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

Thank you. Good afternoon and welcome to RingCentral's second 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, 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.

In addition, we would like to invite you to tune in on Wednesday, September 5th when we will be celebrating the 5th anniversary of RingCentral's IPO by ringing the closing bell at the New York Stock Exchange.

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.

As Paul mentioned, today we're celebrating our 20th quarterly report as a public company. We're proud of our unbroken record of meeting and exceeding investors' expectations for this entire stretch. Q2 was no exception. We had an outstanding quarter. This was led by continuing strength in our mid-market and enterprise business, and momentum with our channel partners.

I'll begin by covering some of the key highlights of the quarter.

First, total revenues for the second quarter grew to $161 million. This is a 34% increase year-over-year, up from 30% in the year-ago quarter. This was above the high end of our guidance range.

Second, our core subscription business excluding AT&T continued its strong performance. Core subscription revenue grew 37% year-over-year, up from 32% in the same quarter last year.

Third, mid-market and enterprise business showed excellent results. We define mid-market and enterprise as 50 seats or greater. This grew 80% year-over-year and is now a $237 million business. Our enterprise business, defined as customers with $100,000 dollars or more in annual recurring revenue or ARR, grew over 110% year-over-year. It is now over $120 million dollars.

Fourth, we saw strong performance in Europe. We won a number of large deals in the U.K. and France. We are pleased with the momentum we are seeing in the region.

Finally, our channel partners continue to deliver impressive growth. This quarter our channel business grew over 100% year-over-year to $139 million. We are seeing more of our partners choose to lead with RingCentral solutions.

Cloud is winning, and RingCentral is winning in the cloud. Cloud is winning because legacy phone systems, designed for fixed locations and supporting voice-only communications, no longer meet needs of modern mobile and distributed workforces. RingCentral, in our view, is winning in the cloud because of our relentless focus on innovation. These investments drive new, well-differentiated capabilities that bolster our industry leadership.

Our investment in innovation resonates with our customers. Customers choose RingCentral as much more than legacy, land-line voice replacement. We shared data at our recent Investor Day on our platform capabilities that influenced the purchasing decision of our top 15 customers. Mobility, team messaging, video, contact center and open platform were all critical considerations. This is the most important aspect of our strategy. Our industry-leading cloud communication solutions allow businesses to completely re-imagine their internal and external communications and work-flows. And numbers speak for themselves. While voice usage grew a healthy 40% year-over-year in 2017, the other modes of communication like team messaging, video and third party API calls all grew at over 100% year-over-year.

This quarter the story continued. Our largest wins in the quarter were again influenced by customers wanting an integrated solution that offers mobility, team messaging, video, contact center, open platform and more. Our COO Dave Sipes will add more color to this and some of my other preceding comments.

Our technology leadership and differentiation is being similarly recognized by leading industry analysts and associations. As we mentioned in our press release, we won several awards recently. These include recognition of Glip as a team messaging industry leader because of its mobile first design, best-in-class user experience and ability to serve as a digital communications hub to increase workforce productivity, as well as recognition of our open platform for technical innovation, adoption and reception by the developer community.

We are continuing to invest and widen the moat between us and the rest of the field. With a growing lead in the cloud communications industry and the large underpenetrated market opportunity ahead, RingCentral is 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. We are pleased with the results of the quarter and the momentum we saw in our mid-market and enterprise business.

Our sales growth is being fueled by our growing scale, as well as our expertise and maturity across all of our sales channels. In our Enterprise segment we continue to densify across the major metros or NFL cities and we are expanding internationally. Additionally, our Enterprise segment efficiencies are improving even as we are scaling the team. Mitesh will go into more detail on that point later.

Earlier Vlad mentioned the numerous reasons customers choose RingCentral. Let me walk through just a few customer win examples from our second quarter. I'll highlight the critical capabilities that helped secure these wins like ease of deployment, integrated contact center, video, mobility, global reach and team messaging.

