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EDITED TRANSCRIPT

Q3 2019 SecureWorks Corp Earnings Call

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PRESENTATION

Operator

Good morning, and welcome to the SecureWorks Third Quarter Fiscal 2019 Financial Results Conference Call. (Operator Instructions) 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 Teri Miller, Vice President and Chief Accounting Officer. You may begin.

Teri L. Miller *SecureWorks Corp. - VP & CAO*

Good morning, everyone, and thank you for joining us today to review SecureWorks' financial results for the third quarter of fiscal 2019. This call is being recorded. 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 November 2, 2018. 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 the description of these risks and uncertainties in this morning's earnings press release and in the company's annual report on Form 10-K for the year ended February 2, 2018, which is available on our Investor Relations website and on the Securities and Exchange Commission's website.

All forward-looking statements made on this call are based on assumptions that we believe to be reasonable as of this date, December 6, 2018. 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 effects 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. Also, as a reminder, all financial information discussed is non-GAAP and growth rates are compared to the prior-year period unless otherwise stated.

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) In the event you have additional questions that are not covered by others, please feel free to reach me, and we will do our best to come back to you. Thank you for your cooperation in this.

Now I would like to turn the call over to Mr. Cote.

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

Thank you, Teri, and thank you, everyone, for joining us this morning for our third quarter 2019 earnings call. We appreciate your flexibility given the change in our earnings date to allow us to join our fellow Americans in honoring the late President George H.W. Bush.

This was another record quarter for SecureWorks. Revenue was \$133 million, which was above our expectations and up 13.5% over prior year. We improved our operating leverage, generating record quarterly EBITDA of \$8.6 million. Cash flow from operations was \$15 million, and we reported record non-GAAP earnings per share of \$0.06.

We delivered strong financial results for the first 3 quarters of the year, putting us on track to generate revenue in excess of \$0.5 billion, with positive EBITDA and strong cash flow for the full year.

I want to thank the entire SecureWorks team for their continued focus, executing against our plans and for their dedication to delivering on our customer commitments.

International revenue growth was strong again in the third quarter, up 51% over the prior year. Our EMEA business, which was recently recognized by Forrester as a leader in the European MSSP market [reference added by the company - The Forrester Wave™: Managed Security Services Providers (MSSPs), Europe, Q4 2018, Forrester Research, Inc., 19 November 2018], grew 47% year-over-year, while APJ grew 65%.

International operations now represent 23% of total revenue. This quarter, the international sales team as well as the North American commercial team continued to deliver year-over-year growth in the value of new annual sales contracts, which we refer to as ACV.

As we've talked about in prior calls, our North American enterprise sales performance has been inconsistent and missed our ACV expectations in Q3. The pipeline is solid. But after strong ACV performance in Q2, we did not have sufficient opportunities deep in the sales cycle to repeat Q2's strong performance again this quarter.

We continue to focus on talent and coverage in this important market. We augmented the North American enterprise leadership team in early Q3. And as the team gains traction, we're seeing encouraging signs, particularly around the addition of new sales talent. We also have a greater number of sellers with longer tenure, which is a key factor in their productivity. I believe we have the right team in place in the right geographies and are focused on the right opportunities.

My confidence in accelerating our growth is bolstered by our unique ability to bring value to our customers with innovative, intelligence-driven, software-enabled solutions.

As I talk to customers, it is clear that the security landscape is changing quickly. As companies undergo greater degrees of digital transformation, including a surge in the number of endpoints, expansion of software-defined networks and the emergence of the Internet of Things, the attack surface has expanded, creating additional risk for customers.

This is precisely where SecureWorks enters the picture. Our solution set is focused on expanding the application of our intelligence across our customers' ecosystems, positioning us to detect what can't be prevented, respond rapidly to high-risk threats and predict where the



threat actor is going next so that new prevention methods can be deployed.

