NETSCOUT SYSTEMS INC
Form 10-K
June 04, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended March 31, 2007

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 0000-26251

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

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, $0.001 Par Value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES ¨ NO x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES ¨ NO x

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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 aggregate market value of common stock held by non-affiliates of the registrant as of September 30, 2006 (based on the last reported sale price on the Nasdaq Global Market as of such date) was approximately $116,687,325. As of June 1, 2007, there were 32,190,872 shares of the registrant s common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

(1) Portions of the Registrant s Proxy Statement for the fiscal year 2007 Annual Meeting of Stockholders are incorporated by reference into Part III of this Annual Report on Form 10-K. Except as expressly incorporated by reference, the proxy statement is not deemed to be part of this report.

NETSCOUT SYSTEMS, INC.

FORM 10-K

FOR THE FISCAL YEAR ENDED MARCH 31, 2007

TABLE OF CONTENTS

PART I

Item 1.	Business	4
	Industry Background	5
	Traditional Approaches to Network Performance Management	6
	NetScout s Approach to Network and Application Performance Management	6
	NetScout Products and Performance Technology	7
	Strategy	8
	Sales and Marketing	10
	Support Services	11
	Research and Development	11
	Manufacturing	12
	Customers	12
	Channels	12
	Seasonality	12
	Competition	12
	Intellectual Property Rights	13
	Employees	13
	Available Information	13
Item 1A.	Risk Factors	13
Item 1B.	Unresolved Staff Comments	21
Item 2.	Properties	21
Item 3.	Legal Proceedings	21
Item 4.	Submission of Matters to a Vote of Security Holders	21

PART II

Item 5.	Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	22
Item 6.	Selected Financial Data	23
Item 7.	Management s Discussion and Analysis of Financial Condition and Results of Operations	24
	Overview	24
	Critical Accounting Policies	25
	Comparison of Years Ended March 31, 2007 and March 31, 2006	30

	Comparison of Years Ended March 31, 2006 and March 31, 2005	35
	Contractual Obligations	39
	Off-Balance Sheet Arrangements	39
	Guarantor s Agreements	40
	Liquidity and Capital Resources	40
	Recent Accounting Standards	42
Item 7A.	Quantitative and Qualitative Disclosures About Market Risk	43
Item 8.	Financial Statements and Supplementary Data	43
Item 9.	Changes in and Disagreements With Accountants on Accounting and Financial Disclosure	43
Item 9A.	Controls and Procedures	43
Item 9B.	Other Information	44
PART III		
Item 10.	Directors and Executive Officers of the Registrant	45
Item 11.	Executive Compensation	45
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	45
Item 13.	Certain Relationships and Related Transactions	45
Item 14.	Principal Accountant Fees and Services	45
PART IV		
Item 15.	Exhibits and Financial Statement Schedule	46
	Signatures	47
	Index to Consolidated Financial Statements	F-1
	Index to Exhibits	
Exhibit 21	Subsidiaries of NetScout.	
Exhibit 23	Consent of PricewaterhouseCoopers LLP	
Exhibit 31.1	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	
Exhibit 31.2	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	
Exhibit 32.1	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	
Exhibit 32.2	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	

PART I

Item 1. Business

NetScout Systems, Inc. (We , NetScout or the Company), a Delaware corporation founded in 1984 and headquartered in Westford, MA, designs, develops, manufactures, markets, sells and supports a family of products that assures the performance and availability of critical business applications and services in complex, high-speed networks. We manufacture and market these products as an integrated hardware and software solution that is used by enterprises, governmental agencies and service providers worldwide. We have a single operating segment and substantially all of our identifiable assets are located in the United States of America.

Businesses have continued to increase their reliance on software applications and computer networks, making them strategic assets for competitive advantage and essential to business operations. To support the growing number of users and their demands for faster and more reliable computer network access, new network technologies and products are continually being introduced. New services and applications are increasingly based on service-oriented architectures, implemented over virtualized resources, including networks, storage, and servers. Furthermore, with the proliferation of malicious computer viruses, destructive worms and sophisticated hackers, businesses and service providers have adopted robust security systems and procedures that are not always consistent with performance goals. The result is increasingly large, geographically dispersed, and complex networks and infrastructures that are challenging to manage and make service performance levels difficult to guarantee. Computer network malfunctions, resource contention, and infrastructure and application misconfigurations all can cause service disruptions, lost revenue and customer dissatisfaction. Consequently, network operators are recognizing the critical importance of addressing customer service performance problems quickly and proactively. The NetScout Systems suite of products is designed for this rapidly growing market of organizations running complex networks that are built for performance while striving to be completely secure.

The *nGenius*® Performance Management System, our integrated, appliance-based software solution, monitors, collects and publishes information on the behavior of individual applications and services, such as Voice over Internet Protocol (VoIP), streaming media, supply chain management, and customer relationship management, as well as the performance of the underlying network (routers, switches and communication links), and the level of activity by end-users or subscribers. The *nGenius* Solution draws on performance data collected directly from multiple sources, including our lines of network monitoring appliances called *nGenius* Probes and *nGenius* Application Flow Monitors (AFMon) as well as infrastructure devices. The hardware probes attach to the network non-intrusively and collect in-depth information about application and network activity in real time. Organizations can gain substantial visibility to better understand and manage service and application performance across the network by instrumenting strategic locations throughout a network.

