Safe Harbor:

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

Thank you. Good afternoon and welcome to RingCentral's second 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 second quarter earnings conference call. We delivered another strong quarter of results highlighted by continued industry acceptance of our unique collaborative communications platform. Overall revenues for the quarter grew to $119 million, up 30% year-over-year. This was driven by strength in mid-market and enterprise, supported by break out growth from our channel partners.

Our mid-market and enterprise segment continued to surge. It is now a $131 million annualized business, up 80% year-over-year. This quarter we closed 7 deals over $1 million in total contract value, up from 6 last quarter, and 5 in the fourth quarter of 2016. This quarter's large deals included, a $5 million TCV with a Fortune 1000 global retailer, and wins with Marketo, Extra Space Storage, Pacific Dental and ChenMed amongst others.

From an industry perspective, the struggles of legacy on-premise system vendors are becoming well documented. They are either struggling financially like Avaya or consolidating like the recent announcement from Mitel and ShoreTel. Legacy systems simply cannot effectively meet the communication and collaboration needs of a mobile and globally distributed workforces. The customers are taking notice. Third party data from Synergy Research Group indicates that legacy on-premise unified communications providers saw a high single digit decline in year over year revenue. At the same time cloud based solutions saw significant double digit gains, with RingCentral growing at approximately double that rate.

Within the cloud segment, Synergy recognized RingCentral as the #1 worldwide market share leader with 19% of the UCaaS market. RingCentral was the largest market share gainer over the last year in the UCaaS segment. The data clearly shows we are now pulling away from the competition.

In addition to Synergy, we also received four other industry recognitions this quarter. This included Infonetics who ranked RingCentral as a leader in its 2017 North American UCaaS Scorecard.

Put simply, cloud is winning and RingCentral is winning in the cloud.

Fundamentally we are winning because of our core differentiators:

1) our industry-leading open platform with broad integration capabilities,
2) our unique integrated communications and collaboration capabilities
3) our superior, mobile-first user experience
4) our extensive global coverage

No other competitor provides all these capabilities in a single integrated open collaborative communications platform. This gives us a strong position as the massive installed base of legacy on-premise systems shifts to the cloud. Our broad platform enables our customers to replace multiple products and services from vendors like Cisco, Avaya, WebEx, Slack, Five9 and others with a single unified solution from RingCentral.

As the market shifts, reseller channel partners that previously only sold legacy on-premise systems are increasingly switching to selling cloud solutions. In Q2, we saw a significant increase in new business from these channel partners, now contributing 85% of the total indirect bookings mix up from about 40% a year ago. In addition, we signed 3 more of Avaya's key resellers and we are in active conversations with many more.

With our differentiated offering, our growing enterprise opportunity and momentum with channel partners accelerating, I feel confident in achieving our $1 billion target by year 2020.

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

David D. Sipes RingCentral, Inc. - COO
Thank you, Vlad.

We had another great quarter led by our mid-market and enterprise segments and supported by significant momentum in our indirect channel. As Vlad mentioned, our open platform with integration capabilities, unique collaboration tools and our global coverage continue to help us win key deals.

Our enterprise segment had a strong bookings quarter. Enterprise bookings tripled from a year ago, and the enterprise pipeline has grown even faster.

Our channel partners this quarter delivered 4 of our 7 largest deals. Bookings from our channel partners again grew over 100% year over year. As legacy vendors continue to struggle and channel partners continue to shift toward cloud solutions we anticipate continued success working with our partners.

This quarter we won a $5 million TCV with a Fortune 1000 global retailer. This is just one example of our success in the enterprise segment with channel partners. The customer needed to replace legacy on-premise Avaya systems and evaluated many alternative legacy vendors and other cloud competitors. They chose RingCentral because of our unique global capabilities, our open platform enabling easy integration with their existing applications, and our ability to deliver an integrated contact center solution. The customer is deploying our solution across their retail and corporate offices globally totaling over 5,000 users.

Another example from our large deal wins is Extra Space Storage, the second largest operator of self-storage facilities in the U.S. Their employees needed a mobile solution so they could move around their facilities and still remain available to customers. They also needed collaboration capabilities that would help employees stay efficiently connected to managers. Additionally, they wanted the capability to centrally administer the solution for their large and growing footprint of locations. Extra Space Storage is deploying RingCentral across their US footprint, reaching 3,000 users.

