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Q2 2019 SecureWorks Corp Earnings Call

EVENT DATE/TIME: SEPTEMBER 05, 2018 / 12:00PM GMT

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## PRESENTATION

**Operator**

Good morning, and welcome to the SecureWorks Second Quarter Fiscal 2019 Financial Results Conference Call. (Operator Instructions) We are webcasting this call live on the SecureWorks Investor Relations website. (Operator Instructions)

Now I will turn the call over to Ms. Teri Miller, Vice President and Chief Accounting Officer. You may begin.

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

Good morning, everyone, and thank you for joining us today to review SecureWorks' financial results for the second quarter 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 1 year.

This morning, SecureWorks issued a press release announcing results for its fiscal quarter ended August 3, 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, September 5, 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 effect of these item. 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 as 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) Thank you for your cooperation on this.

Now I'd like to turn the call over to Mr. Cote.

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

Thank you, Teri, and thank you, everyone for joining us this morning for our second quarter 2019 earnings call. This was our best quarter ever on many fronts. We've continued to build sales momentum and our financial results show significant improvement.

Key highlights for the second quarter include: revenue of $129 million, which was above our expectations and up nearly 11% year-over-year; monthly recurring revenue of $36.2 million, up 12% over prior year; cash flow from operations of $29 million; and adjusted EBITDA of $1 million.

I am very pleased with the progress we have made to the first half of our fiscal year. And with strong market demand and our industry leadership, we have significant opportunity to achieve even greater results in the future. I would like to thank the entire SecureWorks team for their focus on protecting our clients and for executing on our operational objectives.

Q2 was Geoff Haydon's second quarter leading our go-to market efforts, and we continue to make progress with improved results in many areas. We had another record sales quarter, which comes on the heels of a record Q1. With our sales leadership now in place, I have complete confidence that we will continue to see improvements in our sales motion and velocity.

Second quarter sales highlights include the total annual value of contracts signed grew 37% year-over-year. In the quarter, we closed 19 contracts greater than $1 million, which represents a 36% increase in the number of 7-figure deals and a 30% increase in the total contract value of these deals on a year-over-year basis. The 19 deals above $1 million that we sold this quarter represent a broad distribution of clients, indicating that our value proposition resonates well with clients across industries and geographies. North American sales were up 43% over second quarter last year. Although our performance in North America improved, we still see significant room for accelerating our growth domestically. Geoff continues to focus on talent and coverage in this important market, making sure we have the right sales teams in the right markets focused on the right opportunities.

Our international business remains strong, with year-over-year revenue growth greater than 50% again this quarter. International operations now represent 22% of our overall revenue. Our industry leadership, management team, GDPR compliance status and operational execution continue to drive the growth of our international business. In fact, the IDC MarketScape has recognized our Asia Pacific operations, a region where we've experienced strong growth in recent quarters, in 2 separate MarketScape publications. One as a leader in Threat Lifecycle Services and the other as a major player in Managed Security Services. [references added by company: IDC MarketScape: Asia/Pacific Threat Lifecycle Services 2018 Vendor Assessment, July 2018, IDC #AP43699718 and IDC MarketScape: Asia/Pacific Managed Security Services 2018 Vendor Assessment, July 2018, IDC #AP42609818]

We have also made a lot of progress with our go-to-market approach by creating simple package solutions. We recently launched a detect-and-prevent package, a holistic value-priced security solution for small and medium-sized businesses. And in the second quarter, we launched our Managed Detection And Response, or MDR offering, that combines several of our advanced detection and response solutions to form a comprehensive security offering, all in a simply priced package, giving the client predictability and scalability. The MDR package has targeted enterprises that are looking to extend their security team with technology and expertise of a trusted security partner.

The market has been asking for solutions that help streamline the detection and response functions. Our MDR offering pinpoints true security threats, reduces the burden of investigation and gives clients enough context to timely take the right action to remediate threats or allow us to respond on their behalf. This offering is powered by our proprietary Red Cloak analytics and is a comprehensive security approach that keeps clients safe across their endpoints, network and cloud deployments.

