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PRESENTATION

Operator

Welcome to the Radware Conference Call Discussing Second Quarter 2023 Results, and thank you all for holding. (Operator Instructions) As a reminder, this conference is being recorded August 2, 2023.

I would now like to turn the call over to Yisca Erez, Director, Investor Relations at Radware. Please go ahead.

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

Good morning, everyone, and welcome to Radware's Second 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 for the second 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 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 the 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 in 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 submissions 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. We ended the second quarter of 2023 with revenues of $65.6 million and non-GAAP earnings per share of $0.10. Total ARR growth accelerated to 7% year-over-year or $208 million compared to a 5% growth recorded in the first quarter of 2023. Our cloud security business had another strong quarter. Cloud ARR growth accelerated to 23%, reaching $59 million at the end of the second quarter. This strong cloud performance was reflected across multiple metrics, including cloud bookings, new logos and the total number of cloud customers, which all grew double digits.

The growing cloud business and the growth in our product subscriptions are gradually forming a sustainable and durable SaaS business model. This progress is reflected in the steady growth in recurring revenue which increased by 7% in the quarter and now accounts for 79% of total revenues as compared to 65% in the second quarter of last year.

While the cloud security business produced strong results in the second quarter, the appliance business encountered strong headwinds, which we believe is a temporary pullback. The spending patterns of large customers have impacted CapEx purchases. Over the last few weeks of the second quarter, we witnessed increased delays in closing large on-prem deals globally, primarily among large enterprises and carriers. To the best of our knowledge, we have not lost those deals to competitors. Given the macro environment and our results,we have to be prudent in managing our expenses. To that end, we have proactively taken steps to optimize and align our costs and maintain stronger profitability.

We reduced sales and marketing expenses and reallocated spend towards growth markets in our cloud delivery and go-to-market efforts. Guy will elaborate more on this in his remarks.

While large and service providers consider their investments more carefully, strengthening cyber defenses remain a business priority. Organizations around the world are experiencing a dramatic increase in the intensity and sophistication of cyber-attacks. In the first half of 2023, we are observing a significant shift in the DDoS attacks pattern. Increasingly, DDoS attacks are incorporating a mix of Layer 3, 4 and Layer 7 attack vectors. The Layer 7 DDoS or Web DDoS attacks are not about sheer capacity of traffic. Rather, they are encrypted, high-volume requests per second that evade standard web application firewalls and network-based DDoS tools.

The attacks hit many large enterprises across different countries and industries financial services, airports and health care organizations. Microsoft, which was among the affected organizations, disclosed multiple waves of Layer 7 attacks that cost outages in services like Azure, Outlook and OneDrive.

To mitigate these Web DDoS attacks, we introduced our new Cloud Web DDoS Protection Service. The Web DDoS service is based on 2 years of AI algorithms and has uniquely positioned us to combat this emerging generation of aggressive Layer 7 attacks, which are leaving companies vulnerable. Our behavioral-based solution can detect the attack in real-time and scale by 2 orders of magnitude higher than any on-prem solution. And unlike any other solution in the market, it surgically blocks the attacks without blocking legitimate traffic.

With the fast training of the algorithm and excellent proven results in dozens of customers, we have created another strong market differentiator that will set the ground for future DDoS cloud and appliance growth for our business.

In the second quarter, we also announced major enhancements to our Bot Manager, which are part of the 360-degree cloud application protection. The advanced solution prevents Bot from bypassing, additional security controls, to gain unlawful access to native Android and iOS mobile applications. It offers first-to-market integrated authentication for both iOS and Android devices and new identity algorithms, allowing organizations to defend themselves against bot attacks with the highest accuracy and performance.

Our investment in cloud innovation continues to pay off. I would like to share with you a few examples of the deals that demonstrate the critical value we bring to our customers and contributed to our cloud ARR growth in the second quarter.

