Paul Thomas, RingCentral, Inc. – Senior Director of Investor Relations

Thank you. Good afternoon and welcome to RingCentral's third quarter 2017 earnings conference call. I am Paul Thomas, RingCentral's Senior Director of Investor Relations. Joining me today are Vlad Shmunis, Founder, Chairman and CEO, David Sipes, Chief Operating Officer and Mitesh Dhruv, Chief Financial Officer. Our format today will include prepared remarks by Vlad, David and Mitesh, followed by Q&A.

Some of our discussions and responses to your questions may contain forward-looking statements. These statements are subject to risks and uncertainties. Actual results may differ materially from our forward-looking statements.

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. RingCentral assumes no obligation and does not intend to update or comment on forward-looking statements made on this call.

I encourage you to visit our Investor Relations website at ir.ringcentral.com to access our earnings release, 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.
With that, let me turn the call over to Vlad.

Vlad Shmunis, RingCentral, Inc. - Founder, Chairman, and CEO

Good afternoon and thank you for joining our third quarter earnings conference call. This quarter's results were outstanding. We outperformed in multiple ways.
First, our Software Subscription annualized recurring revenue, or ARR, broke the half a billion-dollar mark at $514 million dollars. This is an important milestone towards our stated target of $1 billion dollars by 2020.

Second, our year over year total revenue growth rate increased to 34%, up from 30% last quarter.

Third, our mid-market and enterprise business continued to lead the way. Mid-market and enterprise, defined as 50 seats or greater, is now a $155 million-dollar annualized business. It grew 80% year-over-year, and contributed over 50% of our new Office business in the quarter. Our channel partners were again key contributors to our outsized growth with these customers.

Fourth, this quarter we also closed a record 10 deals with over $1 million in total contract value. This is up from 7 last quarter, and 6 the quarter before.

The strength in our business this quarter reinforces the fact that cloud is winning and RingCentral is winning in the cloud. The reason cloud is winning is because it is able to address the needs of modern mobile and global enterprise workforces that are hard if not impossible for legacy on-premise systems to match.

The reason we are winning in the cloud is because of our core differentiators:

1) our integrated collaborative communications capabilities
2) our open platform with broad integration capabilities
3) our best in class, integrated contact center and video solutions
4) our extensive global capabilities
5) our world class customer care and service organizations

To bring the RingCentral community together, in October we hosted our second annual user conference, ConnectCentral 2017. With triple the attendance of our first user conference last year, we brought together customers, prospects, channel partners, and our open platform developers. We also had a number of our strategic partners present including Google, Salesforce, Okta, Box and others. Additionally, we hosted our first industry analyst day with nearly 20 leading industry analysts participating. It was an exciting event with several new leading -edge product and platform announcements:

1) We announced new integrations with Google G Suite, Amazon Alexa, and Slack.
2) We announced advanced integrations for Glip team collaboration with AI and chatbots.
3) We introduced Real Time Global Quality of Services Analytics. This is very hard if not impossible for legacy systems to provide.

We win on innovation. The moat between us and our direct competitors continues to widen. In fact, we consistently invest more than twice as much in R&D as the number two pure-play cloud vendor, while growing twice as fast on a base almost twice as large.

Our commitment to innovation and customer success has not gone unnoticed. We won multiple awards and recognitions in the third quarter.

- One - For the third consecutive year, RingCentral was named Gartner Magic Quadrant Leader for Unified Communications as a Service, Worldwide. We have again claimed the most visionary spot, while moving up in execution. Interestingly, some other competitors moved in the opposite direction or were dropped from the quadrant all together
- Two - We were named Frost & Sullivan Company of the year for the second year in a row
- Three - We were rated the number one Leader in the IHS Markit 2017 North American UCaaS Scorecard

- And four - Named a leader in The Aragon Research Globe for Unified Communications and Collaboration, 2017

In summary, on-premise solutions are in secular decline. Some Legacy players, including hosted solutions vendors, are consolidating. Meanwhile cloud continues to win across the board and we continue to significantly outpace all direct competitors in the cloud. Moving forward, I would like to reiterate our unwavering commitment to innovation and customer success, as we continue to disrupt the $50 billion dollar plus business communications market through the cloud.

Now, for some additional color, I will pass it over to our Chief Operating Officer, Dave Sipes.

David D. Sipes, RingCentral, Inc. - COO

Thank you, Vlad.

As Vlad mentioned, we saw great momentum this quarter in our business.
We are winning because of our open platform with broad integration capabilities, our integrated communication and collaboration solution, superior mobile first user experience and our global coverage. These differentiators helped us win significant deals in the quarter. Let me give you some color from some of the 10 large wins Vlad mentioned.