I am really excited about the early results. We closed just over $5 million in annual contract value in the 2 months this offering was available during the second quarter while building an impressive pipeline to fuel future sales. The industry has also taken note of our MDR capabilities, with Forrester recently recognizing SecureWorks as 1 of only 2 large MDR providers that have full-scale forensics. [reference added by company: Forrester's Now Tech: Managed Detection And Response (MDR) Services, Q2 2018, Forrester Research, Inc., April 26, 2018]

We were also recognized as a leader in the recent Forrester Wave for Global Managed Security Service providers. [reference added by company; The Forrester Wave™: Global Managed Security Services Providers (MSSPs), Q3 2018, Forrester Research, Inc., August 20, 2018]

We have a strong track record of thought leadership and bringing an innovative technology-led cybersecurity capabilities and solutions to the market.

One of our advancements has been the expanded use of our proprietary Red Cloak analytics. 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. We began to expand the use of the analytics with the introduction of the Red Cloak endpoint agent. And over the last year, we added Red Cloak behavioral analytics to our server monitoring and believe there are greater uses for these key capabilities regardless of the agent deploy.

As part of the effort to extend the use of our Red Cloak analytics, we've just launched our Red Cloak partner program. We see great power in combining our Red Cloak behavioral analytics and Threat Intelligence with best-of-breed endpoint products to provide superior detection capabilities. Red Cloak embodies our advanced analytics, which through the partnership program can be leveraged across a growing number of solution providers. I look forward to announcing new partners in future calls.

I'm also excited about the opportunity we have working with a member of the Dell Technologies family. We completed development of our new managed solution that leverages VMware's AppDefense technology to protect applications running on these v-Sphere, virtualized and cloud environments. At the VM World 2018 Event just this past week, we showcased our SecureWorks Virtual Application Defense offering. By adding AppDefense to existing VMware infrastructure tools, clients can reduce the attack surface and focus detection on unexpected application behavior. SecureWorks will work with the client to define best practices on response policies that match the client's risk profile.

As a thought leader in the industry, one of our goals is to help organizations manage their cyber risk and protect business value. Using our deep analytic capabilities, we have created a proprietary security model, a holistic approach to evaluating cybersecurity maturity based on an organization's business operations and risk profile. The easy-to-use assessment and model provides organizations with a pragmatic approach to evaluating their current security maturity and targeting areas for improvement. It combines control requirements from well-known frameworks such as [NIST] and ISO 27001 to create a consolidated model, addressing the most critical security domains and capabilities to meet today's risk focused requirements. We believe this is a valuable tool that can be used by security leadership to help boards and executives have a better understanding of their organization's risks, help practitioners prioritize their activities and allow us to help these organizations through their journey.

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

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

Thanks, Mike, and good morning, everyone. Before I get into the details, let me say that our second quarter of FY '19 was a very good quarter. In addition to record sales and double-digit revenue and MRR growth, we improved our operating leverage, generated positive cash flow from operations of $29 million, and we're free cash flow positive for the quarter.

Moving on to the results of Q2 FY '19, revenue totaled $128.8 million, a 10.6% increase over Q2 FY '18 and a 2.1% increase sequentially. Our average annual subscription revenue per client increased to $100,000 this quarter, a 12.7% increase over the prior year.

Sales results for contracts greater than $1 million were up 30% year-over-year as we continue to see productivity gains and leverage the investments we made last year in our sales team.

A couple of notable examples of new large deals that we signed in the second quarter include a $3 million, 1-year agreement with a city municipality. This win is a prime example of the strategic advantage of our consulting services. We began the relationship with an incident response engagement, and based on our success and the insight gained into the client's existing security risk, we were able to convert the IR project into an ongoing subscription solution. A second notable example was a $2.4 million, 2-year deal with a large global diversified financial company. The MDR solution Mike mentioned earlier was the foundation of this deal.

We exited the quarter with MRR of $36.2 million, an increase of 12% over the prior year and a 1.9% increase sequentially. Consulting revenue grew 22.7% year-over-year and comprised 23.6% of total revenue for the quarter versus 21.8% of total revenue in Q1. We anticipate our consulting to subscription revenue mix will remain at a similar level to Q2 for the next several quarters as we are leveraging our SRC capabilities as an important component of a comprehensive security solution for our clients.

Revenue retention in the period was 98% versus 100% in the first quarter and 96% in the second quarter of last year. As a reminder, revenue retention measures how well we have maintained revenue from clients we had on the first day of the year. This metric reflects only subscription revenue as of the beginning of the year and excludes backlog.

