06-Jun-2017

SecureWorks Corp. (SCWX)

Q1 2018 Earnings Call

CORPORATE PARTICIPANTS

Rebecca Gardy
Investor Relations Officer, SecureWorks Corp.

R. Wayne Jackson
Chief Financial Officer, SecureWorks Corp.

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

OTHER PARTICIPANTS

Walter H. Pritchard
Analyst, Citigroup Global Markets, Inc.

Sterling Auty
Analyst, JPMorgan Securities LLC

Matthew George Hedberg
Analyst, RBC Capital Markets LLC

Jonathan F. Ho
Analyst, William Blair & Company, L.L.C.

Rob Owens
Analyst, Pacific Crest Securities

Christopher Speros
Analyst, Stifel, Nicolaus & Co., Inc.

Fatima Boolani
Analyst, UBS Securities LLC

Gabriela Borges
Analyst, Goldman Sachs & Co.

Melissa A. Gorham
Analyst, Morgan Stanley & Co. LLC

Saket Kalia
Analyst, Barclays Capital, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the SecureWorks' First Quarter Fiscal 2018 Financial Results Conference Call. Following prepared remarks, we will conduct a question-and-answer session. [Operator Instructions] At this time, all participants are in a listen-only mode. We are webcasting this call live on the SecureWorks' Investor Relations website. After the completion of the call, a recording of the call will be made available on the same site.

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

Rebecca Gardy
Investor Relations Officer, SecureWorks Corp.

Thank you, Regina, and good morning, everyone, and thank you for joining us today to review SecureWorks' financial results for the first quarter of fiscal 2018. This call is being recorded, and this call is also being broadcast live over the Internet and can be accessed on the Investor Relations section 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 May 5, 2017. You can access this press release on the Investor Relations section of the SecureWorks' website.

During this call, our management will make forward-looking statements relating to our expected financial results and other future events. Please refer to our Form 10-K and other SEC filings for a discussion of risks and uncertainties that could cause our actual results and events to differ materially from those presented or implied in these forward-looking statements. We assume no obligation to update our forward-looking statements.

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 impacts of purchase accounting, amortization of intangibles, and the related tax effects of these items. We have provided reconciliations of the non-GAAP financial measures to the comparable GAAP financial measures in today's earnings press release available on our website.

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. We would appreciate you limiting your initial questions to two, so that we may allow as many of you to ask questions as possible in our allotted time. In the event you have additional questions that are not covered by others, please feel free to requeue, and we will do our best to come back to you. Thank you for your cooperation on this.

Finally, I would like to remind you that SecureWorks will be presenting at the Citi 2017 Small & Midcap Conference on Thursday, June 8, in New York; and the William Blair 37th Annual Stock Conference on Tuesday, June 13, in Chicago. Additional information on all these events can be found on the Investor Relations section of the SecureWorks website.

And, with that, I will now turn it over to Mr. Cote.

Michael R. Cote

President, Chief Executive Officer & Director, SecureWorks Corp.

Thank you, Rebecca, and good morning everyone. Thank you for joining the call today. Demand for cybersecurity remains strong, as threat actors continue to allude security ecosystems of organizations around the globe. Threats are increasing in complexity and magnitude. You don't have to search far for evidence. A glance at the recent headlines about the global WannaCry attack are enough to drive that home. And those are just the attacks that you hear about.

Over the last few months, I've met with many of our largest clients, all global enterprises based in North America, representing a substantial amount of our total monthly recurring revenue, or MRR. My interaction with everyone of the CIOs and CISOs I met with confirm the industry continues to mature.

Let me give you two examples. The CIO of a multinational engineering and aerospace company is involving their security strategy and seeking our counsel as they refresh their point products across their entire organization. In the past, their approach was adding layers upon layers of security products. They are now focused on buying the point products that meet their specific requirements in each area, network, endpoint, cloud, and deriving greater value across their ecosystem.

They value of the power of the Counter Threat Platform or CTP, our vendor-agnostic approach, and visibility to see the strengths and weaknesses of each point product. They know that we provide solutions that work across their environment in a coordinated, integrated, and orchestrated manner, on-prem and in the cloud.

I also met with the CIO of one of the largest public universities in the country. We are working together to seamlessly expand their internal security solutions to their affiliated community colleges. Rather than just be informed of suspicious cyber threat activity, the community colleges are benefiting from the powerful network effect and the predictive early warning system we deliver to the university and all of our clients.

The key takeaway from our prospects and clients is that while almost all companies in our space address cyber threat as a technology problem, ours is a highly differentiated approach. We offer a powerful combination of artificial and human-intelligence-driven solutions. We have 17 years of visibility into the threat activity affecting over 4,400 clients in 61 countries. We combine the artificial intelligence and automation of our industry-leading CTP with actionable insights from our team of elite researchers and analysts to provide a powerful network effect. The more clients and endpoints we add to CTP, the more visibility we have across all of our clients to detect and eliminate threats. Clients value our technology leadership and singular focus in the vast and growing cybersecurity market.

According to Frost & Sullivan, the global managed security services market is expected to grow at an average annual rate of 16% over the next three years, reaching approximately $20 billion by 2020. In the first quarter, SecureWorks revenue increased to nearly $114 million, representing almost 14% growth. Gains in gross profit outpaced revenue growth, with margins improving year-over-year by 220 basis points.

I will share more on ways we are scaling in a moment. Net loss this quarter was primarily impacted by higher sales investments to address the substantial market opportunity. Proprietary technology makes up the CTP to a powerful scale on the gross margin line. For example, Foresee, our machine learning technology, auto resolves correlated security events that would have otherwise required analyst review.

