NETSCOUT SYSTEMS INC
Form 10-Q
August 06, 2015
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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 June 30, 2015

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 000-26251

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 July 29, 2015 was 100,736,954.

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

	June 30, 2015 (Unaudited)	March 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	$94,352	$104,893
Marketable securities	112,857	101,392
Accounts receivable, net of allowance for doubtful accounts of $142 and $173 at June 30, 2015 and March 31, 2015, respectively	58,496	82,226
Inventories	12,710	12,130
Prepaid income taxes	—	1,393
Deferred income taxes	21,053	21,755
Prepaid expenses and other current assets	8,425	13,495
Total current assets	307,893	337,284
Fixed assets, net	24,902	23,864
Goodwill	198,222	197,445
Intangible assets, net	48,815	50,180
Long-term marketable securities	60,303	58,572
Other assets	1,617	1,704
Total assets	$641,752	$669,049
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$11,203	$13,077
Accrued compensation	21,780	36,553
Accrued other	7,509	14,474
Income taxes payable	147	107
Deferred revenue	108,179	123,422
Total current liabilities	148,818	187,633
Other long-term liabilities	1,858	1,995
Deferred tax liability	10,653	10,639
Accrued long-term retirement benefits	1,589	1,587
Long-term deferred revenue	27,919	26,961
Contingent liabilities, net of current portion	4,521	4,484
Total liabilities	195,358	233,299
Commitments and contingencies (Note 10)		
Stockholders' equity:		
Preferred stock, $0.001 par value:		
5,000,000 shares authorized; no shares issued or outstanding at June 30, 2015 and March 31, 2015	—	—
Common stock, $0.001 par value:		
150,000,000 shares authorized; 50,834,158 and 50,812,548 shares issued and 40,752,954 and 40,807,805 shares outstanding at June 30, 2015 and March 31, 2015, respectively	51	51

Additional paid-in capital	302,456	298,101
Accumulated other comprehensive loss	(2,858)	(4,645)
Treasury stock at cost, 10,081,204 and 10,004,743 shares at June 30, 2015 and March 31, 2015, respectively	(172,683)	(169,516)
Retained earnings	319,428	311,759
Total stockholders’ equity	446,394	435,750
Total liabilities and stockholders’ equity	$641,752	$669,049

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

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

	Three Months Ended June 30, 2015	2014
Revenue:		
Product	$53,593	$64,366
Service	47,150	43,486
Total revenue	100,743	107,852
Cost of revenue:		
Product	12,498	13,766
Service	8,798	8,830
Total cost of revenue	21,296	22,596
Gross profit	79,447	85,256
Operating expenses:		
Research and development	18,058	18,767
Sales and marketing	38,092	37,272
General and administrative	10,099	8,753
Amortization of acquired intangible assets	809	862
Total operating expenses	67,058	65,654
Income from operations	12,389	19,602
Interest and other income (expense), net:		
Interest income	158	104
Interest expense	(192)	(194)
Other expense, net	(112)	(41)
Total interest and other expense, net	(146)	(131)
Income before income tax expense	12,243	19,471
Income tax expense	4,574	7,995
Net income	$7,669	$11,476
Basic net income per share	$0.19	$0.28
Diluted net income per share	$0.19	$0.27
Weighted average common shares outstanding used in computing:		
Net income per share - basic	40,776	41,081
Net income per share - diluted	41,371	41,808

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

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

	Three Months Ended June 30, 2015	2014
Net income	$7,669	$11,476
Other comprehensive income:		
Cumulative translation adjustments	977	(432)
Changes in market value of investments:		
Changes in unrealized (losses) gains	(59)	44
Total net change in market value of investments	(59)	44
Changes in market value of derivatives:		
Changes in market value of derivatives, net of taxes of $4 and $86	6	138
Reclassification adjustment for net gains (losses) included in net income, net of taxes (benefits) of $460 and ($63)	863	(106)
Total net change in market value of derivatives	869	32
Other comprehensive income (loss)	1,787	(356)
Total comprehensive income	$9,456	$11,120

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

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

	Three Months Ended June 30, 2015	2014
Cash flows from operating activities:		
Net income	7,669	11,476
Adjustments to reconcile net income to cash provided by operating activities, net of the effects of acquisitions:		
Depreciation and amortization	4,986	4,876
Loss on disposal of fixed assets	10	—
Deal related compensation expense and accretion charges	37	38
Share-based compensation expense associated with equity awards	4,595	3,302
Net change in fair value of contingent and contractual liabilities	—	(9)
Deferred income taxes	239	1,409
Other losses	42	28
Changes in assets and liabilities		
Accounts receivable	23,729	27,551
Inventories	(1,806)	612
Prepaid expenses and other assets	6,654	2,053
Accounts payable	(1,629)	(1,558)
Accrued compensation and other expenses	(20,955)	(11,594)
Income taxes payable	40	(791)
Deferred revenue	(14,321)	(9,193)
Net cash provided by operating activities	9,290	28,200
Cash flows from investing activities:		
Purchase of marketable securities	(32,289)	(42,506)
Proceeds from maturity of marketable securities	19,034	13,798
Purchase of fixed assets	(3,415)	(1,865)
Purchase of intangible assets	(88)	(71)
Decrease in deposits	—	17
Net cash used in investing activities	(16,758)	(30,627)
Cash flows from financing activities:		
Issuance of common stock under stock plans	—	8
Treasury stock repurchases	(3,167)	(12,187)
Excess tax benefit from share-based compensation awards	—	1,431
Net cash used in financing activities	(3,167)	(10,748)
Effect of exchange rate changes on cash and cash equivalents	94	73
Net decrease in cash and cash equivalents	(10,541)	(13,102)
Cash and cash equivalents, beginning of period	104,893	102,076
Cash and cash equivalents, end of period	$94,352	$88,974
Supplemental disclosures:		
Cash paid for income taxes	$2,967	$6,142
Non-cash transactions:		
Transfers of inventory to fixed assets	$1,229	$940
Additions to property, plant and equipment included in accounts payable	$245	$95
Gross decrease in contractual liability relating to fair value adjustment	$—	$(49)

Gross increase in contingent consideration liability relating to fair value adjustment	$—	$40

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

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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, 2015.