We bring unique security value to our customers by leveraging 3 key assets. First, our intelligence. when applied across ecosystems generates the consistent visibility needed to detect and isolate advanced threats that evade deployed point solutions. Our intelligence is a combination of proprietary analytics and hunting capabilities, fueled by rich and diverse data sets available because of our multi-vendor approach.

In working with other best-of-breed vendors, we continue to enhance our intelligence and provide a comprehensive and united solution for customers that leverages their security point product investments.

Second, we leverage our Counter Threat Platform, powered by machine learning and advanced analytics that drives rapid cross-correlation of telemetry and produces high-fidelity detections, enabling rapid response to real threats.

And third, as a customer of SecureWorks, our network effect allows you to benefit from knowledge gained from any one of our 4,300 customers across the globe.

An example of how we put these assets to work is the expanded application of our Red Cloak analytics across customer environments. In addition to endpoints, Red Cloak analytics are now deployed across over 40% of our customer networks, and we believe there is additional uses for our Red Cloak intelligence. Red Cloak was initially developed as an internal solution to support our threat hunting and Incident response engagements when commercial products did not provide the telemetry or advanced analytics needed for effective hunting and investigation.

With the recent launch of our Red Cloak partner program, we're decoupling our proprietary analytics from our endpoint agent to make SecureWorks' high-fidelity detection and threat-hunting capabilities available more broadly in the marketplace.

The partner program is designed to provide our customers with consistent detection capabilities across multiple vendors and platforms, allowing customers to leverage their existing security point product investment, while limiting the number of agents on their network. This program illustrates our industry leadership through our ability to bring market leaders together to help customers fight adversaries in a united way. I am pleased that CrowdStrike and Carbon Black are the first 2 partners, and excited about conversations we are having with other industry leaders.

We have also continued our investment in the development of our new application framework I mentioned on prior calls. This is yet another example of how we will enable the application of our analytics through software. This new framework leverages advanced correlation across diverse data sources and will offer policy-based controls over data, ultimately allowing flexibility on where data resides. We are very excited about the opportunity that exists, and I am pleased with our development efforts to date.

In addition to the investment in enhancing our solutions, we are continuing to make advancements in our software-enabled delivery, helping drive operational efficiency and effectiveness. A couple of examples include our initial playbooks from our automation and orchestration efforts that are in production and are driving speed and efficiency in our response time; and a self-service provisioning application, which allows customers to arrange security coverage of their network ecosystem much more rapidly, including asset discovery and one-click device authorization capabilities.

Our entire team is focused on accelerating our growth by delivering innovative solutions that provide measurable security outcomes to our customers.

In addition, we see significant opportunity for growth through partnerships across the Dell Technologies family. As part of Dell's strategy to lead their customers through digital, IT, workforce and security transformation, the Dell Technologies family of companies are creatively working together to combine our collective strengths in product offerings as well as our go-to-market efforts.

SecureWorks is playing an increasingly important role, enabling the security transformation filler, in close collaboration with VMware.



Our managed AppDefense offering, which leverages VMware's virtual AppDefense technology to expand SecureWorks' behavioral analytics into virtualized and cloud environments, went live last month. This is the first of several areas of continued collaboration with VMware and other Dell Technologies companies.

I'm excited about the opportunity that we have to bring value to our customers. And as a result of our progress this year, believe we are well-positioned to accelerate our growth.

I will now turn it over to Wayne to talk about our third quarter performance in more detail. Wayne?

R. Wayne Jackson *SecureWorks Corp. - CFO*

Thanks, Mike, and good morning, everyone.

Before I get into the details, let me say that our third quarter of FY '19 was a very good quarter. In addition to double-digit revenue growth, we improved our operating leverage, delivered record bottom line performance, generated strong cash flow from operations, and were free cash flow positive again this quarter.

