Q1 2017 RingCentral (RNG) Earnings Script – April 25, 2017

Safe Harbor:

Clyde Hosein (CFO)

Thank you. Good afternoon and welcome to RingCentral's first quarter 2017 earnings conference call. Joining me today on the call today are Vlad Shmunis, Founder, Chairman and CEO, David Sipes, Chief Operating Officer and Mitesh Dhruv, Senior Vice President, Finance and Strategy.

Our format today will include prepared remarks by Vlad, David and Mitesh, followed by Q&A.

The purpose of our call today is to provide you with information on our first quarter performance, as well as to provide our financial outlook for the second quarter and full year 2017.

Some of our discussions and responses to your questions may contain forward-looking statements. These will include statements on our expected financial results for the second quarter and full year of 2017, and our expected annual revenues several years out.

In addition, these will include our:

- future plans, prospects, and opportunities;
- trends in the business communications market;
- our expectations regarding our continuing success in the mid-market and enterprise segments;
- and our increasing momentum with our channel partners.

We'll also be making forward looking statements about our:

- competitive position;
- the expected benefits of
  - our investments in technology;
  - our open platform and integrations;
  - our products, including Contact Center and our collaboration communications solution, Glip;
  - and our Global Office and RingCentral Europe solutions;
- our growth strategies;
- current and future market position;
- and expected growth.

These statements are subject to risks and uncertainties. Actual results may differ materially from our forward-looking statements and projections for a variety of reasons, including, but not limited to:

- general economic and market conditions;
- the effects of competition and technological change;
- the success of our marketing, sales and retention efforts;
- and customer demand for and acceptance of our products and services.

A discussion of the risks and uncertainties related to our business is contained in our filings with the Securities and Exchange Commission, and is incorporated by reference into today's discussion. We disclaim any obligation to update information contained in our forward-looking statements, whether as a result of new information, future events, or otherwise.

I encourage you to visit our Investor Relations website at ir.ringcentral.com to access our earnings release and slide presentation, our non-GAAP to GAAP reconciliations, our periodic SEC reports, a webcast replay of today's call, and to learn more about RingCentral.

For certain forward looking guidance, a reconciliation of the non-GAAP financial guidance to the corresponding GAAP measure is not available as discussed in detail on our Investor Relations website.

For your convenience, copies of our script are available on our website.

CFO Transition

Before I turn the call over to Vlad, I wanted to let you know of a transition we announced today. We announced that I will be transitioning the CFO role to Mitesh Dhruv, effective on the signing of the next 10-Q. I will remain with the Company until the end of May and provide support to the RingCentral team.

I have been with RingCentral for about four years, joining just before the IPO. It has been a tremendous experience. We have grown revenue from about $120M to over $400M, have substantially increased the size of customers we address and are now winning multiple enterprise customers. We are profitable, have now generated five consecutive quarters of free cash flow and have a strong balance sheet and no debt.

I have accomplished all the things I wanted when I joined four years ago, including a successful RingCentral IPO and presence as a public company. Mitesh has been at RingCentral even before me, and we have worked together for the last four years. During this time, I've given him increasing responsibilities to manage all the finance functions, including FP&A, controllership, tax, treasury, and more recently an increased role in investor relations. With this succession planning, he is ready to assume the CFO role with a seamless transition.

This transition fits really well with my personal plans. I plan to spend time with my family and I will continue to be a big supporter of RingCentral.

With that, I will turn the call over to Vlad, followed by Dave Sipes and Mitesh. I will be available during the Q&A portion of this call.

With that, let me turn the call over to Vlad.

Vlad Shmunis (CEO)

Thank You, Clyde. Before I give an update on Q1, I want to acknowledge Clyde for all his contributions. Clyde played an important role in our journey from IPO to over $400M in revenues. And I want to thank Clyde for the excellent job he did in transition planning and developing your next generation leadership.

With that onto Q1.

Q1 was a great start to the year. Our software subscription revenue growth accelerated to 30% up from 28% last quarter. Total revenue grew to $112 million, up 29% year over year. Our results were driven by our success in all segments and especially in the mid-market and enterprise, as well as increasing momentum with our channel partners.

Legacy, on-premise vendors' businesses in our industry are mostly shrinking. Cloud is winning and we are winning in the cloud.

We are the largest, fastest growing pure-play cloud provider for business communication solutions. Last quarter we believe our win rates further increased in the mid-market and enterprise. Our channel business continues to accelerate as enterprises are increasing their adoption of cloud communications solutions. With these tailwinds, we believe we are further widening the separation between us and our cloud competitors.

For a little more color, I'd like to talk about the following three areas:

1) Overall industry perspective;
2) Summary of our Q1 performance; and
3) Our continual rapid pace of innovation

We recently participated in Enterprise Connect, the leading trade conference in our industry. It was remarkable how clear it was that the future is cloud. Three years ago, at Enterprise Connect, cloud was just a discussion topic. Even as recently as last year, cloud was still not the clear winner. However, this year, cloud was front and center and the move to the cloud seemed to be a foregone conclusion.