For the quarter, revenue outside the U.S. grew to 22% of total revenue, up from 16% last year on the consistently strong growth in the U.K, Middle East and Japan.

Gross margin totaled $69.9 million in the second quarter of fiscal 2019 or 54.3% of revenue compared with $69.3 million or 54.9% of revenue in the first quarter. Prior year second quarter gross margin was $64.1 million or 55.1% of revenue. On a year-over-year basis, gross margin as a percentage of revenue is lower, primarily related to the increasing mix of large contracts and the overall mix of our consulting business to total revenue and cost of operations.

Moving down the income statement, our second quarter operating expenses totaled $72.2 million compared with $69.2 million last year. While an increase in absolute dollars, we continue to leverage our operating expenses as OpEx as a percentage of revenue decreased 330 basis points year-over-year.

Research and development expenses increased to 16.7% of revenue in the quarter, up from 16.3% last year as we continued to invest in innovative technologies to meet our clients' evolving needs. We will continue to make incremental R&D investments in fiscal 2019 to further advance our automation and new application framework we have discussed in previous calls.

Sales and marketing expenses this quarter were approximately 27% of revenue, down from 30.1% last year as we see productivity improvements from investments and organizational changes made in fiscal 2018.

General and administrative expenses totaled 12.4% of revenue compared to 13.1% last year. We anticipate that we will continue to gain some additional leverage relating to G&A in the second half of the year as compared to prior year.

We had positive EBITDA in Q2 of $1 million compared with a $1.8 million loss last year. Our net loss for the quarter also narrowed to $900,000 from $3.5 million last year as the margin on higher revenue offset the increased R&D investments I just highlighted. Non-GAAP net loss per share was $0.01.

Regarding cash flow and balance sheet items, based on improved operating leverage and good collections activity, cash provided by operations was $29.3 million in the second quarter compared with an $18.4 million use of cash in Q1 and an $11.2 million cash provided by operations in Q2 last year. Recall that first quarter cash flow from operations is usually negative, primarily due to the payment in the quarter of annual compensation. We finished the quarter with cash of $103.3 million. Our net accounts receivable totaled $133.3 million at the end of the quarter, down from $146.8 million in the prior quarter. DSO decreased to 94 days at the end of the quarter, down from

106 days in the first quarter. CapEx was $3.1 million in the second quarter.

Now for FY '19 guidance. During our call to announce Q1 FY '19 earnings, we disclosed the fact that a contract with a large client was up for

renewal at the end of the second quarter. We are very pleased to have extended the relationship with this client. Under the new agreement, the mix of solutions between our subscription and consulting offering will be different and the run rate for subscription revenue may be lower than historical periods, which results in expanding our MRR guidance to a range of $37 million to $39 million. As we expect the new solution mix to be delivered in a more leveraged model, we also anticipate incurring reorganization cost of approximately $0.02 per share in the third quarter. The guidance ranges below fully reflect our estimated impact and timing of the changes with this relationship.

For the third quarter fiscal 2019, we expect GAAP and non-GAAP revenue to be in the range of $130 million to $131 million, and non-GAAP net loss per share to be in the range of $0.05 to $0.06 based on approximately 80.9 million weighted average shares outstanding.

We have updated our full year fiscal 2019 guidance and now anticipate the following: we expect GAAP and non-GAAP revenue to be in the range of $518 million to $520 million; our adjusted EBITDA loss to be in the range of $3 million to $5 million; and our non-GAAP net loss per share to be in the range of $0.15 to $0.17 per share, all improved measures compared with prior guidance reflecting our higher Q2 revenue and EBITDA performance and continued sales momentum.

Additionally, we expect GAAP net loss per share to be in the range of $0.59 to $0.61. For modeling purposes, we estimate that the tax benefit rate will be approximately 24% in the second half of FY '19, and when combined with the tax benefit in the first half, the overall rate for the year is about 22%.

As noted earlier, we expect our MRR to be in the range of $37 million to $39 million at the end of fourth quarter of fiscal 2019.

We had strong first half cash flow activity and now expect cash provided by operations to be in the range of $35 million to $40 million for the full fiscal year 2019, up from roughly $1 million in fiscal 2018. We anticipate we will be free cash flow positive, even without the monetization of the tax receivable from Dell that we will collect in the fourth quarter of this year.