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), to supersede nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration that is expected to be received for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, it is possible more judgment and estimates may be required within the revenue recognition process than required under existing U.S. GAAP, including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. This ASU will be effective for the Company in the first quarter of its fiscal year 2019. Early adoption is not permitted. This ASU allows for either full retrospective or modified retrospective adoption. The Company is currently evaluating the impact of its pending adoption of ASU 2014-09 on its 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. The Company's cash, cash equivalents, and marketable securities are placed with financial institutions with high credit standings.

At June 30, 2015, no direct customers accounted for more than 10% of the accounts receivable balance, while one indirect channel partner accounted for more than 10% of the accounts receivable balance. At March 31, 2015, 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 June 30, 2015, no direct customer or indirect channel partner accounted for more than 10% of the Company's total revenue. During the three months ended June 30, 2014, two direct customers accounted for more than 10% of the Company's total revenue, while no indirect channel partner accounted for more than 10% of the Company's 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.

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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 the Company's employee stock purchase plan (ESPP) based on estimated fair values within the applicable cost and expense lines identified below (in thousands):

	Three Months Ended June 30,	
	2015	2014
Cost of product revenue	$102	$60
Cost of service revenue	373	228
Research and development	1,490	1,026
Sales and marketing	1,403	963
General and administrative	1,227	1,025
	$4,595	$3,302

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, 2015. 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 1st through August 31st and from September 1st through February 28th of each year.

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 June 30, 2015 and March 31, 2015.

Marketable Securities

The following is a summary of marketable securities held by NetScout at June 30, 2015, classified as short-term and long-term (in thousands):

	Amortized Cost	Unrealized Losses	Fair Value
Type of security:			
U.S. government and municipal obligations	$99,792	$(9)	$99,783
Commercial paper	5,099	—	5,099
Corporate bonds	7,977	(2)	7,975
Total short-term marketable securities	112,868	(11)	112,857
U.S. government and municipal obligations	60,338	(35)	60,303
Total long-term marketable securities	60,338	(35)	60,303
Total marketable securities	$173,206	$(46)	$173,160

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The following is a summary of marketable securities held by NetScout at March 31, 2015, 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	$88,651	$3	$88,654
Commercial paper	5,093	2	5,095
Corporate bonds	7,644	(1)	7,643
Total short-term marketable securities	101,388	4	101,392
U.S. government and municipal obligations	56,683	8	56,691
Corporate bonds	1,880	1	1,881
Total long-term marketable securities	58,563	9	58,572
Total marketable securities	$159,951	$13	$159,964

Contractual maturities of the Company's marketable securities held at June 30, 2015 and March 31, 2015 were as follows (in thousands):

	June 30, 2015	March 31, 2015
Available-for-sale securities:		
Due in 1 year or less	$112,857	$101,392
Due after 1 year through 5 years	60,303	58,572
	$173,160	$159,964

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 at June 30, 2015 and March 31, 2015 (in thousands):

	Fair Value Measurements at June 30, 2015			
	Level 1	Level 2	Level 3	Total
ASSETS:				
Cash and cash equivalents	$94,352	$—	$—	$94,352
U.S. government and municipal obligations	58,769	101,317	—	160,086
Commercial paper	—	5,099	—	5,099
Corporate bonds	7,975	—	—	7,975
Derivative financial instruments	—	97	—	97
	$161,096	$106,513	$—	$267,609
LIABILITIES:				
Contingent purchase consideration	$—	$—	$(4,521)	$(4,521)
Derivative financial instruments	—	(456)	—	(456)
	$—	$(456)	$(4,521)	$(4,977)

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	Fair Value Measurements at March 31, 2015			
	Level 1	Level 2	Level 3	Total
ASSETS:				
Cash and cash equivalents	$104,893	$—	$—	$104,893
U.S. government and municipal obligations	46,564	98,781	—	145,345
Commercial paper	—	5,095	—	5,095
Corporate bonds	9,524	—	—	9,524
Derivative financial instruments	—	15	—	15
	$160,981	$103,891	$—	$264,872
LIABILITIES:				
Contingent purchase consideration	$—	$—	$(4,484)	$(4,484)
Derivative financial instruments	—	(1,664)	—	(1,664)
	$—	$(1,664)	$(4,484)	$(6,148)

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 following table sets forth a reconciliation of changes in the fair value of the Company’s Level 3 financial liability for the three months ended June 30, 2015 (in thousands):

	Contingent Purchase Consideration
Balance at beginning of period	$(4,484)
Increase in fair value and accretion expense (included within research and development expense)	(37)
Balance at end of period	$(4,521)

Deal related compensation expense and accretion charges for the three months ended June 30, 2015 was $37 thousand and was included as part of earnings.

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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):

	June 30, 2015	March 31, 2015
Raw materials	$7,241	$6,134
Work in process	266	17
Finished goods	5,203	5,979
	$12,710	$12,130

NOTE 7 – GOODWILL AND INTANGIBLE ASSETS
Goodwill
The Company has two reporting units: (1) Unified Service Delivery and (2) Test Optimization. At June 30, 2015 and March 31, 2015, goodwill attributable to the Unified Service Delivery reporting unit was $195.8 million and $195.0 million, respectively. Goodwill attributable to the Test Optimization reporting unit was $2.4 million at June 30, 2015 and March 31, 2015. 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 three months ended June 30, 2015 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 three months ended June 30, 2015 are as follows (in thousands):

Balance at March 31, 2015	$197,445
Foreign currency translation impact for the three months ended June 30, 2015	777
Balance at June 30, 2015	$198,222

Intangible Assets
The net carrying amounts of intangible assets were $48.8 million and $50.2 million at June 30, 2015 and March 31, 2015, 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.
Intangible assets include an indefinite lived trade name with a carrying value of $18.6 million and the following amortizable intangible assets at June 30, 2015 (in thousands):

	Cost	Accumulated Amortization	Net
Developed technology	$31,005	$(26,150)	$4,855
Customer relationships	38,538	(17,691)	20,847
Distributor relationships	1,640	(804)	836
Core technology	7,177	(3,930)	3,247
Non-compete agreements	289	(289)	—
Other	1,031	(601)	430
	$79,680	$(49,465)	$30,215

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Intangible assets include an indefinite lived trade name with a carrying value of $18.6 million and the following amortizable intangible assets at March 31, 2015 (in thousands):

	Cost	Accumulated Amortization	Net
Developed technology	$30,865	$(25,561)	$5,304
Customer relationships	38,498	(16,935)	21,563
Distributor relationships	1,585	(711)	874
Core technology	7,118	(3,660)	3,458
Non-compete agreements	280	(280)	—
Other	943	(562)	381
	$79,289	$(47,709)	$31,580

Amortization of software and core technology included as cost of product revenue was $758 thousand and $934 thousand for the three months ended June 30, 2015 and 2014, respectively. Amortization of other intangible assets included as operating expense was $847 thousand and $901 thousand for the three months ended June 30, 2015 and 2014, respectively.