We saw double-digit improvement in the portion of the events on which Foresee took action, allowing our security teams to focus on the new threats in our clients' environment. We are seeing the benefit of this technology in our operational metrics. This quarter, we processed up to 220 billion events per day, a 33% increase over the prior year. Over the same period, we saw an approximate 25% efficiency gain in events processed per security analyst, a clear illustration of the powerful scale we can achieve.

Another example is the scale we've achieved in Japan. Three years ago, we invested in this important region ahead of the revenue curve, making a commitment to one of the largest cybersecurity markets in the world and one that we believe is critical to global success. Although still a relatively modest contributor to overall MRR, our Japan investment is ramping nicely. Year-over-year subscription-based contracts sold in Japan have increased more than fourfold. And we have continue to expand margins in the region as we scale. With these and many other operational efficiencies in place, we have created a strong scalable foundation that will serve us well, as we accelerate sales.

Let me turn to what we're doing to grow our top line. In January, Jason Capitel, our Chief Revenue Officer, joined our leadership team and took action to retool our sales process. Within the last few months, we identified areas that needed improvement in order to seize the significant opportunity we have in the enterprise market, particularly, in North America.

And today, I am pleased to share some updates. First, all of Jason's direct reports are now in place, including a new head of sales engineering and a new head of our indirect sales effort. Second, we are focused on adding experienced enterprise [ph] sellers (09:21). We ended the first quarter with approximately 175 quota carriers or 15% more than last year. While we experienced slightly higher attrition during this transition period, the percentage of quota carriers with a tenure of two or more years has remained constant.

Third, by the end of the quarter, we redistributed our resources in our North American enterprise team in order to provide better density of coverage. Our sales teams are now closer to the respective clients and prospects within contiguous markets. They are engaging more efficiently and building deeper relationships to nurture cross-sales opportunities. By hiring additional quota carriers and reducing these margin territories our sales makers will have additional bandwidth to pursue and grow new logos, consistent with our land and expand strategy.

Fourth, we fine-tuned our sales approach to the enterprise market. We made investment in our sales engineering team, increasing head count by nearly 15% over the first quarter of fiscal 2017. Our sales engineers are important to ensure an optimal solution for enterprise prospects. We have also streamlined decision-making and created more clarity of roles and responsibilities. We expect the impact of these changes will properly set client expectation, reduce sales cycles and accelerate installation timelines. While we're in the early innings, we expect these changes to be evident in MRR acceleration in the back half of fiscal 2018.

Let me share a few examples of seven-figure wins with North American companies this quarter. We signed a three-year contract with a U.S.-based subsidiary of a global industrial chemical firm that included AETD Red Cloak; a three-year monitoring contract with a large car retailer; and a three-year advanced remediation management contract with the technology arm of a large private equity firm.

In terms of geography, while North America is our largest market and a key focus, demand for our subscription solutions in EMEA and APJ is growing with a healthy pipeline. This quarter, revenue in EMEA grew by about 40% year-over-year, while revenue in Japan increased 100%.

Relative to industry diversity, we built this company catering to the needs of the financial services industry, but over time, we've diversified. Though financial services clients represent 30% of revenue and that sector continues to grow, we see strong demand across industry verticals, particularly healthcare, state and local government, and insurance. In fact, of our top 10 largest deals this quarter, represented six distinct verticals.

Nurturing relationships with clients across geographies and industries is paramount for us. In the first quarter, we held our annual Enterprise Security Summit or ESS. The event provided senior-level security professionals an exclusive forum to openly discuss security challenges and concerns. It was the largest ESS since inception attended by decision makers at clients from 35 states, four countries, and 12 industries.

Now, let me highlight just a few of our technology innovations this quarter. Making continuous investments, especially in the CTP, is critical for us as we maintain a leadership position in the cybersecurity industry. Our client portal serves as the window into the power of this technology.

In Q1, we saw rapid adoption of our new mobile application. This app provides our clients with new key detection and remediation features of our client portal on a mobile device, facilitating on-the-go threat management, including searching, filtering, and drill-down capabilities. Nearly all of the clients that have subscribed to the app have integrated push notifications into their security workflow.

We also built upon our traditional monitoring capabilities with Microsoft Exchange, SharePoint, and Active Directory, and launched security monitoring of Microsoft Office 365. Together with our offerings in our Cloud Guardian portfolio, this solution is one more way that we help our clients secure workloads in their data centers and in the cloud. We are pleased with the response from clients and prospects. We are also seeing strong demand for our new subscription-based advanced remediation management solution.

Most enterprise organizations have a security model that includes a first layer of security event management responsible for notification, correlation, and filtering. However, the number of events escalated through to the next level still continues, still requires overwhelming resources and delays the client from focusing on real threats.

Developing the staff and skills required to provide advanced threat telemetry and business context is a challenge for many organizations. To address this client need, we now offer our clients the next layer of security event management, including Internet escalation, correlation across the clients' various systems, and orchestration of their remediation activities. This leverage solution delivers deeper event analysis, utilizing CPP alongside existing client tools and systems. Our clients appreciate the approach and clear business value it provide, which enables the best and most effective security decisions possible.

Finally, I would like to share a quick update on Red Cloak, our proprietary technology we used for Advanced Endpoint Threat Detection. While most other vendors focus mostly on detecting malware and endpoints, AETD Red Cloak uses our threat intelligence to detect compromise even in the absence of malware. Over the last year, the subscription contribution of Red Cloak has more than tripled to become a meaningful contributor to MRR. In Q1, Red Cloak-based MRR was up 20% sequentially.

