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Ryan Goodman, RingCentral, Inc. – Director of Investor Relations

Thank you. Good afternoon and welcome to RingCentral's fourth quarter 2018 earnings conference call. I am Ryan Goodman, RingCentral's 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, 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.

We adopted ASC 606 as of January 1, 2018 under the full retrospective method. We have provided comparative numbers for the respective periods of 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 release and in the slide deck.

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 earnings conference call.

Fourth quarter was an outstanding finish to a great year for RingCentral. We saw no slowdown in momentum and we believe we further distanced ourselves from our competition.

Revenue, operating margin, and non-GAAP EPS all exceeded the high-end of our guidance. The performance in the quarter was driven by strong execution in the mid-market and enterprise business, combined with continued momentum with our channel partners.

We closed a record number of seven-digit TCV deals in Q4, bringing the year's total to approximately 80 such deals.

I'm also excited to announce that we secured our first eight-figure TCV deal in Q4. We are seeing enterprises of all sizes moving to the cloud.

Let me cover some of the key metrics for Q4.

1. First, total revenues grew to $189 million. This is a 34% increase year-over-year and above the high-end of our guidance range.
2. Second, our core subscription revenue, normalizing for the legacy AT&T base, grew 38% year-over-year, up from 36% in the same quarter last year.
3. Third, mid-market and enterprise business continued to be a key driver of our outperformance. We define mid-market and enterprise as 50 seats or greater. This grew 73% year-over-year and is now a $309 million annualized business. Our enterprise business, defined as customers with $100,000 or more in annual recurring revenue, or ARR, nearly doubled year-over-year to $171 million.
4. Fourth, our channel business grew over 80% year-over-year to over $180 million, with channel contributing a record number of seven-digit TCV deals for the quarter.

We are seeing that dollars are shifting toward cloud communication solutions from legacy vendors in this $50 billion market. This is consistent with the recent report published by Gartner titled "Cloud-Based Unified Communications and Contact Center Momentum is Refocusing Our Magic Quadrant Research for 2019." It states that "By 2022, four cloud-based UCaaS seat licenses will be sold for every premises-based UC license, driven by an expanding list of capabilities in UCaaS solutions." Workplace communications have become more mobile, distributed, and global.

Cloud now surpasses legacy solutions across a broad range of parameters. It is clear that the cloud is winning, and RingCentral is winning in the cloud.

As we look to service the broadening demands of the mid-market and enterprise customers, we continue to drive product innovation and portfolio expansion. At our user conference in November, we made three key announcements. One, we launched our new unified mobile app, with integrated team messaging, voice, and video seamlessly combined into a single application. This is well-differentiated in the industry. Two, we launched RingCentral Engage, our digital customer engagement platform based on our acquisition of Dimelo. And three, we announced new artificial intelligence partnerships leveraging our open platform to enable real-time and post-call voice analytics.

To build on that momentum, last month we announced the acquisition of Connect First, adding an important product to our customer engagement portfolio. It now includes RingCentral Contact Center for inbound communications and Workforce Optimization, RingCentral Engage for digital customer engagement, and Connect First for outbound/blended customer interactions. We believe our strong customer engagement portfolio provides customers with transformative and differentiated experiences and will accelerate customer transition to the cloud.

As we look ahead to 2019, our commitment to customer success is steadfast. We will continue to rapidly innovate and out-innovate our competition. Our industry leading cloud communications and collaboration solutions, combined with our world class customer support, create a widening gap and deepening moat

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between us and our competitors. We believe that we are well-positioned to achieve our goal of exceeding $1 billion in revenue in 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. It was a great quarter and we are pleased with the continued strength in our mid-market and enterprise business. We attribute the strength to our efforts in expanding go to market capabilities, our rapid pace of product innovation, and our success with land and expand.

On the GTM front, we are focused on three key areas driving our success: 1) expanding direct sales reach; 2) growing the channel; and 3) pushing ahead with our targeted verticals industry program.

