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

Thank you. Good afternoon and welcome to RingCentral's third 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.

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 third quarter earnings conference call.

Third quarter results were excellent. Revenue growth, non-GAAP operating margin and EPS came in at or above the high end of our guidance ranges. Our core subscription performance, led by our mid-market and enterprise business, and momentum with our channel partners continues to be strong. And we expanded our product portfolio and TAM with the acquisition of Dimelo, a leading B2C digital customer engagement platform. Let me begin by covering some of the key highlights of the quarter.

First, total revenues for the third quarter grew to $174 million. This is a 33% increase year-over-year, above the high end of our guidance range.

Second, our core subscription business, normalizing for the legacy AT&T base, continued to outperform. Core subscription revenue grew 38% year-over-year, up from 34% in the same quarter last year.

Third, mid-market and enterprise business continued to lead the way. We define mid-market and enterprise as 50 seats or greater. This grew 75% year-over-year and is now a $270 million annualized business. Our enterprise business, defined as customers with $100,000 dollars or more in annual recurring revenue or ARR, grew over 100% year-over-year. By itself, this business is now over $145 million dollars.

Fourth, momentum with channel partners continues. In the third quarter our channel business grew over 90% year-over-year to over $160 million.

Fifth, we again saw outstanding performance internationally with several large deals in the U.K. and our first million dollar plus TCV deal in Australia.

Finally, this quarter we extended our relationships with both AT&T and BT. AT&T agreed to re-engage with RingCentral and has restarted selling Office@Hand which is based on the RingCentral Platform. AT&T plans to sell the solution through direct and indirect sales channels to enterprises and to vertical sectors like financial services, healthcare and government.

As to BT, they opened up their mid-market and enterprise customers to RingCentral solutions. The mobile-first solution, which has been rebranded as BT Cloud Work, provides the key communications capabilities enterprises need to engage customers, drive greater workforce productivity, and enhance mobility.

We are winning because legacy solutions simply cannot meet the needs of modern mobile and distributed workforces. Our success is rooted in our deep commitment to technology, product excellence and customer satisfaction. This is being clearly recognized by customers and experts alike.

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

According to Gartner "By 2021, 90% of IT leaders will not purchase new premises-based UC infrastructure – up from 50% today."

And we are proud to share that for the fourth consecutive year, Gartner has recognized RingCentral as a Leader in the Magic Quadrant for Unified Communications as a Service. In the Magic Quadrant, RingCentral is now positioned furthest within the Leaders quadrant for completeness of vision and ability to execute. In recognizing our leadership, Gartner stated that "The RingCentral UCaaS offering is strong across the board – UCaaS features and capabilities, project management, sales, and operations."

Not resting on our laurels, we are always looking to strategically extend our product portfolio, enhance the value we deliver to our customers, and to expand our TAM. Our first technology acquisition 3 years ago was the team messaging and collaboration platform, Glip. It allowed us to enable internal team communications via means beyond voice. This acquisition has been a resounding success and is helping us win key enterprise accounts.

This quarter we are excited to announce the acquisition of Dimelo, a leading cloud-based digital customer engagement platform. Dimelo enables external customer communications via non-voice channels. This fills an emerging need of large brands to connect with their customers via multiple digital channels including messaging, in-app messaging, social media, live chat, email and community forums. Dimelo is deployed by leading global organizations such as Allianz, AXA, BNP Paribas, ENGIE, Orange, and Telenor, spanning multiple industries including telecom, financial services, insurance and retail.

The successes of this quarter are still just the beginning. We are in the early innings of what we expect will be a massive shift of all business communication to the cloud. RingCentral is in the lead. We aim to extend our leadership position with continued investment in product and technology innovation, enterprise sales and channel relationships. With a widening gap and moat 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 continuing momentum in our mid-market and enterprise business.

We continue to build on our mid-market and enterprise momentum by expanding both our direct sales presence and channel partnerships across the U.S. as well as internationally in Europe and Asia. Channel continues to be an important part of our enterprise success. This quarter over 80% of our top 20 largest deals came through our channel partner network.

Let me walk through just a few customer win examples from our third quarter.

We have highlighted in the past that enterprise businesses with large workforces dispersed across a significant number of retail locations are well suited to benefit from RingCentral. This quarter we have a new major win with Monro, a leading automotive service company. With RingCentral, Monro can centrally manage their thousands of locations. In addition, they plan to adopt our team collaboration capabilities, Glip, across both their corporate and retail locations.

Also this quarter, Intersection, the smart cities technology, and media company, chose RingCentral to power communications on over 1,500 digital kiosks that are transforming urban environments such as Link in New York City. This has the potential to grow globally as Intersection enters new urban markets across the world.

Our open platform continues to grow rapidly and is a key factor in many purchasing decisions. CRM applications are among our most popular integrations. For example, this quarter RingCentral signed the Tampa Bay Buccaneers. The Bucs are replacing a legacy Avaya system and chose RingCentral for its ability to easily integrate with their cloud CRM system. This is the third NFL entity to choose RingCentral.

Internationally we continue to expand the capabilities of RingCentral Global Office. This quarter we added two more countries with native dialing experience, Hungary and Croatia, bringing the total to 39 countries.

In the U.K. we had a marquee win with the Financial Times, one of the oldest and most distinguished business publications in the world. The Financial Times is digitally transforming the way their staff work, embracing mobile and collaborative technologies. After an extensive market analysis Financial Times chose to partner with RingCentral to deliver enterprise grade cloud communication and collaboration solutions to over 2,000 of their staff across the globe.