The *nGenius* Solution generates, analyzes and publishes performance information in real-time displays and customizable historical reports. These displays and reports communicate application performance, service levels, network and device utilization, and other critical metrics of availability, utilization and performance, and are delivered to the network and service engineering and operations staff in easy-to-read, Web-based formats. Our customers use the information generated by the *nGenius* Solution to detect problems early and to diagnose and solve them rapidly, thereby reducing the Mean Time to Repair/Restore, or MTTR , for service operations. Using the collected performance data they can also manage the delivery of services and monitor service-level agreements, assess infrastructure capacity against future needs, and justify requirements for additional resources.

Increases in both application complexity and traffic loads have given rise to the need for higher speed infrastructures and Quality of Service, or QoS , prioritization policies to optimize service and application performance. To meet the ongoing challenges required for visibility into the health and activity of these applications, services and infrastructures, NetScout continuously extends the *nGenius* Performance Management System. During fiscal year 2007, we delivered several key products that further our ability to provide valuable operational intelligence and reduce MTTR within complex global enterprise, service provider, and government networks. Specifically, we released the first intelligent early warning system in the performance management

marketplace with the introduction of *nGenius* Analytics. That was followed by the release of our *nGenius* AFMon, an advanced real-time traffic monitoring and recording appliance that performs all of the functions delivered by our nGenius Probe products while simultaneously capturing complete, continuous packet sequences for subsequent analysis. Later in the year, we introduced the industry s most cost-effective solution for large scale NetFlow-based performance management.

We market and distribute our products through our own direct sales force and through channel partners that include distributors, resellers, service providers and systems integrators. Our principal customers are Global 5000 enterprises, representing a wide range of industries including financial services, technology, telecommunications, healthcare, retail, manufacturing, and wireless service providers, as well as many large agencies of the federal government. We had no customer representing more than 10% of revenues in fiscal years 2007, 2006 or 2005.

Our principal executive offices are located at 310 Littleton Road, Westford, Massachusetts, and our telephone number is (978)-614-4000.

Industry Background

Enterprise and government organizations are increasingly dependent upon their computer data networks and on the internet to generate and deliver information and business services to their constituents: customers, suppliers, investors, employees, and citizens. At the same time, data networks are taking on new roles: subsuming the role of the voice network and serving as the platform for the next generation of massively distributed, virtualized, service-oriented application architectures. Furthermore, rapidly advancing server technology and mushrooming multimedia applications continue to drive up traffic levels and have spawned a new wave of infrastructure upgrades, including broad deployment of 10 Gigabit per second Ethernet network technology. The combination of these fundamental trends produces unprecedented complexity coupled with unparalleled business impact requiring capable management technology.

Large organizations have been bracing themselves for these challenges by investing in new, more powerful performance management solutions and making organizational and process changes to be able to prevent and resolve service disruptions more rapidly while keeping operating costs, including personnel costs, under control. Core to these changes is the concept of the information system not as a collection of servers, storage devices, network equipment and applications that can be managed in isolation of each other, but as an integral fabric containing all of these elements whose complex interactions must be managed as a whole. This perspective is breaking down organizational walls in Information Technology (IT) and Network Service Operations that traditionally have separated the network group from the data center, server and application groups. These changes necessitate management solutions that can address both new technologies and emerging workflow and organizational models.

The leaders of the server, network, and application management segments of the industry have started to respond to these new realities with a series of acquisitions and strategy announcements, all aimed at strengthening their enterprise management system positions.

Adding to the renewed interest in network and application management solutions in the enterprise and government markets, the service provider segment is also looking for new management solutions. This segment has resumed healthy growth, driven by the proliferation of aggressive last mile technologies, most notably wireless data services, and broadband connections to the home and by the continued shift towards Internet Protocol (IP) based multimedia service delivery architectures.

Although the intrinsic need for better network and application management solutions is growing, successful vendors must demonstrate not only technical superiority, but a sound understanding of the implications of the transformational changes in the industry, and the ability to deliver new solutions to match evolving customer needs. They must also prove their staying power and stability, as well as the ability to partner with industry leaders.

Traditional Approaches to Network Performance Management

Network management solutions providers have developed several approaches to manage different aspects of the overall network management challenge. These approaches are often broadly categorized as element management, event management, and service assurance.

Dominated by tools from the manufacturers of network devices that are specific to managing each vendor s equipment, element management systems provide the basic functions of managing the devices within a network. Most often they present visualizations of device status and are used for making configuration changes to network devices such as routers and switches. Element management systems are silo-like and limited in visibility to other network domains; therefore heterogeneous, or multi-vendor, network environments require multiple element management systems.