One win was with Central Health, a public entity that provides access to high-quality healthcare. They had legacy on premise systems and were looking for an innovative mobile first solution, HIPPA compliance, and integrated cloud contact center. RingCentral's contact center and office solutions gave them best in class mobile performance with integrated contact center and our new HIPAA compliant Glip collaboration capabilities.

Another win was with a leading provider of corporate travel management services. They are growing rapidly and expanding across new locations organically and through acquisitions. Their legacy contact center and PBX systems were not able to keep up. They needed a highly scalable and flexible integrated cloud contact center and UCaaS solution to address their global needs. They also required an open platform to integrate with their existing travel management solutions.

In the UK, we won a global multi-thousand employee digital advertising agency. They were looking to replace their Cisco legacy system. They needed an open platform with integration capabilities with Okta and other solutions. A key requirement was the ability to support their global workforce in 16 countries across 5 continents.
Our channel partners continue to be key contributors to our success. They are choosing RingCentral as more of their customers demand best in class cloud solution. As a result, we are signing up more channel partners who have traditionally sold Avaya,

Cisco, and others. This quarter alone we signed four new Avaya diamond level resellers.

As Vlad mentioned, we win because of our differentiated capabilities including our thriving open platform. Our customers are now using over 850 standard and custom applications that are integrated with RingCentral Connect platform, more than doubling year over year. Furthermore we now have more than 7,000 developers leveraging RingCentral Connect platform to develop integrations enabling efficient enterprise workflows.

Our relentless pace of innovation continues. I'll add some color here to our user conference announcements that Vlad mentioned.

We introduced Global Quality of Services Analytics. Administrators can now see quality of service for every leg of every call on a global basis. This comprehensive dashboard allows them to anticipate and diagnose quality of service in real time.

We expanded our ecosystem with integrations with Google G Suite, Amazon Alexa, and Slack. RingCentral for Gmail is an add-on that intuitively surfaces key contextual RingCentral capabilities within Gmail such as presence, messaging and calling. RingCentral's integration with Amazon Alexa-powered devices enables users to interface with RingCentral through voice commands to play messages and initiate calls and texts. RingCentral for Slack brings video meetings and PSTN calling capabilities into the Slack messaging platform.

We also announced integrations for Glip team collaboration with AI and chatbots. Enhancements included the Salesforce Alert Bot in Glip that captures Salesforce events and sends notifications to Glip teams. In addition, platform partner Kore.AI has enabled four leading bots within the Glip platform, including Salesforce, Twitter, Asana, and Trello.

We also announced the expansion of RingCentral Global Office platform to include Peru, Brazil, and Argentina. By the end of 2017, the RingCentral Global Office footprint will extend to 37 countries and offer virtual numbers in over 80 countries. And we have now done on-site professional service deployments globally in 28 countries.

The cloud is winning and RingCentral is winning in the cloud. Legacy vendors have not innovated meaningfully, and their secular decline continues. As to cloud competitors, we are the largest and fastest growing pure-play cloud provider. With over $500 million-dollar subscription ARR and growing rapidly, we continue to extend our leadership and market share.

After the recent results by the number two pure-play vendor, many investors have been asking questions about secular cloud trends given that company's softening revenue and their flat mid-market and enterprise bookings growth.

We see no such headwinds. If we were to cast our mid-market and enterprise business in that company's terms of customers with over $1,000 MRR, it would be a $188M million-dollar business growing over 60% year over year. Our business is meaningfully larger and growing more than twice as fast as theirs. Additionally, our mid-market and enterprise bookings this quarter grew over 70%.

In summary, we saw significant momentum this quarter. Our strong growth in mid-market and enterprise was driven by innovative capabilities of our products and platform. Our channel partners continue to be key to our success. With our unwavering commitment to innovation and world class customer service we continue to expand our lead in the industry.

I'll now hand it over to our CFO, Mitesh Dhruv.

Mitesh Dhruv RingCentral, Inc. – CFO

Thanks Dave,

Good afternoon everyone.

Before I begin with the results, I want to ask that you refer to the slide deck posted on our IR 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 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. With that, let me move on to our results.

Q3 was an outstanding quarter. We delivered total revenue, operating margin and EPS above the high end of our guidance range. In Q3 our software subscription revenue grew 30%. Normalizing for the decrease in AT&T sales that was consistent with our expectations, our core subscription revenue growth rate was 33%, up from 31% last quarter. For more data on our historical core growth trends, please see our earnings slide deck.

Total ARR grew to $514 million, up 32% year-over-year. ARR for RingCentral Office grew to $434 million, up 37% year-over-year.

Our performance in the quarter was led once again by our mid-market and enterprise business, which has grown to $155 million-dollar in ARR and up 80% year over year. It also represented over 50% of new sales for RingCentral Office, up from over 40% in the year ago quarter.

