference is being recorded, November 1, 2023. (Operator Instructions) I would now like to turn this call over to Yisca Erez, Director of Investor Relations at Radware. Please go ahead.

Yisca Erez - *Radware Ltd. - Director of IR*

Thanks, Avi. Good morning, everyone, and welcome to Radware's Third Quarter 2023 Earnings Conference Call. Joining me today are Roy Zisapel, President and Chief Executive Officer; and Guy Avidan, 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. 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 impact from changing or severe global economic conditions, the COVID-19 pandemic, 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, difference from time to time in Radware's filings. We refer you to the documents that the company files and furnishes from time with the SEC, specifically the company's last annual report on Form 20-F as filed on March 30, 2023. 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 will now turn the call to Roy Zisapel.

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

Thank you, Yisca, and thank you all for joining us today. Before I address our third quarter financial results, I would like to update you on the status of our business operations. As you know, on October 7, the terrorist group, Hamas, attacked the southern border of Israel, resulting in many casualties and kidnappings. Our heart goes to all the people that lost their loved ones, the people who were injured, the hostages, and the people who had gone through this attack. Israel is now fighting to free those who are being held hostage and remove the threat of Hamas.

While this is taking place, I want to assure you that Radware's business operations are working without interruption. Our global technical support centers and cloud security services, which span multiple regions with more than 40 points of presence, are all running as planned.

As needed, we have reallocated internal resources to cover for a number of employees who have been called for reservists for the Israel defense force. You can be assured that Radware has all the required business continuity plans in place within Israel should they need to be activated.

I would like to thank our customers, partners and investors around the world for their support and the kind words during the past 3 weeks. We truly appreciate you standing with Israel.

Additionally, this war has a cyber dimension and Radware is standing at the forefront. We are blocking attacks for some of Israel's critical infrastructure as well as prominent government offices, banking institutes and media organizations. Furthermore, we are using the intelligence we gather to protect our global customers, as the same hackers who are attacking Israel are also targeting Western countries.

With that, I'd like to update you on third quarter financial results.

We ended the third quarter with revenues of $62 million and non-GAAP earnings per share of $0.07. Last quarter was another strong quarter for our cloud security business. Our cloud ARR increased 25% year-over-year to $62.5 million, accelerating growth from 21% in the first quarter and 23% in the second quarter of 2023. In addition, we continue to record double-digit growth across bookings, new logos, and total customers, including midsized enterprises.

Our cloud growth potential is huge, and we are confident in our ability to achieve a sustained CAGR of 25% ARR growth in the coming years. Our subscription revenue, cloud and product subscriptions, has been growing steadily and accounted for 45% of total revenue in the quarter, up from 37% last year. This steady growth is also reflected in recurring revenue, which accounted for 79% of total revenue in the third quarter as compared to 71% during the same period last year.

We are making steady progress in our transition from an appliance company to a cloud security-as-a-service company.

The strength of our cloud security offering is becoming more apparent in the market and to our peers. One of our competitors, which was using our DDoS appliances in their service decided to terminate our partnership because of the growing competitive situation between the companies. This decision resulted in an approximately $5 million reduction in total ARR, which totaled $204 million in the third quarter, 5% growth year-over-year compared to $195 million in the third quarter of 2022.

When excluding this ARR churn from previous quarters due to the unique nature of this competitive relationship, ARR increased 8% year-over-year, a slight uptick from 7% growth in the second quarter of 2023.

In the last few quarters, we've seen a big shift in the threat landscape marked by a dramatic increase in Layer 7 attacks, also known as web DDoS tsunamis. This high-volume encrypted attacks bypass traditional web application firewall and network-based DDoS, rendering them ineffective. Enterprises such as Microsoft, UBS, Wells Fargo and many others were all negatively affected by these attacks. Our new cloud web DDoS protection service, which is specifically built to combat these attacks, has become a strong market differentiator for us. Using our new AI-based algorithms, our solutions detect and surgically block the attacks in real time without disrupting legitimate traffic.

Artificial intelligence is also an emerging area of opportunity for Radware. Bad actors use AI-powered tools to craft adaptive attacks, weaponize zero-day vulnerabilities and build botnets. To help our customers stay ahead of these threats, we fight AI with AI. Radware 360 application protection automates defenses with AI and machine learning-based algorithms that evolve as the attacks change.