In the third quarter of fiscal 2019, revenue was \$133.1 million, a 13.5% increase over Q3 FY '18 and a 3.3% increase sequentially. Our average annual subscription revenue per customer was \$99,000 this quarter, a 9.1% increase over the prior year. That -- total contract value for contracts greater than \$1 million were up 4% year-over-year. A couple of notable examples of new large deals that we signed in the third quarter include: a 3-year \$3 million agreement with a U.S. based manufacturing company. This win is a prime example of the full suite of solutions we bring to the table, including coupling Red Cloak analytics with our advanced remediation management offering. A second notable example is a 3-year \$1.5 million deal with a large U.S. based business services company. The MDR solution we launched in Q2 was the foundation of this deal.

We exited the quarter with monthly recurring revenue or MRR of \$35.1 million, an increase of 5.1% over the prior year. Consulting revenue grew 29.3% year-over-year and comprised 24.5% of total revenue for the quarter. We anticipate our subscription to consulting revenue mix will continue at the 75% to 76% level for the next several quarters as we are leveraging our consulting capabilities, including incident response as an important component of a comprehensive security solution for our customers.

Revenue retention in the period was 91% versus 98% in the second quarter and 97% in the third quarter of last year. As we noted last quarter, we extended the relationship of one of our largest customers. And as we entered this new phase of the relationship, we are transitioning the work to higher-value subscription and consulting solutions. This transition, as we wind down the legacy services and begin ramping some of the new higher-margin solutions, resulted in a reduction of \$1.2 million of MRR and 500 basis point impact on revenue retention in the third quarter.

Finally, revenue outside the U.S. grew to 23% of total revenue in the third quarter, up from 17% last year, on the consistently strong growth in the U.K., Middle East and Japan.

Gross margin totaled \$74.6 million in the third quarter of FY '19 or 56.0% of revenue, up from \$69.9 million or 54.3% of revenue in the second quarter. Prior-year third quarter gross margin was \$65.6 million or 55.9% of revenue. In the third quarter, gross margin improved sequentially as we were able to hold delivery costs flat quarter-to-quarter, while increasing revenue.

Third quarter operating expenses totaled \$69.4 million compared with \$70.0 million last year. We continued to improve our operating leverage as OpEx as a percentage of revenue decreased 760 basis points year-over-year.

Research and development expenses totaled 15.2% of revenue in the quarter, compared with 15.9% last year. As Mike noted earlier, we continued to invest in innovative technologies to increase our operating efficiency and meet our customers' evolving needs. And will accelerate our R&D investments in the fourth quarter and in FY '20 to further advance initiatives, like orchestration and automation capabilities as well as the application framework we have discussed in previous calls.



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Sales and marketing expenses this quarter, approximately 25.5% of revenue, down from 29.2% last year. We continue to leverage our historical sales and marketing investments. And commission costs were lower this quarter due to the lower ACV sold by the enterprise team in North America.

General and administrative expenses totaled 11.4% of revenue, compared with 14.5% last year. We anticipate that we will continue to maintain leverage related to G&A expenses for the remainder of the fiscal year as compared to the prior year.

Adjusted EBITDA in Q3 was \$8.6 million, compared with a \$1 million loss last year. We also delivered record non-GAAP net income of \$5.2 million, compared to a loss of \$3 million last year as the margin on higher revenue offset the increased R&D investment I just highlighted. Non-GAAP earnings per share were \$0.06.

Regarding cash flow and balance sheet items. Based on improved profitability and lower working capital as a result of last year's systems investments and ongoing focus on collections activity, cash provided by operations was \$15.2 million in the quarter.

DSO decreased to 92 days at the end of the quarter, down from 94 days last quarter and 106 days at this time last year. Additionally, CapEx was \$1.6 million in the quarter. Free cash flow was \$13.5 million in the quarter, and we finished the quarter with cash of \$115.8 million.

Now for FY '19 guidance.

For the fourth quarter fiscal '19, we expect both GAAP and non-GAAP revenue to be in the range of \$132 million to \$133 million. And we expect non-GAAP earnings per share to be between breakeven and \$0.01, based on approximately 80.8 million weighted average shares outstanding.