I will now return the call to Mike.

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

Thanks, Wayne. Today marks my 10th earnings call, and I'm in my 17th year as SecureWorks' CEO. I'm honored to hold this position and to lead a team of employees that passionately works to stay ahead of threat actors and protect our clients. We are uniquely positioned in the industry. While I'm pleased with our progress this quarter, we recognize that much work remains to stay on top of such a quickly evolving threat landscape. On behalf of the SecureWorks team, I appreciate your continued interest and support. I look forward to providing further details on our progress next quarter.

Before I turn it over to the operator for questions, I want to again express my gratitude to the hard work and dedication of all of our team members and thank our clients for allowing SecureWorks to service their trusted cybersecurity partner.

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

## QUESTIONS AND ANSWERS

**Operator**

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

**Ugam Kamat** ***JP Morgan Chase & Co, Research Division - Analyst***

This is actually Ugam Kamat on for Sterling this morning. So for the first half of this year, we are seeing like uptick of the consulting activity that you are seeing. What specifically are the areas where you're seeing the pickup in demand in terms of the consulting?

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

So this is Mike Cote. Our consulting picked up a little bit, I think it was 1% or 2% greater from a percentage of revenue, and it's really tied to our focus in the large enterprise space. So the enterprise and large enterprise space, where we picked up some increased incident response work as well as where clients have looked for a -- I'll say a more holistic solution that ties our subscription solution along with over consulting business, and I'd say in a more larger holistic-type solution.

**Ugam Kamat** ***JP Morgan Chase & Co, Research Division - Analyst***

Got you. And if we look at the MRR outlook that you gave for the full year, it is below what you had guided previously. How much of that would you actually attribute to the increased churn versus, I would say, a lower demand for ongoing MSS services?

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

So I wouldn't -- this is Mike Cote, I wouldn't phrase it in either of those manners and it doesn't relate to either of those two. The demand is high as we mentioned. As I mentioned in my prepared remarks, we had record sales in Q2 after having the best Q1 we had in the history of the company. It's really related to the large contract that Wayne referred to in his prepared remarks, which was a client we've had for many years. The service we did for them was firewall management services, not a key value-add in many instances. And we have resigned that, but moved those solutions to more leveraged model and some consulting solutions. And what goes into MRR is our subscription business, so it's really related to the change in the make-up of that contract.

**Ugam Kamat** ***JP Morgan Chase & Co, Research Division - Analyst***

Got you. And if I could squeeze one last one, just a small question. Is there any of the associated revenue uptick that we are seeing, any of that is recurring in nature?

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

First of all, I'm not sure what a small question is, but could you just -- could you repeat the question for us, please?

**Ugam Kamat** ***JP Morgan Chase & Co, Research Division - Analyst***

Yes sure, I was saying it's a -- like a very quick question. So I was -- in the sense like the SRC uptick that you're seeing, is any of that recurring? Or is it more like onetime in nature?

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

So this is Wayne. Relative to SRC, we do have some of our revenues related SRC that is recurring. They're longer-term contracts, and we have mentioned that before. Some of those are 2- to 3-year contracts. So yes, the answer is yes. We have some.

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

Let me just add to what -- this is Mike again, but just to add to what Wayne said, if you look at our overall SRC strategic risk consulting business, the vast majority of it is long-term contracts, meaning a year -- much is longer than a year. It is not shorter -- for the most part shorter transaction contracts. Things like incident response clearly would be in that bucket, but the majority of it is longer-term contracts.

**Operator**

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

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

Maybe for Mike to start, a follow-up on some of the commentary you mentioned in the prepared remarks on the endpoint side. Maybe you could talk a little bit about how does the adoption of next-gen endpoint technology impact the customer's propensity to buy managed security or advanced threat services from SecureWorks. And maybe just walk us through the decision process when a customer does adopt next-gen endpoint technology, how do they decide between a third-party services provider like SecureWorks versus maybe buying that managed services from the next-gen technology provider itself?