So, as I wrap up my comments in the quarter, I want to reiterate that across every dimension of SecureWorks, we are dedicated to putting our clients first. Even as we process an ever-growing number of events and incidence, we continue to scale the CTP's effectiveness, and we are achieving increased efficiencies in our delivery model. This foundation will serve us well as we ignite momentum through our investments and sales. We are confident that MRR will accelerate in the second half of fiscal 2018, and we will sustain that momentum in the years to come, driving profitable growth.

Now, let me turn it over to Wayne for a deeper dive into our first quarter results and to present near-term guidance.

R. Wayne Jackson

Chief Financial Officer, SecureWorks Corp.

Thank you, Mike. Good morning, everyone. Please note that all financial information is non-GAAP, and growth rates are compared to the first quarter fiscal 2017, unless stated otherwise. For the first quarter fiscal 2018, we delivered top line growth and solid gross margin expansion, while making continued investments to accelerate our sales momentum.

For the first quarter of fiscal 2018, the following are our several key metrics. As Mike mentioned, we ended the first quarter with approximately 4,400 subscription clients in 61 countries. Our average annual revenue per client was $87,000 this quarter, an 8% increase.

Next, MRR increased by 10.4% to $31.9 million. We are optimistic about a more robust MRR growth in the second half of fiscal 2018, as we expect to see the benefit of our investments in our sales organizations. We believe MRR is an indicator of annualized subscription revenue. Lastly, we ended the first quarter with a 99% revenue retention rate.

Turning to the P&L. First quarter revenue increased 13.7% to $113.7 million. The percentage mix of revenue from our subscription solutions and security risk consulting services, shifted slightly this quarter, though it remains approximately 80-20. Revenue in the U.S. increased approximately 11%, and we continue to see strong growth in our international markets. This quarter, approximately 14% of revenue was international, up from 12% in the first quarter of fiscal 2017.

Let's take a look, at the rest of the P&L items. Gross margin was 55.8% of revenue during the quarter, a 220 basis point increase. I am pleased with the impact our investments and our global expansion, our technology, and our service delivery model are making on profitability. Operating expenses were 64.1% of revenue, up 40 basis points.

Research and development expense were 16.4% of revenue, 110 basis point reduction. In absolute dollars, R&D spending increased $1.2 million over the first quarter of last year, as we expanded our software engineering team. As an industry leader, we continue to invest in our CTP and to develop new solutions that protect our clients in an evolving threat landscape. We expect R&D expense to maintain the current rate as a percent of revenue throughout fiscal 2018.

Sales and marketing expenses increased to 32.5% of revenue, a 230 basis point increase. Our go-to-market investments resulted in a $6.7 million increase in sales and marketing expense, primarily driven by 17% growth in sales head count and expenses related to sales training. For the remainder of this fiscal year, we expect to maintain sales and marketing expense as a percent of revenue at roughly the current level, while we work to accelerate MRR momentum.

General and administrative expenses in the first quarter were 15.2% of revenue, a 70 basis point improvement. We expect G&A expense to be in the mid-teens for the remainder of fiscal 2018. Net interest and other was a charge of approximately $650,000 compared to income of $365,000 the prior year. The primary driver was the impact of fluctuation in foreign exchange rates.

Our first quarter non-GAAP net loss expanded by $400,000 to $6.5 million or $0.8 per share. The difference to our prior guidance is due primarily to additional investments in sales and marketing and FX impact, partially offset by gross margin improvement. Weighted average shares outstanding, both basic and fully diluted, were $80.056 million for the first quarter. The company's adjusted EBITDA loss improved by $1.3 million to $6.4 million. Given the sales investments we are making this year, we expect a delay in reaching positive adjusted EBITDA until fiscal 2019.

Cash flow used by operations was $19.7 million in the first quarter, primarily due to annual bonus payouts of $22 million. The timing of this payment in the first quarter is consistent with prior years. Regarding cash flow from operations, we continue to expect the receipt of approximately $25 million in the four quarter from Dell Technologies' utilization of our tax attributes. The receipt of the $25 million will be included as cash flow from operations.

For the first quarter, we invested $3.4 million in capital expenditures to support our growth.

We have a strong cash position of $91.6 million, an uncapped $30 million credit facility, and continue to have no indebtedness.

Now, let's turn to our guidance for the second quarter and full fiscal year 2018. Based on the company's performance to the end of the first quarter, the items we have highlighted on this call in current market conditions, we expect the following: For the second quarter, revenue on both a GAAP and non-GAAP basis to be in the range of $113 million to $114 million; net loss per share to be in the range of $0.17 to $0.18; and non-GAAP net loss per share to be in the range of $0.08 to $0.09. We expect approximately 80.353 million weighted average shares outstanding during the second quarter of fiscal 2018.

For full year fiscal 2018, we are updating our prior guidance as follows: We expect GAAP revenue to be in the range of $459 million to $464 million and in the range of $460 million to $465 million on a non-GAAP basis; GAAP net loss to be in the range of $53 million to $55 million; and adjusted EBITDA loss to be in the range of $24 million to $28 million; GAAP net loss per share to be in the range of $0.66 to $0.69; and non-GAAP net loss per share to be in the range of $0.30 to $0.33.

We continue to expect capital expenditures with approximately $18 million to $20 million for fiscal 2018. We expect weighted average shares outstanding in fiscal 2018 to be 80.286 million. And finally, we continue to expect the MRR to be in the range of $34.4 million to $36.4 million at the end of the fourth quarter of fiscal 2018.