Event management focuses on collections of linked network devices. Event management systems discover network components, show network topology and device status, support day-to-day administration and supply break-fix fault and problem management, or troubleshooting, functions. Such systems understand the relationships between multi-vendor network components. They are often called frameworks or manager of managers because they consolidate data from different element management systems and provide a structure for managing heterogeneous, or multi-vendor networks. However, event management systems offer little or no traffic-based network performance information today. As customers strive to become more proactive, there is growing pressure on these solutions to integrate more valuable information from performance management sources. Hewlett-Packard s Network Node Manager and IBM s Tivoli/Netcool® are examples of operations management systems. Our strategy is to integrate with such systems.

Service assurance evolves the concept commonly known as performance management by placing a service-centric orientation towards all of the associated disciplines including proactive measures for monitoring and assuring the quality and level of service provided by the devices and communication links that deliver services and business applications across the network. It also compares the expected performance of the network and applications against actual results by collecting and archiving data over time for baselines, trend analysis, historical usage analysis and service level reporting. The most sophisticated systems collect data in real time for on-the-spot investigation and management as well as to perform advanced, forward-looking analysis. Our *nGenius* Performance Management System, through its real-time monitoring and troubleshooting features, as well as its capacity planning and reporting functions, fully addresses the needs and goals of the service assurance model.

NetScout s Approach to Service Assurance

Our approach is based on three principles: early support for emerging new architectures and technologies, end-through-end scope, and smooth integration with our customers systems environment and management processes.

Early support for emerging new technologies and application architectures is highly valued by our customers who are often leaders within their industries and depend on rapid technology absorption to maintain or extend their market position. Advanced performance management, offering superior visibility, is most needed where these new technologies and architectures are first deployed and their behavior and impact are unknown in advance. NetScout has developed an architecture and technology, called the Common Data Model, or CDM , that uniquely enables the company to respond rapidly to new needs by effectively re-using existing building blocks and thus minimizing new work required to integrate a given new feature. Our customer base broadly benefits from this capability through rapid product development, and resulting delivery of multiple software and firmware releases annually, which are free to our service customers currently active in our maintenance program.

We have developed our unique, patent-pending, technology around the firm conviction that flow-based performance data is the most powerful basis for high-value, business-relevant service assurance solutions. Our

flow-based approach simplifies operational management tasks by integrating application traffic flow data from disparate network-facing data sources into a common model for consistent analysis, views and reports. The CDM technology allows us to collect performance data from multiple sources spanning virtually any network or application technology or topology, whether retrieved from our probes, standards-based infrastructure devices, or value-added performance information from our technology partners devices. Furthermore, new application types, such as peer-to-peer applications; new network technologies, such as OC-48 Packet-over-SONET or 10 Gigabit per second Ethernet; and new architectures, such as Service-oriented Architectures are readily accommodated by this framework. CDM data is mapped into a common performance data repository, where nGenius Performance Manager can be used to provide a comprehensive solution for real-time monitoring, troubleshooting, capacity planning, and service performance management across the enterprise. The CDM technology foundation has allowed us to stay ahead of competition by offering superior visibility into service and application traffic.

To make the greatest impact on assuring performance of applications and services, NetScout is integrating with third-party event management consoles and business service management systems. This integration allows operators to receive alarms on impending performance problems and to drill down into the nGenius Performance Manager application to perform detailed problem analysis and troubleshooting. By partnering and integrating, NetScout fills a significant gap in our customers increasingly integrated operations: visibility into the interaction of applications, services, and infrastructure resources from a network vantage point.

NetScout Products and Performance Technology

We develop, manufacture, sell and support network performance management solutions under the *nGenius* brand. The *nGenius* Performance Management System, based on our patent-pending CDM technology, is a robust and complete solution, consisting of integrated hardware and software components that monitor, measure and report on the network s ability to fulfill its performance, cost and service-level objectives. The system is comprised primarily of two components data collection (via our *nGenius* Probes, nGenius Application Fabric Monitors, *nGenius* Collectors, and Simple Network Management Protocol, or SNMP , polling) and information filtering, aggregation, recording, analysis and presentation via our *nGenius* Performance Manager software application.

nGenius Performance Manager is a multi-function performance management solution implemented in a single, integrated application that monitors and reports on network, service, and application traffic, troubleshoots performance problems and provides precise information for capacity planning. It seamlessly integrates real-time and historical information in a single management application. By using collected data, it provides a logical, business-oriented representation of network, service, and application performance, with the ability to drill down into layers of additional detail, all the way down to the bit-by-bit composition of individual packets. This intuitive solution, which has been designed for ease of use and Web-based distribution, also contains features that simplify and enable logical monitoring and management of large, geographically dispersed networks. *nGenius* Performance Manager v. 4.0, which first delivered high definition extensions to the *nGenius* Solution, began shipping in January 2007 and is used by the majority of our installed base of customers.