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

So Gabriela, there were a couple of different questions in there. So hopefully I'll answer them. Hopefully, if I missed one, please come back to me. But I think the first thing that you've touched on was basically in the endpoint world. What we have found is and the reason we announced the partnering program is there's a couple of different aspects of it. There is the better detection -- first of all, there's the prevention side in the endpoint and what can be prevented, but as we know, not everything will be prevented. So then the question becomes using analytics to detect what's happening, and then you've got the response and ability to hunt. Effectively, a lot of our -- a handful, I'll say, a lot of our clients have approached us looking for us to help them in that process rather than just simply putting a tool out there and to get involved in ensuring that we can respond appropriately and periodically hunt on their network for bad guys to ensure that the network is clean. So what we've done is, taken the Red Cloak, which is initially, as I've said in the prepared remarks, used from an incident response engagement perspective or outside of incident response or somebody may ask us to do a targeted threat hunt across their network and realize that a lot of the secret sauce on our clients, as I mentioned, is in the analytics to detect and the models to detect what's going on bad on the network. So we announced the partner program, and it's much like one of the partnerships that we have today on the endpoint front with Carbon Black. We're going to look to expand where we can apply our analytics to their endpoint technology and have the ability to hunt on their network on their behalf. So we've seen a strong demand for this from the marketplace, and we're excited about the opportunity and look forward to showcasing some of the things that we'll be announcing the future. Did I answer your questions?

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

Yes, I think that covers it. And the follow-up is for Wayne, which is also on the MRR outlook for 4Q. I understand the delta between last quarter because of the 1 large contract that's been renewed. Maybe just taking a step back, it implies a little bit of a deceleration relative to the 12% that you just put up this quarter. Could you explain the puts and take as to why MRR would be decelerating even when adjusted for that 1 large contract?

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

Right. So MRR, we guided for the year, $38 million, $39 million, and we really just, as Mike mentioned earlier, reduced the bottom side. MRR, quarter-over-quarter, ebbs and flows a little bit based on the sales that we have for the quarter and our renewal rate. So when we look at it for the full year, we left the top the same, but just really reduce the bottom end.

**Operator**

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

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

I just wanted to maybe delve a little bit into the new package offerings that you guys described. Can you maybe give us a sense of how that would potentially impact your ASPs as well as potentially win rates when we start looking at the bundled offerings.

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

So Jonathan, this is Mike, appreciate the question. On the -- the win rates have clearly gone up. As I mentioned, it's 2.5x what our historical win rates were. And if for no other reason, because it's a more comprehensive solution, that's an easier package to buy and it's been easier for the CISOs to explain up through their senior management team and the board where the cases they explain to the board. ASPs have also gone up because it's not a bespoke type solution and the sales cycle have been shorter to date.

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

Got it. And then just as the follow-up, can you talk a little bit about what's driving the strength in international and how sustainable that is as we look at the course of the year?

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

So this is Mike again, Jonathan, thanks for the question. The strength in international is really a combination of a few things. The experienced sales leader that we hired, the General Manager that we have in the region that's been driving it for the last few years now, I think has done a tremendous job and continues to do a good job. From an operating perspective, we are -- the operations and the value we're providing is being seen. I mentioned earlier that we are GDPR-compliant, which has helped in the market. And there is clearly a -- as there is in North America, there's clearly a large demand throughout Europe, the Middle East and in the Asia Pacific market. But I would say in the Asia Pacific market, clearly the largest of those in that market is Japan. And we've got leadership positions in those markets, our investments are working well and our execution.

**Operator**

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

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

Question around customer count. I'm just curious with the success you're seeing with regard to some of the record sales, is that coming from increased velocity in terms of customers or larger deals in terms of customers. I don't think you actually gave a customer count, and that only counts as one question and there was like three different things in there.

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

Rob, this is Wayne. I'll take the customer count. So we didn't mention it, but what we did talk about was the 12% increase in ARPU year-over-year as we've focused more and more in the enterprise space. We've talked about that before. You will see in the Q that we file later today, the customer count actually rounded down this quarter to 3,300.

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

4,300.

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

I'm sorry, 4,300, I keep saying that. 4,300 from 30 -- from 4,400. So a little bit of rounding down there. But again our focus, we've shifted at the enterprise, 12% year-over-year ARPU, is how I would address that.

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

Not shifted, but the enterprise increased the investment in the enterprise from a growth perspective as we've talked about.

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

Sure. As I look at that 37% growth in total contract value that you guys talked about with a record bookings this quarter, are you seeing -- is that enterprise with duration extension then? Is that how we should think about that, that you're getting larger customers to commit to longer deals?