In summary, while we build momentum on the top line through investments, we continue to deliver operating leverage and manage our operating expenses. Our cash position remains strong, and we believe that we will continue to win in the market as we use our unique mixture of human and machine intelligence to help our clients secure themselves against cyber threat activity.

Operator, will you please open the call for questions at this time.

QUESTION AND ANSWER SECTION

Operator: I would now open the call for questions. [Operator Instructions] We'll take our first question from the line of Walter Pritchard with Citi. Please, go ahead.

Walter H. Pritchard
Analyst, Citigroup Global Markets, Inc.

Q

Hi. Thanks. Just a question around the sales and marketing spend. It seems like you had a plan last quarter, and you hit it on the top line. And just wondering what was it specifically about the way you changed the sales organization? Were some of those onetime expenses? It sounds like they persisted at the end of the year. Just trying to understand three months ago versus today and the spend.

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

A

Walter, this is Mike Cote. Thanks for the call. If I can just divert for a minute, I understand that in the prepared remarks I said, 220 billion events, when I was talking about the volume. It's actually 240 billion events, so that the record can be clear.

To answer your question, Jason has been with us five months now. And as he came in and traveled around the globe to meet with clients, prospects, and our team, we got really excited about the opportunity and the prospects in front of us, and took three attack vectors. One is talent.

So, as I mentioned, he has all of his direct reports in place, including new leaders in the Middle East and Australia, the new sales engineering lead and indirect sales leader. We had slightly higher attrition during this transition period, but the solace of tenure remained constant. He aggressively hired seniored – so faster than we had anticipated in seniored sales executives and sales engineers and supporting individuals.

From a coverage perspective, so, the first is talent; the second area was coverage. We increased quotas carriers by 15%, again, hiring more seasoned individuals; redistributed resources in North America to be closer to our clients. The sellers are better engaged in deeper relationships in those regions and allowing us to focus really on the land and expand that I mentioned in the prepared remarks.

The third point will be quality of sale, which is increasing the sales engineers by 15%. And again, those were more sales engineers and more seasoned sales engineers than we had looked at earlier or planned on, I should say, earlier. And we did some adjustments, too, and improvements in the tools and systems that we're reporting.

In the first quarter, from an expense perspective, there were some one-time cost that we would not have recurred through the year, such as training at our annual sales meeting, but we expect, for the most part, of those costs will be offset as we continue to do and fill out the head count that we're looking for.

Walter H. Pritchard
Analyst, Citigroup Global Markets, Inc.

Q

And then, Mike, just to follow up on that, maybe for Wayne. I know you're not giving 2019 guidance as we think about getting to EBITDA positive in 2019. Should we think about like a change in the trajectory of revenue or a change in the trajectory of expenses to get there, or is it just sort of draw these lines that we have coming out of 2018 into 2019?

R. Wayne Jackson
Chief Financial Officer, SecureWorks Corp.

A

Hi, Walter. Good morning. So, relative to 2019, you're right, too early to give guidance on that right now. But relative to 2019 and the growth rate of revenue, we forecasted the 34.4% to 36.4% of MRR growth, which gives you some indication of the revenue growth we're expecting in 2019.

And as revenue ramps, first off, from a gross margin perspective, you think about the P&L revenue's going to ramp our gross margins. We continue to expect for the investment we're making to help in our gross margin line. Then R&D scales; G&A scales; sales and marketing too early innings to know exactly what the investments next year will need to be. But we're optimistic that we'll get EBITDA positive in sometime in fiscal 2019. Hope that answers your question.

Walter H. Pritchard
Analyst, Citigroup Global Markets, Inc.

Q

Okay, Thank you. Yes. Yes, it does. Thank you.

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

A

Let me just tie on a couple of points with what Wayne said, if I could. So, one would be, I think it's important to note that in Q4 of last year, we were adjusted EBITDA positive. The second thing is we will be cash flow positive from operations this fiscal year. So, the decision to spend this incremental money was really a conscious decision based upon Jason's analysis of the market, and what he saw in the field, and the opportunity for us to really take a much larger leadership position in the market.

Operator: Your next question will come from the line of Matt Hedberg with RBC Capital Markets. Please go ahead.

Matthew George Hedberg
Analyst, RBC Capital Markets LLC

Q

Great. Thanks for taking my questions. Mike, the threat landscape is obviously robust. I'm wondering are you seeing customers using your SecureWorks platform really as a way for them to consolidate or rationalize some of their security spending.

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

A

So, Matt, that's a great question, and thank you. As I mentioned in the prepared remarks, we are seeing some of our clients approach us to ensure that they have the right point products for them across their ecosystem. So, they may – in your specific question, in this case that I gave the example of, that actually had multi layers of defense, and now they're looking to rationalize that cost and put it in a more focused and effective manner based upon the security control they're looking across their ecosystem.

Matthew George Hedberg
Analyst, RBC Capital Markets LLC

Q

That's helpful. And then with the investments to accelerate MRR in the second half here, can you remind us what percentage of your revenue MRR comes from the channel? And how does Jason think about deploying additional resources on the channel side of your business?

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

A

From an indirect perspective, and remember, the channel is not [indiscernible] (30:14) because of what we do, if you will. Our ratio of revenue coming in or sales coming in from the channel is roughly the same, which is in the 6% range of revenue. We've, in the last 90 days, I believe, hired the new indirect channel leader, and we are looking at – and these deals take longer, because of the types of relationships they are. But outside of North America, in particular, we have some very promising opportunities in Europe, and in APJ, in particular, where we're looking to partner with some complementary companies from a go-to-market and delivery perspective that I am hoping I can announce some more on this later in the year.

