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SCWX - Q2 2018 SecureWorks Corp Earnings Call

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PRESENTATION

Operator

Good morning and welcome to the SecureWorks Second Quarter Fiscal 2018 Financial Results Conference Call. (Operator Instructions)

Now I will turn the call over to Rebecca Gardy, Head of Investor Relations. Ms. Gardy, you may begin.

Rebecca Gardy

Good morning, everyone, and thank you for joining us today to review SecureWorks' financial results for the second quarter of fiscal 2018. This call is being recorded. This call is also being broadcast live over the Internet and can be accessed on the Investor Relations site of SecureWorks website at investors.secureworks.com. The webcast will be archived at the same location for one year.

This morning, SecureWorks issued a press release announcing results for its fiscal quarter ended August 4, 2017. You can access this press release on the Investor Relations section of the SecureWorks website.

During this call, management will make forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, but are not limited to, guidance with respect to GAAP and non-GAAP revenue and net loss per share as well as adjusted earnings before interest, taxes, depreciation and amortization. Our forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from those anticipated by these statements. You can find a description of these risks and uncertainties in this morning's earnings press release and in the company's annual report in Form 10-K for the year ended February 3, 2017, which is available on our Investor Relations website and on the Securities and Exchange Commission's website. Additional information also will be set forth in the company's quarterly report on Form 10-Q for the quarter ended August 4, 2017, and in its other SEC filings. All forward-looking statements



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made on this call are based on assumptions that we believe to be reasonable as of this date, September 6, 2017. We undertake no obligation to update our forward-looking statements after this call as a result of new information or future events.

Some of the financial measures we use on this call are expressed on a non-GAAP basis. These non-GAAP measures exclude stock-based compensation, the impact of purchase accounting, amortization of intangibles and the related tax effect of these items. We have provided reconciliations of the non-GAAP financial measures to GAAP financial measures in today's earnings press release available on our website. Non-GAAP measures are not intended to be considered in isolation from, a substitute for or superior to our GAAP results, and we encourage you to consider all measures when analyzing SecureWorks' performance.

With us on today's call are Michael Cote, President and Chief Executive Officer of SecureWorks; and Wayne Jackson, Chief Financial Officer. Following their prepared remarks, we will take your questions. (Operator Instructions) Thank you for your cooperation on this.

And now, I would like to turn it over to Mr. Cote.

Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

Thank you, Rebecca. And thank you, everyone, for joining us on our second quarter earnings call.

We are pleased with our overall performance this quarter. Revenue grew 12% year-over-year to \$116 million, resulting from increases in our subscription-based solutions. Monthly recurring revenue grew over 8% year-over-year to \$32.3 million, and we generated cash flow from operations of \$11 million.

In the midst of the ongoing digital transformation, our clients tell us they are facing challenges such as updating their legacy business processes and applications, moving workloads to the cloud, redefining themselves digitally and complying with greater regulatory requirements. Not only are so many aspects of their technology ecosystem changing, but the pace of that change is also accelerating. Alongside these changes, cybercrime continues to present a significant business risk. The online criminal landscape is complex, comprised of individuals, organized crime, hacktivists and nation states working with a diverse range of capabilities and motives. Organizations around the globe are looking for help as they navigate the landscape while keeping their focus on their core business.

Our clients choose us because security is at the heart of what we do. Through advanced analytics and machine learning, we leverage our years of knowledge of cyber threats and our deep understanding of the current threat actors' tactics, techniques and procedures to make our Counter Threat Platform, or CTP, smarter every day. Moreover, the CTP is also constantly enhanced with the network effect of thousands of clients, with hundreds of thousands of devices in over 60 countries and our partnerships with best-of-breed technology companies.

We are constantly innovating to keep clients safe across their entire architecture, including on-premise devices, endpoints and public hybrid and private cloud deployments. Regardless of where their workloads and data reside or where they are along the continuum of cybersecurity maturity, we help clients leverage their security spend to prevent attacks, detect those that cannot be prevented and take the appropriate prioritized action against cyber threat activity.

In the process, we also bring simplicity to complex security operations by working with our clients' existing security infrastructure. Before I highlight our recent technology developments that are driving greater client value and our key sales achievements during the quarter, I want to point out that in the spirit of transparency, I will be sharing greater insight into certain metrics this quarter.

First, our Advanced Endpoint Threat Protection, or AETP solution. SecureWorks and Carbon Black have come together to offer a new solution, which combines Carbon Black's next-generation antivirus with our Red Cloak analytics platform to deliver an advanced AV solution with the power of SecureWorks' threat intelligence and machine learning. The endpoint continues to be a key attack vector used by threat actors. AETP is a fully managed solution that extends our prevention and detection capabilities and provides visibility into more client endpoints. We have several clients that are early adopters of this solution, and it will be generally available in the next few weeks. In a relatively short period of time, we have approximately \$10 million of AETP opportunities already in our pipeline.