The following is the expected future amortization expense at June 30, 2015 for the years ending March 31 (in thousands):

2016 (remaining nine months)	$4,864
2017	5,726
2018	4,901
2019	3,991
2020	3,510
Thereafter	7,223
	$30,215

The weighted average amortization period of developed technology and core technology is 6.7 years. The weighted average amortization period for customer and distributor relationships is 13.3 years. The weighted average amortization period for amortizing all intangible assets is 10.1 years.

NOTE 8 – DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

NetScout operates internationally and, in the normal course of business, is exposed to fluctuations in foreign currency exchange rates. The exposures result from costs that are denominated in currencies other than the U.S. Dollar, primarily the Euro, British Pound, Canadian Dollar, and Indian Rupee. The Company manages its foreign cash flow risk by hedging forecasted cash flows for operating expenses denominated in foreign currencies for up to twelve months, within specified guidelines through the use of forward contracts. The Company enters into foreign currency exchange contracts to hedge cash flow exposures from costs that are denominated in currencies other than the U.S. Dollar. These hedges are designated as cash flow hedges at inception.

All of the Company's derivative instruments are utilized for risk management purposes, and the Company does not use derivatives for speculative trading purposes. These contracts will mature over the next twelve months and are expected to impact earnings on or before maturity.

The notional amounts and fair values of derivative instruments in the consolidated balance sheets at June 30, 2015 and March 31, 2015 were as follows (in thousands):

	Notional Amounts (a)		Prepaid Expenses and Other Current Assets		Accrued Other	
	June 30, 2015	March 31, 2015	June 30, 2015	March 31, 2015	June 30, 2015	March 31, 2015
Derivatives Designated as Hedging Instruments:						
Forward contracts	$19,014	$20,203	$97	$15	$456	$1,664

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(a) Notional amounts represent the gross contract/notional amount of the derivatives outstanding.

The following table provides the effect foreign exchange forward contracts had on other comprehensive income (loss) (OCI) and results of operations for the three months ended June 30, 2015 and 2014 (in thousands):

Derivatives in Cash Flow Hedging Relationships	Effective Portion Gain (Loss) Recognized in OCI on Derivative (a)		Gain (Loss) Reclassified from Accumulated OCI into Income (b)			Ineffective Portion Gain (Loss) Recognized in Income (Amount Excluded from Effectiveness Testing) (c)		
	June 30, 2015	June 30, 2014	Location	June 30, 2015	June 30, 2014	Location	June 30, 2015	June 30, 2014
Forward contracts	$10	$(224)	Research and development	$47	$10	Research and development	$34	$63
			Sales and marketing	1,276	159	Sales and marketing	(14)	4
	$10	$(224)		$1,323	$169		$20	$67

(a) The amount represents the change in fair value of derivative contracts due to changes in spot rates.

(b) The amount represents reclassification from other comprehensive income to earnings that occurs when the hedged item affects earnings.

(c) The amount represents the change in fair value of derivative contracts due to changes in the difference between the spot price and forward price that is excluded from the assessment of hedge effectiveness and therefore recognized in earnings. No gains or losses were reclassified as a result of discontinuance of cash flow hedges.

NOTE 9 – LONG-TERM DEBT

On November 22, 2011, the Company entered into a credit facility (the Credit Agreement) with a syndicate of lenders led by KeyBank National Association (KeyBank) providing the Company with a $250 million revolving credit facility, which may be increased to $300 million at any time up to 90 days before maturity. The revolving credit facility includes a swing line loan sub-facility of up to $10 million and a letter of credit sub-facility of up to $10 million. The credit facility under the Credit Agreement matures on November 21, 2016. At June 30, 2015, there were no amounts outstanding under this credit facility.

At the Company's election, revolving loans under the Credit Agreement bear interest at either (a) a rate per annum equal to the highest of (1) KeyBank's prime rate, (2) 0.50% in excess of the federal funds effective rate, or (3) one hundred (100.00) basis points in excess of the London Interbank Offered Rate (LIBOR) for one-month interest periods, or the Base Rate; or (b) the one-, two-, three-, or six-month per annum LIBOR, as selected by the Company, multiplied by the statutory reserve adjustment, or collectively, the Eurodollar Rate, in each case plus an applicable margin. Swing line loans will bear interest at the Base Rate plus the applicable Base Rate margin. The applicable margin depends on the Company's leverage ratio, ranging from 100 basis points for Base Rate loans and 200 basis points for Eurodollar Rate loans if the Company's consolidated leverage ratio is 2.50 to 1.00 or higher, down to 25 basis points for Base Rate loans and 125 basis points for Eurodollar Rate loans if the Company's consolidated leverage ratio is 1.00 to 1.00 or less.

The Company may prepay loans under the Credit Agreement at any time, without penalty, subject to certain notice requirements. Debt is recorded at the amount drawn on the revolving credit facility plus interest based on floating rates reflective of changes in the market which approximates fair value.

The loans are guaranteed by each of the Company's domestic subsidiaries and are collateralized by all of the assets of the Company and its domestic subsidiaries, as well as 65% of the capital stock of the Company's foreign subsidiaries directly owned by the Company and its domestic subsidiaries. The Credit Agreement generally prohibits any other liens on the assets of the Company and its subsidiaries, subject to certain exceptions as described in the Credit Agreement. The Credit Agreement contains certain covenants applicable to the Company and its subsidiaries, including, without limitation, limitations on additional indebtedness, liens, various fundamental changes (including material mergers and dispositions of assets), dividends and distributions, capital expenditures, investments (including material acquisitions and investments in foreign subsidiaries), transactions with affiliates, sale-leaseback transactions, hedge agreements, payment of junior financing, material changes in business, and other limitations customary in senior secured credit facilities. In addition, the Company is required to maintain certain consolidated leverage and interest coverage ratios as well as a minimum liquidity amount. At June 30, 2015, the Company was in compliance with all of these covenants.

