

McAfee First Quarter 2009 Earnings Call

Good afternoon and thank you for joining us today. This afternoon's conference call is being recorded and will be available for replay on McAfee's investor relations home page at investor.mcafee.com.

With me on today's call are our President and Chief Executive Officer, Dave DeWalt ... and our Chief Operating Officer and Chief Financial Officer, Rocky Pimentel.

Dave will open this afternoon's call with a high level review of the quarter and a strategic discussion. Then, Rocky will provide financial details and guidance for the second quarter 2009. Dave will close and we will be pleased to take your questions.

You will find, in our press release and on the investor relations section of our website, a GAAP to non-GAAP reconciliation of the first quarter 2009 financial results discussed in this conference call. The link is: investor.mcafee.com, and our results are posted under "quarterly results." We will post our prepared remarks to the website following the conclusion of today's call.

During this conference call and the question and answer session we will make forward-looking statements regarding future events and the future performance of the Company, including our guidance on revenue, operating income margins and earnings levels for the second quarter of 2009, the assumed tax rate for 2009 we used in estimating our guidance, our business strategy and future business plans and prospects, trends in the security market and our competitive position, strategies and

opportunities, the anticipated benefits of our current, new and future products, and the anticipated benefits of our acquisitions, partnerships and alliances .

Forward looking statements are based on management's current expectations and are subject to risks and uncertainties.

We caution listeners that actual results may vary, perhaps materially, from the forward-looking statements made during this call and the question and answer session this afternoon. We encourage listeners to review the risk factors contained in today's press release, as well as the Company's filings with the SEC, including the Annual Report on Form 10-K filed March 2, 2009, for more detailed information on the risks and uncertainties related to the Company and its business. We do not undertake to update any forward looking statements.

With that, it is my pleasure to turn the call over to our President and CEO, Dave DeWalt ...

Thank you, Kelsey.

Good afternoon and welcome everyone. Thank you for joining us today.

INTRODUCTION

McAfee had an excellent start to 2009.

As we mentioned when we reported earnings in February -- 2008 was about making strategic investments to drive growth. We also commented

at the time that we are focused on optimizing our business model to build incremental shareholder value.

Our first quarter 2009 results show the impact of that strategy.

It was a quarter of many records:

- Record revenue of \$448 million, up 21% year-over-year, and our 13th consecutive quarter of double-digit, year-over-year revenue growth;
- Record revenues for both our corporate and our consumer businesses;
- Record non-GAAP operating income of \$114 million, up 38% year-over-year;
- Record non-GAAP earnings per share of \$0.57, up 31% year-over-year, including \$0.03 benefit from insurance and \$0.02 dilution from the acquisition of Secure Computing; and
- Record cash flow of \$146 million which was up 105%, including a \$14 million litigation payment related to our derivative lawsuit from 2006.

So, Why is security proving to be so resilient for McAfee in a challenging economic environment?

First - The growth of the internet & global markets on-line coupled with a low risk, high reward for cyber criminals is driving a significant increase in

the threat landscape. Breaches are occurring daily in both the private and public sector with mass deployments of highly sophisticated worms and viruses. In addition, cyber warfare is beginning to escalate worldwide along with the increasing threat of cyber-terrorism. In the last 6 months alone, we have seen some of the most significant breaches and mass virus infections in the history of security.

For example,

- In the last 12 months, McAfee AVERT labs saw a 500% increase in malware and more malware than we had seen in the last 5 years combined.
- Also, 285 million data records were breached in 2008 compared with 38 million in 2007.
- The FBI reported a 33% increase in internet crime complaints in 2008 over 2007.
- On top of that, we now believe the worldwide problem related to data loss and identity theft exceeds \$1 trillion dollars.
- The need for a strong, global security provider has never been greater.

And these trends are only increasing as we move through 2009.

Companies are trying to be more frugal than ever in this difficult economic environment, Security has been a highly fragmented market for many years with many, many vendors. The climate is creating an opportunity to consolidate costs, vendors, and resources. The global security provider with the strongest suites will gain the most market share.

The regulatory environment is also becoming increasingly complex. Regulations now mandate controls over confidential and personally identifiable information on a global basis.

- Any company that processes a credit card must be able to prove PCI compliance.
- More than 40 countries have data protection regulations.
- And, there are more than 50 different regulatory requirements worldwide.

