

McAfee Third Quarter 2009 Earnings Call

Good afternoon and thank you for joining us today.

This is Kate Scolnick, vice president of investor relations. It is my pleasure to be here today and join the McAfee team.

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 fourth quarter 2009. Dave will close and we will be pleased to take your questions.

You will find, in our press release and on our investor relations website, a GAAP to non-GAAP reconciliation of the third 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 fourth quarter of 2009, the assumed tax rate for 2009 we used in estimating our guidance, our strategies and opportunities, trends in the security market, our competitive position and momentum, 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 Form 10-Q filed August 7, 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. Our guidance as to revenue, operating income margins and earnings levels discussed during this conference call and the question and answer session replaces and supersedes any previous guidance with respect to future periods and is valid as of today only.

Now, it is my pleasure to hand the call over to Dave.

Thank you, Kate.

Kate and I have worked together for a number of years. It is great to be working with you again and to have you on the McAfee team.

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

I would like to start by thanking all the McAfee employees for their hard work, we have over 6000 employees and appreciate their dedication and passion. We have made great progress in becoming the leading global security technology company, taking market share and driving strong financial results. I am very proud to be part of this team.

With that, I'm pleased to report the third quarter of 2009 was another record-setting quarter for McAfee. This marks the 15th consecutive quarter of double-digit, year-over-year revenue growth for the company.

We are proud to report another "triple double" this quarter, with double digit, year-over-year growth on three major financial metrics: revenue, operating cash flow and non-GAAP earnings per share. We are clearly continuing our market momentum with:

- Record revenue of \$485.3 million, an increase of 18.5% year-over-year and up 3.5% sequentially
- Record deferred revenue of \$1.33 billion, an increase of 26% year-over-year
- Moreover, we saw strong growth across the world with both our domestic and international geographies delivering record revenues
- As expected, operating cash flow rebounded from last quarter and, as a matter of fact, it was our strongest cash flow quarter ever. Cash flow from operations reached \$152 million, an increase of 74% year-over-year. Year to date, McAfee has generated \$351 million in operating cash flow, up 47% over the same period last year. Note that our reported cash flow includes a payment we accelerated to one of our partners. More on that partner later.
- Non-GAAP earnings per share reached a record \$0.62, an increase of 16% over the same period last year

Our focused execution combined with strong demand for leading comprehensive security solutions again delivered solid results for McAfee. More importantly, we strengthened our foundation for the future with key partnership wins around the world. We expect this to help McAfee continue to grow financially and strategically, accelerating our efforts to become the No. 1 global security technology provider from the individual consumer to the largest enterprises.

McAfee has an exceptionally strong business model with great visibility. Approximately 75% to 80% of our revenue each quarter comes off the balance sheet; 90% of our revenue is recurring. We have exceptional balance in our model with 36% of revenue coming from consumer, 64% of revenue from corporate, 56% of revenue from North America and 44% from international.

This quarter I am especially proud of our **consumer** business with 12.5% sales growth year-over-year, a number of very strategic partnerships won, an expanded product portfolio, and great leadership, led by Todd Gebhart and his team.

Partners are key to our success and a cornerstone of our strategy. In Q3 we continued to build on our partnership strategy:

- Today we're announcing a new partnership that extends our relationship with one of the world's largest PC manufacturers, Dell Inc. The new agreement extends our premier position with Dell for two more years beginning October 31 with McAfee's option for a third year. Our agreement with Dell provides that McAfee will have "exclusive recommended" and "default placement" status for Dell personal computers sold around the world, across all Dell's consumer product lines. This relationship continues to be very profitable for McAfee and makes great economic sense. Included in our cash flow success in Q3 we accelerated a payment to Dell and will make a similar size payment in the fourth quarter. Even with these payments we are on track for a record operating cash flow year.
- In addition, I am very pleased to announce a new strategic partnership with Verizon. This partnership will span from consumers to small businesses to the largest corporations globally.
 - Verizon Business has agreed to offer McAfee's entire line of enterprise security products and services, while we will use Verizon Business' data center outsourcing, expert consulting and managed services capabilities. Additionally, we have agreed to jointly develop a suite of next-generation, cloud-based managed security services.
 - Verizon's consumer business has agreed to offer McAfee as the exclusive security provider to users of its broadband services beginning in 2010. This is a multi-year arrangement that we believe further cements our position as the leader in providing security through Internet service providers.
- On that same note, today we announced a strategic partnership with AT&T. This partnership also spans from consumers, to small businesses, to large enterprises.
 - AT&T High Speed Internet customers nationwide now receive McAfee software to help protect them against viruses, spyware and hackers as part of their subscription service. The enhanced AT&T Internet Security Suite, powered by McAfee, allows customers to surf the Web, shop and bank online worry-free.
 - In addition, McAfee is partnering with AT&T to jointly develop enterprise security products and a suite of next-generation, cloud-based managed security services.
- Adobe Systems is another new strategic partner on both the corporate and consumer side of our business.
 - Under our multi-year partnership, Adobe has agreed to let McAfee give Adobe consumers the ability to run a security scan, get a trial subscription to McAfee, or buy McAfee products when downloading an Adobe program or update. Adobe offers hundreds of millions of content downloads each year, opening up another large consumer distribution channel for McAfee.
 - On the enterprise side, McAfee and Adobe have agreed to deliver and jointly sell an integrated data loss prevention and enterprise digital rights management solution to expand the reach of data protection beyond the enterprise boundaries.
- During the quarter our partner Lenovo began shipping Windows 7-based consumer PCs that are preinstalled with McAfee VirusScan Plus. Also, as part of our plans to develop a more aggressive partnership in China, Lenovo has agreed to

market our products through about 5,000 Lenovo retail outlets in China, opening up a significant new retail channel for McAfee.

- The official release of Windows 7 last week is a milestone not only for Microsoft, but for McAfee as well – nobody delivers a better solution to secure Windows 7 than McAfee. McAfee ships on more than 50% of the PCs shipped by the top 10 PC OEMs, which means many people buying a new PC with Windows 7, will also get McAfee. New PC purchases on both the consumer side and pent-up demand on the corporate side will benefit McAfee all around.

We have expanded our consumer product portfolio. We added McAfee Family Protection in the second quarter and now also offer a new online backup product and our new 2010 security suites. All of our consumer security suites include Active Protection, our in the cloud, reputation-based service that provides real-time malware detection and blocking. Active Protection has been available for more than a year and has significantly boosted our detection rates, leading to top rankings by reviewers including AV Comparatives and Computer Bild, one of Europe's most influential consumer computer magazines. Also, McAfee was honored with the Fall 2009 STAR Award for Service Excellence from the Technology Services Industry Association specifically for excellence in consumer support. This award reflects our continued dedication to customer service and the consumer experience.

Our winning consumer go-to-market model continues to expand and diversify with the best products and the best support worldwide. We believe we are well positioned for continued consumer revenue growth.

Turning to our corporate business, the broad partnerships I mentioned have also had a positive impact and we saw a new record for million dollar plus deals in the third quarter. We closed 472 deals greater than \$100,000 in value, including 74 deals greater than \$500,000 and 31 deals valued over \$1 million.

These 31 deals continue to show the standardization decisions that are being made by enterprises, many of which were competitive displacements. Corporate revenue reached a record \$308 million, an increase of 25% year-over-year.

I'm especially thrilled to share that, in Q3, we achieved one of the largest quarterly total node counts sold ever for our flagship enterprise suite, Total Protection for Endpoint. These results demonstrate strong growth and serve as reaffirmation that customers continue to see how ToPS for Endpoint can help them achieve lower costs while ensuring stronger security. ToPS for Endpoint sales grew 13% year-over-year.

Also of note, our third-quarter sales to government, healthcare and education customers globally grew 34% year-over-year, showing continued strength in that part of our business. This is an area where we expect to see continued growth in the future.