First, throughout 2018, we further densified our direct enterprise salesforces across major US, UK, and Canada metro markets as well as expanding in France and Australia.

An example of continued international momentum in the UK was our Q3 win with the Financial Times, which we have now followed in Q4, with a seven-figure plus TCV win with a second major news and media organization. This new customer had a past experience with disruptive events shutting down their legacy on-premise system. Our highly fault tolerant, distributed, and mobile-first cloud architecture was critical in addressing their unique business continuity needs. Furthermore, our Global Office and open platform integrations with Google G Suite and other cloud applications were also key in securing this win.

Second, we increased our coverage in the channel with strong growth in new partners. Channel contributed more than 70% of our seven-figure wins in Q4. In addition, we announced re-engagement with AT&T in late 2018. We have initiated enablement and training of their salesforce. We are encouraged with our progress to date and look forward to growing this partnership in 2019.

Third, we increased our GTM focus on vertical industries initially targeted at Financial, Healthcare, and SLED. In fact, in Q4, we had several seven-figure wins in each of these verticals, comprising more than 30% of our seven-figure TCV deals.

An example of a win in SLED is our recent announcement of our largest deal ever, Columbia University. Columbia selected our cloud solutions to support 44,000 faculty, staff and students. We will deploy 14,000 seats of RingCentral Office for the faculty and staff, and we will roll out team messaging to 30,000 students. We are thrilled to be chosen by Columbia University as they modernize their communications infrastructure across the entire institution.

In terms of product innovation, key focus areas include high availability, mobility and collaboration, a differentiated open platform, Global Office, and integrated contact center.

Our high availability platform and unified app with integrated collaboration capabilities were critical in securing a win with the Golden State Warriors. RingCentral will power all of the Warriors' business communications, including the new Chase Center Arena. RingCentral beat out a well-known legacy provider in the process. This is a clear example of the cloud winning, and RingCentral winning in the cloud.

We continued to expand our open platform and Global Office capabilities. The number of registered developers on our platform is now close to 20 thousand, and we have approximately 2,000 certified app integrations. Last quarter we added several countries to Global Office, bringing total count of Global Office countries to over 40.

A good example of an enterprise leveraging our platform and Global Office capabilities was our 3,000 seat win with Copart, a provider of online vehicle auctions. They will use our open APIs to create custom workflows that will allow them to improve efficiencies in their yards. Our Global Office capabilities were paramount as they need to deploy across locations in EMEA, Asia Pacific, and Latin America. This customer was brought to us by one of our new enterprise focused national channel partners.

We also continued our strong momentum with Contact Center, securing a 1 thousand seat win with a large cloud software applications provider. Our strong omnichannel capabilities, integrations with multiple cloud enterprise applications, and end-to-end QoS analytics were all key to winning.

Last, but not least, our land and expand strategy is working. A good example is Heartland Dental, one of the nation's largest dental support organizations. After winning their business in late 2017, we had 4,000 seats deployed. In Q4, the customer expanded the deployment plan to 6,000 seats.

I also want to give a brief update on RingCentral Engage, a product based on our Dimelo acquisition that we are now beginning to integrate with our core platform.

We are happy to see Dimelo expanding their relationship with SFR, a large telco in France. SFR was able to consolidate multiple digital channels into one integrated customer engagement platform with Dimelo. Dimelo also expanded its relationship with La Redoute, a large 180-year old French apparel and hardgoods retailer, helping them through their digital transformation. La Redoute began working with Dimelo in early 2018 and is now supporting 7 digital channels, including Apple Business Chat.

In summary, Q4 was a great quarter with continued strength in our GTM and product portfolio capabilities, including our first 8-figure TCV customer deal and a thousand seat contact center win. With this momentum, we look forward to extending our market leadership in 2019.

Now for 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.

2018 was another good year. We exited with a revenue run-rate of over $750 million. Our growth rate was 34% and our operating margin was approximately 9%. We are executing above the Rule of 40, a combination of revenue growth and operating margin. We believe that the Rule of 40 is a key metric to evaluate profitable growth across SaaS companies and is a high bar we will strive to sustain.