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NOTE 10 – COMMITMENTS AND CONTINGENCIES

Acquisition related – The Company has one contingent liability related to the acquisition of Simena, LLC (Simena) in November 2011 for future consideration to be paid to the former seller which had an initial fair value of $8.0 million at the time of acquisition. At June 30, 2015, the present value of the future consideration was $4.5 million.

Legal – From time to time, NetScout is subject to legal proceedings and claims in the ordinary course of business. In the opinion of management, the amount of ultimate expense with respect to any current legal proceedings and claims, if determined adversely, will not have a significant adverse effect on the Company's financial condition, results of operations or cash flows.

NOTE 11 – TREASURY STOCK

On April 22, 2014, the Company's board of directors approved a stock repurchase program. This program authorizes management to make additional repurchases of NetScout outstanding common stock of up to $100 million. The share repurchase authorization does not have an expiration date and the pace and timing of repurchases will depend on factors such as cash generation from operations, cash requirements for acquisitions, economic and market conditions, stock price and legal and regulatory requirements. Through June 30, 2015, the Company has repurchased 824,452 shares totaling $34.3 million in the open market under this stock repurchase plan. At June 30, 2015, $65.7 million of common stock remained available to be purchased under the plan. The Company repurchased 67,752 shares for $2.8 million under the program during the three months ended June 30, 2015.

In connection with the vesting and release of the restriction on previously vested shares of restricted stock units, the Company repurchased 8,709 shares for $381 thousand related to minimum statutory tax withholding requirements on these restricted stock units during the three months ended June 30, 2015. These repurchase transactions do not fall under the repurchase program described above, and therefore do not reduce the amount that is available for repurchase under that program.

On May 19, 2015, the Company's board of directors approved a new share repurchase program, conditional upon the completion of the Company's planned acquisition of Danaher Corporation's (Danaher) Communications Business. This new program will enable the Company to repurchase up to 20 million shares of its common stock. This plan became effective on July 14, 2015 upon the completion of the acquisition and replaces the Company's existing open market stock repurchase program. For additional information regarding the acquisition of Danaher's Communications Business, see Note 16 of the Company's Notes to Consolidated Financial Statements.

NOTE 12 – NET INCOME PER SHARE

Calculations of the basic and diluted net income per share and potential common shares are as follows (in thousands, except for per share data):

	Three Months Ended June 30,	
	2015	2014
Numerator:		
Net income	$7,669	$11,476
Denominator:		
Denominator for basic net income per share - weighted average common shares outstanding	40,776	41,081
Dilutive common equivalent shares:		
Weighted average stock options	—	17
Weighted average restricted stock units	595	710
Denominator for diluted net income per share - weighted average shares outstanding	41,371	41,808
Net income per share:		
Basic net income per share	$0.19	$0.28
Diluted net income per share	$0.19	$0.27

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The following table sets forth restricted stock units excluded from the calculation of diluted net income per share, since their inclusion would be antidilutive (in thousands):

	Three Months Ended June 30,	
	2015	2014
Restricted stock units	19	—

Basic EPS is calculated by dividing net income by the weighted average number of shares outstanding during the period. Unvested restricted shares, although legally issued and outstanding, are not considered outstanding for purposes of calculating basic earnings per share. Diluted EPS is calculated by dividing net income by the weighted average number of shares outstanding plus the dilutive effect, if any, of outstanding stock options, restricted shares and restricted stock units using the treasury stock method. The calculation of the dilutive effect of outstanding equity awards under the treasury stock method includes consideration of proceeds from the assumed exercise of stock options, unrecognized compensation expense and any tax benefits as additional proceeds.

NOTE 13 – INCOME TAXES

The Company's effective income tax rates were 37.4% and 41.1% for the three months ended June 30, 2015 and 2014, respectively. Generally, the effective tax rates differ from statutory rates due to the impact of the domestic production activities deduction, research and development credits if enacted, the impact of state taxes, income generated in jurisdictions that have a different tax rate than the U.S. statutory rate, and losses not benefited in certain foreign jurisdictions. The effective tax rate for the three months ended June 30, 2015 is lower than the effective rate for the three months ended June 30, 2014 primarily due to interim accounting treatment of certain foreign losses for which the benefit was not previously realized.

NOTE 14 – SEGMENT AND GEOGRAPHIC INFORMATION

The Company reports revenues and income under one reportable segment. The consolidated financial information is used by the chief operating decision maker in deciding how to allocate resources and in assessing performance.

The Company manages its business in the following geographic areas: United States, Europe, Asia and the rest of the world. In accordance with United States export control regulations, the Company does not sell or do business with countries subject to economic sanctions and export controls.

Total revenue by geography is as follows (in thousands):

	Three Months Ended June 30,	
	2015	2014
United States	$78,273	$86,018
Europe	12,607	9,046
Asia	3,532	6,717
Rest of the world	6,331	6,071
	$100,743	$107,852

The United States revenue includes sales to resellers in the United States. These resellers fulfill customer orders and may subsequently ship the Company’s products to international locations. The Company reports these shipments as United States revenue since the Company ships the products to a United States location. A majority of revenue attributable to locations outside of the United States is a result of export sales. Substantially all of the Company’s identifiable assets are located in the United States.

NOTE 15 - RELATED PARTY TRANSACTIONS

A member of the Company’s Board of Directors also serves as a member of the board of directors for EMC, Corp. (EMC) and therefore, the Company considers sales to EMC to be a related party transaction. The Company recognized $79 thousand in revenue from EMC during the three months ended June 30, 2015 in the ordinary course of business. Another member of the Company’s Board of Directors also serves as a Section 16 officer of State Street Corporation (State Street) and therefore, the

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Company considers sales to State Street to be a related party transaction. The Company recognized $60 thousand in revenue from State Street during the three months ended June 30, 2015 in the ordinary course of business.