Even the legacy vendors have recognized that cloud is winning. The legacy PBX vendors are mostly no longer promoting their purely on-premise offerings. Instead, they are trying to push a “hybrid” or hosted systems approach. But, these are still at their core, expensive legacy solutions which continue to suffer from lack of innovation, closed architectures, and poor onboarding and user experience.

Larger enterprises are increasingly looking to the cloud to better:

- serve their global work-forces;
- integrate the communication stack with other lines of business applications; and
- consolidate multiple disparate systems and vendors into a single solution

Legacy or legacy-based hosted systems simply cannot effectively meet these challenges.

We are seeing channel partners rapidly getting more comfortable leading with our UCaaS solution. The strong demand from our channel partners is particularly coming from those who in the past used to lead with legacy solutions such as Avaya’s. To better satisfy demand generated by the channel, we have recently introduced RingCentral Europe. This new offering now enables us and our channel partners to serve needs of businesses headquartered in thirteen European countries.

These market shifts are reflected in our Q1 results.

In Q1, our midmarket and enterprise segment grew 86% year over year and is now an over $115 million-dollar recurring revenue business. Our enterprise sales team had another record quarter. I’m happy to say that in Q1, usually a seasonally slow quarter for large deals, we closed six deals with TCV north of $1 million dollars up from five in Q4. One of these wins was at Hyatt Hotels Corporation. Hyatt will be replacing legacy Avaya system at their headquarters with RingCentral Office. Dave will later provide you more color on Hyatt and some other key wins.

In Q1, new business from channel partners showed impressive growth of over 100% year over year and over 20% quarter over quarter. A number of our large enterprise deals came through our channel partnerships.

Moving forward, we expect to continue expanding our momentum by extending our clear technology and product competitive leadership.

We continue to make product enhancements to address the increasing needs of mid-market and enterprise customers. We also continue to out-invest our nearest cloud competitor by over 2x in R&D.

Our unique differentiators remain the seamless integration of enterprise communications and team collaboration, open platform, global footprint and our relentless focus on usability and mobility.

With our strong growth, expanding enterprise demand, rapidly evolving partner eco-system and continual innovation leadership, I feel confident that we will achieve our $1B revenue goal by the end of 2020.

Now, for some additional color I will pass the call over to our COO Dave Sipes.

David Sipes (COO)

Thank you Vlad. I want to also thank Clyde for his support and leadership over the years. I wish you all the best.

I will now give more color on our Q1 performance.

Our strong performance in Q1 illustrated the market inflection we are seeing across all segments and especially in the midmarket and enterprise. The combination of our industry-leading integrated solution, global and open platform and a rapidly expanding partner channel continues to distance us from the competition.

Our integrated open platform includes enterprise voice, video, contact center, team messaging, collaboration and conferencing. With these capabilities, our cloud solution is not just a replacement for legacy voice-only PBX systems. In many of our deals, we are also displacing a wide range of discrete legacy communication tools. As a matter of fact, in a number of wins, we are replacing multiple products and services such as Avaya and Cisco PBX and contact centers, WebEx web meetings, and Slack team messaging.

Our pipeline for mid-market and enterprise customers continues to show strong growth as demonstrated by our six 7 figure deals in the quarter.

A key winning differentiator is our integrated collaborative communications capability. Vlad mentioned Hyatt earlier as one of our 7 figure wins. This is a replacement of legacy on-premise Avaya system, initially at Hyatt's headquarters. Multiple vendors competed for this business, including our closest cloud competitors. Hyatt chose us because our solution seamlessly integrates voice, video, team messaging and collaboration. In the future, Hyatt plans to standardize its communications solutions across its mobile and distributed workforce.

Another example of a seven figure TCV enterprise win that was driven by our unique collaborative communications capability was an 1,800 user win from a specialty communications provider. This account is going to be deployed globally including in the UK, Brazil, Germany, and South Africa. Additionally, the customer is also deploying over 200 RingCentral contact center seats. In the process, we are replacing multiple legacy systems that are currently providing discrete voice, video and collaboration solutions.

Another key differentiator enabling us to win larger deals is our open platform. This provides our ISV partners and enterprise customers the ability to easily integrate communications data and services into their applications. This has proven pivotal in several large customer wins including an 1,100 user win at N3, a global sales execution and demand generation firm. For productivity improvements, N3 is utilizing Microsoft Dynamics integration with RingCentral Office to customize their business workflows. In addition to our open platform, N3 chose RingCentral based on our proven global capabilities.