During fiscal year 2007, we introduced a next-generation multi-function instrumentation device named the *nGenius* AFMon. The *nGenius* AFMon combines the extended, direct, forensic packet recording and analysis functions previously delivered via the *nGenius* Flow Recorders with the real-time monitoring functions of our *nGenius* Probe. Like the *nGenius* Flow Recorder, the *nGenius* AFMon is a security-hardened, Linux-based appliance, however the *nGenius* AFMon also boasts substantially improved and extended features for packet analysis and a tight user interface and workflow integration with *nGenius* Performance Manager.

The principal hardware-based portion of the *nGenius* Performance Management System consists of our *nGenius* Probes, which are at the core of our network performance management solution. These high performance appliances attach to the network in a non-intrusive, passive manner and monitor traffic patterns in

real time on critical segments of the network. Through in-depth, on-the-fly analysis of traffic information, *nGenius* Probes are able to monitor error rates, usage levels and response times by application, by user and by server and are able to detect and alarm on unexpected conditions. By placing *nGenius* Probes at strategic locations throughout a network, organizations gain network-wide visibility of their traffic flows so they can better understand and optimize application performance and delivery.

We continually enhance our probe technology to ensure visibility into all types of network traffic and communications technologies. *nGenius* Probes monitor all services and business applications, as well as voice, video, multicast, and Web traffic. They support a wide range of network topologies, including Gigabit Ethernet; 10 Gigabit Ethernet; Fast Ethernet; Frame Relay and Wide Area Network T1/E1 and T3/E3; Demarcation-point T1D/E1D; TS3/E3 for HSSI; DS3/E3 for ATM; OC-3c/STM-1, OC-12c/STM-4, and OC-48C/STM-16c for Packet-over-SONET; OC-3c/STM-1 and OC-12c/STM-4 for ATM.

Our track record of innovation began with the introduction of Ethernet Probes in 1992 and continues at an accelerated pace today. We have continued to advance probe technology with the addition of more than thirty new probes over the past ten years.

We also continue to advance our solutions for integrated performance management utilizing third party data sources. In particular, during fiscal 2007, we released an updated version of our *nGenius* Collector, previously known as the *nGenius* Flow Collector, which added support for active testing via Cisco s Internet Protocol Service Level Agreement, or IPSLA functions in addition to dedicated collection of NetFlow information. The *nGenius* Collector offers enterprises a high-capacity, cost-effective solution for extending their existing investment in infrastructure products that generate NetFlow and IPSLA data. Our underlying CDM Technology ensures that all the *nGenius* Collector data is mapped into the common formats found in *nGenius* Performance Manager, combining it with other standards-based and *nGenius* Probe information to provide a comprehensive solution for real-time and historical troubleshooting, capacity planning, and applications performance management across the enterprise.

Finally, during fiscal 2007, we released and began commercially distributing the *nGenius* Analytics product, an award-winning advanced performance early warning system utilizing patented technology which NetScout acquired as part of the assets of Quantiva, Inc. (Quantiva) in April 2005. *nGenius* Analytics gathers key performance metrics from the other elements within the *nGenius* System, learns normal patterns of behavior, and intelligently identifies important anomalies that represent emerging performance issues warranting proactive attention by operations personnel.

Strategy

Enhancing shareholder value through sustained growth and increased profitability based on market leadership is our continued objective. We intend to pursue growth through expanding our worldwide presence and customer base, establishing relationships with new technology partners, increasing our mindshare with strategic resellers and increasing our ongoing business with our established customers. We intend to extend our market leadership by continuing to expand the market s first strategic, integrated, network performance management platform that overlays the network and to create the information needed to avoid network failures and performance degradations. Key elements of our strategy include:

Extend Technology Leadership. We intend to continue to invest significantly in research and development to expand and enhance our first-to-market, integrated platform for performance management solutions that capitalize on our extensive experience with global organizations and their very large computer networks. Key aspects of our technology leadership include the ability to generate new statistics and information from network traffic, the ability to develop new and groundbreaking performance management techniques based on that information, the ability to deliver solutions across a multi-vendor environment, and our vision of emerging uses of communications technology and networked environments. As part of our strategy, we will endeavor to enter

into strategic relationships with, and/or possibly acquire other companies to complement our technologies. We intend to incorporate new technologies and provide solutions that will enable businesses, service providers, and governmental agencies to manage and optimize the performance of their networks, network-delivered applications and network-based service offerings.

Expand Reporting and Analysis Software Solutions. We plan to enhance our analysis, presentation and reporting software to capitalize on growing demands for integrated performance management solutions and opportunities that have been created by changes and trends in networking and application technologies such as VoIP. We also plan to leverage the unique information generated by our probes through enhanced integrated reporting and analysis tools.

Extend Probe Family. We plan to continue the expansion of our probe line of products, extending our monitoring capabilities to meet emerging network environment demands including higher speeds, new types of traffic, new communications architectures and technologies and new network topologies. To ensure that our customers are able to achieve comprehensive oversight of their networks, we will maintain our support for older technologies while regularly introducing probes for newer ones. Our probe family covers technologies for both domestic and international markets.