Alongside the growth in our cloud security business, the challenging macro environment continues to tamper our appliance business. On the one hand, we still encounter hesitation to close large CapEx deals, and on the other hand, the very early signs of stability are encouraging. We see positive customer discussions and renewed interest in on-prem ADC and security solutions.

On our own execution plan, we continue to focus on improving the performance in the Americas. While we still have a lot of work to do, we are confident that our customer base, partnerships and sales and support infrastructure will enable us to resume growth in this region.

As we highlighted on our last call, we've also taken actions to optimize and align our expenses and reallocate our investment to support high-growth areas such as cloud security. These actions are already reflected in our operating expenses, which were reduced to $50 million in the third quarter of 2023.

Before I close, let me share with you a few examples of our success in the third quarter. We signed a sizable new logo deal with one of the largest banks in Europe. They were looking for a complete data center security solution, including hybrid cloud DDoS and application security. We replaced an incumbent solution.

We also closed a multi-million dollar deal with a leading provider of energy and telecommunication services in Asia Pacific. This new logo wanted to enhance its security posture and we replaced the incumbent solution with our portfolio.

The third quarter was also a successful quarter with Cisco. We signed many deals, including a European financial institute, a European utility and service organization, a leading U.S.-based medical center, and many more.

In summary, we have successfully grown our cloud security business and we'll continue to execute our cloud strategy. We are cautiously optimistic about the recovery of the appliance business. Together with the large opportunities in the cloud security market, we believe we will return to total revenue growth next year. In addition, we remain committed to improving our profitability by driving revenue and taking a disciplined approach to expense management. With that, I will now turn the call over to Guy.

Guy Avidan - *Radware Ltd. - CFO*

Thank you, Roy, and good day, everyone. I'm pleased to provide the analysis of our financial results and business performance for the third quarter of 2023, as well as our outlook for the fourth quarter of 2023. Before beginning the financial overview, I would like to remind you that unless otherwise indicated, all financial results are non-GAAP. A full reconciliation of our results on a GAAP and non-GAAP basis is available in the earnings press release issued earlier today and on the Investors section of our website.

Revenue for the third quarter 2023 was $61.6 million compared to $70.5 million in the same period of last year. The third quarter revenue decline was due to changes in the buying pattern of large enterprise and service providers, which resulted in delaying the closing of large on-prem deals, a pattern that we have been experiencing in the last few quarters. We believe that some of the delays are related to the macro environment and budget scrutiny. However, we do witness early signs of improvement in the business, which are reflected in better bookings in Q3 and quarter-to-date compared to Q2 2023.

Despite the challenges in closing large on-prem deals, our cloud business accelerated its growth in the third quarter. Cloud ARR in the third quarter of 2023 grew 25% year-over-year to $62.5 million compared to $50 million at the end of the third quarter of 2022. Cloud ARR accounted for 31% of total ARR compared to 26% last year. The growth of our cloud business is also reflected in our recurring revenue, which accounted for 79% compared to 71% in Q3 2022. Total ARR increased by 5% to $204.5 million. It was impacted by a terminated DDoS agreement with one of our customers that Roy mentioned earlier in his remarks.

Excluding the $5 million ARR churn from this extraordinary cooperation in Q3 2022, ARR growth would have been 8% in Q3 2023, up from 7% in Q2 2023.

On a regional breakdown, revenue in the Americas in the third quarter of 2023 was $25 million, representing a 24% decrease year-over-year. On a trailing 12-month basis, Americas revenue decreased by 10%. The decrease is mainly a result of decline in on-prem large deals. We're still working on improving our execution in this region.

EMEA revenue in the third quarter of 2023 was $19 million compared to $22 million in Q3 2022, a decrease of 13% year-over-year, and also on a trailing 12-month basis. Finally, APAC revenue in the third quarter of 2023 was $17 million, which represents an increase of 12% year-over-year. On a trailing 12-month basis, APAC revenue increased by 1%.

Americas accounted for nearly 41% of total revenue in the third quarter, EMEA accounted for 31% of total revenue, and APAC accounted for the remaining 28% of total revenue in the third quarter of 2023.