Our previous acquisitions continue to demonstrate excellent results for McAfee as evidenced by new offerings such as:

- Expanded application protection in McAfee Firewall Enterprise, a former Secure Computing product.

- Our expanded email security strategy, combining MX Logic, Secure Computing and McAfee technologies.
- Our new RiskAdvisor 2.0 product, which was originally a Foundstone offering.

Our acquisitions are contributing to our strong financial results. The biggest deal in MX Logic's history was closed in the third quarter, after the acquisition by McAfee.

Secure Computing is a key component of the planned offerings in our partnerships with AT&T and Verizon.

Also, in Q3 we signed new deals to ship our Solidcore whitelisting technology on ATMs manufactured by Hitachi and Fujitsu, as well as on multifunction printer/copiers/scanners sold by Panasonic/Fujitsu. Meanwhile, our partnership with hardware makers has resulted in McAfee now shipping on two-thirds of all secure USB drives sold today.

Other highlights from our third quarter corporate business include expanded endpoint protection products for the Apple Macintosh platform; an expanded blade strategy with Hewlett Packard BladeSystem; a partnership with BMC Software; and an additional 14 partners for our ground breaking Security Innovation Alliance, bringing the total number of SIA partners to 80.

Our midmarket business had a strong third quarter. Overall, we saw double-digit sales growth. Our performance has diversified as license sales grew more than 20%. We also saw more than 20% growth in license upgrades to TOPS. More importantly, we saw users of our competitors' products move to our Total Protection Suite, with a 53% increase in displacement sales.

We're seeing tremendous adoption of our "Security in 15 Minutes" Best Practices Methodology for small and medium businesses. We've also just released the "Security Paradox," the most comprehensive study of the costs of security for small and medium business.

At our FOCUS Security Conference earlier this month we had more than 1,400 attendees, almost 200 of which were mid-market companies, attesting to the strength of our products.

In addition, our midmarket momentum is shown by:

- An expanded agreement with Hewlett Packard which now offers an 18-month subscription to McAfee Total Protection Service on HP desktop and notebook PCs in EMEA. HP already is shipping McAfee software globally on its SMB systems.
- We released McAfee Total Protection Service 5.0, a Security-as-a-Service solution offering always-on guard protection without additional investment in on-premise infrastructure.

As these results indicate, we have a growing opportunity to expand our security footprint on almost every layer of the technology stack. We have the products, the partnerships, the momentum and the market conditions continue to be strong.

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

Thank you, Dave. Good afternoon everyone.

The third quarter of 2009 marked another great quarter for McAfee. McAfee's achievement of record results from revenue to net income and operating cash flow takes a focused team, diligent execution and consistent management of our operations. Clearly our business model is working well and our efforts are being rewarded.

Our 2009 strategic operating imperatives include driving operating efficiency, improving our business model and sales productivity, and successful integration of our acquisitions, to ensure we are positioned for a strong 2010 and beyond. We continue to improve our infrastructure to support McAfee's strategies to expand and diversify our product portfolio, address a broader marketplace and take market share from our competition.

Turning to the Q3 results;

We delivered record revenue of \$485.3 million up 18.5% year-over-year and including a negative impact from currency of approximately \$10 million. On a quarter over quarter basis, currency had a positive impact of \$9 million dollars.

On a geographic basis, we had double-digit year-over-year growth in nearly all of our geographies.

North America revenue in Q3 was \$273 million, up 25% from last year and accounted for 56% of revenue. This was another record revenue quarter for North America, reflecting the contribution of Secure Computing, strong performance in our endpoint and risk and compliance portfolio and strong growth in our consumer business.

International revenue reached a record \$212 million, an increase of 11% over last year, and accounted for 44% of revenue. As reported in U.S. dollars, revenue results in our international geographies, compared to Q3 2008 showed:

- Europe, the Middle East and Africa grew 4%;
- Asia Pacific grew 42%;
- Latin America grew 20%;
- And, Japan grew 16%.

In local currency, international revenue grew 15% year-over-year and grew in each theatre worldwide as follows:

- Europe, the Middle East and Africa grew 12%;
- Asia Pacific grew 52%;
- Latin America grew 20%;
- And, Japan grew 3%.