The ability to deliver collaborative communication solutions to enterprises globally is a unique advantage of our platform over legacy systems. Another example of a Global Office win this quarter is Ultratech, a leading supplier of semiconductor manufacturing equipment. In addition to its US headquarters, this customer has employees in Brazil, Costa Rica, Ireland, the UK and Singapore. As a matter of fact, we now have over 700 enterprises on our Global Office platform, up from around 600 last quarter.

Contact Center also continued to be a strong growth vector for us, and now accounts for about 15% of our mid-market and enterprise new business, up from 4% a year ago. RingCentral Contact Center is integrated with RingCentral Office collaborative communications capabilities for a strongly differentiated competitive offering.

We continue to see strong and improving acceptance of our solutions by channel partners. This is helping us efficiently grow our enterprise business, as these partners are enabling us to reach more enterprise customers, faster, and with higher win rates. This quarter, five of our six seven figure deals were won with channel partner involvement.

As we continue to ramp up more channel partners, we expect this to continue to be a key driver of scalable growth in mid-market and enterprise.

We are also seeing good traction from Google. For example, during the quarter, we won a 650 user deal with a New York based global independent advertising network. This customer chose RingCentral Office based on its tight integration with Google Cloud’s G-Suite. We also added 15 new Google partners in Q1 for a total now of about 40.

In summary, Q1 was a fantastic quarter, with continued industry-leading growth. Many investors have asked how our mid-market and enterprise revenues compare if we were to cast it as customers with over $1K MRR that some other vendors use. By that measure our mid-market and enterprise business is now approximately $150M and grew over 70% year over year.

It’s no longer a question if enterprises will switch to the cloud, it’s only a question of how quickly. And RingCentral is best positioned to benefit from this trend, given our world class go-to-market, technology platform and accelerating pace of innovation.

I will now hand it over to Mitesh. Congratulations Mitesh.

Mitesh Dhruv (SVP, Finance & Strategy)

Thanks, Dave. Good afternoon everyone. Before I start, I want thank you Clyde for your mentorship over the years. It’s been a pleasure working for you.

I joined RingCentral prior to our IPO, and it’s a privilege to step up to the CFO role. We see many years of strong and profitable growth ahead for RingCentral, and I look forward to working with all of you over the coming quarters and years.

Before I begin with the results, I want to ask that you refer to the slide deck posted on our Investor Relations website which will help summarize the key points in our call today, as well as provide some supplemental information. Unless otherwise indicated, all measures that follow are non-GAAP with year-over-year comparisons. A reconciliation of all GAAP to Non-GAAP results was provided with our earnings press release issued earlier today, and in the slide deck posted on our IR website.

Q1 was yet another strong quarter for RingCentral. We delivered total revenue ahead of the high end of our guidance range, along with year-over-year improvements in operating margin and earnings per share. Q1 was underscored by 30% software subscription revenue growth and non-GAAP software subscription gross margin of over 81%, amongst the best-in-class SaaS companies.

More important, we saw strong momentum in our midmarket and enterprise execution. Our midmarket and enterprise segments are now over a $115 million business, grew 86% and represented around 45% of our new sales for RingCentral Office.

Total annualized exit monthly recurring subscriptions (or ARR) grew to approximately $451 million dollars, up 32% year-over-year and up 9% sequentially. ARR for RingCentral Office grew to approximately $373 million, up 39% year-over-year and up 9% sequentially. I should note that the quarter was aided by a number of factors including Avaya’s bankruptcy news, un-forecasted new business from AT&T, albeit at a diminishing contribution, and better monetization of our customer-base. As a result, we expect Q2 ARR to grow more normalized at 6-7% sequentially, in line with our last year’s growth, although at a much higher level of revenue.

The indirect channel contributed 27% of ARR in Q1. As we continue to grow and diversify our indirect channel, an increasing percentage of our indirect channel bookings is coming from our channel partners, which are our non-carrier partners. In fact, channel partners had a record bookings quarter and now represents more than 60% of the total indirect bookings.

In Q1, over 40% of our new Office business came from existing customers. Overall, this demonstrates customer satisfaction with the RingCentral platform along with tailwinds from 'land and expand' with larger customers as we consistently expand up market.

Office net monthly subscription dollar retention was once again over 100% across the installed base. Software subscription revenue in Q1 was $103.7 million, up 30% year-over-year and up 6% sequentially.

Other revenues were $8.1 million bringing total revenue for the first quarter to $111.8 million, up from $86.5 million in Q1 a year ago, representing 29% year over year growth. We reverted to the direct sales model for the hardware business which generated a 2-point tailwind to our total revenue growth in Q1. This had no impact to our subscription growth rate.

Our software subscription gross margin was over 81% during Q1, consistent with last quarter and represents over a point of improvement year-over-year, once again demonstrating the leverage from our multi-tenant SaaS model.