NOTE 16 – SUBSEQUENT EVENTS

On July 14, 2015 (Closing Date), the Company completed the acquisition of the Communications Business of Danaher, which included certain assets, liabilities, technology and employees within Tektronix Communications, Arbor Networks and certain portions of the Fluke Networks Enterprise business. The acquisition was structured as a Reverse Morris Trust transaction (the Transaction) under which the total equity consideration was $2.3 billion based on issuing approximately 62.5 million new shares of NetScout common stock to the existing common unit holders of Potomac Holding LLC (Newco), based on the July 13, 2015 NetScout common stock closing share price of $36.89 per share.

The Transaction will be accounted for under the acquisition method of accounting with the operations of the Communications Business included in the Company's operating results from the date of acquisition. The acquisition method of accounting requires, among other things, that assets acquired and liabilities assumed be recognized at their fair values as of the acquisition date. The Company is in the process of obtaining valuations of acquired intangible assets and certain acquisition related liabilities in connection with this Transaction.

The table below represents a preliminary purchase price allocation for the acquisition of the Communications Business, based on that business's financial information and valuation models as of December 31, 2014 (in thousands):

Purchase Price allocation:		
Total equity consideration	$2,305,612	(1)
Less: Equity consideration for replacement awards	(22,188	) (2)
Estimated Purchase Price	2,283,424	
Estimated fair value of assets acquired and liabilities assumed:		
Cash	7,412	
Accounts Receivable	204,342	
Inventories	85,500	
Prepaid Expenses and Other Assets	16,361	
Property, Plant and Equipment	32,043	
Trademarks	47,700	
Customer Relationships	735,700	
Developed Technology	230,800	
Other Intangible Assets	83,300	
Accounts Payable	(48,759	)
Accrued Compensation	(28,275	)
Accrued Other	(76,311	)
Deferred Revenue	(131,886	)
Accrued Retirement Benefits	(7,412	)
Deferred Tax Liabilities	(375,129	)
Goodwill	1,508,038	

(1) Represents approximately 62.5 million new shares (plus cash in lieu of fractional shares) of NetScout common stock issued to the existing common unit holders of Newco based on the July 13, 2015 NetScout common stock closing share price of $36.89 per share.

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(2) Represents the value of certain outstanding Danaher equity awards held by Newco employees for which continuing employees will receive value after the closing date. A portion of this amount relates to awards that have been modified such that the awards will vest in Danaher shares after the Closing Date. These future compensation amounts will be settled in shares other than shares of the acquired business. The balance of this amount also represents future compensation expense and relates to a cash award to be paid by NetScout to acquired Newco employees on the later of the first anniversary of the transaction closing date or August 4, 2016. The cash payment by NetScout will be reimbursed by Danaher. These items are further described in that certain Employee Matters Agreement dated July 14, 2015 by and among NetScout Systems, Inc., Danaher Corporation and Potomac Holding LLC and have been accounted for separately from the Communications Business Acquisition.

In connection with RBC Capital Markets' services as NetScout's financial advisor, NetScout has agreed to pay RBC Capital Markets an aggregate fee of $11.0 million, a portion of which was payable upon delivery of RBC Capital Markets' opinion and $9.5 million of which was contingent upon consummation of the Mergers. NetScout also has agreed to reimburse RBC Capital Markets for expenses reasonably incurred in connection with RBC Capital Markets' services and to indemnify RBC Capital Markets and related persons against certain liabilities, including liabilities under the federal securities laws, arising out of RBC Capital Markets' engagement.

The Company has incurred $3.4 million in acquisition related costs during the three months ended June 30, 2015.

Pursuant to the previously disclosed Agreement and Plan of Merger and Reorganization, dated October 12, 2014, by and among the Company, Danaher, Newco, RS Merger Sub I, Inc. and RS Merger Sub II, LLC (Merger Agreement), the Company agreed to appoint to the Company's Board one individual designated by Danaher, effective on the closing date of the Transactions. Danaher designated, and the Board elected, James A. Lico as a Class I director. The Merger Agreement requires that, subject to the Board's fiduciary duties, the Board nominate Mr. Lico as a director nominee for election to the Board at the Company's 2015 annual meeting of stockholders, to serve until the Company's 2018 meeting of stockholders and until his successor is duly elected and qualified. Mr. Lico is Danaher's Executive Vice President and is a holder of Danaher common stock. In the Transactions, Mr. Lico was eligible to participate in the exchange offer being conducted by Danaher in connection with the Transactions on the same terms as all other Danaher stockholders. In connection with the Transactions, the Company entered into or assumed obligations under various ancillary agreements with Danaher or a subsidiary of Danaher, including a Commercial Lease Agreement and a Transition Services Agreement. Under the Commercial Lease Agreement, in addition to paying all costs and expenses relating to the premises, the Company is obligated to pay Danaher or one of its subsidiaries base rent during the first two lease years of $984,000 per annum and during the third lease year, of $3,000,000 per annum. The Transitions Services Agreement provides for payment for services on a schedule-by-schedule basis, and the terms and costs of such services vary.

On July 14, 2015, the Company entered into a certain credit facility with a syndicate of lenders pursuant to a Credit Agreement (Credit Agreement), dated as of July 14, 2015, by and among: the Company; JPMorgan Chase Bank, N.A. (JPMorgan), as administrative agent and collateral agent; J.P. Morgan Securities LLC, KeyBanc Capital Markets, Merrill Lynch, Pierce, Fenner & Smith Incorporated, RBC Capital Markets and Wells Fargo Securities, LLC, as joint lead arrangers and joint bookrunners; Santander Bank, N.A., SunTrust Bank, N.A. and U.S. Bank National Association, as co-documentation agents; and the lenders party thereto. The Credit Agreement provides for a five-year $800,000,000 senior secured revolving credit facility, including a letter of credit sub-facility of up to $50,000,000. The Company may elect to use the new credit facility for working capital purposes or repurchase up to 20 million shares of common stock under the Company's common stock repurchase plan. The commitments under the Credit Agreement will expire on July 14, 2020, and any outstanding loans will be due on that date.

Subsequent to the credit facility closing, the Company drew down $250 million to support general working capital requirements as well as to help finance the repurchase of NetScout's common stock under its recently approved 20 million share common stock repurchase plan.