Matthew George Hedberg
Analyst, RBC Capital Markets LLC

Q

That's helpful. Thanks a lot guys.

Operator: Your next question comes from the line of Rob Owens with Pacific Crest Securities. Please, go ahead.

Rob Owens
Analyst, Pacific Crest Securities

Q

Great. Thanks, and good morning.

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

A

Good morning, Rob.

Rob Owens
Analyst, Pacific Crest Securities

Q

Mike, curious around your comments around how the industry continues to mature. Relative to discussions with customers in sale cycles, which I know had been longer than you had wanted. A, given the threat landscape of things you're talking about; B, given some refinement in terms of go-to-market, what are you seeing now in terms of those sales cycles? And maybe you can address it as well as you're entering new verticals or having more success in new verticals. Thanks.

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

A

So, great question, Rob, and thank you. On the sales cycles themselves, I would say that we are beginning to see them shortened, and that people are becoming more decisive. And again, this is not a dramatic change, but it sure feels, anecdotally, from the visits that I've made and the conversations that I've had that clients are becoming more decisive and understanding what they wanted in the pause that seem to exist, if you will, over the 9-month period of time, or 6 to 12 months is going away some. From a vertical perspective, our partnership with the Dell organization is helping dramatically, particularly, for example, in state and local government, where in many instances, those sales cycles are being shortened as we leverage our relationships as an overall organization there.

Rob Owens
Analyst, Pacific Crest Securities

Q

Great. Thank you.

Operator: Your next question comes from the line of Fatima Boolani with UBS. Please go ahead. Your line may be on mute.

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

A

Fatima?

Operator: And if you're on a speaker phone, please pick up your handset.

Fatima Boolani
Analyst, UBS Securities LLC

Q

Hi. Good morning. I apologize for that. Maybe a question for Wayne. Wayne, around the time of the IPO, you had discussed some metrics around your lifetime customer value and some of the repeat purchasing patterns that you've seen within your base that, I think, pretty loyal. Can you just give us an update on sort of how maybe you're top 25 and top 50 customers are spending, into what multiples they're now spending at, and maybe how that diverges, as you move out of the enterprise enrollment into the SMB customer cohort you have?

R. Wayne Jackson
Chief Financial Officer, SecureWorks Corp.

A

Hi, Fatima. Good morning. So, relative to our top 25 clients to 50 clients, and that's a pretty broad range for us, we see fairly consistent spending patterns certainly over the last two years since becoming a public company. The mix of our top 25 have changed, as we brought in some larger clients, some of the mid-teens to low-20s clients have fallen out of the top 25. So, as we focus on the enterprise phase we are signing up some clients that have fairly large contracts for us. If this is what you're asking, the demand for the solutions that we have are pretty consistent in our client base.

Fatima Boolani
Analyst, UBS Securities LLC

Q

And a quick follow-up, if I may, understand Jason's still getting his sea legs in fine-tuning the organization in the rest of the year. But I'm curious if you can comment on any quantifiable impact you've seen as a result of onboarding some of this new sales capacity. And maybe in the form of what your lead generation volumes look like, what your pipeline conversions look like, or any kind of broad color around those metrics to better understand how the changes are manifesting so far. That's it for me. Thank you.

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

A

This is Mike, Fatima, great question. From a quality of sale perspective, sort of the third leg that I mentioned earlier, in the improved tools and reporting, we're looking at the quality and the consistency of the sales pipeline and actually drilling down on a per-seller perspective in the movement through that pipeline. And then, as the movement moves through, as prospects move through particularly to closure, we continue to shorter sales cycles. So, Jason and I have had regular conversations to watch how that is moving. And in particular, in the last, I say 30 days, we're beginning to feel much better about looking at it from a pipeline perspective and quality of sale.

Operator: Our next question will come from the line of Melissa Gorham with Morgan Stanley. Please go ahead.

Melissa A. Gorham
Analyst, Morgan Stanley & Co. LLC

Q

Thanks for taking my question. So, just based on the commentary of increasing sales investment, it sounds like you feel as though you are capacity constrained. Is that a fair characterization, and you feel like MRR growth would actually be higher if you had more feet on the street? And then given that, what do you think in terms of the productivity levels of your existing sales force? Are they at full productivity today, or is there still room to go to improve the guys that you have today?

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

A

So Melissa, the last part of your question was productivity, the first part again was capacity?

Melissa A. Gorham
Analyst, Morgan Stanley & Co. LLC

Q

If you feel as though your capacity constrained today significantly, and that's the biggest inhibitor to growth?

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

A

Yeah. This is Mike. Thank you for the question. On the capacity side of things, what Jason has really done is look to bring in more experienced individuals, more seasoned individuals to complement the ones that we have on staff, those that we're looking to be with us longer term, to bring in more enterprise sales engineers to address the North American enterprise selling opportunity.

We have the right number of people on today to reach the guidance that we've given, from an MRR perspective, but believe that with the new folks in place and continuing to ramp for fiscal 2019 and beyond, the decision was really done based upon our valuation of the market opportunity and Jason being in the field. He traveled all around the globe in the last 150 or 120 days. He's excited about the opportunity, and there's no one company in the space that has 5% market share, and we're clearly the one that's growing the fastest. And our hope is to reignite that into prior year levels. And Jason, I think is confident that he can do that as quickly as possible. From a productivity perspective, we clearly believe that our sales productivity close per seller can improve and will improve over time.