I'll now discuss profit and expenses. Gross margin in Q3 2023 was 81.1% compared to 82.9% in the same period in 2022. The change in gross margin is mainly attributed to the decline in revenue. We are encouraged by early signs of improvement in bookings, which we believe will drive revenue growth in 2024, and with that will drive gross margin to previous level of above 82%.

As we highlighted a few quarters ago, we are prudent and minded to our expenses, especially in this challenging macro environment. We reduced our operating expenses in the third quarter to approximately $50 million, below the lower end of our guidance. We expect to improve our profitability going forward due to continued expense discipline and full benefit of cost reduction, which was implemented in the third quarter of 2023. While we reduced operating expenses, we believe that the expense structure is efficient to operate the business and enable our future growth.

Financial income continued to grow and reached $3.8 million in the third quarter as a result of higher interest rates in the market. Net income in the third quarter was $2.9 million as compared to $6.7 million in the same period of last year. Radware's adjusted EBITDA for the third quarter was $1.6 million, which included $2.6 million negative impact of the Hawks business.

Diluted earnings per share for Q3 2023 was $0.07 compared to $0.15 in Q3 2022.

Turning to cash flow statement and balance sheet. Cash flow from operations in Q3 2023 was negative $9.8 million compared to positive cash flow from operations of $1.5 million in the same period of last year. The negative cash flow from operations is attributed mostly to the lower net income in Q3 2023 compared to Q3 2022 and a decrease in deferred revenue in Q3 2023.

During the third quarter, we repurchased shares in the amount of approximately $21 million. As of September 30, 2023, approximately $15 million remained in our share repurchase plan. We ended the third quarter with approximately $372 million in cash, cash equivalents, bank deposits and marketable securities.

I'll conclude my remarks with guidance. We expect total revenue for the fourth quarter of 2023 to be in the range of $63 million to $66 million. We expect Q4 2023 non-GAAP operating expenses to be between $49.5 million to $51 million. Also, we expect Q4 2023 non-GAAP diluted net earnings per share to be between $0.11 and $0.13 in the fourth quarter of 2023.

I'll now turn the call over to the operator for questions. Operator, please.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And we will take our first question from George Notter with Jefferies.

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

I guess maybe to start, I wanted to just say to everybody, good luck through this difficult situation in Israel. We're all thinking about you, and we wish you the very best. And please definitely stay safe, and I hope all goes as well as it can. I guess maybe to start out with questions. Your cloud subscription business really seems to be improving here. I guess I'm looking for another kind of layer of detail in terms of what's driving that improvement? I know the attack environment seems to have intensified over the last few weeks and months. But maybe you can talk a little bit about where you think the strength is coming from in that cloud subscription business?

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

Okay. So first, thanks, George, for your opening comments. Regarding the cloud, we're seeing very strong growth from new logos acquisition. And the core of this is our ability to mitigate sophisticated attacks that become very, very common, like the web DDoS scenario that I've mentioned. So we're seeing both, in DDoS, and in application security, new vectors that came following the war of Russia and Ukraine and other activities in the market. And that creates a new level of sophistication and burden on the defense systems.

So we see more and more customers that understand the hard way sometimes or by looking at what happens to their peers in their industry that the current security measures they have are insufficient. So that's definitely creating a strong advantage. And second, the more references we have, especially in the high-end, were seen to get more and more customers. And the last point I would mention, Cisco, and to some extent, Check Point, have started to contribute more into our cloud business as well, especially as Cisco now is on the EA, we are on the enterprise agreement, we're seeing more openness towards our cloud security solutions. So those would be the 3 factors there.

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

How about -- I know you guys have put out some new scrubbing services. I know there was a deal in New Zealand. I think there's a deal in India, partnerships with service providers. Can you talk about how those are progressing? Is that contributing to the growth?

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

Yes. So what we're seeing there is long way comments that current solutions are insufficient. We're seeing carriers and MSSPs around the world understanding that in order to continue to serve their customers, they must increase the level of tools, capabilities, automation they have. And what we were able to do is to sign some of those partnerships agreements around the world. You've mentioned the India one and our press release on the New Zealand one, where basically they are leveraging our cloud security nodes to assist them in their MSSP operation.