We also had other large wins where our integrated Glip collaboration capabilities in our Office product was key to winning. For example, Pacific Dental Services, one of the largest dental services companies in America, was looking for a communication solution for 500 US locations spread across 17 states. Interestingly, Glip collaboration became the primary communication vehicle during the sales cycle. When fully ramped, Pacific Dental Services will have 4,000 RingCentral Office users.

Our Contact Center again saw a strong quarter of adoption as customers overwhelmingly choose an end to end solution with best in class capabilities. ChenMed, a recently announced takeaway from a cloud competitor added over 300 Contact Center seats to their 1,900 Office seats. The advanced routing, queuing, and call distribution of Contact Center, closely integrated with RingCentral Office, helps ChenMed deliver better patient services. This integration enables a seamless experience that keeps help-desk agents connected with customers and other employees across the entire enterprise.

In addition to winning large deals upfront, we continue to seed land and expand opportunities where customers initially subscribe for only a portion of their total employee base. For example, this quarter we won a 400 user deal with a major media and entertainment company, which has a total base of over 13,000 employees, creating a significant future upsell opportunity.

To extend our competitive lead, we continue to invest more than twice as much in our platform and products compared to our nearest competitor. These investments are bearing fruit. For example, we recently launched RingCentral Live Reports, an add-on capability to Office which enables customers to monitor in real time the service quality being delivered to their customers. Live Reports is already seeing traction in the marketplace. This quarter Carvana, a leading eCommerce automotive platform added 500 licenses of Live Reports to its existing 700 Office users.

We also launched Business MMS enabling customers to send and receive images and multimedia files from their RingCentral business numbers. This capability is unique among our largest competitors.

On the service provider side, we expanded our relationship with TELUS Canada with the release of TELUS Business Connect Mobile which brings enterprise grade communication capabilities to smartphones and tablets.
In summary, Q2 was a great quarter. With our strengthening product advantages and momentum in enterprise and channel we are well position to extend our market leadership.

Now, to discuss our financial results, I will pass the call 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 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 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.

Q2 was another great quarter for RingCentral. We delivered total revenue and operating margin above the high end of our guidance range, along with year-over-year improvements in EPS. In Q2 our software subscription revenue grew 28%. Normalizing for the decrease in AT&T sales consistent with our expectations, our core subscription revenue growth rate was 31%.

Total annualized exit monthly recurring subscriptions (or ARR) grew to approximately $478 million, up 31% year-over-year and up 6% sequentially. ARR for RingCentral Office grew to approximately $399 million, up 37% year-over-year and up 7% sequentially. This was at the high end of our expectations outlined on our last call of between 6% and 7% sequentially.

Underpinning our growth rate was strong momentum in our mid-market and enterprise execution. As Vlad mentioned, our mid-market and enterprise segments combined are now over a $131 million dollar business and grew 80% year over year. These segments represented around 50% of our new sales for RingCentral Office, up from 45% last quarter.

Many investors have asked how our mid-market and enterprise revenues compare if we were to cast it as customers with over $1,000 MRR. By that measure our mid-market and enterprise business is now approximately $165M and grew over 60% year over year.

Our indirect business contributed 28% of ARR in Q2. It showed sequential improvements as we were able to offset AT&T headwinds with strong contributions from channel partners. In Q2, these channel partners delivered record bookings, which more than doubled from a year ago. As Vlad mentioned, these bookings now represent more than 85% of our total indirect bookings, up from roughly 40% a year ago.

This shift has positive effects on our financial model. On spend, upfront sales and marketing expenses are lower as channel partners are mostly compensated on a recurring basis after a transaction. This also helps lower churn as channel partners are incentivized to help retain the customer, resulting in about 40% lower gross churn compared with our direct deals.

Moving to the income statement, total revenue for the second quarter was $119 million, up from $92 million in Q2 a year ago, representing 30% year over year growth. Adjusting to the direct phone sales model resulted in 3-point tailwind to our total revenue growth in Q2 but had no impact on our subscription growth rate.