Melissa A. Gorham
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Thank you. And then just one follow-up kind of related to that. In terms of thinking about the investments and where they're going to go domestically versus international. It sounds like you are having some momentum internationally. And the U.S. is obviously a more mature market for you. So, as we're thinking about the increased investments in the second half of the year, can you help us understand how you're prioritizing, moving more internationally versus investing more here in the U.S.?

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

A

From a dollar perspective, the U.S. will be the bigger part of the investment, just because our presence in APJ and EMEA's smaller. However, because of the growth opportunities we have and the success that we've had in both markets, we're really – both markets being EMEA and APJ, we will continue to invest in those markets, both from an indirect perspective, as well as a direct perspective in going to market. I described earlier, the successes we are having in both of those markets. And we're really excited about the leadership team that we have in EMEA, and the leadership team we have in APJ, and the successes that we've had there. So, we will proportionately continue to invest.

Melissa A. Gorham
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Thank you.

Operator: Your next question comes from the line of Sterling Auty with JPMorgan. Please go ahead.

Sterling Auty
Analyst, JPMorgan Securities LLC

Q

Yeah, thanks. Hi, guys. So, on the sales and marketing being held as a percentage of revenue, how does that translate into further head count increases versus non-head count spend?

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

A

So, Sterling, this is Mike Cote. In Q1, we had some one-time non-head count items. I mentioned the sales training, and the annual sales meeting, in particular. And then we had some transition of individuals on the sales team. You should expect us to continue to hire some incremental head count through the rest of this year as we would ramp up actual dollar amounts in Q2, Q3, and Q4 to be in the approximate guidance that Wayne's given.

Sterling Auty
Analyst, JPMorgan Securities LLC

Q

But just to follow on that, just can you give us a sense, is there a target by the end of the year that you would expect either quota carrying head count to be up a certain percentage as well as give some commentary around the sales engineer head count as well? So, where are those trending?

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

A

You should expect to see quota carrying head count go up to somewhere in the neighborhood of 195. And sales engineering head count will go up ratably. And we will actually have a higher ratio of sales engineers to sellers than we've historically had in the past, but we brought on a lot of sales engineers quickly.

Sterling Auty
Analyst, JPMorgan Securities LLC

Q

Okay. One quick follow-up. What was linearity like in the quarter, and how did that your impact cash flow?

R. Wayne Jackson
Chief Financial Officer, SecureWorks Corp.

A

I'm sorry, Sterling. It's quite...

Rebecca Gardy
Investor Relations Officer, SecureWorks Corp.

A

Can you clarify that?

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

A

Can you repeat that?

Sterling Auty
Analyst, JPMorgan Securities LLC

Q

Yeah. So, what was linearity like in the quarter, and how did that impact cash flow?

Rebecca Gardy
Investor Relations Officer, SecureWorks Corp.

A

Sterling, this is Rebecca. So, when you say linearity, can you...

Sterling Auty
Analyst, JPMorgan Securities LLC

Q

So, relative to what I was thinking cash from operations would like. It looked like accounts receivable actually ended up higher than what I was anticipating. That typically needs a more back-end loaded quarter for maybe some of the new deals that you signed. Didn't know if that's the case, or if there were something else in collections in the quarter that stood out to you.

R. Wayne Jackson
Chief Financial Officer, SecureWorks Corp.

A

Okay. So, let me spend maybe one moment on explaining both AR, and deferred revenue, and the extra week we had in – this really relates, Sterling, to Q4. In Q4, as everyone may recall, we had an extra week, the 53rd week. For us, we bill once a month and so whether we have an extra week or not, we bill once a month. But we had an extra month of cash collections, so that reduced AR for the fourth quarter.

Compared to the fourth quarter, it looks like AR increased more significantly than it has historically. But in reality, it was because of that extra week of collections. And the same with deferred revenue, we had an extra week of recognizing revenue, which reduced DR at the end of the year. So, on a linear basis, it does look a little unusual, but it was more of the impact of the extra week than anything unusual in our billing or cash collection patterns.

Sterling Auty
Analyst, JPMorgan Securities LLC

Q

Got it. Thank you.

R. Wayne Jackson
Chief Financial Officer, SecureWorks Corp.

A

You're welcome.

Operator: Your next question comes from the line of Jonathan Ho with William Blair & Company. Please go ahead.

Jonathan F. Ho
Analyst, William Blair & Company, L.L.C.

Q

Hey, guys. Can you give us a little bit of additional color in terms of what you're seeing on the Red Cloak side, and maybe the percentage of customers you think can maybe up-sell to that product over time?

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

A

Good morning, Jonathan, and thank you. This is Mike. So, from a Red Cloak perspective, we are very excited about both our progress in the last couple of quarters as well as the sales pipeline, which today is, 5 times to 6 times the revenue that we've closed, the revenue that we have.

And it works again both in situations where we can apply Red Cloak, where clients don't have an endpoint solution, or quite frankly, where they do have an endpoint solution, and we use it to help bring in incremental telemetry. And the real key is it helps detect threats where there is an absence of malware. So, we are excited about where it fits in the market. We're excited about the incremental opportunity. And we've got a big pipeline and expect to see continued momentum.

Jonathan F. Ho
Analyst, William Blair & Company, L.L.C.

Q

Got it. Got it. And then just in terms of the sell side, can you maybe give us a little bit more color in terms of the lead gen side of things, and whether you're seeing sort of enough pipeline of opportunity? Because, I guess, from my perspective, if you're adding additional quota carriers, it seems like you're not saying that there's a demand issue, but at the same time, we're not seeing sort of the MRR potentially increased by the end of the year. So, you can maybe rectify that. I'd definitely appreciate the additional color.

