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

Thank you. Good afternoon and welcome to RingCentral's first quarter 2018 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, Dave 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, 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.

RingCentral®

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

Good afternoon and thank you for joining our first quarter earnings conference call.

First quarter results were excellent. Q1 showed outstanding revenue growth, operating profit and EPS performance. Our core subscription business accelerated as mid-market and enterprise customers continued to adopt our industry-leading cloud communication solutions. Our channel partners delivered another strong quarter of growth. And, we set the stage for continued growth by announcing innovative new products. Let me begin by covering some of the key highlights of the quarter.

First, total revenues for the first quarter grew to $150 million dollars. This is a 34% year-over-year increase, up from 30% in the year-ago quarter and above the high end of our guidance range.

Second, our core subscription business, excluding AT&T, accelerated even faster. In Q1, our core subscription revenues of $125 million grew 37% year over year, up from 32% in first quarter of last year.

Third, our mid-market and enterprise business had another outstanding quarter. We define mid-market and enterprise as 50 seats or greater. This is now an over $200-million-dollar business that grew 77% year-over-year.

Now for something really exciting. Last quarter we introduced a new enterprise business metric. We define enterprises as customers with $100,000 or more in annual recurring revenue, or ARR. This quarter, our enterprise business ARR crossed $100 million dollars and grew more than 110% year over year.

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

Legacy players' struggles are mounting. They are consolidating. They are going private. Legacy systems simply cannot effectively meet the modern communication and collaboration needs of mobile and globally distributed workforces.

Nowhere was this more apparent than at last Enterprise Connect, the leading conference for enterprise communications and collaboration. We believe many of you who attended the conference would have noticed that RingCentral had the most extensive presence at the show.

This year at Enterprise Connect, just as last year, legacy players gave lip service to the cloud. However, their solutions are still tethered in their on-premise history. While the competition talks about the cloud, *we* continue to deliver. This quarter, we launched three new innovative products: RingCentral Collaborative Contact Center, RingCentral Pulse and Collaborative Meetings.

RingCentral Collaborative Contact Center is a differentiated solution that synchronizes contact center agent groups with Glip teams.

RingCentral Pulse provides intelligent service bots that monitor critical call center metrics in real time. It sends automated alerts and notifications directly to Glip teams. This enables agents and supervisors to communicate and collaborate across their organizations in real time to resolve customer issues efficiently.

Finally, RingCentral Collaborative Meetings delivers integrated team messaging and video conferencing to enable a well differentiated and productive meeting experience.

Innovations like these further reinforce our industry leadership position. There are only a handful of scaled up pure-play cloud companies in the market, and we are the clear leader. Last year RingCentral grew twice as fast as the number two company in our space on a business that is nearly twice as large.

I am pleased with our first quarter results. Our core business strengthened. We extended our leadership position in the cloud with excellent traction in the mid-market and enterprise business. And, we enhanced our platform with new and innovative solutions.

The future looks bright. We are still in the early stages of this $50 billion plus opportunity. And as the industry leader, RingCentral is in prime position to benefit as the on-premise market continues its transition to the cloud. With a great start to this year, we are well on the way to our billion-dollar target by 2020.

Now, for some color, I will turn the call over to our Chief Operating Officer, Dave Sipes.

Dave D. Sipes, RingCentral, Inc. - COO

Thank you, Vlad.

We definitely had great results across our business. This was led by mid-market and enterprise customers. In our enterprise business we saw triple digit year over year growth and crossed the 100 million dollar milestone in ARR. The keys to our growth have been the investments we are making in our technology platform, the field enterprise sales force and the channel partner network. We continued to expand our channel reach this quarter by signing up additional partners including another major Avaya reseller. Our global expansion continues as well and this quarter we opened a new sales office in Australia where we already signed new channel partners.

Our success begins with our commitment to innovation. 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.

For example, Citizen, a global watch manufacturer and distributor, was using multiple communication and contact center systems to manage their business. The company wanted to unify this to a single cloud platform. They chose to deploy our integrated RingCentral Office and RingCentral Contact Center solution. A key differentiator for us in this win was our recently announced Collaborative Contact Center featuring our innovative RingCentral Pulse technology. We won this with a channel partner and replaced two legacy vendors and one cloud vendor.

This quarter, one of our most significant wins came from Corporate Travel Management North America, a leading corporate travel management services company. They chose RingCentral for its best in class communication and contact center on a unified platform with unified support.

Our integrated team messaging capability sets us apart in the marketplace. It was key to an enterprise win with a leading company in the education space. They chose RingCentral and plans to standardize on Glip as the primary communication application for seamless integration of voice, video and messaging capabilities. This is just one example. We saw many customers across all segments who site our integrated team messaging and communication solution as a key decision factor for choosing RingCentral.

Our expanding global coverage continues to be a compelling differentiator for us as well. This quarter a large financial services organization was looking to transition off multiple legacy providers across multiple countries. They chose RingCentral for our global coverage which greatly simplifies multi-country deployments, eliminating the need for multiple carriers and hardware deployments to manage. Their initial deployment will cover four countries with future potential to expand to more.

Another key differentiator is our open developer platform. This quarter, Procore, a provider of applications for the construction industry needed a solution that would span globally across their business and would easily integrate with their other cloud applications. They chose RingCentral because of our integrations with Google G Suite and Okta and our global office capabilities. This deal was also won with a channel partner.

And many of our enterprise customers are just beginning with us. While they initially deploy RingCentral in a few offices or a region, they typically have a much larger employee base. Over 40% of our new business comes from existing customers.