And, again, the strongest global security provider to help simplify regulations and reduce costs of audits will drive the most revenues.

Finally, consumers are under attack like never before from identity theft, child predators and malware. The rise of Web 2.0 applications, new devices, and easy access to the internet create new opportunities for security providers.

Security has never before been more significant to our customers and the need for a dedicated security company has never been more important.

WHY McAfee?

These macro-conditions play right into the strengths of McAfee's model and are contributing to our growth.

Other growth drivers, specific to McAfee include:

- Security product leadership.

- Our partner eco-system and alliance initiatives.
- And, a powerful business model.

First, we lead the security industry with a product portfolio that focuses on integration and manageability. Our 2009 product pipeline features:

- A focus on increased manageability. Our next generation ePO platform – 4.5 – which is now in beta with over 2,300 participants. This next generation management console features improved scalability, an enhanced user interface and improved dashboards and reporting functionality. In addition, it offers increased integration of our recently acquired products and provides cross-selling opportunities for our install base, enabling lower switching costs from our competitors.
- Second, the interlock between our endpoint products and our network products: With an increased threat landscape, the need to correlate data across layers of security defense is critical. We are now beginning to ship Total Protection capabilities for Data Loss, Network Admission Control, Intrusion Prevention, FireWalls, Web Security and Email Security. In addition, Total Protection for Compliance is our newest example of this interlock – featuring agent and agent-less integration and management. We do not believe any competitor in the market can replicate our capabilities in this area.
- Third, a suite based approach grounded in reliability and ease of use: Our most recent suite announcement is a network solution – called McAfee Unified Threat Management firewall. Our UTM firewalls feature seven different models fully integrated with intrusion

prevention, network firewall protection, and VPN services. These solutions are cost effective and easy to deploy and targeted at the small and mid-market.

- And, finally, enhanced protection for consumers: McAfee Family Protection will help families keep themselves and their children safe on the Internet, including email contact approval; content filtering; time limits and social networking controls. Family Protection is expected to be available later this quarter.

McAfee's technology leadership has been acknowledged by industry analysts and publications. Most recently we received SC Magazine's Excellence Award for Best Security Company; Best Endpoint Security Solution; and Best Email Security Solution.

Second, we recognize that an open approach and a partner eco-system will create incremental value for our customers, partners and shareholders. We believe, security will ultimately become ubiquitous. To take advantage of that opportunity we have deliberately executed a strategy that will extend our reach.

Our partner eco-system now includes:

- More than 12,000 resellers worldwide.
- 60+ Security Innovation Alliance partners (or ISV's) committed to helping customers drive operational savings with McAfee compatible products.
- Nearly 50 OEM partners which license, bundle and extend McAfee's reach to a broader user base.

- And, more than 200 brand name consumer partners driving global distribution. This total includes relationships with major PC OEM manufacturers, internet service providers, financial institutions and some of the largest telecommunications providers.

The market accessed through our partnerships and alliances is significant.

Finally, McAfee operates a resilient business model:

- Approximately 81% of revenue in the first quarter came from the balance sheet.
- Our business is recurring in nature with 51% of total revenue this quarter from service and support and 41% from subscriptions – with approximately 92% of total first quarter is recurring.
- In addition, we have high customer retention rates - enterprise customers have approximately 90% retention rates, and our average consumer life cycle now extends more than 3 years.
- And, finally, we are leveraging our cost structure. First quarter non-GAAP operating margin was 25.4%. This was over a 300 basis point improvement compared to last year's first quarter non-GAAP operating margins.

McAfee continues to grow faster than the security market and faster than our competitors in this space.

First quarter 2009 results demonstrate that, despite a challenging environment, our strategy is working. Our customers – from the consumer to the largest enterprise – value the enhanced protection, integration, manageability and improved return on their security investment offered by McAfee.

And, with that, let me hand it over to Rocky for a financial review of the quarter and guidance.

Rocky...

Thank you, Dave. Good afternoon everyone.

We reported an exceptional start to 2009 and we are pleased with our first quarter results which demonstrate the benefits of a ratable business model, improved operating leverage and the strong operating cash flow characteristics of our business.

Sales, which are orders recorded during the quarter, grew 21% year-over-year during the first quarter, even factoring in an approximately 5% negative impact from foreign currency. Excluding the impact of foreign exchange, we had double-digit, year-over-year growth in sales during the first quarter in the McAfee core business.