We have uplifted our full fiscal year 2019 guidance and now anticipate the following. We expect GAAP and non-GAAP revenue to be in the range of \$520 million to \$521 million. Our adjusted EBITDA to be positive for the full year in the range of \$11 million to \$12 million. And our non-GAAP loss per share to be breakeven to \$0.01 per share. We expect cash provided by operations to be between \$45 million and \$50 million for the full fiscal year 2019, up from roughly \$1 million in fiscal 2018. As noted last quarter, we anticipate we will be free cash flow positive, even without the monetization of the approximately \$20 million tax receivable from Dell that we will collect in the fourth quarter.

Additionally, we expect GAAP net loss per share to be in the range of \$0.45 to \$0.46. For modeling purposes, we estimate that the tax benefit rate will be approximately 24% in the fourth quarter and 23% for the full year. We expect our MRR to be in the range of \$35.0 to \$36.5 million at the end of the fourth quarter fiscal 2019. Key factors, including this year's ending MRR, include ACV, although on track to increase 13% to 15% year-over-year, is expected to be lower than we originally anticipated.

The mix of ACV includes more long-term consulting arrangements, including incident response than our historical trends as these services help large customers fully leverage our managed security solutions and the timing and shift in mix of solutions for a larger contract, which we discussed, having \$1.2 million impact on MRR.

Based on our fiscal 2019 year-to-date performance and current business trends, we would also like to provide some preliminary comments on FY '20.

At this time, we believe that FY '20 GAAP and non-GAAP revenue will be in the range of \$565 million to \$575 million. We will provide more fulsome guidance regarding earnings metrics during our fourth quarter earnings call.

We had a great third quarter, and we are very pleased with the financial performance and are excited about our opportunities in the fourth quarter and beyond.

I will now return the call to Mike.



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

Thanks, Wayne. Before I turn it over to the operator for questions, I want to again thank the entire team for their hard work and dedication. And to thank our customers for the trust they placed in us as their cyber security partner. As I think about our performance this year, I am certainly pleased with our progress, but I am truly inspired by the strides we have made as a company over the last several years.

For instance, thinking about where we have been, we have grown from \$342 million in revenue and an EBITDA loss of \$48 million in fiscal 2016, the year before the IPO, to \$520 million in revenue and between \$11 million and \$12 million in positive EBITDA this year and have more cash on the balance sheet than when we started with after the IPO. This financial performance puts us in a position to take advantage of opportunities to continue to develop solutions that deliver value to our customers and reinforce our industry leadership.

We work closely with an outstanding Board of Directors and are collectively focused on our long-term success, which will drive value for our customers, employees and shareholders.

I am more excited and optimistic about our future than ever before. On behalf of the SecureWorks team, we appreciate your continued interest and support.

Operator, if you'll now open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question will come from the line of Sterling Auty with JPMorgan.

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

I want to start with the -- there was the article a couple of days ago about the data breach at Marriott. Is there anything that you can comment to and if that's having any impact on business?

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

Sterling, Mike Cote. Thanks for the question. I think there were a couple in there. But we have not seen any impact on business, to answer your last question first. And due to the nature of SecureWorks' business, we cannot comment publicly or privately to discuss the work that we do on behalf of our customers. It should, however, be noted that the reference to SecureWorks in the December 3 Forbes article attributed to an unnamed source, contains inaccuracies. The article appears to inaccurately imply a connection between the claimed June 2017 incident and the current matter, which Marriott has publicly stated began in 2014, relating to Starwood, which Marriott acquired in the fall of 2016. Furthermore, Starwood was not a client of SecureWorks in 2014.

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

All right, perfect. And then on the North America side, you alluded to not having enough opportunities deep in the pipeline. So I'm curious is -- was the issue of North America more about transitioning or nurturing the deals that were there, so you had plenty of opportunities in the top of the funnel? Or do you need more top-of-the-funnel activity to migrate through the sales process, and that's the issue?