At the Company's election, revolving loans under the Credit Agreement bear interest at either (a) a Base Rate per annum equal to the greatest of (1) JPMorgan's prime rate, (2) 0.50% in excess of the federal funds effective rate, or (3) an adjusted LIBO rate plus 1%; or (b) such adjusted LIBO rate (for the interest period selected by the Company), in each case plus an applicable margin. For the initial period until the Company has delivered financial statements for the quarter ended March 31, 2016, the applicable margin will be 1.75% per annum for LIBOR loans and 0.75% per annum for Base Rate loans, and thereafter the applicable margin will vary depending on the Company's leverage ratio, ranging from 1.00% per annum for Base Rate loans and 2.00% per annum for LIBOR loans if the Company's consolidated leverage ratio is greater than 2.50 to 1.00, down to 0.25% per annum for Base Rate loans and 1.25% per annum for LIBOR loans if the Company's consolidated leverage ratio is equal to or less than 1.00 to 1.00.

The Company's consolidated leverage ratio is the ratio of its total funded debt compared to its consolidated adjusted EBITDA. Consolidated adjusted EBITDA includes certain adjustments, including, without limitation, adjustments relating to extraordinary, unusual or non-recurring charges, certain restructuring charges, non-cash charges, certain transaction costs and expenses and certain pro forma adjustments in connection with material acquisitions and dispositions, all as set forth in detail in the definition of Consolidated EBITDA in the Credit Agreement.

Commitment fees will accrue on the daily unused amount of the credit facility. For the initial period until the Company has delivered financial statements for the quarter ended March 31, 2016, the commitment fee will be 0.20% per annum, and thereafter the commitment fee will vary depending on the Company's consolidated leverage ratio, ranging from 0.35% per annum if the Company's consolidated leverage ratio is greater than 2.50 to 1.00, down to 0.20% per annum if the Company's consolidated leverage ratio is equal to or less than 1.00 to 1.00.

Letter of credit participation fees are payable to each lender on the amount of such lender's letter of credit exposure, during the period from the closing date of the Credit Agreement to but excluding the date which is the later of (i) the date on which such lender's commitment terminates or (ii) the date on which such lender ceases to have any letter of credit exposure, at a rate per annum equal to the applicable margin for LIBOR loans. Additionally, the Company will pay a fronting fee to each issuing bank in amounts to be agreed to between the Company and the applicable issuing bank.

Interest on Base Rate loans is payable at the end of each calendar quarter. Interest on LIBOR loans is payable at the end of each interest rate period or at the end of each three-month interval within an interest rate period if the period is longer than three months. The Company may also prepay loans under the Credit Agreement at any time, without penalty, subject to certain notice requirements.

The loans and other obligations under the credit facility are (a) guaranteed by each of the Company's wholly-owned material domestic restricted subsidiaries, subject to certain exceptions, and (b) are secured by substantially all of the assets of the Company and the subsidiary guarantors, including a pledge of all the capital stock of material subsidiaries held directly by the Company and the subsidiary guarantors (which pledge, in the case of any foreign subsidiary, is limited to 65% of the voting stock), subject to certain customary exceptions and limitations. The Credit Agreement generally prohibits any other liens on the assets of the Company and its restricted subsidiaries, subject to certain exceptions as described in the Credit Agreement.

The Credit Agreement contains certain covenants applicable to the Company and its restricted subsidiaries, including, without limitation, limitations on additional indebtedness, liens, various fundamental changes, dividends and distributions, investments (including acquisitions), transactions with affiliates, asset sales, including sale-leaseback transactions, speculative hedge agreements, payment of junior financing, changes in business and other limitations customary in senior secured credit facilities. In addition, the Company is required to maintain certain consolidated leverage and interest coverage ratios. These covenants and limitations are more fully described in the Credit Agreement.

The Credit Agreement provides that events of default will exist in certain circumstances, including failure to make payment of principal or interest on the loans when required, failure to perform certain obligations under the Credit Agreement and related documents, defaults under certain other indebtedness, certain insolvency events, certain events arising under ERISA, a change of control and certain other events. Upon an event of default, the administrative agent with the consent of, or at the request of, the holders of more than 50% in principal amount of the loans and commitments may terminate the commitments and accelerate the maturity of the loans and enforce certain other remedies under the Credit Agreement and the other loan documents.

In connection with the Company's revolving credit facility described above, effective as of the Closing Date, the Company terminated its existing term loan and revolving credit facility pursuant to the Credit and Security Agreement, dated as of November 22, 2011, by and among NetScout Systems, Inc., KeyBank National Association, as joint lead arranger, sole book runner and administrative agent, Wells Fargo Bank, National Association, as joint lead arranger and co-syndication agent, Merrill Lynch, Pierce, Fenner & Smith Incorporated, as joint lead arranger, Bank of America, N.A., as co-syndication agent, and Silicon Valley Bank and Comerica Bank, as co-documentation agents, and the Lenders party thereto.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

In addition to historical information, the following discussion and other parts of this Quarterly Report contain forward-looking statements under Section 21E of the Exchange Act and other federal securities laws. These forward looking statements involve risks and uncertainties. These statements relate to future events or our future financial performance and are identified by terminology such as "may," "will," "could," "should," "expects," "plans," "intends," "seeks," "anticipates," "believes," "estimates," "potential" or "continue," or the negative of such terms or other comparable terminology. These statements are only predictions. You should not place undue reliance on these forward-looking statements. Actual events or results may differ materially due to competitive factors and other factors referred to in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for our fiscal year ended March 31, 2015. These factors may cause our actual results to differ materially from any forward-looking statement.

Overview

We are an industry leader for advanced network, application and service assurance solutions, providing high-quality performance analytics and operational intelligence solutions that facilitate the evolution toward new computing paradigms, such as virtualization, mobility and cloud. We design, develop, manufacture, market, license, sell and support these products focused on assuring service delivery quality, performance and availability for some of the world's largest, most demanding and complex internet protocol (IP) based service delivery environments. We manufacture and market these products in integrated hardware and software solutions that are used by commercial enterprises, large governmental agencies and telecommunication service providers worldwide. We have a single operating segment and substantially all of our identifiable assets are located in the United States.

We have been a technology innovator for three-plus decades since our founding in 1984. Our solutions continue to change how organizations manage and optimize the delivery of business applications and services and assure user experience across global IP networks. We have continually enhanced and expanded our product portfolio to meet the needs of organizations by providing solutions to manage dynamic network and application environments and by improving user experience by providing high-value analytics that help validate and assure service availability, quality and reliability.