Software subscription gross margin was over 81%, among the best-in-class SaaS companies. This is consistent with last quarter and represents over a point of improvement year-over-year, demonstrating the leverage inherent in our model. Total gross margin was 76.2%, down 50 basis points year over year. On a comparable basis, adjusting for the change to the direct phone sales model, total gross margin would have been 140 basis points higher.

Sales and marketing expenses were about $57 million for the quarter, or 48% of revenues. This was up from 47% in the second quarter a year ago and down from 49% last quarter. The decline from Q1 was due to seasonality of certain expenses.

Let me double click on sales and marketing. Our investment focus is on the mid-market and enterprise segments which have positive long-term impacts to the business model.

Mid-market and enterprise customers have roughly half the gross churn rate versus small business customers. Also, penetrating larger accounts seeds our land and expand pipeline. In Q2, over 40% of our new Office business came from existing customers.

The combination of these two effects result in higher overall net retention. In fact, our annualized net retention for our mid-market and enterprise business exceeds 125% underscoring the significant opportunity we are capturing.

Continuing down the income statement, R&D expenses were $16 million for the quarter, or 13% of revenues, down from 16% in Q2 a year ago and roughly flat with last quarter.

G&A expenses were $15 million for the quarter, or 12% of revenues, roughly flat with Q2 a year ago and last quarter. G&A expenses include investments in our systems to support our future growth and we expect to see more leverage over time.

As we continue realizing leverage, our operating profit was $3.5 million resulting in an operating margin of 2.9%, above the top end of our guidance range of 2.0% to 2.5%. This is up from 1.9% in both Q1 and the year ago quarter.

Net income improved to $3.6 million, compared to $1.5 million in Q2 of last year and $2.1 million last quarter. EPS was four cents, at the high end of our Q2 guidance of two to four cents. Share count was 82 million fully diluted shares.

On a GAAP basis, our Q2 net loss was $7.0 million or a loss of nine cents per share. The difference between our GAAP and non-GAAP results was 13 cents per share, primarily driven by stock-based compensation.

We ended Q2 with cash and short-term investments of $167 million, compared to $150 million at the end of Q1.

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Free cash flow was $3.2 million in Q2, up from $1.9 million in Q1

Now guidance for the third quarter,

- We expect software subscription revenue of $116 to $117 million, or an annual growth of 26% to 27%
- We expect total revenue of $125 to $127 million, or an annual growth of 29% to 31%. Adjusted for the direct phone sales model, growth would be 3 points lower.
- We expect non-GAAP operating margin of 2.5% to 3.0%.
- We expect non-GAAP EPS of $0.03 to $0.05 based on 83 million fully diluted shares.
- The difference between our Q3 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 is difficult to forecast

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

- We are raising our software subscription revenue guidance to $453 to $457 million or an annual growth of 27% to 28%. This is up from our prior guidance of $450 to $456 million.
- We are raising our total revenue guidance to $489 to $496 million, or an annual growth rate of 29% to 31%. This is up from our previous guidance of $486 to $494 million. Adjusted for the direct phone sales model, growth would be about 3 points lower.
- We are raising the non-GAAP operating margin to 2.8% to 3%, from our prior range of 2.5% to 3%.
- We are raising non-GAAP EPS guidance to $0.16 to $0.18, up from $0.14 to $0.18 previously. This is based on fully diluted shares of 82.5 million
- The difference between our 2017 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 is difficult to forecast.
- We are raising our free cash flow guidance to $10 to $14 million, up from $8 to $12 million previously.

For some perspective on our long term business model, on our last earnings call, we discussed 'the rule of 40' which is the sum of revenue growth plus free cash flow margin adding up to at least 40%. Our goal is to deliver results that meet or exceeds that benchmark when we reach our $1 billion target. The levers for this come from several vectors:

1) First, scale in various facets of our business
2) Second, leverage from a higher ramped percentage of upmarket sales force and expanding contribution from our channel partners
3) Third, improved churn and upsell from an increased mix of upmarket and channel within the install base

With these drivers in place we are confident in our ability to deliver a healthy balance of revenue growth and margin expansion over the long term.

One final note before moving on to Q&A, we would like to invite our investor community to attend our second annual user conference, Connect Central on October 24th and 25th in San Francisco. The event is focused on educating and empowering our customers, prospects and partners and will feature some exciting guest speakers. Looking forward to seeing you all there.

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