I'd like to highlight the progress we've made in improving our European operations. The third quarter was especially strong in the consumer space and the organizational

changes our European leadership has made over this year are showing progress and driving expansion of our sales presence. We are seeing results from these initiatives and are very encouraged by the growth opportunities we see in this area of the world.

For the third quarter, approximately 78% of total revenue came from deferred revenue off the balance sheet. Approximately 52% of total revenue this quarter came from service and support and 38% from subscriptions – with 90% of total third quarter revenue recurring.

This was another record revenue quarter for our corporate business and we achieved revenue of \$308 million, up 25% year-over-year.

Our Mid-Market focus on building our channel and inside sales capacity continues to pay off. We've focused on diversifying our business outside of primarily anti-virus in this space and in the third quarter "non-Systems" sales grew 18 percent year-over-year. In Systems, we saw sales growth in our Total Protection Suites of more than 30 percent year-over-year.

On the consumer side, third quarter revenue grew 8 percent year-over-year to \$177 million. Highlights include –

Record sales, up 12.5% over the same period last year.

And, it was our fourth straight quarter of record online sales, including every international geography setting a new record for online sales.

We also saw sales of our Total Protection Suite for consumers in our online business grow 100% year-over-year demonstrating consumer migration to security suites verses point products.

McAfee continues to deliver above-market revenue growth in the consumer space and our strategic advancements offer new routes to market that we believe position us for future growth. We are reaching hundreds of millions of consumers through various distribution channels. Alongside improved reach thru PC OEMs, we also are very excited about the non-PC OEM channels. Partnerships like the ones Dave mentioned today including Adobe, Verizon and AT&T demonstrate our focus on continuing to expand our diversified consumer portfolio. This adds to our total of more than 200 consumer partners worldwide.

Reviewing the rest of the income statement, non-GAAP gross profit margin for the third quarter was 78.8%, compared with last quarter's 79.7% and a year-ago gross profit margin of 79.6%. This slight decrease was due primarily to product mix related to our appliances. As part of our overall enterprise performance initiatives, we continue to focus on the cost performance of our appliance business thru improved supply chain management, better processes around design for manufacturing, and virtualization on partner appliances.

Q3 non-GAAP operating income was \$129 million resulting in a non-GAAP operating margin of 26.5%, above the Q3 guidance range provided of 24 to 26 percent, and exceeding our plan.

Over the past year, we've invested in our business to both grow our market share and drive operational efficiencies.

As we have discussed in the past, we continue to improve our business processes and invest in technology to improve the efficiency and capabilities of our worldwide sales and marketing functions. We are strengthening our worldwide consumer business thru technology investments in our web portals and operational infrastructure to enable a leading customer experience, a higher quality of service, and scalability for the future. These investments, once fully deployed, should also contribute to giving us greater cost leverage.

In addition, we continue to enhance our skills for integrating acquisitions and our team has executed well this year. We are committed to having leading competency in acquisition integration and believe we have a scalable framework in place to drive the maximum value from our acquisitions.

These are just a few of the operational projects helping us to take advantage of the opportunities available to us in 2010 and beyond.

Total employee headcount at the end of the quarter was 6,102 employees, up 324 employees from the second quarter of 2009 reflecting approximately 200 employees from the MX Logic acquisition and approximately 120 new McAfee employees primarily in our sales and research and development organizations. We continue to focus on striking the right balance in our headcount requirements to support our future opportunities.

Continuing, Q3 non-GAAP other income improved from last quarter and was \$1 million.

On a non-GAAP basis, our tax rate continues to be 24%. For the quarter we had a GAAP tax rate of 16%. The lower GAAP tax rate this quarter is primarily due to tax reserve releases related to various statute expirations.

Q3 non-GAAP net income was \$99 million. Non-GAAP earnings per diluted share was \$0.62, up 16% year-over-year.

Turning to a few items on the balance sheet;

Net accounts receivable balance at the end of the third quarter 2009 was \$232 million, down 13% compared with \$266 million for the second quarter of this year, primarily due to strong cash collections.