Our solutions are intended to help users in various roles to: quickly analyze data, achieve real-time visibility into and intelligence about their organization's operations, identify service delivery issues early, improve service levels, reduce operational costs, mitigate security risks, and drive better business decisions. Our value proposition to our customers is helping them to achieve their objectives regarding return on investments and risk mitigation as they develop their IT infrastructure to support their business needs. Our proactive intelligence and analytics provides our customer with knowledge regarding potential issues before their users are impacted.

Our mission is to enable information technology (IT) and service providers to realize maximum benefit with minimal risk from technology advances, like IP convergence, network function virtualization (NFV), software defined networking (SDN), virtualization, cloud, mobility, bring your own device (BYOD), web, and the evolving Internet by managing the inherent complexity in a cost-effective manner. Our Adaptive Session Intelligence (ASI) technology, which we have developed in support of this mission, has the potential of not only expanding our leadership in the network performance management and application performance management (NPM+APM) space, but can also serve as a gateway for future intelligence solutions including cyber and business intelligence.

Our operating results are influenced by a number of factors, including, but not limited to, the mix and quantity of products and services sold, pricing, costs of materials used in our products, growth in employee related costs, including commissions, and the expansion of our operations. Factors that affect our ability to maximize our operating results include, but are not limited to, our ability to introduce and enhance existing products, the marketplace acceptance of those new or enhanced products, continued expansion into international markets, development of strategic partnerships, competition, successful acquisition integration efforts, our ability to achieve expense reductions and make structural improvements and current economic conditions.

On July 14, 2015, we completed the acquisition of the Communications Business of Danaher Corporation (Danaher), which included certain assets, liabilities, technology and employees within Tektronix Communications, Arbor

Networks and certain portions of the Fluke Networks Enterprise business. The acquisition was structured as a Reverse Morris Trust transaction (the Transaction) under which the total equity consideration was $2.3 billion based on issuing approximately 62.5 million new shares of NetScout common stock to the existing common unit holders of Potomac Holding LLC (Newco), based on the July 13, 2015 NetScout common stock closing share price of $36.89 per share. The Transaction is expected to more than double NetScout's total addressable market to over $8 billion by extending its reach into growth-oriented adjacent markets, including cyber security, with a broader range of market-leading products and capabilities, strengthen its go-to-market

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resources to better support a larger, more diverse and more global customer base, and increase NetScout's scale and elevate its strategic position within key accounts. For additional information regarding the Transaction, see Note 16 of our Notes to Consolidated Financial Statements.

Results Overview

Although there continued to be strong interest in our offerings from customers and prospects in our primary vertical markets during the quarter ended June 30, 2015, our product revenue declined 17%, or $10.8 million, compared to the same period in the prior year. This was due to the timing and magnitude of increased product orders received during the quarter ended June 30, 2014 from our service provider customers. The decline in product revenue during the three months ended June 30, 2015 was partially offset by an 8%, or $3.7 million, increase in service revenue when compared to the quarter ended June 30, 2014 reflecting an increase in our installed base and therefore our related maintenance contracts.

Our business has maintained strong gross profit margins. The gross profit percentage remained flat at 79% during the quarter ended June 30, 2015, when compared to the quarter ended June 30, 2014.

Net income and net income per share decreased 33% and 32%, respectively compared to the same period in the prior year due to the decline in revenue, and higher expenses associated with the acquisition of Danaher's Communications Business.

We continue to maintain strong liquidity. At June 30, 2015, we had cash, cash equivalents and marketable securities of $267.5 million. This represents an increase of $2.7 million from March 31, 2015.

Use of Non-GAAP Financial Measures

We supplement the generally accepted accounting principles (GAAP) financial measures we report in quarterly and annual earnings announcements, investor presentations and other investor communications by reporting the following non-GAAP measures: non-GAAP revenue, non-GAAP net income and non-GAAP net income per diluted share. Non-GAAP revenue eliminates the GAAP effects of acquisitions by adding back revenue related to deferred revenue revaluation. Non-GAAP net income includes the foregoing adjustment and also removes expenses related to the amortization of acquired intangible assets, share-based compensation, certain expenses relating to acquisitions including compensation for post-combination services and business development charges, net of related income tax effects. Non-GAAP diluted net income per share also excludes these expenses as well as the related impact of all these adjustments on the provision for income taxes.

These non-GAAP measures are not in accordance with GAAP, should not be considered an alternative for measures prepared in accordance with GAAP (revenue, net income and diluted net income per share), and may have limitations in that they do not reflect all our results of operations as determined in accordance with GAAP. These non-GAAP measures should only be used to evaluate our results of operations in conjunction with the corresponding GAAP measures. The presentation of non-GAAP information is not meant to be considered superior to, in isolation from, or as a substitute for results prepared in accordance with GAAP.

Management believes these non-GAAP financial measures enhance the reader's overall understanding of our current financial performance and its prospects for the future by providing a higher degree of transparency for certain financial measures and providing a level of disclosure that helps investors understand how we plan and measure our business. We believe that providing these non-GAAP measures affords investors a view of our operating results that may be more easily compared to our peer companies and also enables investors to consider our operating results on both a GAAP and non-GAAP basis during and following the integration period of our acquisitions. Presenting the GAAP measures on their own may not be indicative of our core operating results. Furthermore, management believes that the presentation of non-GAAP measures when shown in conjunction with the corresponding GAAP measures provide useful information to management and investors regarding present and future business trends relating to our financial condition and results of operations.

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The following table reconciles revenue, net income and net income per share on a GAAP and non-GAAP basis for the three months ended June 30, 2015 (in thousands, except for per share amounts):

	Three Months Ended June 30,	
	2015	2014
GAAP revenue	$100,743	$107,852
Deferred revenue fair value adjustment	—	18
Non-GAAP revenue	$100,743	$107,870
GAAP net income	$7,669	$11,476
Deferred revenue fair value adjustment	—	18
Share based compensation expense	4,595	3,302
Amortization of acquired intangible assets	1,567	1,796
Business development and integration expense	3,362	—
Compensation for post combination services	21	536
Income tax adjustments	(3,552)	(1,910)
Non-GAAP net income	$13,662	$15,218
GAAP diluted net income per share	$0.19	$0.27
Per share impact of non-GAAP adjustments identified above	0.14	0.09
Non-GAAP diluted net income per share	$0.33	$0.36

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America consistently applied. The preparation of these consolidated financial statements requires us to make significant estimates and judgments that affect the amounts reported in our consolidated financial statements and the accompanying notes. These items are regularly monitored and analyzed by management for changes in facts and circumstances, and material changes in these estimates could occur in the future. Changes in estimates are recorded in the period in which they become known. We base our estimates on historical experience and various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from our estimates.