Gross margin from other revenues was 13% in the quarter. Other gross margins reflect the change to the direct sales model in our hardware business. On a sustained basis, we expect Gross margin from other revenues to be between 10 and 15%. As a reminder, the Other Revenues line includes phones, professional services, and revenues from rental phones.

Total gross margin was 76.4%, up about 60 basis points year over year. On a comparative basis, adjusting for the change to direct hardware sales, total gross margin would have been up 180 basis points year over year.

Sales and marketing expenses were about $55 million for the quarter, or 49% of revenues. This was up from 46% in the first quarter a year ago and flat from 49% last quarter. These expenses include investments we are making in the enterprise segment which remains a significant opportunity for us with meaningfully higher lifetime values. Our long-term unit economics continue to be attractive. For each dollar invested in sales and marketing, we continue to see $9 of revenue and $7 of gross profit over the projected life of an Office customer. For mid-market we continue to see $12 of revenue and for our enterprise customers we continue to see $15 of revenue over the projected life.

R&D expenses were $15 million for the quarter, or 13% of revenues, down from 15% in both Q1 a year ago and from last quarter.

G&A expenses were $13 million for the quarter, or 12% of revenues, down from 14% in Q1 a year ago and up from 11% last quarter.

Our operating profit was $2.2 million resulting in an operating margin of 1.9% versus our guidance range of 1.8% to 2.2%. This is up from 1.5% in Q1 a year ago. Sequentially the operating margin is down 20 basis points from Q4 driven by 1 point of headwind from seasonal effects such as reset of payroll taxes.

Net income improved to $2.1 million, compared to $1.0 million in Q1 of last year and $2.0 million last quarter. Earnings per share was three cents, at the high end of our Q1 guidance range of one to three cents. Share count was 80 million fully diluted shares.

On a GAAP basis, our Q1 net loss was $7.3 million or a loss of 10 cents per share. The difference between our GAAP and non-GAAP results was $9.4 million, or 13 cents per share. This is primarily driven by 12 cents of stock-based compensation, while 1 cent was due to amortization of intangibles and other items related to the Glip acquisition.

We ended Q1 with cash and short-term investments of $150 million, compared to $160 million at the end of Q4. The decline in our cash balance reflects a $15 million repayment of our entire debt.

Deferred revenue was $49 million, an increase from $45 million in Q4 and $39 million a year ago. For the quarter, cash flow from operations was $9 million compared to $7 million for Q4 and $5 million in the same period a year ago.

Free cash flow was $1.9 million in Q1. Free cash flow included a one-time working capital headwind due to a switch to direct hardware sales, which was offset by higher deferred revenue, stronger collections, and other improvements in working capital.

Before I move on to the guidance, I would point out that our AT&T new business peaked in Q2 of last year and optically is a tough compare looking ahead to Q2 of this year. We expect the growth rates to normalize in the second half as channel partners increase their contribution to the indirect channel. This is reflected in our full year guidance.

Now for our outlook for the second quarter and full-year 2017.

- For the second quarter,
    - We expect software subscription revenue of $109 million, plus or minus half a million dollars, which represents an annual growth of 27%.
    - We expect total revenue of $117 million to $119 million, which represents an annual growth of 27% to 30%. On a comparative basis adjusted to the direct sales model, growth would have been 3 points lower.
    - We expect non-GAAP operating margin of 2.0% to 2.5%.
    - We expect non-GAAP earnings per share of 3 cents, plus or minus a penny, based on 81 million fully diluted shares.

    - The difference between our Q2 GAAP and non-GAAP EPS is expected to be approximately 14 cents, including 13 cents of stock based compensation and one penny of amortization of intangibles and other items related to the Glip acquisition. This excludes any effects from currency re-measurement, which is difficult to forecast.

- For the full year 2017,
    - We are raising our software subscription revenue guidance to $450 - $456 million, or an annual growth of 26% to 28%, up from our prior guidance of $447 to $454 million.
    - We are raising our total revenue guidance to $486 to $494 million, which implies year-over-year growth of 28% to 30%. This is up from our previous guidance of $484 to $492 million. On a comparative basis, adjusted to the direct sales model, growth would be about three points lower.
    - We expect non-GAAP operating margin of 2.5% to 3.0%, consistent with the guidance we provided last quarter.
    - We are raising our non-GAAP earnings per share guidance to 14 to 18 cents, up from 13 to 17 cents previously.
    - The difference between our 2017 GAAP and non-GAAP EPS is expected to be approximately $0.55, including $0.53 of stock based compensation and $0.02 of amortization of intangibles and other items related to the Glip acquisition. This excludes any effects of currency re-measurement, which is difficult to forecast.
    - We expect fully diluted shares to be 81 million.
    - We expect free cash flow for the year of approximately $8 to $12 million, up from $5 to $10 million previously.

In summary, Q1 was another great quarter that marks a strong start to the year. With that, I'll turn the call over to the operator for Q&A.