Our seven figure deals have helped drive this performance. These deals have grown not only in numbers but also in size. Over the last four quarters the average TCV of seven figure deals has increased over 40%, demonstrating success in our expansion into the enterprise. Moreover, our enterprise expansion is more broad based than just seven figure deals. In the future, we are considering providing dollar based metrics like ARR, that will more holistically capture the pace of our enterprise momentum.

Channel partners were a key contributor to our up-market performance as well. In Q3 channel partners delivered another quarter of record bookings. This is the sixth quarter in a row that our channel partner bookings have more than doubled compared with the year ago period. Channel partners contributed about 30% of our overall bookings in the quarter up from about 15% last year.

Now for some more color on the financial statements:

Starting at the top of the income statement, total revenue for the third quarter was $130 million, up from $97 million a year ago. This represents 34% year over year growth driven by record new sales, and led by mid-market and enterprise performance. Adjusting to the direct phone sales model resulted in a 3-point tailwind to our total revenue growth but has no impact on our subscription growth rate. Software subscription gross margin was 81.8%, among the best-in-class SaaS companies. This represents a year-over-year improvement of 170 basis points, demonstrating the leverage in our model as our business scales.

Total gross margin was 77.2%, up 40 basis point year over year. On a comparable basis, adjusting for the change to the direct phone sales model, total gross margin would have been 210 basis points higher.

Sales and marketing expenses were $63 million for the quarter, or 49% of revenues. This was flat year over year and up from 48% last quarter. The sequential increase was driven primarily by higher sales commissions from stronger new sales in the quarter.

Our sales and marketing investment focus is on the mid-market and enterprise customers. This focus has resulted in positive impacts to our business model. For example, mid-market and enterprise customers have roughly half the gross churn rate versus small business customers. They also seed our land and expand pipeline. Driven by these trends, in Q3, we saw record low churn, strong sales momentum and over

40% of our new office business coming from existing customers. The combination of these positive indicators drove higher overall net retention.

Continuing down the income statement, R&D expenses were approximately $16 million for the quarter, or 13% of revenues. This was roughly flat with last quarter and down from 14% last year. Our innovative products are the fundamental reason why we win, and R&D investment is what fuels our differentiation. We anticipate continued investment in R&D in the future to drive our success in the market.

Moving on to G&A, total G&A expenses were $16 million for the quarter, or 12% of revenues, roughly flat with last quarter and a year ago. G&A expenses included investments in our systems and personnel to support our future growth and we expect to see more leverage over time.

Wrapping up the income statement, Q3 demonstrated strong operating leverage from higher revenue. Operating margin of 3.7% was above the top end of our guidance range of 2.5% to 3.0%. EPS was six cents, above the high end of guidance of three to five cents.

On a GAAP basis, our EPS was a loss of 7 cents. The difference between our GAAP and non-GAAP EPS was primarily driven by stock-based compensation.

Free cash flow was $4.4 million in Q3, up from $3.2 million in Q2

Now onto guidance for the fourth quarter,

- We expect software subscription revenue of $126 to $127 million, or an annual growth of 29% to 30%
- We expect total revenue of $136 to $138 million, or an annual growth of 30% to 32%. Adjusted for the direct phone sales model, growth would be 3 points lower.
- We expect non-GAAP operating margin of 3.5% to 4.0%.

- We expect non-GAAP EPS of $0.06 based on 84 million fully diluted shares.
- The difference between GAAP and non-GAAP EPS is expected to be approximately $0.13 mainly due to stock-based compensation. This excludes any effects from currency remeasurement, which are difficult to forecast

Moving on to our outlook for the full-year 2017.

- We are raising our software subscription revenue guidance to $459.5 to $460.5 million or an annual growth of 29%. This is up from our prior guidance of $453 to $457 million.
- We are raising our total revenue guidance to $497 to $499 million, or an annual growth rate of 31%. This is up from our previous guidance of $489 to $496 million. Adjusted for the direct phone sales model, growth would be about 3 points lower.
- We are raising the non-GAAP operating margin to 3.1% to 3.2%, from our prior range of 2.8% to 3%.
- We are raising non-GAAP EPS guidance to $0.19 to $0.20, up from $0.16 to $0.18 previously. This is based on 82 million fully diluted shares.
- The difference between GAAP and non-GAAP EPS is expected to be approximately $0.53, including $0.51 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 remeasurement, which are difficult to forecast.
- We are raising our free cash flow guidance to $12 to $15 million. This is up from prior guidance of $10 to $14 million.

In summary, Q3 was another great quarter with solid execution.

With that, I'll turn the call over to the operator for Q&A.