We closed the deal with one of the largest transportation hubs in North America. This customer didn't have active DDoS protection for its data centers. Instead, it was using a public cloud solution. While we were engaging with the customer, it was hit with the wave of DDoS attacks that were targeted in the region. When the cloud computing provider failed to mitigate the attacks, the customer recovered under our emergency on-boarding. This enabled us to showcase our capabilities in real time and win the business.

We also closed an important cloud DDoS deal with a large Tier 1 carrier and managed security service provider in Asia Pacific. Recent attacks on financial services and government organizations impacted the provider's ability to protect some of its customers properly and expose the weakness in the incumbent solution ability to mitigate this new wave of attacks.

Our leaders in DDoS mitigation and proven expertise in these verticals position us as the go-to vendor to replace the incumbent and pave the way strategic seller partnership agreement.

Going forward, we intend to continue to focus on our cloud security strategy and our SaaS business model, which is an even more resilient and durable business model. Together with continuous improvement in our go-to-market, our expectation for recovery in the on-prem purchases, we trust we can strengthen our company performance. We are confident in our leadership position in our technology and products, and we have significant advantages in mitigating real-time cyber-attacks for large enterprises and carriers. We have a superb customer base, and we are becoming more and more critical to our customers' operations. All these assets position us very well to achieve our long-term targets.

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 second quarter of 2023, as well as our outlook for the third quarter of 2023.

Before beginning the financial overview, I'd 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 2023 was $65.6 million compared to $75.1 million in the same period of last year. As Roy noted, the decline in revenue was due to large enterprises and service providers delaying the closing of large on-prem deals. The behavior pattern intensified in the last couple of weeks of the second quarter. We believe that some of the delays are related to macro environment and budget constraints.

Despite the macro headwinds and in accordance with our strategy, our cloud business continued to perform well also in the second quarter. Cloud ARR in the second quarter of 2023 grew 23% year-over-year to $59 million compared to $48 million at the end of the second quarter of 2022. Cloud ARR accounted for 28% of total ARR compared to 25% last year.

The growth of our cloud business is also reflected in our recurring revenue, which increased 7% year-over-year and now accounts for 79% of total revenue compared to 65% in Q2 2022. The increase in recurring revenues despite the headwinds that we are witnessing, signals our shift to a more resilient subscription-based business model.

On regional breakdown, revenues in the Americas in the second quarter of 2023 was $27 million, representing a 10% decrease year-over-year. On a trailing 12-month basis, Americas revenue decreased by 6%.

EMEA revenue in the second quarter was $23 million compared to $30 million in Q2 2022, a decrease of 24% year-over-year, an 11% decrease on a trailing 12-month basis.

The performance of the Americas and EMEA region is related to the decrease in sales of appliance-based products in the quarter, predominantly to carriers and large enterprises.

Finally, APAC revenue in the second quarter was $16 million, which represents an increase of 3% year-over-year. On a trailing 12-month basis, APAC revenue was flat.

Americas accounted for 41% of total revenue in the second quarter, EMEA accounted for 34% of total revenue and APAC accounted for the remaining 25% of total revenue in the second quarter.

I'll now discuss gross margin in Q2 2023 was 82.3% compared to 83.3% in the same period in 2022. The change in gross margin is mainly attributed to higher costs related to cloud security centers launched during the last year, as well as to the decline in revenue.

Operating expenses in the second quarter were $52 million at the lower end of guidance, representing a decrease of 4% compared to the same period in 2022.

Financial income continues to grow and reached $3.4 million in the second quarter as a result of higher interest rates in the market.

Net income in the second quarter was $4.5 million as compared to $8.1 million in the same period last year.

Radware's adjusted EBITDA for the second quarter was $4.1 million, which includes $2.7 million negative impact of the Hawks business.

Diluted earnings per share for Q2 2023 was $0.10 compared to $0.18 in Q2 2022.

Turning to the cash flow statement and the balance sheet.

Net cash provided by operating activities in Q2 2023 was $4.9 million compared to $32 million in the same period of last year. The lower cash flow from operation is attributed to the lower net income in Q2 2023 compared to Q2 2022, and the modest increase in deferred revenue in Q2 2023, relative to the large increase in the third revenue in Q2 2022.