We're basically becoming their MSSP technology or behind the curtain of the MSSP, the ones that deliver the service. We see that as a very good motion going forward because it allows us to gain significant market share in those markets.

So if a carrier in a market is actually using you for DDoS, so for AppSec, they will first generally migrate, maybe over time, over a year or so, but they would migrate their existing customer base off the platforms they have towards the MSSP while starting to sell and promote additional services. We're planning to leverage that. We think we are uniquely positioned to support that, as our tools are OEM capable, white label capable. Our operation is very well trained in supporting partners like Cisco, Nokia and Check Point. So to the same extent, it can support those carriers. And we believe, for us, it's an ability to take a lot of share quickly in these markets.

Operator

And we will take our next question from Chris Reimer with Barclays.

Chris Reimer - *Barclays Bank PLC, Research Division - Analyst*

Can you mention some of the measures that have contributed or will further contribute to the cost management side of things?

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

We're doing several things. One, we've looked at the sales and marketing organization as a whole. And we looked for places that we thought our investment did not yield the right ROI. And obviously, we either consolidated or changed that level of investment. Second, we took some measures in some of the third-party or overlay investments that we had. And maybe it's more, I would say, quota-carrying direct selling relationship. Third, we've taken some of those costs that we've taken out of the model and actually allocated them towards our cloud security business, to improve cloud success managers and numbers and coverage, to improve the operation, to invest more towards R&D.

So all in all, we've done the measured steps on the organization to align the level of business. Starting to see, obviously, as Guy mentioned, in the third quarter, the results in the P&L. And we're going to continue to balance the revenue with expense. And as you see from our guidance, we do expect profitability, because of these steps, to improve.

Operator

(Operator Instructions) And we will take our next question from Alex Henderson with Needham & Company.

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

Let me start off by saying thanks for the print, but I also hope everybody is safe in Israel and that all your families are safe. But with that as a starting point, can you talk a little bit about whether there's -- what percentage of your employees were called up from reserves and if that's a factor in the outlook going forward if the war stays more extended in time, just so that we can talk to that risk.

Guy Avidan - *Radware Ltd. - CFO*

Yes. So as of today, around 60 employees are in reserve. We don't expect this number to increase. That's 5% of total head count in the company. We've replaced, in terms of functions, all these people. So we don't see any impact on the business.

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

Perfect. Didn't expect there to be, but I wanted to make sure I had the statistics. The second question, can you talk a little bit about the exchange rate and how your hedging programs or -- what's going on there for the simple reason that the shekel is obviously under a lot of pressure over the last couple of quarters.

Guy Avidan - *Radware Ltd. - CFO*

Yes. So for the time being, and as we earlier discussed previously, 2023 is hedged already. So the impact of the above 4 FX will not be seen this year. That being said, we hedged some of 2024. We still have room to hedge, and that will allude to the conclusion that, obviously, we will have a better hedging strategy next year, which means lower OpEx.

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

And it does seem like the events in Israel have resulted in some pull-in in expectations and spending intentions. So is the macro environment showing any change in conditions from September into October? Or is that relatively stable? Or is it too early to tell? Can you talk to that a little bit?

Guy Avidan - *Radware Ltd. - CFO*

We mentioned in the prepared commentary that we are seeing some early signs, and we are watching linearity. We also mentioned that in the script that, let's say, the first month of the quarter, this quarter was better than the quarter before. It means that macro-wise, we think we're in a better position versus the last 2 quarters.

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

And just to add to that, also from the activity in the threat landscape, actually we're seeing a lot of attacks across in Israel, of course, but more importantly, for the global, across the world, whether it's U.S., Canada, all of Western Europe and so on. So actually, from a demand perspective and the criticality of our solutions, this geopolitical event is actually creating more sense of urgency, we think. So all in all, we are cautiously optimistic that there's actually not going to be a pull down from the war and might be actually a bit acceleration of cycles.

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

Great. And just want to say thanks for giving me that tour of your cloud war room when I visited you guys in Israel in September. It was pretty impressive. Thanks.

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

You're always welcome, Alex. Thanks for your comments.

Operator

And there are no further questions at this time. So I will now turn the call back to Mr. Roy Zisapel for closing remarks.

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

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

Operator

Ladies and gentlemen, this concludes today's conference call, and we thank you for your participation. You may now disconnect.