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

It is larger customers. Clearly, we've seen a growth, as I mentioned, 19 over $1 million. From a deal-term perspective, Rob, I would tell you, most of the larger contracts are going to be in the 2...

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

2 to 3, yes.

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

2- to 3-year term, and I think we've got a few of the bigger ones we've negotiated from a 5-year term perspective.

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

That's correct.

**Operator**

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

**Matthew John Swanson** ***RBC Capital Markets, LLC, Research Division - Senior Associate***

Matt Swanson on for Matt. Wayne, this is a really solid quarter for revenue billings in MRR, but also profitability. Kind of looking back to the investments you guys made last year, how are you thinking about investing for growth versus margin right now? Or I guess how do you feel about investments you already made in sales capacity?

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

So Matt, I think relative to growth versus -- revenue versus margin, we clearly -- as we've talked about several quarters, we made investment in the sales and marketing group. From a gross margin perspective, we're still investing both for internal solutions as well as external solutions. We're investing in automation and orchestration, all to help drive efficiency so that, long term, we'll see the margin improvement that we've discussed over the quarters.

**Matthew John Swanson** ***RBC Capital Markets, LLC, Research Division - Senior Associate***

And then you've talked before about trying to take some of the positive things that you've been doing at international regions and bringing them to the U.S. It seems like the domestic execution has been a bit better, just some update on how that's gone.

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

So Matt, Mike Cote. You're correct. The leadership under Geoff Haydon and the changes that he's made as we've set the groundwork over the last, let's say, 6 to 12 months are clearly showing that there's a large opportunity. Geoff runs our global sales organization. We have all of our -- almost all of our leaders in place from a global perspective, sales leadership perspective and are building the team out. We're seeing strong results with increased productivity, strong demand in the marketplace, and I would say I'm pleased, but not satisfied, and that the productivity will continue to increase.

**Operator**

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

**Anjelo Dedoyco Austria** ***Morgan Stanley, Research Division - Research Associate***

This is Anjelo Austria in for Melissa. I just wanted to speak to you at large deals again. Another strong quarter of double-digit deal is greater than $1 million. How does this compare to your expectations? And I guess putting -- in other words, looking forward, how should we think about the level of large deals that are baked into forward targets?

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

So this is Mike Cote. We've pretty consistently continued to -- well, let me back up, about a year or so, maybe 18 months ago, we invested heavily in the enterprise space and have clearly begun to see more traction in that space. And I would expect that we will, going forward, continue to see more traction in the enterprise and large enterprise space, some of which will be in, we said, large deals, deals over $1 million. I was -- mentioned it in my prepared remarks, I was pleased that it was a good distribution across verticals and clients, so there was a lot more contracts, let's say in and around $1 million rather than some bigger whales that will move it. We still got some deals, we're chasing in that area. But if we can continue to grow the contracts that are about $1 million in annual contract value a year, I would be pleased and that will be our plan and our [product] support plan.

**Anjelo Dedoyco Austria** ***Morgan Stanley, Research Division - Research Associate***

Got it. That's helpful. And just a quick modeling question, obviously a big EPS beat on Q2, full year EPS guidance is raised at the bottom end but not at the high end, is that just the reorganization cost or where the incremental expenses that we weren't taken account before?

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

You got it. So in Q3, it's the $0.02 and net flow is in full year as well, $0.02 related to the reorg.

**Operator**

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

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

Wayne, maybe for you. You both -- you and Mike both have talked about the contract value and the strength and the growth there, both in excess of 30%. I'm curious how I should be interpreting the delta between the 30%-plus growth in contract values in MRR and also total revenue growth. And a follow-up, if I may.

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

So relative to MRR, we have the guidance for the full year of $38 million to $39 million, which included an assumption of the revenue growth that we're now seeing. I know we've improved the revenue growth over guidance in each of the last 2 quarters, but basically that was considered in the $38 million to $39 million that we guided to earlier. The sales comps, year-over-year, again was anticipated. The renewal rate, if you think about what impacts MRR, it's new sales and renewals. Our renewal rate for the year to date is pretty much in line with the last several quarters. So renewals about the same. Sales was anticipated in the MRR guidance to begin with.