While all of our accounting policies impact the consolidated financial statements, certain policies are viewed to be critical. Critical accounting policies are those that are both most important to the portrayal of our financial condition and results of operations and that require management's most subjective or complex judgments and estimates. We consider the following accounting policies to be critical in fully understanding and evaluating our financial results:

- marketable securities;
- revenue recognition;
- valuation of goodwill, intangible assets and other acquisition accounting items; and
- share-based compensation.

Please refer to the critical accounting policies set forth in our Annual Report on Form 10-K for the fiscal year ended March 31, 2015, filed with the Securities and Exchange Commission (SEC) on May 20, 2015, for a description of all of our critical accounting policies.

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Three Months Ended June 30, 2015 and 2014

Revenue

Product revenue consists of sales of our hardware products and licensing of our software products. Service revenue consists of customer support agreements, consulting and training. During the three months ended June 30, 2015, no direct customer or indirect channel partner accounted for more than 10% of our total revenue. During the three months ended June 30, 2014, two direct customers accounted for more than 10% of our total revenue, while no indirect channel partner accounted for more than 10% of our total revenue.

	Three Months Ended June 30, (Dollars in Thousands)						Change			
	2015			2014						
		% of Revenue			% of Revenue		$		%	
Revenue:										
Product	$53,593	53	%	$64,366	60	%	$(10,773	)	(17	)%
Service	47,150	47		43,486	40		3,664		8	%
Total revenue	$100,743	100	%	$107,852	100	%	$(7,109	)	(7	)%

Product. The 17%, or $10.8 million, decrease in product revenue was due to a $20.2 million decrease in revenue from our service provider sector which reflects the timing and magnitude of various projects with service providers. This decrease was partially offset by a $9.5 million increase from our general enterprise sector. Compared to the same period in the prior year, we realized a 13% decrease in units shipped, and a 7% decrease in the average selling price per unit of our products due to product mix.

Going forward, we expect that the revenue mix in future quarters will be oriented toward service provider customers since the revenue from Tektronics Communications is nearly 100% from the service provider sector and the majority of revenue at Arbor Networks also came from this sector. We expect that the service provider sector will be approximately 60% of total quarterly revenue, depending on the timing and magnitude of certain projects.

Service. The 8%, or $3.7 million, increase in service revenue was due to a $3.5 million increase in revenue from new maintenance contracts and renewals from a growing support base and a $224 thousand increase in revenue from premium support contracts. We expect continued service revenue growth to be generated by product revenue growth which increases our installed base and therefore our related maintenance contracts.

Total product and service revenue from direct and indirect channels are as follows:

	Three Months Ended June 30, (Dollars in Thousands)						Change			
	2015			2014						
		% of Revenue			% of Revenue		$		%	
Indirect	$54,725	54	%	$42,103	39	%	$12,622		30	%
Direct	46,018	46		65,749	61		(19,731	)	(30	)%
Total revenue	$100,743	100	%	$107,852	100	%	$(7,109	)	(7	)%

The 30%, or $12.6 million, increase in indirect channel revenue is the result of the increase in sales to our general enterprise sector in the United States, as well as in our service provider sector internationally. Sales to customers outside the United States are export sales typically through channel partners, who are generally responsible for distributing our products and providing technical support and service to customers within their territories. Our reported international revenue does not include any revenue from sales to customers outside the United States that are shipped to our United States-based indirect channel partners. These domestic resellers fulfill customer orders based upon joint selling efforts in conjunction with our direct sales force and may subsequently ship our products to international locations; however, we report these shipments as United States revenue since we ship the products to a domestic location. The 30%, or $19.7 million, decrease in direct revenue is

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primarily the result of decreased domestic revenue from our service provider sector, partially offset by increases in our general enterprise sector.

Total revenue by geography is as follows:

	Three Months Ended June 30, (Dollars in Thousands)				Change	
	2015		2014			
		% of Revenue		% of Revenue	$	%
United States	$78,273	78 %	$86,018	80 %	$(7,745)	(9)%
International:						
Europe	12,607	13	9,046	8	3,561	39 %
Asia	3,532	3	6,717	6	(3,185)	(47)%
Rest of the world	6,331	6	6,071	6	260	4 %
Subtotal international	22,470	22	21,834	20	636	3 %
Total revenue	$100,743	100 %	$107,852	100 %	$(7,109)	(7)%

United States revenues decreased 9%, or $7.7 million, compared to the same period last year, primarily due to the aforementioned decrease in the service provider sector, offset by an increase within the general enterprise sector. The 3%, or $0.6 million, increase in international revenue is primarily due to an increase across the service provider sector, partially offset by a decrease in the general enterprise sector. We expect revenue from sales to customers outside the United States to continue to account for a significant portion of our total revenue in the future. In accordance with United States export control regulations we do not sell to, or do business with, countries subject to economic sanctions and export controls.

We expect that the combined company will have a more balanced geography mix with approximately one third of our revenue coming from outside of North America.

Cost of Revenue and Gross Profit

Cost of product revenue consists primarily of material components, manufacturing personnel expenses, manuals, packaging materials, overhead and amortization of capitalized software, acquired software and core technology. Cost of service revenue consists primarily of personnel, material, overhead and support costs.

	Three Months Ended June 30, (Dollars in Thousands)				Change	
	2015		2014			
		% of Revenue		% of Revenue	$	%
Cost of revenue						
Product	$12,498	12 %	$13,766	13 %	$(1,268)	(9)%
Service	8,798	9	8,830	8	(32)	— %
Total cost of revenue	$21,296	21 %	$22,596	21 %	$(1,300)	(6)%
Gross profit:						
Product $	$41,095	41 %	$50,600	47 %	$(9,505)	(19)%
Product gross profit %	77 %		79 %			
Service $	$38,352	38 %	$34,656	32 %	$3,696	11 %
Service gross profit %	81 %		80 %			
Total gross profit $	$79,447		$85,256			