First quarter 2009 revenue was \$448 million, up 21% year-over-year, a record revenue quarter for McAfee and our 13th straight quarter of double-digit, year-over-year revenue growth.

Revenue from Secure Computing was \$41 million for the first quarter. Foreign currency negatively impacted core McAfee revenue by approximately \$15 million year-over-year and was not significant sequentially.

Of the \$448 million in revenue during the quarter, \$228 million was service and support, up 21% year-over-year, and \$182 million was subscription, up 13% year-over-year.

North America revenue was \$254 million, an increase of 34% from last year's first quarter, and accounted for 57% of the business. This was another record revenue quarter for North America, reflecting the impact of the acquisition of Secure Computing, strong performance in the core McAfee portfolio and highlighted by several significant competitive displacements in both our network and endpoint businesses.

International revenue was \$194 million, an increase of 7% when compared to the same period last year, and accounted for 43% of the business. Please note that foreign exchange negatively impacted international revenue growth by approximately 8% compared to first quarter of 2008. As reported in U.S. dollars, revenue in our international geographies, compared to the first quarter of 2008, was:

- Down 1% in Europe, the Middle East and Africa. In local currency EMEA grew 8% year-over-year;
- Up 14% in Asia Pacific;
- Up 31% in Latin America;
- And, up 31% in Japan. In local currency Japan grew 14% year-over-year.

For the first quarter, approximately 81% of total revenue came from deferred revenue off the balance sheet. This result is consistent with the company's historical trends.

During the first quarter we closed 350 deals having a value greater than \$100,000, including 41 deals over \$500,000 and 16 deals over \$1 million. We continue to see momentum in large deal opportunities, including strength in the pipeline. Our broader security focused portfolio is driving larger sales opportunities.

Corporate revenue was \$276 million, up 28% year-over-year. This was another record revenue quarter for our corporate business. This was our sixth consecutive quarter of double-digit, year-over-year revenue growth in our systems and network product segments.

Sales of Total Protection, or ToPs, Endpoint grew 34% year-over-year and ToPS continues to drive competitive displacements.

On the consumer side, revenue grew 12% year-over-year for the first quarter to \$172 million. This was another record revenue quarter for our consumer business and we were very pleased with the results, especially in light of the weaker macro consumer environment.

Additional highlights from our first quarter consumer business include:

- The signing or extension of 15 new consumer partnerships and launching of 69 new or enhanced online partnerships during the quarter.

- We had a record number of new, trial registrations worldwide with growth of more than 150% year-over-year.
- Online sales of Total Protection, our high-end consumer security suite, grew 98% year-over-year.

Reviewing the rest of the income statement, GAAP gross profit margin for the first quarter 2009 was 74.7%, compared with the fourth quarter 2008 of 75.2% and first quarter 2008 of 75.7%. Non-GAAP gross profit margin for the first quarter was 79.3%. This was unchanged compared to last quarter and down slightly compared to a year-ago first quarter gross profit margin of 79.5%.

Total GAAP operating expenses in the first quarter 2009 were \$283 million, compared with \$226 million for first quarter 2008 and \$286 million for the fourth quarter of 2008. Total operating expenses, on a non-GAAP basis, in the first quarter 2009 were \$242 million, compared with \$212 million for the first quarter 2008 and \$229 million for the fourth quarter of 2008.

Please note that, effective this quarter, we have reclassified expenses associated with sales order operations. Formerly included in general and administrative expense, sales order operations will now be included as a component of sales and marketing expense, consistent with other companies in the software industry. All numbers presented in this afternoon's call reflect this reclassification.

GAAP sales and marketing expenses for the first quarter 2009 were \$149 million. First quarter 2009 sales and marketing costs, on a non-GAAP basis were \$139 million, or 31.0% of revenue, compared to \$134 million for

the fourth quarter. This increase, on a non-GAAP basis, was primarily driven by head count from Secure Computing and the reclassification of sales order operations expense, offset by reduced marketing expenses.

First quarter 2009 GAAP research and development costs were \$78 million. First quarter 2009 research and development costs, on a non-GAAP basis, were \$71 million, or 15.9% of revenue, compared to \$61 million for the fourth quarter, also reflecting the impact of Secure Computing. We were granted 6 new patents in the first quarter, bringing our total portfolio to 426.