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

A

There's a couple of question in there. Let me try and answer, this is Mike, and if I've not, come back to me. On the demand gen side of it, I think what I mentioned was as Jason went and met with our sellers and travelled around meeting with the clients and prospects and coming through the sales pipeline, he was more excited about the opportunities in the market in front of us, which caused us to look to higher incremental, more seasoned sales executives, particularly, here in North America and [indiscernible] (45:20) happening.

So, for me, market opportunity, lead gen, demand gen, we are bullish on opportunities in front of us. From an execution perspective, Jason's been here – this is his first full quarter. And I think he's been here about five months. So, we are not looking to get too far ahead of our skis on – and we'd like to come from Missouri, in the Show-Me State, to see some things happen, as we make incremental quarters go through the year from a success perspective. But we are clearly monitoring and looking at the consistency and quality of the sales pipeline, the movement through that pipeline and there is incremental inspection that's occurring on that as we go through this transition period.

Jonathan F. Ho
Analyst, William Blair & Company, L.L.C.

Q

Thank you.

Operator: Your next question comes from the line of Gur Talpaz with Stifel. Please go ahead.

Christopher Speros
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Hi. This is actually Chris Speros on for Gur. In March, you announced a series enhancements to your Cloud Guardian portfolio. Can you talk about those enhancements, and what demand's been like for that portfolio?

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

A

Sure. So, I mentioned a little bit on this. This is Mike, Chris. Thank you for the question. From a cloud perspective, I mentioned a little bit in the prepared remarks, we're basically, in the Cloud Guardian portfolio, we have a solution that effectively puts us in a position where we can ensure that CIOs and CISOs have their security policies in place and in-force throughout their organization for anybody that maybe using, in this case, AWS was the first release, and we are moving to release that to Azure as well. And it allows us to do management and monitoring of their cloud security devices.

And we've added to that the recent announcement, which we just came out with as I disclosed in the prepared remarks. And from a sales pipeline perspective, we are excited about the opportunities coming in from both Office 365 and from the other parts of the Cloud Guardian Portfolio, in particular, the ones around allowing there to become some sort of control.

In many of the instances, what ends up happening is the businesses are the ones that adapt cloud and basically through a credit card will get out into the cloud. And this is allowing the Chief Information Security Officer, the Chief Information Officer gain some sort of control or understanding around what security is there.

It's important, I think, to understand that SecureWorks addressed things like this over the last 17 years, as we've seen adjustments in the industry and where they're going. And we feel really excited about our opportunity to provide solutions, both for clients that have needs on-prem, in a hybrid cloud, or if they'd moved into the public cloud. So, we see the movement to the cloud to be both a risk and an opportunity, but we're excited about our role and where we play in that.

Christopher Speros
Analyst, Stifel, Nicolaus & Co., Inc.
Q

Great. One more if I may. Can you talk about the buying behavior from a vertical standpoint? And has GDPR [ph] emerged (48:39) as a demand driver?

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.
A

So, this is Mike again. Chris, thank you. From a buying behavior perspective, I would say that we are seeing increased demand in incremental verticals, whether it be healthcare, retail, state and local government, manufacturing, the ones that I mentioned earlier, which were behind, clearly, over the years, financial services. So, we are seeing increased opportunities and increased demand across the whole host of verticals.

And I think GDPR playing into that, particularly, outside of North America is clearly a concern coming up in all of our contracts and all of our negotiations and discussions. We have a very focused effort to ensure that we implement all of the requirements and are compliant in the next 12 months. And we've got activities within the company underway across each of the different work streams to make this a success. By the way, I think it's an increased opportunity for us, as we're addressing the market.

Christopher Speros
Analyst, Stifel, Nicolaus & Co., Inc.
Q

Great. Thank you.

Operator: Your next question comes from the line of Gabriela Borges with Goldman Sachs. Please go ahead.

Gabriela Borges
Analyst, Goldman Sachs & Co.
Q

Great. Good morning. Thanks for taking the question. I was hoping you could contextualize for us a little bit better the 15% increase in quota carrying reps that you saw in FIRST QUARTER. Maybe you could just help us understand, how does that compare to the previous fiscal year or fiscal year 2016? Just trying to get a sense of the magnitude of exploration. Thank you.

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.
A

So, Gabriela, this is Mike Cote. We can get back to you with the actual numbers. So, this is rough percentages or rough estimates, because I don't have them in front of me. But I would tell you that, that is the largest increase we've had in a while through most of 2000. And if I looked at that compared to 2016 or 2015, our increases would have been probably single digits, maybe even, in some cases, flat.

Gabriela Borges
Analyst, Goldman Sachs & Co.
Q

That's very helpful. And as a follow-up, if I could, great to see maintaining of the MRR guidance exiting the year. Maybe, Mike, you could just talk a little bit about whether your assumptions that go into that number, whether, if at all, they've changed? You mentioned a little bit on the shorter sales cycles, created some changes in 1Q as well with the sales force structure. How you're getting to that MRR number, and has the visibility or confidence in achieving that changed at all?

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

A

I would say that – and thanks, again, for the question. The confidence or visibility to that number since we're one quarter through the year is clearly better than it was because of the passage of time, and the results, and Jason getting his feet on the ground, and the increased number of quota carriers, and the increased number of sales engineers.

