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

Thank you. Good afternoon and welcome to RingCentral's fourth quarter and full year 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 will 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 deck, comparisons of historical results under 605 and 606 accounting standards, 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 in the slide deck posted 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 fourth quarter and full year earnings conference call.

Our fourth quarter was an outstanding finish to a great year for RingCentral. We extended our lead in the market. Businesses are increasingly taking advantage of our industry leading cloud communications and collaboration solutions. Let me begin by covering some of the key highlights for the last quarter and the year.

First, total revenues for the fourth quarter grew to $141 million dollars. This is a 34% year over year increase and is above the high end of our guidance range. Total revenues for the full year 2017 were $502 million dollars, and 32% year over year growth. Crossing the half a billion dollar revenue mark is a significant milestone for a software-as-a-service company.

Second, the growth in our core subscription business, excluding the impact of AT&T, continued to excel. In Q4 our core subscription revenues of about $115 million, grew 36% year over year, up from 28% in Q4 of last year.

Third, our mid-market and enterprise business continued to lead the way. We define mid-market and enterprise as 50 seats or greater. It is now a $178 million-dollar annualized business. It grew 76% year over year, and contributed over 55% to our new Office business in the quarter, up from 50% in the previous quarter.

Fourth, this quarter we closed a record 15 deals with over $1 million dollars in total contract value. This is up from 10 deals in the previous quarter and 5 deals at year ago. These wins highlight the significant progress we have made last year with enterprise customers.

Fifth, as the market transitions from on-premise solutions to the cloud, channel partners are increasingly gravitating toward cloud providers. We are benefiting from this shift. Our channel partners capped off the year by delivering another stellar quarter of growth. For the seventh quarter in a row our channel partner bookings grew by over 100% year over year. Channel partners contributed over 35% of our overall bookings in the quarter. This is up from about 20% last year and 30% last quarter.

Finally, I want to provide you with an update on our AT&T business. In January of this year, we acquired all RingCentral Office@Hand by AT&T accounts. The transitioning of these customers to RingCentral Office has commenced, and is expected to be completed over the next twelve months.

It is clear that cloud is winning and RingCentral is winning in the cloud.

The shift to the cloud is ubiquitous. Cloud players are gaining share from legacy with a few pure cloud providers vying for the $50 billion dollar plus market disruption opportunity. We continue to significantly outpace in the cloud. Last year we grew twice as fast as the number two company in this space on a business that is almost twice as large. And we win across all segments. Casting our mid-market and enterprise business as customers with over $1,000 MRR, in Q4 ours was a $219 million dollar business, growing at over 60% year over year. This is twice their growth rate and it is on a meaningfully larger base.

The reason we are winning is because of our relentless focus and commitment to innovation. Our investments in innovation over the last several years have created a well differentiated platform. To recap, we offer:

1) leading collaborative communications suite offering unified experience of comprehensive cloud PBX and fully featured team messaging
2) industry leading open platform with a rich app gallery. In fact, I encourage you to go to apps.ringcentral.com and see for yourself. We now have over 1,000 standard and custom applications integrated with our open platform. And we have a fast growing community of over 10,000 developers building efficient enterprise workflows using our platform.

3) best in class user experience with integrated contact center, web meetings and video conferencing
4) world class delivery capabilities offering native experience in 37 countries for global multinational enterprises

In summary, it was a great finish to an outstanding year. We are now a half billion dollars recurring revenue company with industry leading growth. We continue to extend our lead in the market with excellent traction in all segments, especially mid-market and enterprise.

We believe we are well positioned for success. We look forward to an exciting year ahead and to crossing the $1 billion dollar mark in 2020.

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

David D. Sipes, RingCentral, Inc. - COO

Thank you, Vlad for highlighting the success we had in the quarter and the year.

The momentum we are seeing spans across all segments, especially in the mid-market and enterprise. This is the result of our commitment to innovation and customer success. To that end, in Q4 we completed our previously stated goal of establishing local enterprise sales force presence in major cities across the U.S., Canada and the UK. But this is just the start our Enterprise expansion. The 15, million dollar plus TCV deals that Vlad mentioned demonstrates the success we are experiencing in this segment. We will continue to aggressively grow our enterprise direct sales presence to capture the large cloud opportunity at hand and to further cement our market leadership.

We are winning with our integrated communication, collaboration and contact center solutions which are differentiated by our mobile-first user experience, open platform and global coverage. Our market leading product suite helped us close numerous significant deals in the quarter. Let me give you some color on just a few of our wins.

Our global presence continues to grow. I'll start with a seven figure deal we won with Ladbrokes Coral, the largest provider of betting and gaming services in the UK. Ladbrokes Coral was migrating off their legacy platforms and was looking for a best in class cloud based solution. What set RingCentral apart from the competition was our tight integrations with Google and Salesforce and the ability to scale up to thousands of locations quickly and easily. When fully deployed, Ladbrokes Coral will have 6,000 users.