In Australia, we have made rapid progress in a short period of time. Recall that in Q1 of this year we announced that we had opened our first sales office in the region. This quarter we are pleased to share that we signed our first million dollar plus TCV contract with Technology One, one of the largest enterprise software vendors in Australia. They selected RingCentral for our user experience, quality of service reporting and global capabilities.

In addition to these sizeable new logo wins, we continue to expand with our existing enterprise customers.

For example, Red Lobster started with around 200 seats last year. This quarter they added 2,000 seats with the potential to add more as they roll out RingCentral to all their North American locations. RingCentral solution improved the performance of Red Lobster's to-go ordering process while reducing system costs compared with a legacy solution.

In summary, it was a great quarter. We are seeing the momentum of our prior wins drive significant new wins and expansion from existing customers. We are gaining traction both domestically and internationally as we continue to build our direct and channel presence globally. We continue to believe we are well positioned to win the significant market opportunity in front of us.

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 an outstanding third quarter. All our key financial metrics came in at or above the high end of our guidance. This was led by continued strength in our mid-market and enterprise business supported by channel partners.

In the third quarter, our subscription revenue grew 32% year-over-year to $158 million, up from 30% a year ago. Our core subscription revenue, normalized for the legacy AT&T base, grew 38% up from 34% a year ago.

Total ARR grew to $674 million, up 31% year-over-year. And ARR for RingCentral Office grew to $592 million, up 36% year-over-year.

Our performance again was led by robust growth in mid-market and enterprise business. It was up 75% year-over-year, with ARR of $270 million. Our enterprise business of over $145 million growing in triple digits year-over-year represented over half of this business.

As it relates to new sales, the share of mid-market and enterprise business was over 60% for RingCentral Office, up from over 50% a year ago.

Channel partners again made a significant contribution to our growth. ARR from our channel partners was over $160 million and grew more than 90% year-over-year.

In addition to our third quarter financial results, I also want to highlight some encouraging longer term trends. We are seeing multiple benefits because of our focus on mid-market and enterprise customers and working with our channel partners.

First -- lower churn. In the third quarter we saw record low gross churn.

Mid-market and enterprise customers have less than half the gross churn rate of small business customers. In addition, customers acquired through channel partners have less than half the gross churn of customers who purchased directly.

Second – growth through land and expand.

Typically, customers begin transitioning to cloud communications by purchasing a subset of our product portfolio for just a portion of their employees. This presents a significant opportunity to cross sell and upsell. Recall at our Investor Day we shared that we are only about 15% penetrated in our mid-market and enterprise customers. Leveraging this opportunity, once again this quarter over 40% of our new office business came from existing customers.

The combination of lower gross churn and robust land and expand drove strong net retention in Q3.

Now, moving on to our Q3 financials.

Total revenue increased 33% to $174 million, above the high end of our guidance range.

Subscription gross margin was 83.1%, up 130 basis points year-over-year.

Operating margin was 8.2%, at the high end of our guidance range.

We ended the quarter with $577 million in cash, an increase of $10 million from Q2.

We closed the acquisition of Dimelo in late October. The acquisition is not estimated to have any significant financial impact on FY18.

Before turning to our outlook, I want to share color on two points.

First, taxes:

Given our recent non-GAAP profitability, we will be introducing a non-GAAP tax rate in FY19. The rate is expected to be in the range of 22-24%. We determined this by applying an average long term expected tax rate. Note that we do not expect to pay any cash taxes given our carry forward losses.

Second, disclosures relating to core revenue.

With the return of AT&T as a partner, we want to ensure that the metrics we disclose continue to offer insight into the fundamentals of our business performance. We will continue disclosing the core revenue metric through the end of this year for comparative purposes. We will share our plans for FY19 during our next earnings call.

Now let's turn to our outlook.

We are raising our 2018 guidance.

We expect software subscription revenue to be between $606 million and $608 million for an annual growth of 30% to 31%.

We expect core subscription revenue to grow 36% for the year.

We expect total revenue to be between $664 million and $667 million for an annual growth of 32%.

We expect non-GAAP operating margins of 8.4%, up 90 basis points year-over-year, consistent with our earlier guidance of delivering 75-100 bps of expansion.

We expect non-GAAP EPS of $0.71 to $0.73 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
- $0.20 of amortization of debt discount relating to our convert
- $0.09 of amortization of acquired intangibles and acquisition related expenses

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 fourth quarter guidance.

We expect subscription revenue to be between $165 million and $167 million for an annual growth of 27% to 28%.

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

We expect total revenue to be between $179 million and $182 million for an annual growth of 27% to 29%.

We expect non-GAAP operating margin of 7.9% to 8.1%.

We expect non-GAAP EPS of $0.17 to $0.19 based on 87 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 had strong third quarter both financially and strategically, seeding several long-term drivers.

- Our core business continues to perform well, reaching 38% year-over-year growth.
- We had significant new customer wins both domestically and internationally.
- We had record low churn and robust net retention.
- We re-established our relationship with AT&T and expanded our engagement with BT.
- We extended our lead over the competition and again were recognized by Gartner as a UCaaS Magic Quadrant leader.
- And we completed an important strategic acquisition, Dimelo, expanding our TAM in the B2C customer digital engagement market.

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.

Finally, a brief reminder that our 3rd annual user conference, ConnectCentral, is happening next week in San Francisco on November 12th-14th. Space is limited so please reach out to our Investor Relations team if you would like to attend. We hope to see you there.

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