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

So the -- this is Mike again, Sterling, sorry. Our pipeline is good. And the North American productivity, actually, in the first 6 months of the year, in second quarter, in particular, were strong and ahead -- slightly ahead of our expectations. And I think what we did was accelerate a lot of opportunity, and the second quarter didn't have quite as much -- and the third quarter, I'm sorry, quite as many deals as far down the process passed to close in Q3.

Operator

Our 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

Did you guys disclose a customer count in the quarter?

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

I think I said it in my prepared remarks.

R. Wayne Jackson SecureWorks Corp. - CFO

Rob, this is Wayne. It's 4,300 flat.

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

4,300. Now that number has been flat for some time. So understanding that maybe Q2 was strong and maybe some Q3 weakness. But just help us understand this, I guess, as my second question, but from a market perspective, where you are from a new logo acquisition perspective? And is it competition or -- I'm surprised, just given the security environment, that we're not seeing more robust growth in that numbers, especially given now your success internationally.

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

Yes, thanks, Rob. This is Mike. Our -- as I think we've mentioned on the last call, our focus has shifted from an investment perspective and go-to-market to enterprise, and has somewhat moved up, I'm not -- we've reduced our commercial go-to-market team, but the increased sales and marketing costs, just so that I'm clear, has been focused more in the enterprise space and had moved up in the larger deals. I think, in the average revenue per client, we've got a -- which is at \$99,000 is a 9.1% increase year-over-year. So it's really bigger deals we've been signing for the most part.

Operator

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

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

Wayne, I had a question. You explained the impact to Q4 MRR. Looking back, it effectively implies kind of flattish sequential MRR for, I think, about 4 quarters. Yet, your fiscal '20 guide, I think about 10% growth on the revenue side, is impressive. Can you talk about sort of the pipeline visibility on revenue and with MRR being flattish for a -- sequentially for a few quarters sort of your confidence level on that guide?

R. Wayne Jackson SecureWorks Corp. - CFO

So thanks for the question. I can. If you think in terms of MRR, just as a reminder, that's our subscription business. And as we look out with a subscription business given the impact of the one large contract and the ACV momentum we had in Q3 and what we see for the rest of this year, we've guided to the MRR that we guided to just now. But when we combine that with what we've seen on the consulting side, the strong revenue growth, number 1, for Q3 and then what we're seeing in Q4 in the pipeline, we're pretty -- we're very comfortable with staying in the \$565 million to \$575 million range for next year for overall revenue.

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

And I think, just to add to that, this is Mike. I guess, Wayne, I think you mentioned that in your prepared remarks, what was an 80-20 mix throughout the year has moved closer to a 76 -- 75%, 76% subscription and 24% to 25% in the -- on the consulting side of the house, which is clearly closely tied to subscription, including long-term contracts as well as incident response engagements.

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

That's super helpful, guys. And then maybe just a quick one on international. Obviously, you've had several quarters of very strong growth there. When you think about next year, and I think you talked in the prepared remarks about added investments to R&D. How do you think about allocating resources internationally, given the demand and the growth that you're seeing there?

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

So good -- great question, Matt. And actually, Wayne and I had a trip to the Middle East and throughout Europe earlier in the quarter, and we're excited about the prospects going into fiscal year '20 there as well. Our investments in that market will focus both from a sales and sales engineer, sales support perspective, as well as from an operational delivery perspective. So I think the growth there will continue to support incremental growth into the future.

Operator

Your next question comes from the line of Gabriela Borges with Goldman Sachs.

Daniel Peter Church *Goldman Sachs Group Inc., Research Division - Associate*

This is Dan Church on for Gabriela Borges. I just want to go back to the sales productivity, particularly in North American enterprise. And any commentary you can make on some of the changes that you made over the quarter and some of the incremental changes going forward?