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Also this quarter, we extended our Red Cloak solution to Windows servers. Servers are at the nexus of data and processing for organizations, making them highly valued targets for threat actors. Using Red Cloak, clients can move quickly to detect and mitigate attacks on their networks. We believe this bundled solution, which is currently available to clients worldwide, substantially increases the value of our Server Monitoring solution and augments our Red Cloak activity. Our current Red Cloak pipeline is over \$60 million.

Lastly, we continue to extend the capabilities of our valuable Attacker Database to more industry-leading firewalls. Our Attacker Database is part of our suite of Threat Intelligence solutions that leverage our global threat visibility across thousands of clients' networks and the expertise of our security research team. Subscribers get access to our intellectual property to stop a variety of threats and cyber attacks. With this offering, clients using certain Cisco, Palo Alto and Juniper devices with our attacker database gain timely, actionable intelligence and increase the value of their existing security investments.

Our Threat Intelligence and our highly skilled security analysts comprise the human intelligence, which is a key differentiator for us. We employ some of the world's best security researchers, engineers and analysts. Every day, our elite team, with access to the latest threat intelligence and analysis, deliver proactive prevention and detection capabilities and actionable insights to our clients.

A great example was the work of our Counter Threat Unit, or CTU, who uncovered a sophisticated cyber-espionage campaign. We announced our threat analysis 6 weeks ago at the annual Black Hat conference, detailing how a threat group, working on behalf of a foreign government, created an online persona to lure technology, oil and gas, telecommunications and aerospace employees into unknowingly opening networks to remote access. We alerted our clients to this suspicious activity and put in place protections for the malware and targeted infrastructure identified in this campaign in early 2017.

Another exciting area of growth for us is our Advanced Remediation Management, or ARM, solution that helps enterprise clients perform the incident investigation and response steps referred to as security orchestration in the marketplace today. We offer our clients meaningful value by taking our proprietary validation response procedures and enhancing them with client-specific context. We then investigate, prioritize and remediate malicious activity identified by CTP, taking the appropriate actions on behalf of our clients.

While I am pleased with the progress we are making with our technology investments, we must continue to innovate and bring solutions such as these to the marketplace. During fiscal 2018, alongside our investments to maintain our technology excellence and differentiation, we also made investments to lay the foundation for an accelerated sales trajectory. The changes we made in our sales organization include: one, talent, hiring experienced enterprise sales leaders and strengthening the ranks of our sales engineers; two, coverage, aligning our sales force to more optimal territories, putting them closer to our clients and prospects to drive deeper engagement; and three, improved quality of sale, growing out and executing a sales process that is uniform, proven and targeted for the types of solutions we offer.

Let me touch on specific sales highlights this quarter. Quota-carrier headcount reached 179 at the end of the second quarter, a 13% increase year-over-year and a 3% increase over last quarter. Attrition has stabilized this quarter, and the number of quota carriers with tenure over 2 years has increased 15% over last year.

We saw strength this quarter in both the volume and size of deals with total value over \$1 million, with both measures increasing more than 50% over last quarter. The number of large opportunities on North American pipeline increased by double digits over last year. And sales performance in EMEA and APJ during the quarter continued on a strong growth trajectory.

I'm excited to see our invigorated sales culture becoming established. Although we've made significant progress, we still have work to do. Overall, we expect that the investments we made in the first half of the year will continue to become more productive and deliver increased benefits in the second half.

And with that, I'll turn the call over to Wayne. Wayne?



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R. Wayne Jackson - *SecureWorks Corp. - CFO*

Thanks, Mike, and good morning, everyone. Today I will review with you our second quarter performance and share our outlook for the third quarter and full year fiscal 2018. All financial information I will refer to is non-GAAP, and growth rates are compared to the prior year periods unless otherwise stated.

Our results in Q2 FY '18 exceeded our guidance on both the top and bottom line. We expanded gross margins, experienced some leverage in our operating expenses and maintained a strong liquidity position bolstered by cash flow from operations this quarter.

For the second quarter, revenue grew 12% to \$116.3 million with the overall percent split of revenue between our MSS and our security risk consulting services remaining at approximately 80%, 20%. Revenue outside the U.S. grew to 16% of total revenue for the quarter, up from 13% last year.

Our average annual subscription revenue per client was \$88,000 this quarter, a 7% increase over the prior year. While this growth was broad-based, we saw an increase in the mix of international accounts and in the average revenue derived from our enterprise client base. In North America, enterprise clients generated approximately 10x more average revenue than SMB clients. Our subscriber count stayed constant at approximately 4,400 clients for the quarter.

Our monthly recurring revenue, or MRR, was \$32.3 million, an increase of 8.4% over Q2 '17 and 1.3% sequentially.