For example, AssuredPartners is a fast-growing national insurance agency with numerous offices across the country. They had multiple legacy systems which were complicated to manage. We won this account with a leading channel partner. They started with about 500 seats of RingCentral across a few offices. The users liked the expanded capabilities of the RingCentral solution. Additionally, administrators were impressed with the significant benefits of centrally deploying and managing the solution. This quarter AssuredPartners decided to standardize on RingCentral across their organization and contracted to add an additional 4,000 seats.

In summary, we are differentiated on our integrated communication, collaboration, and contact center platform, our global coverage, and our open developer ecosystem. Our market-leading product suite helped us win significant deals from new customers as well as existing customers. We are committed to innovation and customer success and we believe that we are well positioned to expand our lead in the industry.

Now, for some color on the financials, I will turn the call over to our Chief Financial Officer Mitesh Dhruv.

Mitesh Dhruv RingCentral, Inc. – CFO

Thanks Dave and 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, that provides the key points in our call today and some supplemental information.

We have adopted 606 starting Jan 1’ 2018 under the full retrospective method and have provided comparative numbers for comparable periods for 2017 in the slide deck and press release.

Unless otherwise indicated, all measures that follow are non-GAAP with year-over-year comparisons. A reconciliation of all GAAP to Non-GAAP results is provided with our earnings press release and in the slide deck.

With that, let’s move on to the results.

We had a solid start to 2018, with all our key financial metrics beating the high end of our guidance. Our performance was driven by our mid-market and enterprise customers and continuing momentum with our reseller partners.

Our core subscription revenue growth accelerated, and we translated that momentum into strong profitability.

In Q1, our subscription revenue grew 32% year over year to $137 million, up from 30% a year ago. Normalizing for AT&T, core subscription revenue grew 37%, up from 32% a year ago and up from 36% last quarter. For more historical data on our core growth trends, see our earnings slide deck.

Total annualized exit recurring subscriptions, or ARR, grew to $589 million, up 31% year over year and 8% sequentially, up from 6% sequential growth in Q4. ARR for RingCentral Office grew to $509 million, up 37% year over year and 9% sequentially.

Our mid-market and enterprise business led the way again. It is now over $200 million dollars business, and grew 77% year over year. Our enterprise business represented half of this business, over $100 million growing in triple digits. Mid-market and Enterprise business also contributed over 50% of new sales for RingCentral Office, up from 40% last year.

Our channel partners delivered another outstanding quarter of growth. ARR from our channel partner business is now over $115 million dollars and it grew nearly 100% year over year.

Our focus on mid-market and enterprise customers and on working with channel partners yields many benefits.

First -- lower churn.

Mid-market and enterprise customers have less than half the gross churn rate of small business customers. In addition, customers acquired through a channel partner also have less than half the gross churn of customers than purchased direct. These trends brought record low churn in Q1.

Second, these customers seed our land and expand pipeline.

Typically, customers begin transitioning to cloud communications by purchasing RingCentral for just a portion of their employees and not all products. This presents a significant opportunity to upsell as adoption of cloud communications grows within the customer's business. Once again over 40% of our new office business came from existing customers.

The combination of these positive indicators drove robust net retention in Q1.

Moving on to the financials

Q1 was strong across revenue and margins.

Total revenue for the first quarter increased 34% to $150 million.

Subscription gross margin was a record 82.8%, up 140 basis points year over year. I would note that we benefited from some one time catch up payments, totaling a little less than a point.

Operating margin was 8.6%, resulting from our strong top line and gross margin performance.

We ended the quarter with $555 million in cash, an increase of $374 million from Q4. This increase reflects the net proceeds from our recent zero percent convertible debt offering.

Now for an update on AT&T:

Last quarter we announced that we would transition all Office@Hand by AT&T customers to a direct billing and account relationship with RingCentral.

The customer transition is progressing. It is early in the process but for the customers that have migrated, we are seeing high levels of customer satisfaction. For guidance purposes, however, we continue to make conservative assumptions that factor in normalized churn as well as potential incremental churn from migration. Consistent with last year, we continue to assume no new incremental business from these customers.

Turning to our outlook:

We are increasing our 2018 outlook driven by strong Q1 results and the benefits that will carry throughout the year.

We expect subscription revenue between $588 and $594 million, for an annual growth rate of 26% to 28%.

Excluding the impact of AT&T, we expect core subscription revenue to grow 32% to 34%. 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 $638 and $647 million, for an annual growth rate of 27% to 28%.

We expect non-GAAP operating margin of 8.1% to 8.3%.

We expect non-GAAP EPS of $0.61 to $0.65 cents based on 86.0 million fully diluted shares. The difference between GAAP and non-GAAP EPS is expected to include $0.83 of stock-based compensation, $0.19 of amortization of debt discount relating to our convert 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 for Q2 guidance

In the second quarter, we expect subscription revenue between $142.5 and $143.5 million, for an annual growth rate of 28% to 29%.

We expect our core subscription revenue to grow 34% to 35%.

We expect total revenue between $154.5 and $156.5 million, for annual growth of 29% to 31%.

We expect non-GAAP operating margin of 7.5% to 8.0%.

We expect non-GAAP EPS of $0.14 to $0.16 cents based on 85 million fully diluted shares. The difference between GAAP and non-GAAP EPS is expected to include $0.21 of stock-based compensation, $0.06 of amortization of debt discount and $0.02 of amortization of acquired intangibles. Again, we do not forecast any effects of currency remeasurement.

You can find all of our guidance details in our press release and our earnings deck.

In summary, we are pleased with the performance of our business, led by traction in the mid-market, enterprise, and the channel and expect a solid year ahead.

Finally, we are excited to invite you to our RingCentral Investor Day in New York on Thursday, June 14th. Please join us as we outline the state of our business today and where it's headed tomorrow. You'll hear updates on strategy, innovation, and vision for the future. You'll also hear directly from RingCentral customers and partners. We look forward to seeing you there.

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