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

So this is Mike, Dan. We -- I think -- and we may have mentioned this previously, we've brought in a new West Coast leader (inaudible) -- going back up half a step. Our performance in the North American enterprise sales team has been good or was very good for the first 6 months of the year, and year-to-date has achieved our expectations. It was very strong, mostly bolstered by the eastern half of the United States under a sales leadership team and sales organization that's been with us for a while. On the West Coast, we have a new sales -- West Coast sales enterprise leader that started at the beginning of the fiscal -- beginning in the calendar quarter. And there's been some hiring in that region and building of the team, so a real focus on talent and coverage and messaging and methodology. We do have, across the enterprise sales team, the tenure greater than 2 years has increased, and we expect productivity to continue to improve. I will tell you, if you looked at it, and it's no surprise, Q1 productivity was up over the prior year; Q2 was up strong over Q1 of the prior year; and then Q3, as we mentioned, was disappointing, but we expect that to turn around.

Daniel Peter Church *Goldman Sachs Group Inc., Research Division - Associate*

Okay. Just as a quick follow-up. I know you've mentioned efforts to monetize the Counter Threat Platform, and I believe you talked it was in beta last quarter. Anything you can share in terms of updates, customer feedback, plans -- the path to monetization for 2019 or fiscal '20 would be great.

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

So I think you're referring to the new application framework that we've talked about. And I mentioned in my prepared remarks that I am excited about the progress that we're making. We are actually, right now, in beta with some customers. So I'm cautiously optimistic that we'll be -- we'll have some more detailed news that's positive as we go through the year.

Operator

Your next question comes from the line of Jonathan Ho with William Blair & Company.

John Gregory Weidemoyer *William Blair & Company L.L.C., Research Division - Associate*

This is John Weidemoyer for Jonathan. I'm sorry, I'd like to make sure I'm clear on the North American sales situation. Did I hear you say in your prepared remarks, Mike, that there was new hiring going on? And I think, in answer to Sterling's question, you mentioned a timing issue as well. I understand the new West Coast leader, so it seems like it will take a bit of a time to get acclimated and get that situation rectified. Is it -- is there -- are there process issues involved here as well then? And if there were -- if it's a hiring -- if hiring is going on, do you think this is something that's going to rectify in a quarter? Or do you think it's going to have some lingering effects?

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

So, John, let me see if I -- because there are a couple of questions in there. If I don't address them all, please come back at the end. But we -- across the North American enterprise sales team, we had strong growth or good growth in Q1 and really good growth in Q2. Most of that was bolstered by the eastern half of the United States' sales organization. And we brought in a new sales leader on the western part of the United States, effective the beginning of Q3, and our leader there has been bolstering his team with some incremental hiring.



So year-to-date, we're actually where we thought we would be from an enterprise sales perspective. Q2 -- Q3 was disappointing. I don't see any process issues. I think we'll continue as we've done, we actually have increased our quota-carrying sellers across the organization, so it's not as if we've had a lot of increased turnover. It's an expansion of the sales organization from a quota-carrier perspective throughout North America, and we would expect the productivity to continue to improve.

John Gregory Weidemoyer *William Blair & Company L.L.C., Research Division - Associate*

Okay. Does that count, I suppose, my questions? If it does, it's okay.

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

I'm sorry?

John Gregory Weidemoyer *William Blair & Company L.L.C., Research Division - Associate*

If it doesn't -- okay. If that doesn't count, I suppose, my questions, then I'll also ask can you talk about the competitive landscape, please, any changes there, please?

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

Sure. Mike again. From a competitive landscape perspective, I don't think we've really seen a large change. Let me tell you from a sales go-to-market segment perspective, I think in the enterprise segment in both Europe and North America, we probably see IBM the most. And I think the competitive landscape is no different than it has been from a sales perspective in that market, whether it's Europe or North America. In the commercial market or the SLED, state local education, it's really kind of smaller regional players, and we're seeing some tremendous traction in those markets in our MDR solution that we announced about a quarter ago or a little bit more, and -- which has a lot more of our intellectual property attached to it. And that solution is, I think, has been counted by some of the analysts. So it's not -- from a competitive landscape perspective, overall, I would say, it's not been a big change in the last 90 days or even, for that matter, in the last 9 months.