To provide further color on Q2 sales activity, in the second quarter, we closed 23 transactions greater than \$500,000 in total contract value, including 14 transactions over \$1 million versus 9 transactions last quarter. A few examples of seven-figure deals this quarter include a 3-year contract with a regional Middle Eastern bank that wants to mature its security posture by increasing visibility across their existing security clients' endpoints, a 3-year contract with a global business advisory firm that included Red Cloak, virtualized appliances and monitored Office 365 from our Cloud Guardian portfolio and a 2-year deal with a multinational brewing company that included cloud solutions and virtualized appliances.

Revenue retention in the period was 96% compared to 99% in the first quarter. This metric excludes backlog and is a reflection of active revenue. Our revenue retention can be impacted by the timing of exchanges and renewal rates. An example of timing of an exchange would be if we turned off a particular service for a client in one period but do not turn on or install the exchange revenue until the next quarter. This would negatively affect revenue retention. In the second quarter, we had one large client with this situation, and the impact to revenue retention was about 1%.

Our Q2 gross margin was 54.7%, an increase of 210 basis points compared to last year. This margin expansion came from continued growth in our managed security solutions and reflects continued scale delivered from our -- derived from our delivery model.

For the second quarter, total operating expenses were \$71.4 million, or 61.4% of revenue, compared to 61.8% last year and 64.1% last quarter.

Research and development expenses remained consistent at 16.3% of revenue.

Sales and marketing expenses this quarter were approximately 32% of revenue, up from 30.3% last year due to the increased investments in our sales and go-to-market strategy. We expect sales and marketing expenses as a percent of revenue to stabilize at Q2 levels for the remainder of the year.

General and administrative expenses in this quarter included a benefit of \$1.6 million for state jobs tax credits, which helped reduce our G&A expense to 13.1% of revenue from 15.5% last year and 15.2% last quarter. We expect G&A to return to Q1 levels as a percent of revenue for the balance of the year.

Operating loss was \$7.8 million for the quarter, and adjusted EBITDA loss was \$4.6 million, or 3.9% of revenue.

Increased operational efficiency on higher revenue offset by investments in sales led to a slight improvement in our net loss for the quarter to \$5.4 million compared to \$5.6 million last year. Based on 80.353 million shares outstanding, net loss per share was \$0.07.



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We finished the second quarter with a strong balance sheet. We had cash and cash equivalents of \$98 million, total accounts receivable of \$123 million and total deferred revenue of \$148 million. Our average contract length remained relatively constant at approximately 2 years.

Cash flow provided by operations for the quarter was \$11.2 million, bringing the total for the trailing 12-month period to \$6.3 million. We continue to expect that cash inflow in the fourth quarter of approximately \$25 million from Dell related to our current tax receivable.

Turning now to guidance and other key modeling points. Our guidance takes into account our financial performance for the first half of the fiscal year and the type of forward-looking information that Rebecca referred to earlier. It also takes into account the impact we expect from changes that we introduced in the last 2 quarters in our sales organization.

For Q3 fiscal 2018, we expect GAAP and non-GAAP revenue to be in the range of \$115 million to \$116 million. And we expect non-GAAP net loss per share to be in the range of \$0.09 to \$0.10, using approximately 80.362 million weighted average shares outstanding.

For the fiscal year, we increased GAAP revenue guidance to be in the range of \$462 million to \$465 million and in the range of \$463 million to \$466 million on a non-GAAP basis. We now expect our GAAP net loss to be in the range of \$52 million to \$54 million. And we narrowed our adjusted EBITDA loss by \$3 million to be in the range of \$21 million to \$25 million.

Based on approximately 80.286 million weighted average shares outstanding, we now expect net loss per share to be in the range of \$0.65 to \$0.68 and non-GAAP net loss per share to be in the range of \$0.29 to \$0.32.

We are reiterating our guidance for MRR to be in the range of \$34.4 million to \$36.4 million at the end of the first quarter -- fourth quarter of fiscal 2018. We continue to expect our capital expenditures will be approximately \$18 million to \$20 million for the full year.

In summary, I am pleased with our results in Q2, though as Mike said earlier, we have more work to do. We are executing according to our plan for second-half acceleration. We continue to believe that the increased investments we are making this year in our sales organization to capture the significant global demand for our solutions continues to be the right move. We look forward to sharing further evidence of our progress in the second half of fiscal 2018.

This concludes my prepared remarks, and I will turn the call back over to the operator to begin the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We'll take our first question from the line of Sterling Auty with JPMorgan.

Sterling Auty - JP Morgan Chase & Co, Research Division - Senior Analyst

Just wondering in terms of where you've been layering in the incremental sales resources, where are you seeing the fastest ramp? And is there anything that you can take from that and apply to other regions or other areas?