As we continue penetration of Enterprise accounts, well known referenceable customers are key. For example, last year we announced a win with Extra Space Storage, the second largest operator of self-storage properties in the U.S. Subsequently, this quarter we won Public Storage, the world's largest owner and operator of self-storage facilities and a Global 2000 business. Public Storage was using a legacy system that was struggling to meet the needs of their modern-day workforce and they were facing significant reliability issues with that system. Public Storage chose RingCentral because of its recognized industry leadership, strong channel relationships and proven capability to professionally deploy across thousands of locations.

Public Storage has more than 2,300 U.S. locations across 38 states. The legacy system they were using had taken 12 months to deploy across all of their locations. Now compare that to their RingCentral deployment. Using a combination of RingCentral capabilities and a key channel partner, we deployed across all of their more 2,300 locations in just two and a half weeks.

Another example of an Enterprise win was in healthcare where we were selected by One Medical, a leader in technology-enabled primary care. One Medical chose RingCentral for its integrated multi-modal communications, contact center capabilities and our open platform. With our open platform APIs, One Medical plans to integrate our communication platform directly with their electronic medical record system. When fully deployed One Medical will have a combined 1,400 seats of RingCentral Office and Contact Center.

In education, we won a significant deal with Southern New Hampshire University. They chose RingCentral because of our video meetings, and our powerful administration capabilities. When fully deployed they will have over 2,500 seats of RingCentral Office.

As Vlad mentioned, we had a strong quarter in Europe. For example, this quarter we won our first $1M+ total contract value deal in France. Circom is a professional association of public service television in Europe. They chose RingCentral for our global and mobile capabilities and our ability to deploy rapidly. Circom will have 2,000 seats of RingCentral Office when fully deployed.

In the U.K. we won an important deal with Luxfer Holdings, a global highly-engineered advanced materials company. Luxfer selected RingCentral because of our global reach, unified platform and professional services capabilities. Luxfer plans to deploy over 900 seats in the U.S., U.K. and Czech Republic.

Our channel partners contributed significantly to our success in these large opportunities. This is a result of our investments in the channel across the globe. For example, of the six wins I just mentioned, five were won with channel partners.

Now I'll cover some of our land and expand deals in the quarter. First up, Internet Brands, a leader in online advertising and e-commerce websites, has been a long-time customer of RingCentral. Internet Brands had over 1,600 seats combined of RingCentral Office and Contact Center and had broadly deployed our Glip team messaging. This quarter they signed an expansion agreement to increase the deployment to 3,600 seats.

Another example is Brinker International, owners of Chilli's and Maggiano's restaurants. Brinker originally deployed RingCentral Office across their restaurant locations. This quarter they expanded their deployment by adding RingCentral Office and RingCentral Contact Center to their headquarters location. Brinker now has over 6,000 seats deployed on RingCentral.

Hand in hand with our outstanding sales performance goes our unwavering commitment to customer success. This underpinned our strong retention and upsell results as will be further shared by Mitesh.

In summary, we had an impressive quarter with significant new wins and expansion from existing customers, both domestically and internationally. Our Enterprise penetration continues at a rapid pace and is supported with strong weighted pipeline growth that has more than doubled year-over-year along with our growing enterprise sales team. We are committed to innovation and customer success and we believe that we are well-positioned to win the substantial market opportunity in front of us.

Finally, excitement is building for our 3rd annual user conference show, ConnectCentral, that will be held in San Francisco on November 12th-14th. I hope you will join us there.

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 discussing RingCentral's results, I'd like to ask you to refer to the slide deck posted on our IR website. This provides the key points of our call today as well as supplemental information.

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 press release and in the slide deck.

With that, let's move on to the results. We had a great second quarter. Once again, all our key financial metrics beat the high end of our guidance. This was led by our mid-market and enterprise business supported by our strong performance with channel partners.