During the second quarter, we repurchased shares in the amount of approximately $19.7 million out of the $100 million share repurchase plan that we have in place. As of 2023, approximately $35 million remained in our share repurchase plan. We ended the second quarter with approximately $402 million cash equivalents, short-term bank deposits and marketable securities.

I'll conclude my remarks with guidance.

Although we believe the macroeconomic headwinds are temporary, we cannot predict the timing and intensity. During this time, Radware is mindful of its expenses, and is agile in adjusting its cost structure as needed. We are taking a few steps, including resource reallocation and headcount reductions. These steps will align our expenses with the changing market condition and will enable us to come out stronger. We are committed to improving profitability over time.

We expect total revenue for the third quarter of 2023 to be in the range of $61 million to $64 million. We expect Q3 2023 non-GAAP operating expenses to be between $51 million and $52.5 million. As a result of the resource allocation and headcount reduction, we expect our OpEx to decrease to approximately $50 million, exiting 2023.

We expect non-GAAP diluted net earnings per share to be between $0.06 and $0.10 in the third quarter of 2023.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We'll take our first question from George Notter at Jefferies.

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

I guess I wanted to ask about the change in the sales incentive plans. I know that you guys made some changes coming into the year. I know you tilted the plan more away from appliances and towards the cloud business. But is that having an impact on appliance sales? Is that part of the narrative here also?

And then on the macro environment, I guess I'm just wondering why you only started to see this kind of towards the end of the quarter? Was there something about the environment that kind of changes the dynamics for you in the marketplace? Or is this something that's been building over time?

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

Yes. So first, regarding the compensation plan, we did move the compensation to cloud base plan. And I'm sure it had some impact on cloud sales, that's the major one in this regard. It's obvious that our sales force is (technical difficulty) and more cloud-based sales like we want them to be. And I don't think that within existing customers that would change the dynamic. It might be more towards the new customers. Our decline came mainly in large customers and carriers. So I don't think that's the main cause. It might have effect like you mentioned in general. But I would not call it a tough one in this area.

Regarding the way the quarter progressed, we started with a guidance that we saw took into account. The environment and the challenges (technical difficulty) and as we've mentioned, the main difficulties we've experienced were in existing customers where we felt we have good understanding of the environment, process, et cetera. Therefore, we were surprised in the last several weeks of the quarter, although everything was tracking well all the time to get those pushouts, budget cancellations, et cetera.

We tried to take into account of course, when we build the guidance for Q3, the phenomena that we saw and to take a way more cautious and conservative view also on the existing customer business, where we feel we are positioned very well. The value is proven. We are blocking attacks in real time. There's a high user satisfaction. As you can see from the ARR and retention rates, so we feel good about our position, but we do need to find a way to accelerate those on-prem purchases also in our existing customers.

Operator

And we'll move next to Tim Horan of Oppenheimer.

Graham Rushton Hawes - *Oppenheimer & Co. Inc., Research Division - Research Analyst*

This is Graham Hawes on the line for Tim Horan. So just on the AI front, I just wanted to hear about what kind of trends you've seen across the security landscape versus this year versus last year? And you mentioned AI with -- some of these cloud DDoS service, and Layer 7 attacks. So I guess kind of how you guys are thinking about the impact of AI to your business kind of over the second half of this year and really going into 2024?

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

So first, the real-time mitigation, detection and mitigation. On one hand, we are deepening the usage of algorithms constantly. We started with that many years ago. We have a whole battery of different algorithms across our DDoS, WAF, API security, that has been for years, our competitive advantage (technical difficulty) prepared remarks for Web DDoS, we believe we are in a competitive advantages using algorithms.

We are using AI, not only for remediation or accelerating certain processes, but for the actual detection and mitigation. That's a bit unique in the market. So that's on our front. I think it improves our capabilities. It improves our efficacy. It improves (technical difficulty). There's a lot of benefits for AI in our land of security.