GAAP general and administrative expenses for the first quarter of 2009 were \$38 million. On a non-GAAP basis, G&A expenses for the first quarter 2009 were \$31 million, or 7.0% of revenue, compared to \$33 million for the fourth quarter. This includes the \$3 million reclassification of sales order operations expense. In addition, included in fourth quarter 2008 and first quarter 2009 G&A expenses were insurance benefits related to historical litigation activity of \$5 million and \$6.5 million, respectively. The timing of this first quarter benefit was not anticipated and, therefore, was not included in first quarter guidance.

GAAP operating income for the first quarter was \$52 million - resulting in a GAAP operating margin for the period of 11.6%. The year-over-year decrease in GAAP operating margin percentage is driven primarily by acquisitions.

Operating income on a non-GAAP basis for the first quarter was \$114 million resulting in a non-GAAP operating margin of 25.4%. Excluding the impact of the previously mentioned insurance benefit, non-GAAP operating

margin was 24.0%. We exceeded the first quarter non-GAAP operating margin guidance we provided in February.

The sequential and year-over-year improvement in McAfee's non-GAAP operating margin was the result of the cost savings and cost avoidance initiatives we outlined for you at the beginning of the year, which included:

- Containing discretionary marketing spend;
- Disciplined headcount management - total employee headcount at the end of the quarter was 5,548 employees, down 15 employees from our year-end total of 5,563;
- Integration synergies related to Secure Computing. Additional synergies are expected to be achieved throughout the rest of 2009 in accordance with our integration plan;
- Focused discretionary cost control and;
- Execution of ongoing business process improvements.

Moving on, GAAP other income for the quarter was \$2 million.

Non-GAAP other income was \$3 million, compared with \$6 million in the fourth quarter 2008 and \$15 million in the first quarter 2008. This decrease in other income reflected lost interest income associated with cash used for acquisitions and lower interest rates, as well as interest expense from our \$100 million unsecured term loan drawn down early in January as part of a credit agreement entered into with a consortium of banks late in 2008.

For the quarter we had a GAAP tax rate of 1%. This effective GAAP tax rate is primarily due to tax benefits recognized in the quarter as the result of statute expirations in various jurisdictions. On a non-GAAP basis, our tax rate was 24%.

In the first quarter of 2009 we reported net income, on a GAAP basis, of \$53 million, or \$0.34 per share on a diluted basis.

Our first quarter net income, on a non-GAAP basis, was \$89 million. Non-GAAP earnings per diluted share was \$0.57, up 31% year-over-year.

Our non-GAAP earnings per share results for the first quarter of 2009 included \$0.03 per share for the insurance benefit previously mentioned. Non-GAAP results also included approximately \$0.02 per share of dilution from the acquisition of Secure Computing.

Investors and potential investors are encouraged to review the complete reconciliation of GAAP to non-GAAP financial measures set forth in the attachment to our press release issued this afternoon.

Turning to the balance sheet, our net accounts receivable balance at the end of the first quarter 2009 was \$240 million compared with \$195 million for the same period last year. Days sales outstanding were 48 days for the first quarter 2009, unchanged from the first quarter of 2008.

Deferred revenue at the end of the first quarter 2009 was \$1.269 billion, up 17% year-over-year. Foreign currency negatively impacted deferred revenue by approximately \$79 million year-over-year and approximately \$35 million sequentially.

We ended the first quarter with \$979 million in short-term deferred revenue, down \$10 million when compared with the fourth quarter 2008.

Long-term deferred revenue was down by \$13 million in the first quarter compared to the fourth quarter 2008, ending the quarter at \$291 million.

We did not see unusual contract extensions nor did we see any unusual discounting during the quarter.

The composition of our deferred revenue balance at the end of the first quarter of 2009 was 66% related to Corporate and 34% for Consumer. Please note that this slight shift in weighting towards corporate deferred revenue compared to prior quarters is the result of the acquisition of Secure Computing which closed in the fourth quarter of 2008.

We ended the first quarter of 2009 with cash and marketable securities of \$801 million compared with \$594 million at the end of the fourth quarter of 2008. This sequential increase was primarily due to increased cash flow of our business, as well the \$100 million unsecured term loan drawn down in early January.

We have \$250 million in stock repurchase authorization remaining through July of 2009.