I think there are opportunities for us, as the sales organization continues to mature. And we are in the early innings of this process and went through the talent, coverage, and quality of sales focus. All of those are really items that have taken action and moved steps in the last 90, if you will, maybe 120 days or 110 days. So, as that continues to mature and accelerate quickly, we hope to feel better about where we're heading and where we're going. But we are confident in our ability for the reiteration that Wayne gave on the MRR guidance at the end of the year.

Gabriela Borges
Analyst, Goldman Sachs & Co.

Q

Great. Thank you very much.

R. Wayne Jackson
Chief Financial Officer, SecureWorks Corp.

A

Gabriela, this is Wayne. Maybe to add some qualitative to Mike's comments. If you think about what drives new sales, and therefore, MRR, it's the number of quota carriers, we've talked about that. It's the tenure of those quota carriers. New ones obviously take time to ramp. We've got some seasoned quota carriers. It's the productivity. They're at levels now that, we believe, will get us to MRR. And then the objective is to increase productivity over time. It's the closed cycles, and it's the pipeline. So, we take all those factors into consideration, and that's when we reaffirm the guidance. We feel good about the guidance.

Gabriela Borges
Analyst, Goldman Sachs & Co.

Q

And, Wayne, if you could just remind us the typical time that you would expect from when a sales rep joins to when they get up to full productivity?

R. Wayne Jackson
Chief Financial Officer, SecureWorks Corp.

A

Yeah. It varies between SMB and enterprise, but generally, six months to nine months on the enterprise side to full quota.

Gabriela Borges
Analyst, Goldman Sachs & Co.

Q

That's helpful. Thank you very much.

R. Wayne Jackson
Chief Financial Officer, SecureWorks Corp.
A

You're welcome.

Operator: Our next question comes from the line of Saket Kalia with Barclays. Please go ahead.

Saket Kalia
Analyst, Barclays Capital, Inc.
Q

Hi, guys. Thanks for taking my questions here. One question's on the sales and marketing, but want to shift gears just a little bit and talk a little bit about competition. Mike, could you talk to us a little bit about whether competitor rates have changed at all? And, specifically, can you just talk about how that maybe compares versus maybe some of your carrier -based competitors versus other security companies that are maybe getting a little bit more serious about the MSSP market?

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.
A

So, let me just make sure, Saket, I understand your question. You're talking about our compensation to our individuals?

Rebecca Gardy
Investor Relations Officer, SecureWorks Corp.
A

Competition

Saket Kalia
Analyst, Barclays Capital, Inc.
Q

No, no, no. Sorry, competition.

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.
A

Competition?

Saket Kalia
Analyst, Barclays Capital, Inc.
Q

That's right.

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.
A

Aah.

Saket Kalia
Analyst, Barclays Capital, Inc.
Q

So, competition versus the Verizons and AT&Ts of the world versus competition of the FireEyes of the world, to get specific, that are maybe getting more serious about this market?

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.
A

Aah. Okay. Great. Thank you. Thanks for the clarification. So, I think, and I mentioned, as the markets continue to mature, what's clearly happening from what we've seen is that four of the carriers, in particular, the types of services that they're providing, which is basically, in most cases, management of devices, I think, the value around that is going down. And I think there's price pressure in that area, as clients are not necessarily seeing it as what's the most valuable to them.

So, I think we're probably seeing decreased competition, or not that there was a lot in that area, unless you went back a few years from Verizon, if you will. So, we just don't see them in a lot of competitive bids. Now, my sense is that in their IPO contracts, they're probably throwing security in there. Although, more and more, we're seeing client pull security out to look for that from a different perspective, because they understand it's not the same as what falls in the general IPO contract.

We've not seen FireEye competitively at any of the deals that we've gone after, at least none that I'm aware of. From the security-specific competitors in this space, I would tell you that we're probably seeing at the enterprise space IBM more than anyone, in particular, some buzz about the Watson commercials that they've been doing. And in small to medium-sized business place, it's typically local smaller organizations that have relationships.

Saket Kalia
Analyst, Barclays Capital, Inc.
Q

Understood. And then for my follow up, maybe just talk about competition in a different light, what do you hear from clients about their willingness to do security in-house versus outsourcing it to an MSS like yourself?

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.
A

So, that's a great question. And I think, there's an increased discussion from clients of a desire to potentially look to do things in-house or to understand what part of the security spectrum they should take responsibility of. This industry has matured. For a long period of time, people lived in the fear of uncertainty and doubt world and just tried to throw money at it.

And I think, now, there's become more of an influence of large enterprises, in particular, in the financial services base have been here for years. But I think the rest of the verticals and the rest of the clients or prospects from an SMB to the enterprise base are beginning to look and say, we need to own part of this responsibility in some way, shape or form and are gaining in their knowledge and understanding of it. So, that becomes a bigger question around that.

Clearly, our value proposition around the visibility that we have with 4,400 clients in 59 countries allows us to see things quicker than anybody else can. And our ability to work across verticals in a vendor-agnostic manner from the SMB to large enterprises and show the value that we have in the power of the CTP is what we need to be selling.

Saket Kalia
Analyst, Barclays Capital, Inc.
Q

Understood. Thanks very much guys.

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

A

Thank you.

Rebecca Gardy
Investor Relations Officer, SecureWorks Corp.

I think that was the final question. And I want to say thank you to everyone for listening on today's call. And if you have any further questions, please reach out to me. This is Rebecca Gardy.

R. Wayne Jackson
Chief Financial Officer, SecureWorks Corp.

Thanks, everyone.

Michael R. Cote
President, Chief Executive Officer & Director, SecureWorks Corp.

Thank you. Have a great day.

Operator: This concludes today's conference call. You may disconnect at this time.