Our integrated contact center continued to be a strategic differentiator for us. It has helped us win significant deals during the quarter including 6, of our million dollar plus TCV deals. For example, in Q4 a leading healthcare technology service provider wanted to replace their legacy systems with cloud communication solutions. They chose RingCentral because of our ability to deliver a best in class integrated contact center and communication solution. When fully deployed, this customer will have over 700 seats of RingCentral Contact Center and over 1,000 seats of RingCentral Office. This deal is worth approximately $7 million in TCV.

As Vlad mentioned, our channel partners continue to be key contributors to our success. A great example of our success in the channel was a win of the largest RE/MAX real estate franchisee in the country, RE/MAX Results. This customer needed a flexible solution that allowed it to communicate from any location and in any mode, to make its employees more productive. The customer was also focused on providing superior user experience and flexible integration capabilities, key differentiators for RingCentral. When fully deployed, RE/MAX Results will have 1,000 seats of RingCentral Office.

Helping bolster our success in financial services this quarter, we achieved compliance with FINRA cyber security controls for cloud service providers. This helped us win FirstBank, a Midwest financial services provider. FirstBank was looking to replace their legacy provider with a cloud solution. What differentiated RingCentral was the full scope of our offering: our collaborative communication capabilities with Glip, our integration capabilities with popular applications like ServiceNow, and our best in class integrated contact center solution. When fully deployed, FirstBank will have over 1,000 seats combined of Office and contact center over multiple locations. Additionally, within the quarter, we had two more new customer wins in financial services that exceeded $1 million in TCV each.

In addition to our success with new customers, we continue to progress with our land and expand strategy. Avery Dennison, a global leader in adhesive and packaging technologies, started with less than 100 seats. With the success achieved by the customer with the initial installation, Avery has expanded globally to more than 1,000 seats in multiple countries and has added contact center capabilities.

Another example of our land and expand is Sofi, an online personal finance company. They wanted to find an innovative cloud solution with advanced integration capabilities delivering high reliability and security. Sofi initially signed up for 800

RingCentral Office users in Q1 of 2017 and has since nearly doubled its deployment of RingCentral to over 1,500 seats.

Our mid market and Enterprise growth and large deal success contributed to a great quarter, finishing up an excellent year. We see robust addition of new logos as well as existing customers buying more. With our unwavering commitment to innovation and customer success we believe that we are well positioned to expand our lead in the industry.

Lastly, I'd like to invite you to join us at our RingCentral keynote presentation at Enterprise Connect in Orlando on March 14th to see some of our exciting product developments.

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

Mitesh Dhruv RingCentral, Inc. – CFO

Thanks Dave, good afternoon everyone.

On the call today, I will cover key financial results, growth drivers, the impact of ASC 606, and guidance for 2018.

Our Q4 and FY17 results are under the historical 605 accounting standard. Guidance for 2018 will be under ASC 606. We are adopting 606 starting Jan 1' 2018 under the full retrospective method and have provided comparative numbers for 2016 and 2017 in the earnings deck posted on our IR website.

In addition, 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 and in the earnings deck.

With that, let me move on to our results.

We were very pleased with our ability to once again exceed expectations across all of our key financial metrics during the quarter.

We delivered total revenue and EPS above the high end of our guidance range. In Q4, our subscription revenue grew 32% year over year to $130 million. Normalizing for the impact of AT&T, our core subscription revenue growth rate was 36%, up from 28% in Q4 of last year. More historical data on our core growth trends is contained in our earnings slide deck.

Total annualized exit recurring subscriptions (or ARR) grew to $546 million, up 32% year-over-year and 6% sequentially. ARR for RingCentral Office grew to $466 million, up 36% year-over-year and 7% sequentially. In the first quarter of 2018, we anticipate our total ARR to increase in the range of 6% to 7% sequentially. This is in line with historical trends, although at a much higher level of revenue.

As Vlad mentioned, the key growth driver for RingCentral continues to be our expansion to mid-market and enterprise customers, supported by momentum in channel. This expansion has multiple positive impacts to our business.

First land and expand:

In Q4, we yet again saw strong performance in new bookings from our existing customers. Upsells represented over 40% of the new business mix in the quarter.

Second reduction in churn rate:

The gross churn for upmarket customers was less than half of the overall Office rate. With the increasing mix of upmarket customers in our base, our annual gross churn rate for Office improved by one full percentage point to 10% in 2017.

The combination of strong upsell and lower gross churn resulted in higher overall net retention. In fact, our annualized net retention for mid-market and enterprise business was about 130%, underscoring the significant opportunity we are capturing.