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 to start with you, Mike. Just trying out some of the newer initiatives from the product perspective, it was really helpful. I mean a couple of things you've got in the fire there with the app framework and the MDR and then disaggregation of Red Cloak, excuse me, Analytics from Endpoint. I'm curious if there's things that you need to do differently from a go-to-market perspective to really get these products to mainstream commercialization? And a follow-up for Wayne, if I could.

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

So a great question, Fatima. I would tell you the things we need to do differently, the answer is probably, no and yes or yes and no. And what I mean by that is the sales opportunities in things such as MDR and the Red Cloak partner program are pretty consistent. We're having to go through some of the training and the launch process that we typically would do to ensure that our sellers are in sync. Where I said it is slightly different would be, for example, in the VMware go-to-market partnership, it's a partnership. So getting the connections in the field and the ability to cross-reference and work together adds a little bit of an incremental step that may take some time, but we're excited about aligning our partnership message to, yes, we're going to market together. The same thing exists, I'd say, on in the endpoint partner program, I am extremely excited and optimistic about the way this will kickoff. I also think it leads to some incremental opportunities for us to work with other Dell Technologies companies where there will be probably some channel opportunities as we go into fiscal year '20.

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

That's super helpful. Wayne, for you, just as a point of clarification. You talked about the revenue retention rate at 91%, with a 500 basis point headwind from the prior quarter large renewal, and that makes the business shifting a little bit. I just wanted to clarify those comments, first. And then, secondly, what are some of most sensitive drivers to really help December sort of get back up to the 100% and 100%-plus level from here?

R. Wayne Jackson *SecureWorks Corp. - CFO*

Sure. So maybe to reiterate, the 91% 500 basis points relates to the large contract that we now discussed for a couple of quarters. That gets you to the 96%. Last year's revenue retention as of the third quarter was 97%. So we don't like to give up even 100 basis points, but there were some other non-renewals of some contracts that make up the 100 basis points difference. I think what we're focused on, in your question, is still -- it still boils down to sales motion, right? We need to cross-sell because our revenue retention are those clients as of beginning of the year. And in order to grow that number above 100, you have to cross-sell and keep your renewal rate high, so that's really it. Now it ties exactly, though, back into your first question and the thing that Mike and I both are excited about, which are the offerings we have rolled out? MDR, we're seeing great traction, probably the best new launch we've had in a long, long time, and the other offerings. So -- and some of those, we've not talked about a lot, but some of those include our own IP, which has a much higher renewal rate, and therefore, long term, we're optimistic about that as well.

Operator

(Operator Instructions) Our next question comes from the line of Gur Talpaz with Stifel.

Christopher Caleb Speros *Stifel, Nicolaus & Company, Incorporated, Research Division - Associate*

This is Chris Speros on for Gur. You noted that you believe that there are additional use cases for Red Cloak Analytics. Can you speak to those types of use cases and what sort of dollar opportunity that represents?

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

So Chris, this is Mike. I guess, what I'd start is Red Cloak was really developed, as I mentioned, as part of our threat hunting from an incident response perspective to ensure we got the telemetry that we needed to really do the detections and understand what the hackers are doing. So the first use case would be the endpoint partner program that we've talked about, of which CrowdStrike and Carbon Black are the first 2 that have joined that program, and I think, in my prepared remarks, I also said we've got some other opportunities to expand our IP in that area with people who have approached us that we're excited about. In addition, the application of that intelligence, not just across end points, but across the security ecosystem, in general, it really represents from a Red Cloak perspective our overall intelligence and analytics that we have. So think about this not just in the case of endpoints, but in the case of the complete security ecosystem. As the hackers begin to move and continue to move from one vector to another and it gives us the ability to partner with various security vendors, one of the things that I've talked about for a while as I believe that we, on the good guy's side of this, the security companies need to find better ways to work together. And applying our intelligence, for example, we apply it today, the network security devices from a firewall perspective and a vendor-neutral manner, probably top 3 or 4 firewall vendors. We will continue to roll this out which will drive increased revenue directly to SecureWorks and our partnership program in higher client retention, both for those vendors we partner with, the best-of-breed vendors, and for SecureWorks, a better results for the client at the end of the day.