At the same time, the hackers are also leveraging more and more algorithms, more and more AI. For instance, those Layer 7 attacks, Web DDoS attacks I referred to, they are way more randomized difficulty). And they are way more real user traffic than we ever saw before. And that poses a huge challenge for the defense because those sessions, this attack looks very, very similar to normal legit traffic. So by using algorithms also on the attacker side, I would say the sophistication, the level of the challenge is increasing significantly.

Taking those 2 parameters into account together, I believe the barrier to entry (technical difficulty) mitigating real-time attacks is getting higher and higher. You would need to have years of investment in those algorithms, understanding of the attack tools, et cetera, to be able to do (technical difficulty) and therefore, competitively, although on one hand, you can say (technical difficulty) getting higher, the defense needs to invest more. All of that is true. But competitively, I think it's actually a good phenomena for our (technical difficulty).

Graham Rushton Hawes - *Oppenheimer & Co. Inc., Research Division - Research Analyst*

Got you. And just as one quick follow-up. Just looking at ARR, specifically the non-cloud portion of ARR. It looks like it's kind of fluctuated around that $145 million range. So I'm just curious, as customers move to the cloud, what kind of uplift are you guys seeing in ARR? So for every dollar like non-cloud ARR, what kind of conversion is that to the cloud? And -- or is that not the right way to think about it?

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

I think there are 3 buckets in our ARR. One is the cloud that as I mentioned, has accelerated in the second quarter. Second is product subscription which is software that we sell as a subscription and is also growing and has grown nicely in the last quarter and the maintenance of appliances that is more tied to the installed base and so on.

Definitely, we see traction in all our subscription, product and cloud. That's growing consistently. And I think the maintenance would be more in line with our product sales. In some of our cloud deals, cloud can bring with them also appliance sales, namely the hybrid DDoS. In most of our business, for example, ADC and DDoS on-prem (technical difficulty), those have no relation to the cloud business. It's not cannibalizing nor it's supporting today in the sale of ADC.

We are working, of course, to create (technical difficulty) between our cloud security to the ADC to the DDoS on-prem to accelerate that. And as the year progresses, I think we will launch several of such modules to create stronger ties between the two. But today, we're enjoying cloud growth that is unrelated basically to the product ARR.

Operator

We'll take our next question from Tavy Rosner of Barclays.

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

Questions. I wanted to touch on OEM and also on EMEA. So I just wanted to check if the traction with OEM is in line with the broader revenue dynamics that we've seen. And I also noticed that the decline in EMEA was a bit cheaper than the rest of the geography. So just wanted to get some color on both of these points, please?

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

I take the OEM. We actually continue to see good traction with the OEMs . We've mentioned in the Analyst Day that Cisco cloud solutions into their -- cloud DDoS solution into (technical difficulty).

We're starting to see more activity from our OEMs in the cloud and they continue to contribute good level of new customers, and there's now nice numbers coming from the OEM channel, we're definitely seeing growth year-over-year from that channel.

Guy Avidan - *Radware Ltd. - CFO*

Tavy and regarding your question about EMEA. So comparing to last year, we had one extraordinary deal in the second quarter of '22, that's one. The second thing, as we mentioned, in the prepared commentary, due to macro headwinds the impact on large enterprises and carriers was negative, some of them were in EMEA. All in all, we believe our business is solid.

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

And just looking at capital allocation given your significant cash position. Have you considered changing the pace in terms of buybacks and any other considerations there?

Guy Avidan - *Radware Ltd. - CFO*

So as mentioned, we're running on a $100 million plan. We still have, as of June 30, $35 million. Obviously, prices -- share prices will set the pace of repurchase of additional shares in the future.

Operator

And we have no further questions at this time. I'll turn the call back to Roy Zisapel, for closing remarks.

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

Thank you, everyone, and have a great day.

Operator

And this concludes today's conference call. Thank you for your participation. You may now disconnect.