Last year we used million dollar TCV deals as an approximation of our progress in the enterprise segment. In Q4 we had a record 15 seven figure TCV deals, up from 10 in Q3 and 5 a year ago. Now as the enterprise segment is becoming a more meaningful component of our bookings and revenues, we would like to provide a more comprehensive measure of our progress. To that end, as we mentioned last quarter, we will be providing a dollar based enterprise metric defined as all customers with ARR more than $100K dollars.

Exiting Q4'17 these customers represented an $86 million dollar business that grew more than 110% year over year.

We saw this momentum reflected in our Q4 results:

Total revenue for the fourth quarter grew 34% to $141 million. The growth was driven by our mid-market and enterprise business. Adjusting to the direct phone sales model resulted in a 3-point tailwind to our total revenue growth but had no impact on our subscription growth.

Operating margin was 3.9%, at the high end of our guidance range of 3.5% to 4.0%.

Moving on to full-year 2017 results:

Subscription revenue grew 30% to $463 million. Total Revenue grew 32% to $502 million. Adjusting to the direct phone sales model resulted in a 3-point tailwind to our total revenue growth but had no impact on our subscription growth.

Non-GAAP operating margin expanded 130 basis points year over year. The improvement demonstrates the inherent leverage in our operating model as the business continues to scale.

Cash flow from operations increased to $41 million, up from $30 million in 2016. Capex in 2017 was $27 million or approximately 5% of revenue. In 2018, we expect capex as a percent of revenue to increase by a point as we expand our infrastructure to support growth initiatives.

Now for an update on AT&T:

As Vlad mentioned earlier, we are transitioning all Office@Hand by AT&T customers to a direct billing and account relationship with RingCentral. This transition has no impact on our revenue accounting for these customers.

We’re confident in delivering continuous and incremental value to these customers over time. For planning purposes, we have made conservative assumptions that factor in normalized churn as well as potential incremental churn from migration. Also, consistent with last year, we have assumed no new incremental business from these customers.

Before giving guidance for 2018, let's cover the impact from ASC 606:

The adoption of 606 drives two primary changes. The first change is to our revenue treatment. Under the 606 standard, certain discounts will be amortized over the life of the contract. Overall, the impact of this change is immaterial to our revenue and year over year growth.

The more significant change relates to the treatment of sales commission costs. Previously we expensed all commissions as incurred. Under the 606 standard, certain sales commissions will be capitalized and amortized over the expected customer life. The impact of this change will result in approximately a 4-point decrease to sales and marketing expense as a percent of revenue.

As a reminder, this new standard is an accounting change only. It has no impact on our operating or free cash flow.

Turning to our outlook:

As I mentioned earlier, our guidance is under the new 606 standard.

For 2018, we expect subscription revenue between $581 and $589 million, or an annual growth rate of 25% to 27%. Excluding the impact of AT&T, we expect core subscription revenue to grow 31% to 33%. The relative impact of AT&T on our overall growth will begin to abate in 2019 as our revenue base gets larger and AT&T compares normalize.

We expect total revenue between $629 and $639 million, or an annual growth rate of 25% to 27%.

We expect non-GAAP operating margin of 7.8% to 8.2%. Our guidance includes about a four-point tailwind from the adoption of the 606 standard. Removing that impact, we expect 75 to 100 basis points of underlying margin expansion, consistent with our earlier outlook.

We expect non-GAAP EPS of $0.56 to $0.60 based on 86.5 million fully diluted shares. The difference between GAAP and non-GAAP EPS is expected to include $0.82 of stock-based compensation and $0.06 of amortization of acquired intangibles. We do not forecast any effects of currency remeasurement, which could be a significant reconciling item between GAAP and non-GAAP EPS, because it is difficult to predict and subject to constant change.

Now outlook for the first quarter of 2018:

We expect subscription revenue between $134 and $135 million, or an annual growth of 29% to 30%. Excluding the impact of AT&T, we expect our core subscription revenue to grow 33% to 35%.

We expect total revenue between $144.5 and $146.5 million, or an annual growth rate of 29% to 31%.

We expect non-GAAP operating margin of 7.0% to 7.6%.

We expect non-GAAP EPS of $0.11 to $0.13 cents based on 85 million fully diluted shares. The difference between GAAP and non-GAAP EPS is expected to include $0.18 of stock-based compensation and $0.01 of amortization of acquired intangibles. Again, we do not forecast any effects of currency remeasurement.

You can find our Q1 and fiscal 2018 guidance details in our press release and our earnings deck.

In summary, we continue to execute well, delivering strong results in 2017. As a testament to our industry leadership, our core growth improved on a larger base. We are excited for 2018 as we continue capturing market share from legacy providers while distancing ourselves from cloud competitors.

Last but not least, I'm happy to announce that we will be holding our second Investor Day on June 14th in New York. More details will be available soon and we look forward to seeing you there.

With that, let me turn the call to the operator for Q/A