Michael R. Cote - SecureWorks Corp. - CEO, President and Director

Sterling, great question. This is Mike Cote. The new sales resources have been layered in, in large -- in the large enterprise market, in particular, in region around, I'll say, the NFL cities in North America. And these are high-quality individuals who have relationships and connections with the prospective clients that we're looking at. And it's helped tremendously to get in the door quickly and to ramp fast. So clearly, Jason is looking to continue to replicate that until we get all of the markets filled.



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Sterling Auty - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Got you. And then on technology side, you mentioned the partnership with Carbon Black for the new antivirus acquisition that they had done. But I'm kind of curious, what's your relationship with them around EDR? Well, let me just leave it at that.

Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

Around what?

Sterling Auty - *JP Morgan Chase & Co, Research Division - Senior Analyst*

EDRs. So beyond just the antivirus, so some of the remediation technology, is there a relationship there as well?

Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

To my knowledge, right now, that may be on the road map, but nothing that we've announced publicly.

Operator

Our next question comes from the line of Saket Kalia with Barclays Capital.

Saket Kalia - *Barclays PLC, Research Division - Senior Analyst*

Maybe we'll start with you, Wayne, really quick housekeeping question. Did SRC outperform your expectations at all? I know we said it was still roughly an 80-20 split, but I guess, with MRR improved a little bit sequentially, but given the in-quarter revenue beat, I wonder if there were any upfront components of revenue that maybe came in a little bit better than you expected?

R. Wayne Jackson - *SecureWorks Corp. - CFO*

Thanks for the question. SRC -- to answer your specific question, if I understood, SRC did not beat our expectations. MSS was a little bit above our expectation. And we had a very small amount of one-offs that we had not included in our guidance from last quarter. But SRC was reasonably on track.

Saket Kalia - *Barclays PLC, Research Division - Senior Analyst*

Got it. And then for my follow-up, maybe more strategic for you, Mike. In your conversations with customers, how has their appetite for in-house security versus outsourcing through MSS changed, if at all here?

Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

So the -- Saket, it's a great question. In the last 6 months, I would tell you that there seems to be an increased demand and interest in solving the problem. And we still clearly have a shortage of skilled and talented security people. We still also have -- we still have the problem of visibility and how do you understand what's going on with something outside your network. So from SecureWorks' perspective, we're bringing visibility of 4,400 clients across geographies and verticals and small to medium-sized business to large enterprise and Fortune 100 organizations. So I think that the -- there's been an increased appetite in the traditional way you may think of us working, for example, with a very large organization. There -- that



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-- there's some things we have under way that may change it, so it's not the traditional way you may think of us working with them. But I think there's an -- there is clearly -- I should say, there is clearly an increased desire and appetite to find a mutually beneficial way from the small to medium-sized business all the way up to the largest organizations.

Operator

Our next question comes from the line of Matt Hedberg with RBC Capital Markets.

Matthew George Hedberg - *RBC Capital Markets, LLC, Research Division - Analyst*

Wayne, you talked about several drivers for customers choosing SecureWorks right now in your prepared remarks. And certainly, I think the large deals, to us, stood out, the strength there that you saw this quarter. Can you give us a bit more detail on what's driving the large deal strength now? Is it just sort of more culmination of a lot of the market drivers? Or anything that maybe Jason's impacting on the sales force?

R. Wayne Jackson - *SecureWorks Corp. - CFO*

Thanks, Matt. I think it's some of all of what you've mentioned is -- if I understand the question. So on -- let's start with the sales organization, right? We've hired some more experienced sales talent. They're ramping 6 months into it. We also added sales engineers, which helped us align the client's expectations with ours, helps us explain to the clients our solutions. That's -- we're beginning to see traction in those areas. We've rolled out some new products that Mike has talked about as well. So it's a combination of all of those.

Matthew George Hedberg - *RBC Capital Markets, LLC, Research Division - Analyst*

Got it. And then maybe just a quick follow-up. It was great to hear the size of the Red Cloak pipeline. I'm curious, can you give us a sense of how that \$60 million pipeline has increased maybe on a year-over-year basis?

Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

On the Red Cloak -- this is Mike, Matt. On Red Cloak?

Matthew George Hedberg - *RBC Capital Markets, LLC, Research Division - Analyst*

Correct.

Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

Yes. I don't have the data, but -- in front of me, but I -- it was a pretty substantial increase.

R. Wayne Jackson - *SecureWorks Corp. - CFO*

Yes, Matt. Keep in mind, we've rolled Red Cloak out about a year, maybe 5 quarters ago. So it's ramped pretty significantly since 5 quarters ago. We've got pretty nice installed base as well, we do, yes.



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Operator

Our next question comes from the line of Jonathan Ho with William Blair.

Jonathan Frank Ho - *William Blair & Company L.L.C., Research Division - Technology Analyst*

Just wanted to start out with a question in terms of the public cloud. How do you think about that opportunity as more and more infrastructure transitions? And what does that mean in terms of the MSSP market?

Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

So Jonathan, this is Mike. Thanks for the question. And we are excited about the movements that are occurring in the cloud. Actually, we didn't bring it up because although it's still fairly small, our cloud revenue quintupled in the quarter. So we've had nice growth in the solutions that we're providing around Cloud Guardian, which we talked a little bit about last quarter. And we're just -- we're excited about the movement there and the opportunity.

Jonathan Frank Ho - *William Blair & Company L.L.C., Research Division - Technology Analyst*

Got it. And then just in terms of your confidence around the reacceleration in the second half of the year. Can you maybe walk through what underpins that confidence and maybe your visibility from a pipeline perspective into some of the larger deal opportunities?

Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

Sure. So I'll try and go into a little more depth but reiterate some of the things that I've said -- this is Mike, Jonathan -- in my prepared remarks, which is it's really focused around the consistency of talent, coverage and quality of sale, and the maturing of the sales organization and continuing to get everybody in the same spot. We're sort of 2 quarters into this process, which we expect to last a little bit longer. But I'm excited about an -- and feel really good about the results we've had to date. We've had, as I mentioned, 179 quota carriers that are onboard at the end of the quarter, which is an increase over where we were before. We've got -- the tenure of 2-plus-years is increased by about 15% year-over-year. Our sales productivity is beginning to improve and has improved from the second quarter -- in the second quarter from the first quarter. We've seen a 55% increase in large deals that closed from 9 to 14, as Wayne mentioned. Those are deals over \$1 million. And as I mentioned, we saw both an increase in the number of deals in the pipeline and the number and the size of those deals that we've closed. We're also adding, as we touched on new types of solutions. I mentioned the ARM solution, which has been growing very well, the Red Cloak being added to the server monitoring. I mentioned -- I just gave you the update on cloud. So we're very confident in the leadership position we have, the powerful combination of our machine and human intelligence as we're taking this to market, our analytics and our 100% focus on security and under the new leadership from our sales organization, the reinvigorated culture from a sales perspective. So we clearly -- I gave you some insights into the pipe, but clearly, the sales pipeline, we feel very good about as well.

Operator

Your next question comes from the line of Melissa Franchi with Morgan Stanley.

Melissa A. Gorham - *Morgan Stanley, Research Division - VP*

So just a follow-up on that previous question. In terms of the changes to the sales force, I'm just wondering if the bulk of the changes that you described, whether it's more coverage and, I guess, ramping on the quota-carrying sales heads, is that largely behind you and now you're just looking for an improved sales productivity from existing -- your existing sales force? Or are you still making changes to the sales organization?

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Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

No, it's behind us. I mean, clearly, we will continue to add to the sales organization as we fill out markets and grow. And as I just mentioned a moment ago, we're excited about the increased productivity that we saw in Q2 over Q1 on a per sales force basis or productivity per sales dollar invested and expect that to continue.

Melissa A. Gorham - *Morgan Stanley, Research Division - VP*

Great. Okay. And then just one follow-up for Wayne. So in this quarter, we did see a pretty nice beat on operating margins as you did beat on revenue, and some that flowed through to operating income. As we're heading into the second half of the year, can you just kind of remind us your philosophy in terms of either reinvesting any top line upside back into the business or letting it kind of flow through to the leverage?

R. Wayne Jackson - *SecureWorks Corp. - CFO*

Okay. Thanks, Melissa, for that. So just real briefly on margin, as you said, year-over-year strong growth, 210 basis points. Over the last 10 quarters, our margin has continued -- has made quite significant improvements. And we expect margins to stay strong relative to the next 6 months for the rest of this year. We -- as I talked about it in my prepared remarks, in each of the sections, R&D and sales and marketing, we expect to continue to invest in both of those areas, especially in sales and marketing as a percent of revenue. So we're not going to bring a lot of that down to the bottom line. We did improve EBITDA by \$3 million for the second half. So we're going to see some of it coming down, but not more than what I talked about. Does that answer your question, Melissa? I don't know if you wanted more details.

Operator

Your next question comes from the line of Gur Talpaz with Stifel.

Gur Talpaz - *Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst*

So my first question, I wanted to ask about the MRR guide. And specifically, what needs to happen from a Red Cloak, AETP, Cloud Guardian, and really the broader pipeline conversion to hit both the low end and the high end of the range that you've both -- that you've reiterated?

Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

So if I understand the question, it's -- are you asking about the guidance itself, the range and how comfortable we are or specifically for those solutions?

Gur Talpaz - *Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst*

Effectively, yes, and more the former, but just so -- you've given some good metrics around the pipeline for Red Cloak and AETD. And I'm just sort of curious as to what's sort of baked in, in terms of assumptions to hit that MRR guidance, plus conversion on that pipeline.

Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

Yes. So this is Mike. I'll jump in, Wayne, and then you can add if you want. The way I'd respond to that is we clearly have -- the 2 components that'll hit MRR are going to be new -- or cross, a, new sales to new clients, new sales to existing clients and minus client churn or service churn -- minus client churn and service churn, I should say, so those 4 components. And we are clearly working on all 4 components and have seen, as I mentioned,



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sales productivity, both new sales to new clients and cross sale. And we have the pipeline to support and expect to have continued increase in sales productivity, i.e. strong growth on the sales front as what we're shooting for and then reducing service churn overall, service and client logo churn or continuing to have it hit our expectations would basically put us within the range, which is why we provided the guidance.

R. Wayne Jackson - *SecureWorks Corp. - CFO*

And then maybe to touch on your specific questions relative to -- we expect, of course, the pipeline to continue to grow as we accelerate and then the conversion front in that pipe we'll need. Red Cloak is a fairly important part of that. Cloud Guardian is still early. Our cloud offerings are still early and are not as significant to the second half for us as it will be going forward.

Gur Talpaz - *Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst*

That's helpful. And then Mike, when you think about products like AETP and Red Cloak, how do you balance the idea of sort of being solution agnostic, a Switzerland of sorts, while also advocating for your own native solutions that you're bringing to market with your customers?

Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

Well, if you look at what Red Cloak does -- first of all, great question. If you look at what Red Cloak does, it's really the increased telemetry to allow us to do discovery. It's the reason why, for example, in this case, we've partnered with Carbon Black and we're evaluating other endpoint technologies, where we can partner on the prevention and/or detection side. The key components of Red Cloak are not -- is its ability to give us the telemetry to allow us to do a better job in understanding what that threat actors are doing. So the key component is the incremental revenue we can get in most cases around helping us do a better job on the telemetry. And -- well, actually, while I'm on advanced endpoint threat protection, going back to a question Sterling, if you're still on the line, the Carbon Black EDR, that -- I guess, it's now Carbon Black Defense, which is a component of our advanced endpoint threat protection. We use Carbon Black Respond in our advanced endpoint solution, AETD, and our -- and the AETP solution is Carbon Black Defense. So we are working with them in the EDR area. Didn't mean to take us off track.

Operator

Your next question comes from the line of Rob Owens with KeyBanc Capital Markets.

Robbie David Owens - *KeyBanc Capital Markets Inc., Research Division - Senior Research Analyst*

I want to ask about your success in -- with midmarket customers because what you've highlighted to us kind of some of your success upmarket \$1 million deals and what have you, you're just still not seeing a lot of growth in the total client base at this point. So I'm curious more -- I don't want to call it run rate business, but probably more of that midmarket segments kind of what you guys are seeing there.

Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

Yes, so the small- and medium-sized business, so small through midmarket is a very important market for us and continues to be. And as Jason came in, he focused first on reigniting the large enterprise part of the sales organization. We've recently put a new leader in charge of the SMB marketplace. So on the sales revenue growth front, we are expecting increased sales productivity and effectiveness in the SMB area as well going forward. And we have a renewed effort in going after that market from a client relationship perspective and trying to draw our -- ensure that we get closer to the clients and what they're looking for, helping them from a reporting perspective up through their organization.



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R. Wayne Jackson - *SecureWorks Corp. - CFO*

Yes, Mike, and the one thing I'd add to that, because it is a very important segment for us, some of the new solutions that Mike talked about, we put together specifically for the SMB space. So we expect good things from that as well.

Robbie David Owens - *KeyBanc Capital Markets Inc., Research Division - Senior Research Analyst*

And when you speak to a second half inflection, given there's a lag in your model, obviously, it's going to show up probably in the gross MRR number at first. So is the anticipation then that really, this is kind of a first half of fiscal '19 thing, where we actually see it in the revenue numbers?

R. Wayne Jackson - *SecureWorks Corp. - CFO*

Absolutely, it will show up in MRR first because that includes backlog, of course. And then we'll begin to see it early to mid. Depends on how late in Q3 and then when the sales are closed, and also same in Q4. We -- the sooner we sign them, the sooner they -- that we get them installed because just as a reminder, it's 90 to about 120, 140 days before our install time depending on the complexity of the solution and the client. So you got it right.

Operator

Your next question comes from the line of Fatima Boolani with UBS.

Fatima Aslam Boolani - *UBS Investment Bank, Research Division - Associate Director and Equity Research Associate Technology-Software*

Maybe the first one for Michael. Michael, just a big picture question for you. Artificial intelligence in the realm of cybersecurity is a bunch of buzzwords that get thrown around, and I'm wondering if you can help make the opportunity tangible for us and help us understand how you are incorporating artificial intelligence-type techniques to get better efficiencies out of your finite resources. And then a follow-up for Wayne, if I may.

Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

Sure. So great question, Fatima. Let me try and attack this from a couple of perspectives. This is all that we have done for over 15 years now. And we've kept the historical attack data, so we use that as our training set. And we've developed technologies such as Foresee, which will effectively put a probability and confidence around using our current knowledge of the threat actors, our historical threat data that we have and the information coming in across our 4,400 clients, figuring out what probability of confidence associated, whether something is malicious or not. We will do that in a supervised manner and then we move it into an unsupervised manner, effectively creating algorithms, which move into the artificial intelligence world, if you will, kind of machine learning and then artificial intelligence, to make the appropriate decisions. So where you can see that, first of all, is in the gross margin that Wayne talked about earlier. Effectively, we have grown our revenue, our client base and the number of security incidents that we have coming into the organization. And yes, the people that we have dealing with things in our security operation center has remained relatively constant for the past roughly 2 to 3 years.

Fatima Aslam Boolani - *UBS Investment Bank, Research Division - Associate Director and Equity Research Associate Technology-Software*

That's very helpful. And then just a follow-up for Wayne -- Wayne and Mike, actually both, you have mentioned a focus on reducing churn and containing the levels of churn to kind of drive the reacceleration in the back half. I'm wondering on the SMB side, in particular, and especially under the leadership of the new individual you have in place there. What are maybe the top 2 or 3 programmatic things you need to do to contain the level of churn in the SMB arena, which maybe tends to be a little bit more fickle of a customer relative to your enterprise base? And that's it for me.



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Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

Sure. So another -- this is Mike. Another great question. Let me make sure that I address it in a couple of ways. The new leadership that we have in SMB is on the sales front. So some of the changes will be basically going back to the types of things that we've talked about in the enterprise, which is the talent of individuals that we have there focusing on coverage and the specific areas and then the quality of sale from a training perspective and the discipline. And the -- expanding that, I would say, from our sales perspective is going to be from relationships with their ongoing clients rather than having the sellers that are more focused on just selling and not, if you will, ongoing relationships. That will also impact dramatically by what we do from an operations perspective. Our operations team is basically going through to ensure that we do onboarding, whether it's a small to medium-sized client all the way up to the largest clients, in a quick efficient manner. We're actually doing NPS studies of our own -- or NPS, I guess, studies or surveys of our on boarding right after we've onboarded clients or within a 90-day to 120-day period. Those results have been very, very helpful for us and very promising. We're doing a lot around solution architecture and then continued communication with our clients to produce champions reports, i.e. to help ensure that the person that's brought us into the organization understands the value that we're providing and helps them in the communication and education up through their organizations to their CIOs or their CFOs and/or CEOs. One of the things that I'd add that we've seen that's been very interesting is as security -- and this goes across not just SMB, by the way, but as security has become and continues to become more of a focus across boards and C-suites, we're seeing more CFOs and CEOs actually get involved in sales processes towards the end, not that their sales processes slowed down at all, but just that it's, quite frankly, having to -- ensure that you're showing the value of the solution that you're providing, both in renewals and in the sales process.

Operator

(Operator Instructions) Our next question will come from the line of Gabriela Borges with Goldman Sachs.

Gabriela Borges - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Maybe for Mike, maybe just a little more color on the competitive environment would be helpful for us. When I look at the longer-term industry growth target, it's around 16% and where the MRR and the revenues coming in today, I think a lot of the delta there is some of the changes you're making in the go-to-market. But any additional color on how the competitive landscape is changing, what you view is the key differentiator for SecureWorks would be really helpful.

Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

Sure. Thank you, Gabriela. The -- from a competitive landscape perspective, I would not say that we're seeing a lot of changes in the last 90 to 180 days. Effectively, in the large enterprise space, it's going to be the same 2 or 3 organizations that would get an RFP. We are clearly the only one that's solely focused on doing what we do. We're the only one that has CTP and the ability in a vendor-neutral manner to work with all of the best-of-breed technologies that exist on the market -- in the marketplace. And our belief is that we have done a good job in moving the large enterprise sales organization, particularly in North America, back to where we're going to win or are now winning more than our fair share and getting into the -- into more of the opportunities. In global markets outside of North America, we have not seen the change there either, but we are, as I mentioned in my prepared remarks, continuing to see very nice growth and success that is far greater than the market growth, although off smaller numbers in both EMEA and APJ. From an SMB perspective, we have, for 15 years, continued to see small companies come and go over the years and try and attack the market from various perspectives, but there's been no player that has the sort of size and scale that we have and the visibility to support the SMB market as well. So competitively, I would tell you, I think the biggest -- we've not seen a lot of different sales cycles. So roughly been the same over the last couple quarters. And I think it's really been our continued focus and execution and changing to a more sales-led organization.

Gabriela Borges - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

That makes a lot of sense. And as a follow-up, if I could, on your relationship with Dell, could you expand a little on whether you are able to use your relationship there to help you go to market internationally, particularly in some of the large accounts?