Expand Our Installed-Base. We have initiated steps to target existing users of our products with marketing and sales programs designed to promote more extensive use of our performance management solutions. Customers can purchase products through our reseller partners or directly from us. In both cases (reseller or direct sales), we believe in a high-touch selling model to assure customer satisfaction. In this model, our worldwide field sales force maintains a very high presence with customers and prospects, consulting in both direct and reseller sales opportunities to meet customers needs.

Target Market Opportunities. We target our products at markets that we believe have the potential for growth. We have identified the following markets as having the potential for increasingly strong demand for our integrated products:

Global enterprises;

Federal, state and local governments;

Wireless telecommunications;

Financial service providers;

Global service providers, including IP-based wireless and wireline carriers, Internet Service Providers, or ISPs , Managed Service Providers, or MSPs, and outsourcers; and

Professional technology services organizations, such as systems integrators.

Expand Distribution Channels. We plan to continue to increase our direct field sales presence where it is advantageous to do so during fiscal year 2008. We also seek to develop additional indirect distribution channels with systems integrators, resellers and service providers. Our channel relationships include: AT&T, NEC, Dimension Data, JDSU, Terilogy, and others. During this past year we completed several new channel agreements. These channel partners facilitate the worldwide distribution and market acceptance of our solutions.

Facilitate Development of Complementary Third-Party Products and Strategic Relationships. Our probes generate rich performance information that can enhance the value of third-party software products. As a means to increase demand for our products, we encourage the development of applications that add value to our solutions. For instance, *nGenius* Performance Manager can be used with Hewlett-Packard s Network Node Manager. NetScout was accepted as a Platinum Business Partner in HP s Enterprise Management Alliance Program and *nGenius* Performance Manager was certified by HP to integrate with HP Network Node Manager during fiscal year 2005 and recertified for integration with the latest version of HP Network Node Manager during fiscal year 2006.

9

With the advent of CDM technology and our solution s ability to display and analyze disparate performance data sources, we announced an Alliance Program in 2002 targeted at both network infrastructure vendors and network management application providers. During fiscal year 2007, NetScout maintained active joint product and marketing relationships with our alliance partners, including Avaya, HP, and IBM. We also worked to develop new alliance relationships.

Leverage Competitive Advantages. We intend to leverage the competitive advantage of our application and user-level network-traffic-information-generating technology in probes, active agents and analysis software to build the broadest, most robust network performance management solutions for large, global, strategic networks of the future a solution which will be the core management system for those networks.

Sales and Marketing

NetScout targets commercial businesses, governmental agencies, other non-profit entities, and service providers with large, mission-critical networks through a combination of direct and indirect sales channels. We emphasize hiring practices and orientation methods that ensure our sales personnel are highly experienced, talented and well trained. We provide programs for our direct sales force, as well as channel partners, throughout the year, for in-depth product and technical training. We encourage joint initiatives involving both the sales teams of NetScout and our partners.

NetScout s sales force utilizes a direct high-touch sales model that consists of meetings with customers to understand and identify their unique business requirements. Our sales teams then translate those requirements into tailored business solutions that allow the customer to maximize the performance of its network. Due to the complexity of the systems and the capital expenditure involved, our sales cycle can typically extend from three to twelve months in duration. There is significant ongoing opportunity with existing customers as they expand and change their networks and add new types of traffic and new applications to their networks. Our sales model is designed to capitalize on this opportunity.

Our indirect channel partners include original equipment manufacturers, distributors, resellers, service providers and systems integrators. Total revenue from indirect distribution channels represented 61%, 61% and 55% of total revenue for the fiscal years ended March 31, 2007, 2006 and 2005, respectively.

Our sales force is organized into three main geographic regions, North America (including the US, Canada and Mexico), EMEA (including Europe, the Middle East, and Africa) and Asia Pacific (including China, Japan, Singapore, Taiwan and Australia). Revenue from sales outside North America represented 18%, 20% and 18% of our total revenue in the fiscal years ended March 31, 2007, 2006 and 2005, respectively. The majority of our sales in North America are attributable to the United States. Sales outside North America are primarily export sales to indirect channel partners, who are generally responsible for selling products and providing consulting, technical support and service to customers within their territory. Our reported international revenue does not include any revenue from sales to customers outside North America that are shipped to any of our North American-based indirect channel partners. These domestic resellers may sell NetScout products to international locations; however, NetScout reports these shipments as North America revenue since NetScout ships the products to a North American location. We expect revenue from sales outside North America to continue to account for a significant portion of our revenue in the future. For more information on the geographic distribution of our revenue, see Note 17 to the attached consolidated financial statements.

As of March 31, 2007, our North American field sales organization consisted of 81 employees. Our international field sales organization consisted of 37 employees with offices in the United Kingdom, Hong Kong, Germany, Singapore, Taiwan, Australia, China, and Japan. In addition, we had 21 employees responsible for providing telesales, training, and sales and administrative support located in the United States and abroad.