Our fourth quarter capped the year with strong performance on all key financial metrics. Total ARR grew to $726 million, up 33% year-over-year, and ARR for RingCentral Office grew to $644 million, up 38% year-over-year.

Key drivers continue to be mid-market and enterprise with strong contribution from channel partners.

Mid-market and enterprise had another stand-out quarter, with ARR up 73% year-over-year to $309 million. Enterprise ARR nearly doubled again to $171 million.

We also secured a record number of seven-digit TCV deals, including one eight-figure deal. In fact, the average deal size of our million dollar deals increased more than 40% year-over-year. This was a combination of both higher ARR and longer contracts. In other words, with our highest value customers, we're seeing growth in number of wins, the wins are getting larger, and the contract durations are expanding.

This expansion in mid-market and enterprise has multiple positive impacts to our overall business.

First, higher upsell. We yet again saw strong performance in new bookings from our existing customers. This represented over 40% of the new business mix in the quarter.

Second, reduction in churn. In 2018, annualized Office gross churn for the first time dipped below 10%. This was driven by mix shift toward larger customers as mid market and enterprise churn is half of the small business churn.

In terms of mid-market and enterprise metrics, in 2018, we introduced the enterprise metric defined as customers with greater than $100 thousand ARR. We are considering a similar dollar-based metric for mid-market. Dollar-based metrics provide more transparency to investors as they better reflect our expanding product portfolio.

Moving on to the channel. In line with our philosophy of profitable growth, we are laser focused on both the growth economics and the growth itself. To that end, we are happy to see strong growth in our channel business. As relates to channel economics, we see favorable dynamics versus direct. Channel's lower cost to book and lower churn more than offset longer-term residual costs. Faster time to breakeven is an extra benefit.

Simply put, even after cost to book and residuals, channel delivers higher cumulative contribution profit.

Now I'll briefly go through the Q4 financials, and then onto the 2019 outlook.

Total revenue grew 34% to $189 million.

Subscription revenue grew 32% and core subscription revenue, which normalizes for the legacy AT&T base, grew 38%. A bit of housekeeping on the AT&T metric. As we discussed lasted quarter, due to the terms in our revised AT&T agreement, going forward we will only be able to provide overall subscription revenue. We will continue to provide color on AT&T, as appropriate.

Subscription gross margin was 83.3%, up over a point year-over-year as we continue to achieve benefits of scale.

Non-GAAP operating margin of 9.2% was also up over a point year-over-year and well ahead of our guidance driven primarily by the revenue upside.

Now let's turn to our outlook.

For 2019, we expect total revenue to be between $847 million and $859 million for an annual growth of 26% to 28%. We expect non-GAAP EPS of $0.69 to $0.73.

In summary, we finished 2018 with strong momentum across go-to-market execution, product innovation, and financial metrics. Looking ahead, we are well-positioned to continue taking market share from legacy on-premise vendors as well as further extending our lead over cloud competitors. We expect channel and enterprise tailwinds to continue, bolstered by an expanding international footprint and our targeted vertical go-to-market programs.

Longer-term, we see incremental opportunities with our re-established AT&T relationship and our expanded customer engagement product portfolio.

With that as a backdrop, we are confident we will achieve our goal of exceeding both the Rule of 40 and $1 billion in revenue in 2020.

Now, let me turn the call to the operator for Q&A.

Disclaimer: Gartner, Inc., Cloud-Based Unified Communications and Contact Center Momentum Is Refocusing Our Magic Quadrant Research for 2019, January 11, 2019. The Gartner Report described herein, (the "Gartner Report") represent(s) research opinion or viewpoints published, as part of a syndicated subscription service, by Gartner, Inc. ("Gartner"), and are not representations of fact. Each Gartner Report speaks as of its original publication date (and not as of the date of this earnings calls, and the opinions expressed in the Gartner Reports are subject to change without notice.