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Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

So another great question. And I would say, and sort of Dell, I'm going to call it the Dell technologies companies because there's a lot of opportunities for us there with the legacy EMC. So the Dell EMC sales organization as well as the recent announcement we had on AppDefense with VMware, so we're excited. We are putting a bit -- a stronger effort now that the Dell EMC integration is -- I guess, the acquisition merger is over a year old. And we are seeing help from the Dell sellers and -- a good opportunity, the Dell EMC sellers to go to market in the North American large enterprise, in the small- to medium-size business market from a lead-gen perspective and in APJ and in North -- and in EMEA, I'm sorry, where they have strong relationships with clients and can open the doors to bring us in and we can go to market together.

Operator

Your next question comes from the line of Walter Pritchard with Citi.

Jeremy Benatar

It's Jeremy Benatar in for Walter. It seems like larger deal performance is strong, but client count was about flattish. Do you expect large deals to become more of a driver going forward than in the past?

Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

So I would -- this is Mike here. What I would say to respond to that is that the majority -- as we've disclosed over time, the majority of our clients are SMB, but the majority of our revenue comes from the larger deals. As Wayne mentioned in his prepared remarks, the average large enterprise in North America deal is about 10x the SMB. So both are very important to us and both are focused areas for us. But from a revenue perspective, I would expect that the large enterprise revenue is going to continue to be a significant part of our revenue mix in the future.

Operator

Our final question will come from the line of Tal Liani with Bank of America Merrill Lynch.

Michael Feldman - *BofA Merrill Lynch, Research Division - Research Analyst*

This is Michael Feldman on from Tal Liani. So couple of questions. You had -- what is the time line -- you mentioned Red Cloak has a pretty robust pipeline. It's been growing. What is the time line for when you expect that Red Cloak pipeline to convert into actual orders? And how should we think about the margin impact from a higher mix of Red Cloak versus the rest of the business?

Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

So great question, Michael. This is Mike Cote. Red Cloak was announced, I think, we're saying about 4 or 5 quarters ago. Time goes by quickly these days.

R. Wayne Jackson - *SecureWorks Corp. - CFO*

March.

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Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

Last March?

R. Wayne Jackson - *SecureWorks Corp. - CFO*

Yes.

Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

Thank you, Wayne.

R. Wayne Jackson - *SecureWorks Corp. - CFO*

You're welcome.

Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

And it -- typically, Red Cloak conversion into sales is probably on the shorter end of the sales cycle. And converging into revenue from an implementation perspective is definitely on the shorter end and happens pretty quickly. So we've -- we have -- I don't have the numbers in front of me, but we've got a nice install base of Red Cloak already and a growing install base -- or growing pipeline opportunity in front of us. So we would hope that we can convert as much of that as possible. We didn't report -- just so everybody knows, we did not report any pipeline data on other parts of solutions that we have. But we have, overall, seen a growth in the pipeline -- a nice growth in the pipeline from Q1 to the end of Q2.

Michael Feldman - *BofA Merrill Lynch, Research Division - Research Analyst*

And any impact -- what impact do you think that will have on margins as that becomes a bigger piece of the business?

R. Wayne Jackson - *SecureWorks Corp. - CFO*

So from a margin perspective, we go to market with Red Cloak either individually as an endpoint, as a cross sale or as perhaps even the only solution a client may have. Those margins tend to be a little bit higher. To the extent it's included with other solutions, it sort of all gets blended in -- into the -- and it looks a lot like our overall margin for a particular enterprise or SMB client. So it's not that I'm not trying to give you a direct answer. It really depends on if it's standalone or if it's included with other offerings.

Michael Feldman - *BofA Merrill Lynch, Research Division - Research Analyst*

Okay. And then you touched a little bit about public cloud earlier, but as your cloud moves from deploying on-premise security solutions to more like security-as-a-service solutions like cloud-based e-mail or cloud-based web security, what impact does that have on the revenue, you -- that SecureWorks receives from those customers?

Michael R. Cote - *SecureWorks Corp. - CEO, President and Director*

So today, right now -- this is Mike. Today right now, it's been an expansion of the revenue because it's not as if that they're doing away with their on-prem or their hybrid environment. And as they've moved into the public cloud in the shared responsibility model on the public cloud, they



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need someone to help them ensure that their side of the shared responsibility is being done. So again, I mentioned, we are early in the stages, but we saw a great growth in cloud revenue and are cautiously optimistic.

Rebecca Gardy

I think that was our last question. So thank you, again, for joining us on today's call and for all your questions. We appreciate your support, and we look forward to our third quarter call in early December. If we didn't get to your questions during this section, please don't hesitate to reach out to me and Investor Relations for a follow-up. Thank you.

R. Wayne Jackson - SecureWorks Corp. - CFO

Thanks, everyone.

Michael R. Cote - SecureWorks Corp. - CEO, President and Director

Thank you.

Operator

Ladies and gentlemen, that concludes today's call. You may all disconnect at this time.

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