In the first quarter 2009, we generated total GAAP operating cash flow of \$146 million, an increase of 105% over last year's first quarter operating cash flow of \$71 million. This year-over-year increase was primarily driven by growth in net income and increased cash collections of accounts receivable.

Please note that first quarter 2009 operating cash flow included a payment of approximately \$14 million related to our recently concluded derivative lawsuit.

We recognize that operating cash flow is an important indicator of the success of our business as demonstrated by our first quarter results. A successful 2009 should continue to drive strong cash flow results.

SECURE

As I mentioned, revenue contributed by Secure Computing for the first quarter 2009 was \$41 million. Approximately 76% of first quarter revenue for Secure Computing came off the balance sheet.

Secure was \$0.02 per share dilutive to our first quarter non-GAAP earnings per share, outperforming our initial expectations. This was a combination of slightly higher revenue realized during the quarter compared to our initial expectations and expense management across all aspects of the business.

Integration continues to progress according to plan. Next steps include the unification of our price book; integration of our sales order operations functions and IT infrastructure; expanded partner training and certification; and tightening of the integration between Secure Computing's sales force and the core McAfee sales force.

We currently expect this acquisition to be neutral to slightly accretive to full-year 2009 results.

GUIDANCE

Now I would like to turn to guidance.

The following updated guidance replaces and supersedes any previous guidance with respect to future periods and is valid as of today only. I would like to remind our listeners that guidance is based upon management's current judgments and that actual results may vary, perhaps materially, from those results anticipated in this guidance. Please see the footnotes to our press release for further details.

For the second quarter of 2009:

- We expect a revenue range of \$455 million to \$475 million.
- We expect a GAAP operating income margin of 11.0% to 15.0%.
- We expect an operating income margin, on a non-GAAP basis, of 23.0% to 25.0%.
- We expect a diluted share count in the range of 156 to 158 million shares.
- We assume an annual 12% GAAP tax rate and a non-GAAP tax rate of 24% for 2009.

Also, for the second quarter of 2009:

- We expect GAAP earnings per share of between \$0.28 and \$0.32 per share on a diluted basis.
- On a non-GAAP basis, we expect earnings per share in a range from \$0.54 to \$0.58 per share on a diluted basis.

This guidance includes an expected \$0.01 to \$0.02 per share dilution to non-GAAP earnings per share related to the Secure Computing acquisition.

In addition, guidance does not include any impact from future stock repurchases.

In closing, on behalf of the executive management team, we want to thank our employees worldwide for these exceptional results in light of the operating environment around us. This performance is evidence of the passion and dedication our employees have to make McAfee a world class company.

At this point I will turn the call back over to Dave.

Thank you, Rocky.

As Rocky indicated, first quarter 2009 was a strong quarter for McAfee. We had record results in nearly all areas of business, from revenue to operating income to Non-GAAP earnings per share to cash flow from operations.

We believe security will remain a top priority in IT and for consumers as the threat landscape continues to elevate.

Toward that end, we are incredibly focused here at McAfee on becoming the undisputed leader in digital security.

We intend to continue driving sales and build market share through an

approach that bundles market leading solutions into suites; integrates management of this portfolio through ePO; and creates trusted advisor status with McAfee's security only focus and world-class service and support team.

And for the remainder of 2009 our focus is on execution:

- Our pipeline remains strong, with several large deals already closed in the second quarter.
- The go-to-market investments in sales capacity, partners and distribution we made in 2008 are yielding results in both our corporate and consumer segments;
- We remain on track with the integration of Secure Computing where we expect to continue recognizing operational and sales synergies through the remainder of 2009; and
- We continue to prudently manage our cost structure, while investing where we see opportunity and being mindful of the environment.

Thank you for joining us this afternoon. We look forward to answering your questions and to seeing you at Investor Day in New York.

Now, I will turn it back over to Kelsey.

Thank you, Dave and Rocky. As the operator polls for questions, I would like to inform you that McAfee plans to attend the JP Morgan Conference on Wednesday, May 20th in Boston and the Cowen & Company Conference on Thursday, May 28th in New York.

In addition, please mark your calendar for McAfee's Investor Day on Friday, May 15. Investor Day will be held at the Grand Hyatt in New York.

This is an invitation only event. If you are interested and have not received an invitation, please go to our website at investor.mcafee.com where you will find information on how to sign up.

Operator, please poll for questions. In the interest of time, please limit yourself to one question per person. Thank you.

Q&A