As of March 31, 2007, our marketing organization consisted of 13 employees. Our marketing organization produces and manages a variety of programs such as advertising, trade shows, public relations, direct mail, seminars, sales promotions, and web marketing to promote the sale and acceptance of our solutions and to build the NetScout and *nGenius* brand names in the marketplace. Key elements of our marketing strategy focus on market education, reputation management, demand generation, and acceleration of strategic selling relationships with local and global resellers, systems integrators, and our technology alliance partners.

Support Services

Customer satisfaction is a key driver of NetScout s success. NetScout MasterCare support programs offer customers various levels of high quality support services to assist in the deployment and use of our solutions. NetScout offers premium 24/7 toll-free telephone support to its MasterCare Platinum customers in addition to our standard MasterCare Gold support offering. We have support personnel located in the United States and abroad with some of the support provided by qualified third party support partners. In addition many of our certified resellers provide first line support to NetScout customers. This is especially prevalent in international locations where time zones and language, among other factors, make it more efficient for the customer to have the reseller provide initial support functions. MasterCare support also includes updates to our software and firmware at no additional charge, if and when such updates are developed and made generally available to our commercial customer base. If ordered, MasterCare support commences upon expiration of the standard warranties for software and hardware, respectively. For software, which also includes firmware, the standard warranty commences upon shipment and expires ninety (90) days thereafter. With regard to hardware, the standard warranty commences upon shipment and expires twelve (12) months thereafter. We believe our warranties are consistent with commonly accepted industry standards.

NetScout issues a monthly support newsletter, MasterCare News, which informs our MasterCare customers of new releases, patches, technical tips and documentation tips. MasterCare customers receive the benefits of an advanced customer support website that provides an on-line database of Frequently Asked Questions and the latest downloadable patches as well as an on-line trouble ticketing system. NetScout continues to make new investments in call center infrastructure to further improve our ability to service our customers. As of March 31, 2007 our support services organization consisted of 37 employees located in the United States and India.

Research and Development

Our continued success depends significantly on our ability to anticipate and create solutions that will meet emerging customer requirements. We have extensive experience in market development in conjunction with pioneering next generation network performance management technologies. We believe that our core technology for monitoring and troubleshooting network and applications performance remains positioned at the forefront of a growing market. Our *nGenius* Solution integrates the principal functions of network and application performance management: real-time network monitoring, applications monitoring, troubleshooting, proactive alarming, capacity planning and service level management. Our plans are to leverage the comprehensive benefits of this integrated solution into emerging, growth-oriented markets.

As of March 31, 2007, our research and development organization consisted of 103 employees located in the United States and India. In addition, we occasionally contract with independent third parties to perform specific development projects.

We predominantly develop our products internally, with some third party contracting. To promote industry standards and manifest technology leadership, we participate in and support the activities and recommendations of industry standards bodies, such as the Internet Engineering Task Force, or IETF , the 3rd Generation Partnership Project, or 3GPP , and we also engage in close and regular dialogue with our key customers and alliance partners. These activities provide early insight into the direction of network and applications performance requirements for current and emerging technologies.

Manufacturing

Our manufacturing operations consist primarily of final product assembly, configuration and testing. We purchase components and subassemblies from suppliers and construct our hardware products in accordance with NetScout standard specifications. We inspect, test and use process control to ensure the quality and reliability of our products. In February 1998, we obtained ISO 9001 quality systems registration, a certification showing that our corporate procedures and manufacturing facilities comply with standards for quality assurance and process control. In July 2003, we obtained ISO 9001:2000 quality systems registration, a certification showing that our corporate procedures comply with standards for continuous improvement and customer satisfaction. We are scheduled for renewal in August 2007. As of March 31, 2007, our manufacturing organization consisted of 21 employees.

Although we generally use standard parts and components for our products, which are available from various suppliers, each of the computer network interface cards used in our probes is currently available only from separate single source suppliers. We have generally been able to obtain adequate supplies of components in a timely manner from current suppliers. While currently we purchase from specific suppliers, we believe that, in most cases, alternate suppliers can be identified if current suppliers are unable to fulfill our needs. Our reliance on single source suppliers is further described in Item 1A Risk Factors.

Customers

We sell our products to corporations, government agencies, other non-profit entities and other organizations with large- and medium-sized high-speed computer networks. Our products have been sold to customers operating in a wide variety of industries, such as financial services, technology, telecommunications, manufacturing, government, service provider, healthcare and retail.

Channels

During the fiscal year ended March 31, 2007, we added a number of new resellers to our channel partner program and we are putting additional emphasis on growing our international business, including geographic expansion, through establishing new alliances.

Seasonality

We have experienced, and expect to continue to experience, quarterly variations in our net sales as a result of a number of factors, including the length of the sales cycle, new product introductions and their market acceptance, delays in product shipments and other quality control difficulties, In addition, we historically experience stronger sales during our fiscal third and fourth quarters as demonstrated in Footnote 17 Quarterly Results of Operations Unaudited included in Item 15 Notes To Consolidated Financial Statements.