In the second quarter, our subscription revenue grew 32% year-over-year to $146 million, up from 29% a year ago. Normalizing for AT&T, our core subscription revenue grew 37% up from 32% a year ago.

Total ARR grew to $630 million, up 32% year-over-year. And ARR for RingCentral Office grew to $548 million, up 37% year-over-year.

Our performance again was led by robust growth in mid-market and enterprise business. It was up 80% year-over-year, with ARR of over $235 million. Our enterprise business of over $120 million growing in triple digits represented over half of this business.

Channel partners once again continued their rapid expansion this quarter. ARR from our channel partner business was over $135 million and grew more than 100% year-over-year.

Overall, our second quarter top line growth dynamics were strong, but this is only half the story.

At our Investor Day in June, we articulated our philosophy of profitable growth. To grow efficiently, we focused on a few core elements of the SaaS model. These were one-time metrics to give investors a deeper appreciation of our business. We would like to recap these one more time with our Q2 performance to reinforce the elements of the model.

Let me start with growth economics and its two key elements. The first is the cost of acquiring a customer, or cost to book. The second is net retention, which includes upsell to existing customers.

In Q2, both of these SaaS key metrics trended up year-over-year

First, our mid-market and enterprise business cost to book continued to improve. An increasing number of enterprise reps are becoming more experienced, and the productivity for our experienced reps is improving.

Second, our mid-market and enterprise net retention improved nicely year-over-year.

These improving economics enable us to invest more in growth while expanding the bottom line. This drives a virtuous cycle of profitable growth.

Moving on to our Q2 financials.

The Second quarter was strong across revenue and margins.

Total revenue increased 34% to $161 million.

Subscription gross margin was 82.6%, up 120 basis points year-over-year.

Operating margin was 8.8%, up 180 bps year-over-year resulting from our strong top line and leverage in our cost of goods and G&A.

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We ended the quarter with $567 million in cash, an increase of $12 million from Q1.

Now let's turn to our outlook.

We are raising our 2018 guidance

We expect subscription revenue to be between $595 million and $600 million for an annual growth of 28% to 29%.

Excluding the impact of AT&T, we expect core subscription revenue to grow 34% to 35%. The relative impact of AT&T on our overall growth will begin to abate in 2019 as our revenue base increases and AT&T comparisons normalize.

We expect total revenue of between $649 million and $656 million for annual growth of 29% to 30%.

We expect non-GAAP operating margins of 8.2% to 8.4%. This is consistent with our objective of delivering 75-100 bps of expansion annually.

We expect non-GAAP EPS of $0.66 to $0.70 based on 86 million fully diluted shares. The difference between GAAP and non-GAAP EPS is expected to include the following:

- $0.81 of stock-based compensation
- $0.19 of amortization of debt discount relating to our convert
- $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 our third quarter guidance.

In the third quarter, we expect subscription revenue to be between $152 million and $154 million for annual growth of 27% to 28%.

We expect our core subscription revenue to grow 33% to 34%.

We expect total revenue between $165 million and $168 million for annual growth of 27% to 29%.

We expect non-GAAP operating margin of 8.0% to 8.2%.

We expect non-GAAP EPS of $0.15 to $0.17 based on 86 million fully diluted shares. The difference between GAAP and non-GAAP EPS is expected to include the following:

- $0.22 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. All our guidance details are available in our press release and our earnings deck.

In summary, we are pleased with the performance of our business in terms of both our growth rate and underlying economics to deliver that growth. To reiterate our message from Analyst Day, given the size of the opportunity ahead of us our bias is toward growth. With compelling growth economics, we are confident of also delivering operating margin expansion.

Within that context, The Rule of 40, which is the sum of total revenue growth and operating margin, is a high bar that we have set our sights on. In fact, we are tracking above 40% so far this year and are confident to exceed this target while also exceeding a $1 billion in revenue in 2020.

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