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

Fatima, let me try and add to that because I wasn't sure we answered your question, because I wasn't sure I understood it clearly, but I think one of the things is you've got to start with the recurring revenue base we have in the businesses each year. And what will be added to that will be the sales and subtracted would be any business that we lose or clients that leave us. Of the churn that we've had, most of it is service churn where clients may be buying something different. But I think the point when we talked about the good sales growth, and I mentioned in the record Q2, it was a record in the history of the company and Q1 was the best Q1 we've had in the history of the company, that is incremental sales that will be added to the current base. So I think because of the way we're a subscription-based business, it's the recurring revenue that is added to the base that we have, so the reason is a disconnect between the sales number of 30% or 36% of growth versus our revenue growth, that makes sense?

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

Yes, yes, that's very clear. And then maybe just on the cost front, Wayne. You mentioned in the prepared remarks that as you transact larger and larger deals, it is starting to push, but a little bit of pressure on gross margins. I just wanted to understand and flesh out that comment a little bit. And as a follow-up, just if you can clarify the scope of the reorganization costs in the quarter that will be very helpful.

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

Okay. So first, relative to the large contract, we see 2 things with the enterprise -- with the larger enterprise contracts. First is many of these contracts have a combination of subscription and consulting, and the consulting generally comes with a little bit lower margin. So that's one item. And then for the larger contracts, we do see some pricing pressure for the large deals and we make the assessments based on the value that brings to our company and to our clients. So that's what that was relating to. And then the restructuring, the $0.02 per share, as we have a long-term contract. We've -- we're pivoting the services to book a combination of subscription and consulting. And in that pivot, we anticipate we'll leverage our delivery model a little more, but let me take out some costs related to that contract as well.

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

I think the other thing for clarity though is that, that $0.02 in that reorganization is a Q3 event not a Q2 event.

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

Correct.

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

And to touch on the gross margin, we still believe in our long-stated gross margin target of [60%] or greater. Near term, we're focused on offering that can add maximal value to our clients, and we're doing a lot of work with regard to automation and orchestration to improve our efficiency over time.

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**Operator**

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

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

This is actually Chris Speros on for Gur. You noted the launch of the Red Cloak partner program this quarter. Can you talk about how you balance these partnerships with these key endpoint players while also competing against these same players in the endpoint space?

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

Yes. So Chris, this is Mike Cote. We've partnered -- I'll give you an example of this, we've partnered with Carbon Black for many years now. And most of where Red Cloak and the proprietary aspect of Red Cloak and the value in the marketplace is the behavioral analytics, and the analytics we can add from a detection capability. So we don't sell Red Cloak as a product directly competing with those players in most instances. And we found with other partners that have approached us in the endpoint market that are market leaders and our clients, there has been a strong demand for us to take and to use our analytics and support, quite frankly, the process that we've had or the mantra we've had which is to use the best-of-breed solutions from a point product perspective to secure our clients in a holistic manner, applying our intelligence to the various components. And I think we'd do the same thing in the network area. And as the endpoint area has matured, we have found it's maturing in a similar manner where people have basically -- our clients and partners in the marketplace have asked us to work with them in a complementary fashion. If I actually touched on this from a larger industry perspective, quite frankly, I think that the threat actors and people on the, I'll say, other side of the spectrum that are trying to attack our clients tend to work very well together in an orchestrated and coordinated fashion. And I am excited about the fact that parts of the security industry are starting to realize that we need to work better together instead of viewing each other from a competitive perspective and need to do what's in the best interest of our clients. So I am really excited about the opportunity here.

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

That's great color. And I noticed that this has been touched on prior in the call, but with SRC revenues expected to remain at a similar percentage of the top line through the near term, how should we think about the gross margin profile and the potential for gross margin expansion going forward in the near term?

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

I think it's back to something Mike just said earlier. Long term, we're still focused on expanding the margin. We're making the investments that we talked about, that provide -- and that will help us provide maximum value to our clients, but also move the margin in the direction we'd like to see it go.

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

Thank you. So I think that was our last question. This is Mike Cote. I just want to thank everybody for their time and attention and interest in SecureWorks. We are very pleased with the quarter we had and excited to report to you at the end of third quarter in the coming months. Have a great day. Thank you.

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

Thanks, everyone.

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**Operator**

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

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