Competition

The market for our products is rapidly evolving, and we expect it to become increasingly competitive as current competitors expand their product offerings and merge their businesses and new companies enter the market. Our principal competitors include several companies who offer alternative solutions for portions of our product lines. For example, we compete not only with vendors of portable network traffic analyzers and probes, such as Network General but also with a growing number of smaller vendors of software-only network management suites, such as NetQoS. We also compete in the telecommunications service provider marketplace with vendors that provide operational intelligence based on signaling data, such as Tektronix. In addition, leading network equipment providers could offer their own or our competitors solutions in the future. We believe that the principal competitive factors in the network and applications performance management solutions market include product performance, functionality, price, name and reputation of vendor, distribution strength, and alliances with industry partners. Competitive factors in our industry are further described in Item 1A Risk Factors.

Intellectual Property Rights

We rely on patent, copyright, trademark, and trade secret laws and contract rights to establish and maintain our rights in our technology and products. While our intellectual property rights are an important element in our success, our business as a whole does not depend on any one particular patent, trademark, copyright, trade secret, license, or other intellectual property right.

NetScout uses contracts, statutory laws, domestic and foreign intellectual property registration processes, and international intellectual property treaties to police and protect its intellectual property portfolio and rights from infringement. From a contractual perspective, NetScout uses license agreements and non-disclosure agreements to limit the use of NetScout s intellectual property and protect NetScout s trade secrets from unauthorized use and disclosure. In addition to license agreements, NetScout relies on U.S. copyright law and registration to protect against unauthorized copying of software programs, in the U.S. and abroad. NetScout has obtained U.S. and foreign trademark registrations to preserve and protect certain trademarks and trade names. NetScout has also filed and obtained U.S. patents to protect certain unique NetScout inventions from being unlawfully exploited by other parties. However, there is no assurance that pending or future patent applications will be granted, that we will be able to obtain patents covering all of our products, or that we will be able to license, if needed, patents from other companies on favorable terms or at all. Our proprietary rights are subject to other risks and uncertainties described under Item 1A Risk Factors.

Employees

As of March 31, 2007, we had 364 employees, 209 of whom are employed in Westford, Massachusetts. Of the total, 139 were in sales, 13 were in marketing, 37 were in support services, 103 were in research and development, 21 were in manufacturing, and 51 were in general and administrative functions. None of our employees are represented by a collective bargaining agreement.

Available Information

NetScout s internet address is http://www.netscout.com. NetScout makes available, free of charge, on our website our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the Exchange Act), as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission.

Item 1A. Risk Factors.

In addition to the other information in this report, the following discussion should be considered carefully in evaluating NetScout and our business. This Annual Report on Form 10-K contains forward-looking statements. 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, beli 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. Factors that may cause such differences include, but are not limited to, the factors discussed below and in our other filings with the Securities and Exchange Commission. These factors may cause our actual results to differ materially from any forward-looking statement.

Our operating results and financial condition have varied in the past and may in the future vary significantly depending on a number of factors. Except for the historical information in this report, the matters contained in this report include forward-looking statements that involve risk and uncertainties. The following factors are among many that could cause actual results to differ materially from those contained in or implied by forward-looking statements made in this report. These statements involve the risks and uncertainties identified below as

well as additional risks and uncertainties that are not yet identified or that we currently think are immaterial may also impact our business operations. Such factors are among many that may have a material adverse impact upon our business, results of operations and financial condition.

Our quarterly operating results may fluctuate. Our quarterly revenue and operating results are difficult to predict and may fluctuate significantly from quarter to quarter. Most of our expenses, such as employee compensation, benefits and rent, are relatively fixed in the short term. Moreover, our expense levels are based, in part, on our expectations regarding future revenue levels. As a result, if revenue for a particular quarter is below our expectations, we may not be able to reduce operating expenses proportionately for that quarter, and, therefore, this revenue shortfall would have a disproportionately negative impact on our operating results for that quarter.

Our quarterly revenue may fluctuate as a result of a variety of factors, many of which are outside of our control, including the following:

technology spending by current and potential customers;

uneven demand for application and network management solutions;

the timing, size and receipt of orders from customers, especially in light of our lengthy sales cycle;

the timing and market acceptance of new products or product enhancements by us or our competitors;

changes in the distribution channels through which our products are sold;

the timing of hiring sales personnel and the speed at which such personnel become productive;

our ability to anticipate or adapt effectively to developing markets and rapidly changing technologies;

changes in the number and size of our competitors;

the timing and impact of threat outbreaks (e.g., worms and viruses);

rate of adoption of new products and service offerings;

customer difficulty in implementing our products;

changes in foreign currency exchange rates;

our ability to develop and introduce new or enhanced versions of our products;

attrition affecting key employees;

changes in our prices or the prices of our competitors products; and

economic slowdowns or the occurrence of unforeseeable events, such as terrorist attacks, which contribute to such slowdowns.