Days sales outstanding were 43 days for the third quarter 2009, down 3 days compared to the year-ago period.

Prepaid expenses, income taxes and other current assets was \$353 million, up 24% compared with \$286 million for the second quarter of this year, primarily driven by costs related to PC OEM investments. We are excited about our PC OEM business because of the demonstrated profitability and the extended customer lifecycle these partnerships deliver.

Deferred revenue at the end of the third quarter 2009 was \$1.33 billion, up 26% year-over-year. Currency fluctuations had a positive impact on deferred revenue of \$18 million year-over-year and \$23 million quarter-over-quarter.

We ended the third quarter with \$1 billion in short-term deferred revenue, up \$21 million when compared with the second quarter 2009. Long-term deferred revenue was up \$5 million in the third quarter compared to the second quarter 2009, ending the quarter at \$311 million.

The composition of our deferred revenue balance at the end of the third quarter of 2009 was 66% related to Corporate and 34% to Consumer. Overall we did not see any significant change in discounting or contract lengths in the quarter.

We ended the third quarter of 2009 with cash and marketable securities of \$906 million.

During the quarter we expanded our cloud based security portfolio with the acquisition of MX Logic for which we paid \$138 million in the third quarter. McAfee has the broadest Security-as-a-Service portfolio in the industry and we are uniquely positioned in the marketplace to deliver a comprehensive solution for Software-as-a-Service email and web security. The initial feedback from customers regarding this transaction has been very positive.

Reflecting upon our Q3 cash flow, I am very pleased that we generated total operating cash flow of \$152 million, a result of exceptional cash collections and focused worldwide cash management. This includes the Dell payment Dave mentioned previously.

Year to date, we have generated over \$350 million in operating cash flow. Our performance confirms our understanding of the importance to deliver on this metric. Considering annual historical trends, we generally look to a range of non-GAAP operating income to non-GAAP net income to be an indicator of operating cash flow.

I want to point out that in the fourth quarter we will repay our \$100 million term loan that was drawn down early in January. This is in accordance with our agreement. McAfee will continue to have a \$100 million revolving line of credit after retiring the term loan.

Now I would like to turn to our outlook for the fourth quarter.

While this economic environment has been challenging, we remain confident that we have the right vision, strategy and business model to continue to deliver strong execution and solid results. Our product portfolio has never been more diversified and we continue to expand our addressable markets and increase our market share.

For the fourth quarter of 2009 we expect to achieve:

- Revenues in the range of \$505 million to \$525 million.
- GAAP operating income margin in the range of 13.0% to 15.0%.
- Non-GAAP operating income margin in the range of 24.0% to 26.0%.
- And non-GAAP earnings per share in a range of \$0.61 to \$0.65 per share on a fully diluted basis.

Our forecast is based on a fully diluted share count in the range of 160 to 162 million shares for the fourth quarter and we are assuming an annual tax rate of 24% both on a GAAP and non-GAAP basis

In summary, we expect 2009 to continue to be an important year of operational and financial achievements for McAfee and these accomplishments should position us well for continued growth and market share gains in 2010.

On behalf of the Executive Management team we want to thank our employees worldwide for their continued strong performance. In addition, we would like to welcome the MX Logic team to McAfee and look forward to their contributions in making McAfee the market leader in security.

And now I would like to turn it back to Dave for closing comments.

Thank you, Rocky.

As Rocky discussed, third quarter results were very strong. Overall our balanced business model continues to show our ability to deliver triple-double results with double digit, year-over-year growth on revenue, cash flow and non-GAAP earnings per share

Looking ahead to 2010, we're very encouraged by the opportunities we see and we believe McAfee is uniquely positioned to continue to deliver industry leading growth and to increase our market share.

Now, I will turn it back over to Kate.

Thank you, Dave and Rocky. As the operator polls for questions, I would like to inform you that McAfee plans to attend the Credit Suisse Technology Conference on December 1st.

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

Thank you.