Christopher Caleb Speros *Stifel, Nicolaus & Company, Incorporated, Research Division - Associate*

With international -- with international revenues over 50% year-over-year, can you speak to what about your sales motion that is resonating in EMEA and APJ? And if anything about your go-to-market in these regions is different from your North American sales motion?

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

So Chris, great question. The biggest difference, I would tell you, that we see is that our leadership in North America -- I'm sorry, the leadership in EMEA, the gentleman that leads our EMEA operation has been here probably 2 years longer, roughly. And the same with our leader in APJ, who is actually an ex-pat who has been with the team for many, many, many years. So it's a more tenured leadership team that has, say, a more tenured, matured, go-to-market process, which we've rolled out across. It's working in our -- working well in



our commercial team here in North America. It's working well in the enterprise east organization and we're continuing, under Geoff Haydon's leadership, to mature across the rest of the organization, which is part of what leads to the of the optimism that Wayne and I referred to.

Operator

Your next question comes from the line of Howard Smith with First Analysis.

Howard Shepard Smith *First Analysis Securities Corporation, Research Division - MD*

I wanted to follow up on the international strength, the question just asked, and specifically, as you leverage those investments there, which is nice to see. Is there anything different in the complexion of that business once sold in terms of average contract link, consulting versus subscription services, anything that looks materially different than your base here domestically?

R. Wayne Jackson *SecureWorks Corp. - CFO*

Howard, thanks for the question. This is Wayne. I'll speak to the second part, first, relative to the makeup of the contract. For EMEA, especially U.K. and Middle East, the contracts generally include our entire suite, including the consulting services I talked about earlier that we provide that help our managed security solution as well. So it's a lot of subscription solution augmented by our SRC or our consulting capabilities, especially in the U.K. in the large enterprise space made by the full suite of services.

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

I think the thing that I'd add to what Wayne said, Howard, is that it's less -- there's less of the market from a commercial or SMB. It's just not as big, so most of the clients would fall into what we would refer to as enterprise. And from a security maturity perspective, they're really looking for a full suite of solutions for us to really help them from a partnership perspective.

Operator

Our final question will come from the line of Alex Henderson with Needham & Company.

Unidentified Analyst

This is [Dan Parker] on for Alex. So could you just talk about the progress with your automation and orchestration capabilities and if you expect to roll out standalone solution at some point moving forward?

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

Alex, this is Mike. Thanks for the question. I think some of the -- we're in the early stages of the progress of rolling out internally from an operating efficiency perspective, but are already beginning to see some of the results or opportunities in our gross margin. So we're excited about the opportunity to continue to roll it out and accelerate it from a rollout perspective in that we're going to really allow a much broader group of individuals, the people on the front line, to do their own automation because the tools are pretty simplistic for us to use on both automation and an orchestration. From a monetization perspective, our plan is, in fiscal '20, to begin to monetize that from a go-to-market perspective with our clients as well.

Teri L. Miller *SecureWorks Corp. - VP & CAO*

Thank you again for joining us on today's call and for all of your questions. We appreciate your support and look forward to our fourth quarter call in early March. If we did not get to your questions during the Q&A section, please do not hesitate to reach out for follow-up.

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

R. Wayne Jackson *SecureWorks Corp. - CFO*

Thanks, everyone.



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