We most often operate with minimal backlog because our products typically are shipped shortly after orders are received. As a result, product revenue in any quarter is substantially dependent upon orders booked and shipped in that quarter and revenue for any future quarter is not predictable to any degree of certainty. Achieving all or more of our projected sales during a quarter is critical to our achievement of expected financial results and any significant deferral of orders for our products would cause a shortfall in revenue for that quarter.

If we fail to introduce new products and enhance our existing products to keep up with rapid technological change, demand for our products may decline. The market for application and network management solutions is characterized by rapid changes in technology, evolving industry standards, changes in customer requirements and frequent product introductions and enhancements. Our success is dependent upon our ability to meet our customers needs, which are driven by changes in computer networking technologies and the emergence of new industry standards. In addition, new technologies may shorten the life cycle for our products

or could render our existing or planned products obsolete. If we are unable to develop and introduce new network and application infrastructure performance management products or enhancements to existing products in a timely and successful manner, this inability could have a material and adverse impact on our business, operating results and financial condition.

We have introduced and intend to continue to introduce new products related to our previously announced CDM and High Definition Performance Management technology strategies. If the introduction of these products is significantly delayed or if we are unsuccessful in selling these products to our current and potential customers, our business, operating results and financial condition could be materially and adversely impacted.

If our products contain errors, they may be costly to correct, revenue may be delayed, we could be sued and our reputation could be harmed. Despite testing by our customers and us, errors may be found in our products after commencement of commercial shipments. If errors are discovered, we may not be able to correct them in a timely manner or at all. In addition, we may need to make significant expenditures of capital resources in order to eliminate errors and failures. Errors and failures in our products could result in loss of or delay in market acceptance of our products and could damage our reputation. If one or more of our products fail, a customer may assert warranty and other claims for substantial damages against us. The occurrence or discovery of these types of errors or failures could have a material and adverse impact on our business, operating results and financial condition.

We face significant competition from other technology companies. The market for application and network management solutions is intensely competitive. We believe customers make network management system purchasing decisions based primarily upon the following factors:

- product performance, functionality and price;
- name and reputation of vendor;
- distribution strength; and
- alliances with industry partners.

We compete with a growing number of smaller providers of application and network performance management solutions and larger providers of portable network traffic analyzers and probes, such as Network General. In addition, leading network equipment providers, including Cisco and Juniper Networks, offer their own solutions, including products which they license from other competitors. Many of our current and potential competitors have longer operating histories, greater name recognition and substantially greater financial, management, marketing, service, support, technical, distribution and other resources than we do. Further, in recent years some of our competitors have been acquired by larger companies that are seeking to enter or expand in the markets that we operate. Therefore, given their larger size and greater resources our competitors may be able to respond more effectively than we can to new or changing opportunities, technologies, standards or customer requirements.

As a result of these and other factors, we may not be able to compete effectively with our current or future competitors, which could have a material and adverse impact on our business, operating results and financial condition.

The success of our business depends on the continued growth in the market for and the commercial acceptance of application and network management solutions. We derive all of our revenue from the sale of products and services that are designed to allow our customers to manage the performance of applications across computer networks. Therefore, we must be able to predict the appropriate features and prices for future products to address the market, the optimal distribution strategy and the future changes to the competitive environment. In order for us to be successful, our potential customers must recognize the value of more sophisticated application and network management solutions, decide to invest in the management of their networked applications and, in particular, adopt our management solutions. Any failure of this market to continue to be viable would materially

and adversely impact our business, operating results and financial condition. Additionally, businesses may choose to outsource the management of their networks to service providers. Our business may depend on our ability to continue to develop relationships with these service providers and successfully market our products to them.

The current economic and geopolitical environment may impact some specific sectors into which we sell. Many of our customers are concentrated in a small number of sectors, including financial services, government, health and medical, and telecommunications. Certain sectors may be more acutely affected by economic, geopolitical and other factors than other sectors. To the extent that one or more of the sectors in which our customer base operates are adversely impacted, whether as a result of general conditions affecting all sectors or as a result of conditions affecting only those particular sectors, our business, financial condition and results of operations could be materially and adversely impacted.

Our success depends on our ability to expand and manage our international operations. Sales to customers outside North America accounted for 18%, 20%, and 18% of our total revenue for the fiscal years ended March 31, 2007, 2006 and 2005, respectively. We currently expect international revenue to continue to account for a significant percentage of total revenue in the future. We believe that we must continue to expand our international sales activities in order to be successful. Our international sales growth will be limited if we are unable to:

- expand international indirect distribution channels;
- hire additional sales personnel;
- adapt products for local markets and to comply with foreign regulations. For example, in July 2006, the European Union implemented its new Directive on the Restriction of the use of certain Hazardous Substances (RoHS), that is designed to restrict the use of cadmium, hexavalent chromium, lead, mercury and certain halogenated flame retardants (PBBs and PBDEs) in electronic products; and
- manage geographically dispersed operations.

The major countries outside of North America in which we do or intend to do business are England, Germany, Japan and China. Our international operations, including our operations in England, Germany, Japan and China, are generally subject to a number of risks, including: