

THOMSON REUTERS STREETEVENETS

EDITED TRANSCRIPT

SCWX - Q3 2017 SecureWorks Corp Earnings Call

EVENT DATE/TIME: DECEMBER 07, 2016 / 1:00PM GMT



CORPORATE PARTICIPANTS

Rebecca Gardy *Secureworks Corporation - Head of IR*

Michael Cote *Secureworks Corporation - President and CEO*

Wayne Jackson *Secureworks Corporation - CFO*

CONFERENCE CALL PARTICIPANTS

Sterling Auty *JPMorgan - Analyst*

Saket Kalia *Barclays Capital - Analyst*

Melissa Gorham *Morgan Stanley - Analyst*

Gabriela Borges *Goldman Sachs - Analyst*

Walter Pritchard *Citigroup - Analyst*

Matt Hedberg *RBC Capital Markets - Analyst*

Dan Bartus *BofA Merrill Lynch - Analyst*

Rob Owens *Pacific Crest Securities - Analyst*

Fatima Boolani *UBS - Analyst*

Jonathan Ho *William Blair & Company - Analyst*

Gur Talpaz *Stifel Nicolaus - Analyst*

PRESENTATION

Operator

Good morning and welcome to the SecureWorks' third-quarter FY17 financial results conference call.

(Operator Instructions)

As a reminder, this conference call is being recorded. I'd like to turn the call over to Rebecca Gardy, Head of Investor Relations. Ms. Gardy, you may begin.

Rebecca Gardy - *Secureworks Corporation - Head of IR*

Good morning, everyone, and thank you for joining us today to discuss SecureWorks' financial results for the third-quarter FY17. 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 remain available for replay until 5 PM Eastern time on January 7, 2017.

This morning SecureWorks issued a press release announcing results for its fiscal quarter ended October 28, 2016. 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 guidance with respect to GAAP and non-GAAP revenue and net loss per share as well as adjusted EBITDA. Our forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from those anticipated by these



statements. You can find a description of these risks and uncertainties in this morning's earnings press release and in the Company's quarterly report in form 10-Q for the quarter ended April 29, 2016, which is available on our Investor Relations website and on the SEC's website. Additional information also will be set forth had in the Company's quarterly report on forms 10-Q for the quarter ended October 28, 2016, and its other SEC filings.

All forward-looking statements made on this call are based on assumptions that we believe to be reasonable as of this day, December 7, 2016, and we undertake no obligation to update our forward-looking statements after this call as a result of new information or future events.

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

With us on today's call are Michael Cote, President and Chief Executive Officer of SecureWorks; and Wayne Jackson, our Chief Financial Officer. Following their prepared remarks, we will take your questions. We would appreciate your 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 re-queue and we will do our best to come back to you. Thank you for your cooperation on this.

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

Michael Cote - *Secureworks Corporation - President and CEO*

Thank you, Rebecca. Hello, everyone, and thank you for joining us.

We had solid results in the third quarter. We continue to see strong demand for our security solutions as organizations seek to improve their security posture, reduce complexity and optimize their security spending.

Non-GAAP revenue grew 21% to \$107.3 million from \$88.9 million last year. New sales continue to be balanced between sales to new and existing clients.

Our non-GAAP net loss per share was \$0.02 this quarter, as compared to a loss of \$0.18 last year, as we continued on our path to profitability.

And finally, our adjusted EBITDA improved to a loss of \$1.8 million from a loss of \$12.1 million last year.

SecureWorks operates against a backdrop of ever-increasing cyber-attacks on organizations of all sizes across the globe. As a result of these increased attacks, there has been a remarkable proliferation of security vendors.

Estimates indicate there are approximately 2,500 firms that have created individual security point products and solutions. The vast majority of these firms are in start-up phase, with less than one in ten being publicly traded.

The growth in the number of security vendors has led to the approach many organizations adopt to fight cyber-crime. They add multiple layers of point products, each designed to combat a specific attack vector, with almost all products being limited in both scope and visibility. As a result, organizations continue to get hacked as threat actors work the gaps between the point products. Our technology solutions assimilate data feeds from a variety of vendors and apply our knowledge of the threat actors' tactics, techniques and procedures to provide a coordinated and effective approach.

Here is an example of a persistent adversary and how SecureWorks fills the gaps of the disparate point products.



We deployed our forensic software with embedded threat intelligence in a compromised client's environment to assist with containment and combat the attack vector. We remotely observed the threat actors attempting to continue their efforts even after being discovered. The threat actors eventually disabled the third-party security product that had initially detected them to investigate how they had been discovered to enable future evasion techniques. These observed behaviors feed into our Counter Threat Platform, or CTP, enabling detections on other clients' networks. The threat actors had fully compromised individual end points, but our technology is now able to detect these types of attacks, protecting our clients.

In addition to a crowded marketplace of point products and an abundance of solutions that individually cannot solve the cyber threat problem, organizations also face another challenge. The explosive growth in alerts from all of these point products is creating significant activity that needs to be analyzed to find the few alerts that are relevant. Information security teams often suffer from alert fatigue. This overload hinders the security team's ability to effectively and efficiently focus their efforts on the highest priority items.

Our intelligence-driven technology platform is able to make sense of all the data. We identify the legitimate threats and help our clients make the best decisions. This quarter alone we received on average 220 billion events per day from over hundreds of thousands of monitored devices. Leveraging the power of our CTP, we took, or advised our over 4,300 clients to take, about 7,000 actions to 9,000 actions per day. We provided solutions to protect them by preventing those attacks, minimizing the time to detect and reducing the effort required to respond. Our solutions allow our clients to prioritize and best respond using their existing security resources.

CTP, our multi-tenant distributed architecture proprietary software-driven platform, delivers the qualitative and quantitative network aware intelligence that helps our clients make educated, informed decisions in real-time. Each functional component of CTP, analytics, machine learning algorithms and 16 years of historical attack data, works seamlessly, adding intelligence to automation, simplicity to orchestration and confidence in recommended actions.

As the technology backbone of our solutions, the CTP enriches the log data it ingests with client specific context. The global threat intelligence we have amassed from fighting the threat actors for years and our thorough understanding of the adversary. Our continuous investment in the CTP is a key fundamental area of focus for us.

In the third quarter we made the following enhancements.

First, we deployed new machine learning algorithms that automate the creation of accurate and dynamic inventory lists of client assets without requiring any additional client action. Our clients are evolving, growing organizations that constantly change and add assets to their network. By producing an automated, up-to-date inventory list, the CTP prioritizes security events by considering the asset criticality, ultimately increasing the effectiveness of our solutions.

Second, we enhanced the business driven context and intelligence of the CTP to better prioritize and refine the security incidents that are escalated to our clients. CTP adjusts the severity of security incidents when a single event is determined to be part of a larger, more sophisticated attack. This also reduces the alert fatigue I mentioned earlier.

And third, we added new online demand, on demand threat capabilities that increase the speed to address emerging threats. Clients can now shut down an attack from a single screen in our portal. Once initiated by a client, the fully automated counter measure quickly propagates across the network, increasing the speed of response.

In addition to our core platform, investing in our industry leading security solutions for the cloud is also a strategic priority. As we announced at last week's AWS re:Invent, SecureWorks has recently achieved advanced technology partner status, the highest designation an AWS partner can achieve. For over 16 years, we have been there to help organizations navigate security challenges and mitigate risks when adopting emerging technology strategies, such as moving their critical data to a cloud environment.



Through these CTP enhancements and cloud offerings, we continue to address the evolving needs of our clients in the fight against cyber-crime. We provide our clients with the context, relevance and intelligence they need to take the appropriate actions, thereby increasing the effectiveness of their security teams. We operate in a vendor-agnostic manner, working with the various point products across the technology stack of our clients.

I am excited about the opportunities we have today and in the future. We are exceptionally well positioned with organizations of all sizes, across all industry verticals and around the globe. The middle market and large enterprise spaces in particular continue to be a significant source of future growth for us over the long term.

As we shared on prior calls, large deals with enterprise clients are taking longer to close, as these organizations continue to approach security spending more strategically. They face a multitude of choices and are taking a perspective that is increasingly risk based rather than compliance based. As C-suites and Board of Directors are getting more involved in security decisions, there is a greater degree of accountability and measurement. They are asking questions like, "Am I more secure with this additional security spend" or "Are our existing security controls effective?" This was especially highlighted recently when I met with the CISOs and CIOs of our largest European clients at our global client forum in London. It's clear that organizations around the world are elevating cyber security to their highest strategic conversations.

Lastly, before I turn it over to Wayne, I want to share some news regarding a few management changes. Tyler Winkler, our VP of Global Sales and Marketing, has decided to retire from SecureWorks effective at the end of this fiscal year to spend some much deserved quality time with his family.

Tyler was the second person I hired at SecureWorks back in May of 2002. He was instrumental in shaping the go-to-market strategy that propelled our revenue growth over the past 15 years. I sincerely thank Tyler for all that he has done for us over the years.

Given Tyler's retirement, I have taken this opportunity to divide sales and marketing into two separate functions, both reporting to me. After a thorough search, I have hired a global sales leader with extensive enterprise experience that will be joining us after the holidays. He is currently working within the Dell Technologies Organization and I am excited about his experience and connection back into Dell, EMC and RSA and the opportunity he will bring to accelerate revenue growth.

I have also hired a new VP of Global Marketing who started this past Monday. Tyler will work with both of these teams over the next few months to ensure a smooth and meaningful transition of responsibilities.

To capitalize on the market opportunity which we see for our Company, we will be increasing our investment in our go-to-market strategy by increasing our direct sales quota carriers and refocusing our efforts on the indirect sales channel. In addition, we are excited about the combination of Dell and EMC sales teams.

I will now turn it over to Wayne to discuss our third-quarter financial performance and to share our guidance for Q4 and the full year.

Wayne Jackson - *Secureworks Corporation - CFO*

Thank you, Mike. Good morning, everyone. I will start with a review of our third-quarter results and then provide fourth-quarter and full-year FY17 guidance.

The following financial results and metrics will be non-GAAP measures unless otherwise noted. As we review the results, there are three key themes for the quarter that I'd like to highlight.

First, we delivered solid revenue growth driven by continued demand for our solutions. Second, we continue to scale our operating expenses and saw returns on our prior investments, leading to a continued decrease in our net operating loss. And third, we ended the quarter with positive cash flow from operations.

We are pleased to report this quarter's solid performance and the progress SecureWorks has made on its path to profitability.

Starting with our top line results, third-quarter revenue was \$107.3 million, a 21% growth over the prior year. Once again, we have achieved record revenue this quarter.

Monthly recurring revenue, or MRR, at the end of the third quarter was \$30.8 million, a 9% increase over the prior year and a sequential 3% increase. Our revenue retention rate ended the quarter at 96%. We have experienced renewal rates within our historical ranges, though cross sales have not kept pace. We view these trends not as a macro indicator of demand for our solutions, but rather we believe we have an opportunity to accelerate sales momentum.

Gross margin improved to 53.4% of revenue during the quarter, a 70 basis point increase compared to the third quarter of FY16 and an 80 basis point increase sequentially. Gross margin benefited from technology investments in scale, while total events processed by the Counter Threat Platform increased over 45%, solution delivery headcount in the counter-threat operation center increased just 3% over last year, demonstrating the scalability of our technology.

Operating expenses were 57.5% of revenue, down from 69.5% in the third quarter of last year, a 1,200 basis point improvement. This highlights stabilizing cost across functions against 21% revenue growth. We remain committed to revenue growth and will invest as needed.

Let me break down R&D, sales and marketing and G&A for you.

Research and development expenses were approximately 10.7% of revenue, versus 13.7% in the prior year. We experienced a large decrease in outside services due to a surge in development in the prior year related to several projects that were completed.

We spent \$11.5 million this quarter in research and development, as we continuously invest, improve our platform and innovate on future solutions to enhance the CTP.

Our sales and marketing expenses declined to 24.3% of revenue in the current quarter, from 30.5% of revenue in the third quarter last year on solid revenue growth. As Mike indicated earlier, we will continue investing in our sales team as we add capabilities to capitalize on global opportunities.

General and administrative expenses in the third quarter were 22.5% versus 25.3% in the third quarter last year. Scale and business support functions and public company costs were partially offset by investments in software systems and processes.

As a reminder, given the legacy of our carve-out financial statements, our G&A expenses include costs for product management, sales contract support, and other expenses.

This quarter's effective tax rate was 43.8%, compared to 39.4% the prior year. This increase in the tax rate benefit was primarily attributable to the recognition of higher than expected research and development tax credits this quarter.

Our GAAP net loss narrowed to \$7.7 million, or \$0.10 per share, compared to net loss of \$18.5 million, or \$0.26 per share, in the third quarter last year.

Non-GAAP net loss per share was \$0.02 compared to a loss of \$0.18 in the prior year and a loss of \$0.07 in the second quarter. Weighted average shares outstanding, both basic and fully diluted, were \$80 million at the end of the third quarter.

The Company's adjusted EBITDA loss in the third quarter narrowed to \$1.8 million versus an adjusted EBITDA loss of \$12.1 million last year on increased revenue and scaling cost.

We have a solid cash position with \$110.8 million as of the end of this quarter. In addition, we have an untapped \$30 million credit facility and no indebtedness.

Cash flow provided by operations turned positive this quarter and was \$2.9 million. As discussed last quarter, one of the uses of cash year-to-date has been the repayment of \$20 million this fiscal year to Dell for certain operating expenses paid on behalf of SecureWorks after we set up separate legal entities on August 1, 2015.

Before I turn to our guidance, I'd like to remind you that the fourth-quarter FY17 will have 14 weeks versus the standard 13 weeks as SecureWorks operates on a 52/53 week fiscal year. Next year we'll revert back to 52 week year, so please keep this in mind when you are comparing full-year FY16 to FY17 or when you start to model FY18.

Based on the Company's performance through the end of the third quarter, the aforementioned items and current market conditions, we expect the following results.

For the fourth quarter:

Revenue on both a GAAP and non-GAAP basis, to be in the range of \$116 million to \$117 million, net loss per share to be in the range of \$0.14 to \$0.15 and non-GAAP net loss to be in the range of \$0.05 to \$0.07. The Company expects approximately 80.009 million weighted average shares outstanding during the fourth quarter of FY17.

And for the full fiscal year we now expect:

Revenue, on both a GAAP and non-GAAP basis, to be in the range of \$427 million to \$428 million.

Net loss per share to be in the range of \$0.55 to \$0.56 and non-GAAP net loss per share to be in the range of \$0.22 to \$0.24.

Net loss to be in the range of \$42 million to \$44 million and adjusted EBITDA loss to be in the range of \$21 million to \$23 million.

We also expect 77.635 million weighted average shares outstanding during the FY17.

Finally, we invested \$5.4 million in the third quarter in capital expenditures to support our growth, bringing year-to-date CapEx to \$13.3 million. We expect capital expenditures to be approximately \$19 million to \$21 million for the full fiscal year.

To wrap it up, I am pleased with this quarter's results. We have grown our revenue, managed our cost, and built a strong liquidity position. SecureWorks is a market leader in making sense of cyber security in a turbulent, ever-changing world and we are confident that we are positioning our Company to best assist our clients in their fight against threat actors around the globe.

This completes my prepared remarks. Operator, can you kindly open the call for questions at this time?

QUESTIONS AND ANSWERS

Operator

We'll take our first question from the line of Sterling Auty with JPMorgan. Please go ahead.

Sterling Auty - JPMorgan - Analyst

Thanks. Hi, guys. Want to understand or put into context the continued comment about the longer sales cycles and decisions plus the change that you've had with head of sales. And now the guidance that we have for next quarter, meaning that the guidance for next quarter shows a bit of reacceleration in the top line. But we still saw the MRR metric decelerate in this quarter.



What is it in terms of the programs that you put in place that you think can cause a reacceleration starting next quarter and how do you feel about that carrying forward? I know you, you're not giving guidance for next year, but just maybe some qualitative comments around where you think the momentum will be carried into next year.

Michael Cote - *Secureworks Corporation - President and CEO*

Sterling, thanks for the questions. Let me see if I can try and address them and hopefully we can give you some color. Starting with, I would say that we feel really good about the momentum that we've made since being a public Company on the sales front and where our pipeline sits and the actual business that we've closed, both the new and existing clients over the last couple months.

There is a tremendous focus, from our Board of Directors all the way down through everyone in the organization, and alignment around what we're looking to drive from a revenue perspective. When you say the increase in growth, I would want to make sure I'm not -- look, I don't have numbers so maybe Wayne can comment. But one thing maybe to make sure that you're looking at the extra week of revenue in the fourth quarter with the 52/53-week year.

Sterling Auty - *JPMorgan - Analyst*

Well, that's what I expected you to answer, is to come back maybe give a little quantification of that and then again talk to MRR decelerated this quarter. Is that really the indication that maybe some of the growth will continue to decelerate as we head into next year? Or do you think some of the programs and changes that you made will stabilize and actually either hold flat or even reaccelerate revenue as we move into next year?

Wayne Jackson - *Secureworks Corporation - CFO*

Good morning, Sterling. This is Wayne. Let's quickly answer your question on Q4. It is the 14th week in the quarter is one of the reasons sequentially, the guidance we gave, it's an increase quarter-over-quarter. The 14th week has some element of that.

But your other question, let's focus on MRR. I think the way we look at MRR as of the end of Q3 is, we continue to have solid revenue growth. We just raised guidance for the full year. Mike talked about it. We've seen it. We continue to have strong demand for our solutions.

Sales this quarter, from both new were equal -- from both new and existing clients. The renewals, we mentioned this in the prepared remarks as well, the renewals were within our expectations.

However, sales were weaker than we would have liked. So we still see the opportunity out in the marketplace for our MRR to get back to the growth that we expected to get back to.

Sterling Auty - *JPMorgan - Analyst*

Got you. Maybe as my follow-up question, there's been lots of talk around the type of attacks that we're seeing now versus maybe a year ago, not lessening in frequency, but maybe the types of attack or attack severity may be leveling off a bit. How is that impacting the SRC business?

Michael Cote - *Secureworks Corporation - President and CEO*

I would not say -- this is Mike, Sterling. I would not say that we're seeing a decrease in the number of attacks. Actually, we had our Board of Directors meeting last week and gave them the top 10 things that we saw this year from an attack perspective from -- our counter threat unit presented that.



And what you see is, as we walk through that, is the increased sophistication, some of which I tried to bring home in the example that I gave in my prepared remarks, where effectively a hacker had gotten into an organization. We were brought in to help them with that and as we watched what the hacker was doing after we found the individual, the organization, they effectively came back in to dismantle the product that was there and try and reverse engineer how it had found them, so that they could take that increased knowledge. So we have not -- we've actually seen, in my opinion, an increase in the sophistication and the methods and the way that the hackers have gone about doing the things that we -- that they do.

Sterling Auty - *JPMorgan - Analyst*

Got it. Thank you.

Operator

Our next question will come from the line of Saket Kalia with Barclays Capital. Please go ahead.

Saket Kalia - *Barclays Capital - Analyst*

Good morning, guys. Thanks for taking my questions here.

Michael Cote - *Secureworks Corporation - President and CEO*

Sure.

Saket Kalia - *Barclays Capital - Analyst*

So maybe first for you, Mike, just following up on the longer sales cycle commentary over the last couple quarters. Can you just talk about the pipeline qualitatively?

Is it growing faster than MRR growth? And how is the mix of that pipeline changed in terms of enterprise versus mid-size for example over the last year, and of course all qualitatively.

Michael Cote - *Secureworks Corporation - President and CEO*

I don't have all the answers to all the questions you just asked me. What you I would tell you from my conversations on sales calls and discussions with Tyler and our sales leadership team is that they feel very good about what their forecast is for the fourth quarter and the conversion of the sales pipeline into closed deals and we continue to see a tremendous demand.

I think it's across the board from SMB organizations to some of the largest multinationals in the world. And as we've continued -- as we get bigger and continue to grow the large enterprise space and that takes a larger percentage of, if you will, our overall pipe in the business that we're doing, that we see it taking a little bit longer to close the deals there.

I gave the example, we had a lot of conversations with CISOs and CIOs at our European global client forum in London. And there was -- I'm excited about the fact that there's a lot of requests from their bosses, if you will, the CEOs, the CFOs and the Boards, looking for more accountability and measurement around what security teams are doing, why they're doing it, almost from a zero-based budgeting perspective.



And I think that comes right to SecureWorks and I'd actually am excited about the new marketing lead that I mentioned earlier on the call and our ability to take a leadership role in that education.

Saket Kalia - *Barclays Capital - Analyst*

Got it. Got it. That's really helpful. And then maybe for my follow-up for Wayne. Wayne, you mentioned that cross sales maybe haven't kept pace a little bit. So can you just dig into that a little deeper? Were there particular offerings that maybe -- that were more pronounced in terms of maybe coming in a little bit lighter than you expected?

And what do you think is the reason for that? Could some of that be competitive? Is it a little bit more of that scrutiny that Mike was talking about? Just a little more color on the cross sales would be really helpful.

Wayne Jackson - *Secureworks Corporation - CFO*

Sure, Saket. Good morning. Maybe to re-emphasize -- from an MRR perspective, for us it's very positive to see the renewal rates are certainly within our historical ranges. They're about what we expected them to be and we continue to see that strong demand.

I think relative to the sales not being where we would like for them to be, it's exactly what Mike talked about. I'll add the SMB, we're still very focused on that. That's an important part of our market and our go-to-market strategy.

But it really gets back to what we've talked about before in the enterprise space and taking longer to close some of these deals.

Michael Cote - *Secureworks Corporation - President and CEO*

I guess the other -- this Mike again. The other color I'd add to that was that EMEA and the APJ markets, although relatively small, are doing tremendously well this year and far exceeding our expectations from a sales growth perspective.

Saket Kalia - *Barclays Capital - Analyst*

Just on that point, Mike, can we maybe read that some of that lighter cross-sales is maybe more pronounced in the US rather than internationally? Is that fair?

Michael Cote - *Secureworks Corporation - President and CEO*

Yes.

Saket Kalia - *Barclays Capital - Analyst*

Got it. Thanks very much for your time this morning, guys.

Michael Cote - *Secureworks Corporation - President and CEO*

Thank you.

Wayne Jackson - *Secureworks Corporation - CFO*

Thank you.

Operator

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

Melissa Gorham - *Morgan Stanley - Analyst*

Great. Thanks for taking my question. Mike, I just wanted to follow up on the sales leadership transition.

As the new individual comes on-board, are you expecting to see major changes in the sales strategy or the sales organization? And if so, how do you minimize any transition risk or disruption related to that change?

Michael Cote - *Secureworks Corporation - President and CEO*

So I would not expect there to be significant changes, and the best way I would tell you to -- that we're looking to minimize some of this is the transition period between now and when we're able to announce the individual, I am having regular conversations and looking to do everything we can to ensure that the individual comes and is up and running quickly.

Melissa Gorham - *Morgan Stanley - Analyst*

Okay. And then just one follow-up question on the cross sell discussion. One of the areas that the market's been focused on recently is the advanced end point protection, and I know you have the Red Cloak solution. I'm just wondering if you can provide a little bit more color on any traction that you're seeing in that solution or is it still very much early days?

Michael Cote - *Secureworks Corporation - President and CEO*

This is Mike. I would say that -- you mentioned advanced end point threat detection, which for us is where we will work with some of our partners and the leading technologies in the market and as well as Red Cloak and/or supplement it with Red Cloak. So we continue to see very good traction in the advanced end point threat detection area and the pipeline is very good and we're excited about the opportunities in that solution set.

Melissa Gorham - *Morgan Stanley - Analyst*

Okay. Great. Thank you.

Operator

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

Gabriela Borges - *Goldman Sachs - Analyst*

Great. Good morning. Thank you for taking my questions. I want to follow up on some of the commentary on the larger deals that you've been working toward.

Maybe, Mike, if you could just think about the last couple of quarters and the conversations that you're having, have you noticed any change in or progress in the type of conversations or customer willingness to close those types of deals? And I guess as we go into 2017, what do you think the catalyst might be to get some of those deals across the finish line? Thank you.

Michael Cote - *Secureworks Corporation - President and CEO*

Sure. So great question, Gabriela. The way I would put this from a change over the last, say, six months and the conversations that I've been having is, it felt six months ago as if, say three to six months ago, as if there was questions that were being raised, in particular in the C-suite area, that was causing a general stall and almost a put things on hold.

It feels in the last 90 to 120 days as if we're moving forward and that there's a general inquisitive push for more accountability, as I mentioned. So the questions that I kind of put in my prepared remarks with the CFO or the CEO may be saying, okay, we're going to look to approve this, but can you explain to me whether this technology you've been using for the last five years is really a good spend and providing appropriate controls.

So we've been spending a fair amount of time helping to try and -- helping CISOs to try and put together formats to answer those questions for their Boards and for the C-suites, because I think they're looking more for a trusted partner. It's been interesting the incremental deals we've closed as we've got in to kind of uplifting the sales cycle into more the C-suite and getting into parts of that organization, parts of organizations where we're talking to not just the CISOs and CIOs, but the CEOs and the CFOs as well, ensuring that we can communicate across the border.

And I think that actually Melissa, when she had asked, do I expect to see changes, I think we will continue to accelerate our effort and focus into marketing and selling into the full C-suite.

Gabriela Borges - *Goldman Sachs - Analyst*

That's helpful color. Thank you. As a follow-up on that point on the increased investment in the go-to-market strategy, if you could just give us an update on how you're thinking about balancing those investments? What's the continued path for achieving profitability? Thank you.

Wayne Jackson - *Secureworks Corporation - CFO*

So, Gabriela, this is Wayne. As you noted in our Q4 guidance there, we did guide that EBITDA, we were at \$1.8 million EBITDA this quarter. We guided that loss would be a little bit larger next quarter. Part of that is our investment, our continued investment in the sales channel.

We've talked about other investments before in the technology area, as well as in solutions that we innovate to enhance the CTP. So we'll continue to make all the investments. Specifically for Q4, we will continue to invest in the sales teams, the sales effort to increase our capabilities there. And then longer term, we believe we're still on the path to profitability.

Gabriela Borges - *Goldman Sachs - Analyst*

That's helpful. Thank you.

Wayne Jackson - *Secureworks Corporation - CFO*

You're welcome.



Operator

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

Walter Pritchard - Citigroup - Analyst

Hi. Thanks. Two questions for Wayne. I guess first on the mix of revenue, if we think about how that -- or I guess the question is, how has that changed over the last year?

Because we're seeing the MRR growth come down and we're seeing your total revenue growth be basically in line with what we expected. It would seem like you're seeing a shift towards SRC. I just want to make sure I'm following that math correctly.

Wayne Jackson - Secureworks Corporation - CFO

Good morning. Good question. So it's still 80 -- the split's 80/20, revenue for Q3 MSS to SRC, or subscription to SRC. No change there.

Walter Pritchard - Citigroup - Analyst

Okay. And then just -- I might have, I got dropped out of dial in, I might have missed this number. But did you give the number for the impact of the extra week on the fourth quarter?

Wayne Jackson - Secureworks Corporation - CFO

We did not. The earlier question was, did fourth quarter include the benefit of a 14th week, and the answer is yes.

Walter Pritchard - Citigroup - Analyst

So just maybe how can we -- obviously, our models are going to try to normalize for that and so can you either walk us through how that 14th week impacts your numbers or better yet, give us a number to help us sort of see through that accounting impact?

Wayne Jackson - Secureworks Corporation - CFO

How about the former. One way to do it would be to take Q3 and divide it by 13 and use that as a proxy. I don't want to get into your modeling for you but --

Walter Pritchard - Citigroup - Analyst

Simple as that?

Wayne Jackson - Secureworks Corporation - CFO

Yes.

Walter Pritchard - Citigroup - Analyst

Thank you.

Wayne Jackson - *Secureworks Corporation - CFO*

You're welcome.

Michael Cote - *Secureworks Corporation - President and CEO*

Have a good day.

Operator

Your next question comes from the line of Matt Hedberg with RBC Capital Markets. Please go ahead.

Matt Hedberg - *RBC Capital Markets - Analyst*

Thanks, guys. Mike, I wanted to circle back on your comments on achieving advanced technology partner status with AWS. Could you give a little bit more color on what that could mean for sales and is there a way for you to quantify the impact AWS is having on your business?

Michael Cote - *Secureworks Corporation - President and CEO*

So we are in the early stages of our cloud efforts. We've got a pretty aggressive road map of solutions we'd like to bring to the cloud. So I would tell you it's not been material to date.

We are cautiously optimistic that the ramp will continue, the pipeline is growing. So it would be a little hard -- that's probably the best I can do to sort of quantify for you the impact to date and I think when it begins to really get material you'll probably hear us talk about it a little more quantitatively.

Matt Hedberg - *RBC Capital Markets - Analyst*

Great. And then for Wayne. I think sales and marketing as a percentage of revenue was the lowest maybe it's ever been. I was curious, is that a function of less commission expense in the quarter? Is there something else driving that, given it sounds like you guys want to invest -- increase your investments in quota carrying reps and indirect sales.

Wayne Jackson - *Secureworks Corporation - CFO*

We do want to. We will continue to invest, absolutely. The decline as a percent does have something to do with the sales momentum not being where we want it to be. That's correct.

Matt Hedberg - *RBC Capital Markets - Analyst*

Got it. Thanks.

Operator

Your next question will come from the line of Tal Liani with Bank of America-Merrill Lynch. Please go ahead.

Dan Bartus - *BofA Merrill Lynch - Analyst*

Hi, guys, this is actually Dan Bartus on behalf of Tal. Thanks for taking my question. If I heard correctly on the revenue retention, it dipped down a bit to 96% and it looks like customer count looks pretty flattish over the last few quarters at 4,300. Is there anything noteworthy in terms of customer churn this quarter?

Michael Cote - *Secureworks Corporation - President and CEO*

Good morning, Dan. Thanks for the question. So again, we generally talk about it in terms of revenue retention and this quarter 96%.

The things to reiterate is that the sales team, from both new and existing clients, which is a good thing. Our retention rates were -- and you can read that as -- well, just retention rates were pretty much what we expected. Again, I know I'm repeating myself, but it really focuses on the need for additional sales momentum.

From a logo perspective, I will share this. So from a logo perspective, our logo churn, quote-unquote, logo churn is the same this quarter, it's very -- has been very consistent over the last two years. So there's no spike in logo churn or things like that, if that's your question.

Dan Bartus - *BofA Merrill Lynch - Analyst*

Yes. Okay. And then just related to that, I was wondering what you're seeing in terms of the public cloud impacts meaning? I guess especially for SMBs when we think about them, either shifting their network to public cloud, is that -- could that be adding to your customer revenue churn there in terms of it being deflationary for you guys? Thanks.

Michael Cote - *Secureworks Corporation - President and CEO*

This is Mike Cote. On the public cloud, we have actually not seen an impact from a churn perspective. It's not an impact in any way.

And as Wayne mentioned, our logo churn has been consistent with where it's historically been. The cloud opportunity is really more of an opportunity for us than I look at it from a risk perspective of -- and you mentioned in particular the SMBs moving into the cloud. We've just not seen any impact there.

Dan Bartus - *BofA Merrill Lynch - Analyst*

Great. Thanks.

Operator

Your next question comes from the line of Rob Owens with Pacific Crest. Please go ahead. Rob, your line may be on mute.

Rob Owens - *Pacific Crest Securities - Analyst*

Hi, can you hear me?

Operator

We can.

Michael Cote - *Secureworks Corporation - President and CEO*

Yes, we can hear you.

Rob Owens - *Pacific Crest Securities - Analyst*

Hello?

Michael Cote - *Secureworks Corporation - President and CEO*

We can hear you now, Rob.

Rob Owens - *Pacific Crest Securities - Analyst*

So relative to comparative win rates, any just general color in terms of what you're seeing and any change on that front?

Michael Cote - *Secureworks Corporation - President and CEO*

We've not seen a significant change in competitive win rates, so it's been about where we've historically been, both in the SMB and in the enterprise, the mid-market to enterprise spaces. Actually, if I added a little more color on that, I would say in the state and local market, which is a separate go-to-market group for us, we probably are at a higher position and continue to accelerate from where we've -- we've only been in that area for a couple years, but it continues to perform very well. And then I guess I mentioned earlier if I continue to go in APJ and in EMEA, we continue to accelerate and they're doing very, very well for us from a sales perspective.

Rob Owens - *Pacific Crest Securities - Analyst*

And as you're inking new deals, what does average deal size for a new customer look like versus where it's been historically?

Wayne Jackson - *Secureworks Corporation - CFO*

So this is Wayne. We haven't talked about the numbers themselves, but our average revenue per client is definitely going up. The average deal size is going up.

Rob Owens - *Pacific Crest Securities - Analyst*

And I guess lastly, for those logos that do churn off, can you remind us, historically, why they've left? Is it for competitive reasons or M&A or all of the above? And has there been any relative change on that front? Thanks.

Michael Cote - *Secureworks Corporation - President and CEO*

Historically, we've lost clients for three reasons. It's been, they've gone out of business, M&A opportunities. A third, a third, a third. And a third have gone to competitors, usually over price and we've not seen any change from that historical ratio today or in the quarter.

Rob Owens - *Pacific Crest Securities - Analyst*

All right. Thank you.

Wayne Jackson - *Secureworks Corporation - CFO*

Thanks, Rob.

Michael Cote - *Secureworks Corporation - President and CEO*

Thanks, Rob.

Operator

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

Fatima Boolani - *UBS - Analyst*

Just sort of a macro question on the pricing environment and to your point, Mike, about what sort of trends you're seeing with respect to your pricing leverage? And a follow-up for Wayne, if I may.

Michael Cote - *Secureworks Corporation - President and CEO*

So my answer to that, and I'll have Wayne jump in on the back to that if he wants to add anything on the pricing front. But my sense on pricing is that in the large enterprise organizations where there's procurement involved, we continue to have the normal discussion with procurement.

We are doing a lot of work, or fair amount of work, around pricing to figure out if there's easier ways for us to do this for both the client and for us and -- to the heart of your question, we are not feeling any pricing pressure different or out of the ordinary that we've seen anything different than we normally would or historically have.

Fatima Boolani - *UBS - Analyst*

Maybe a quick follow-up for you, Mike, on the sales leadership transition and in the consistent context of the cross sale business maybe not being to the levels where you'd like it -- like to see it. I'm wondering if you have sort of a priority list for the blueprint for go-to-market for next year?

Is it increasing quota for cross-sale products? I'm just trying to understand what changes we can expect on the come to help improve that metric for you, especially with the new sales leadership in place.

Michael Cote - *Secureworks Corporation - President and CEO*

I'd answer that question by saying there's a lot of conversations ongoing with the new sales leadership who will be joining us, as I mentioned, after the holidays, with Tyler, with myself and with the leadership team within the sales organization. And I, as I mentioned in the prepared remarks, you should expect us to hire more quota carriers and there will be an increased focus with the new solutions that we've been coming out with, such as the AWS cloud, such as the AETD, on the endpoint with a renewed focus into cross sales into our existing clients as well as bringing in new clients.

But we are in the process right now of taking the planning we've done over the last couple of months and with the existing leadership team and working through an appropriate transition over the next couple of weeks or whatever it may be, through the end of the holidays, so that we hit the ground running pretty hard into the next year to reaccelerate our revenue growth.

Fatima Boolani - *UBS - Analyst*

Appreciate that color. Quick one for Wayne, if I may. Wayne, on the R&D line item, so a third consecutive quarter of absolute dollar decline on the R&D line there.

And I know you touched on it on your prepared remarks, but can you talk about your use of your flexible staffing model and how that dove-tails into that line item? And that's it from me. Thank you.

Wayne Jackson - *Secureworks Corporation - CFO*

Hi, Fatima. Good morning. Certainly.

So as we tried to touch on a little bit in the prepared remarks, we made significant investments as we've discussed before in FY16. Some of that carried -- some of those projects carried over into FY17.

We do have a part of our R&D resources are outsourced resources so that gives us the flexibility to flex up or down, depending on the road maps and the projects being worked on by our engineering group. And we still are very committed to investing the dollars, little over \$11 million this quarter in spend. We're committed to investing in the dollars for the solutions and the engineering projects that need to be done to continue to grow our Company.

Operator

Our next question will come from the line of Jonathan Ho with William Blair. Please go ahead.

Jonathan Ho - *William Blair & Company - Analyst*

Good morning. I just wanted to start with your comments around separating the sales and marketing functions. And if you could just give us a little bit more color in terms of why the decision now and maybe what that allows you to do maybe a little bit differently in terms of opportunities?

Michael Cote - *Secureworks Corporation - President and CEO*

Thanks, Jonathan. This is Mike Cote. I would tell you the first thing and the first reason is so that I can be more directly involved in the messaging and the allocation and things that we're doing from a marketing perspective. And our sales organization and sales leadership can solely be focused on sales and closing deals and generating incremental revenue.

So we had an opportunity where I wanted to bring in a senior executive to join my leadership team from a marketing perspective because I felt like that organization should have a seat at my executive leadership table and we found a tremendous lady to join us earlier this week. So I'm really excited about the increased focused individually in both of those areas and the ability for my leadership team now to have all of the key areas of the organization having a seat at the table to work well as a team.

Jonathan Ho - *William Blair & Company - Analyst*

Got it. Got it. And I just wanted to maybe get a clarification for some of your comments around maybe the C-suites historically slowing down to maybe consider a broader strategic plan. Did you also say you're starting to see maybe signs of that thawing or maybe some more activity in terms of growth and does that sort of imply that maybe things will start to improve in 2017 in terms of that -- maybe that slowdown starting to unthaw a little bit?

Michael Cote - *Secureworks Corporation - President and CEO*

So this is anecdotal and this is sort of what my experience has been. But if I look back into shortly after we went public earlier this year, I think the conversations when I was out with clients or prospects, particularly those that pushed, it was more like we got the Heisman than anything else.

Effectively, they weren't even -- the CIOs or CISOs weren't even sure how to work with the executive leadership team. And the fact that CIOs, CEOs, CFOs are just -- frankly, and I need to understand this more. It feels like that there's -- we're beginning to get the education into those individuals and some more accountability and comfort around it, and that we are -- I am beginning to see some of the thawing and I would be -- I don't know how quick the thaw will occur, particularly with us heading into the winter season here in the United States, but it feels to me like we're able to have better conversations.

There's a large global organization that I'm involved in, we've gotten the verbal on and we've been working through the sales process, the legal documents. And as I think through the conversations I had with their CIO there, it really felt like things changed from a we can't just do anything to help me provide more accountability around these products that I'm using and how I can fill these gaps and how I can help ensure that the Board and the CEO and the CFO feel good about where we're spending money and why we're spending this money and why it's the best spend.

So again, it went from a hold off, come talk to me later to a help me manage this process internally and then let's move forward. So --

Jonathan Ho - *William Blair & Company - Analyst*

excellent. And just one last one from me. Given the time that you just spent with some of your European customers, with new breach disclosure laws maybe coming online over the next year, year-and-a-half, can you maybe talk about what type of opportunity maybe that could drive internationally?

Michael Cote - *Secureworks Corporation - President and CEO*

So I don't know how much -- this is Mike again and thanks for the question. I don't know how much the breach laws were a part of the conversation we were having.

I definitely am excited about the new leadership that we've hired in London to run our European operation, who I think he's been up and running for a quarter or so now and the way the sales pipeline is growing and our opportunity in that market. And I don't -- we've not heard anything about the new laws slowing down our opportunity in particular from the perspective of the way we're thinking about data in country and things of that nature.

Jonathan Ho - *William Blair & Company - Analyst*

Great. Thank you.

Operator

We'll now take our final question from the line of Gur Talpaz with Stifel. Please go ahead.

Gur Talpaz - Stifel Nicolaus - Analyst

Sure. Thanks for taking my question. So, Mike, have you seen any impact from the adoption of orchestration or sophisticated analytics tools that we're seeing in the enterprise or any impact from the consolidation happening within the security stack in the enterprise.

Michael Cote - Secureworks Corporation - President and CEO

So actually a lot of what we're doing fits into the orchestration world and the path that we're going down. We actually, in a simplistic way, we look at the point products as sort of sensing devices and we look at what the Counter Threat Platform does as the sense-making, the deciding and the acting which is where the orchestration tools play. So we look at that market closely and have added some of those capabilities and we'll continue to add more into the Counter Threat Platform.

So I think that the growth of that market is, quite frankly, helping us and helping the industry overall. So I feel pretty good about where our road map is and from a development perspective where we're looking to head in that era. Was there a second part to your question I missed?

Gur Talpaz - Stifel Nicolaus - Analyst

Yes. The general simplification happening within enterprise networks, right? So you're seeing big enterprises make a push to reduce the number of security solutions or vendors they have in place and to be able to better grasp what they have. Is that having an impact on your business?

Michael Cote - Secureworks Corporation - President and CEO

We're not seeing a lot of that, to be honest. I think there is a desire to consolidate vendors, but at least the clients and the prospects that we've been talking to, it's probably still a pretty small percentage that are going with a single vendor, if you will.

Gur Talpaz - Stifel Nicolaus - Analyst

Right. That makes sense. And then for Wayne, given all the investments in machine learning and sort of the limited headcount growth in CTU, how should we think about the improvement in gross margin over the next several quarters as you continue to leverage those investments?

Wayne Jackson - Secureworks Corporation - CFO

Thanks for the questions. So we'll start with we raised guidance for the full year. We're excited about the quarter we just had.

We're looking forward to finishing out the year on a strong note. And relative to next year, we'll give guidance at the end of Q4.

Gur Talpaz - Stifel Nicolaus - Analyst

Thanks for the color.

Rebecca Gardy - *Secureworks Corporation - Head of IR*

Okay. There's no further questions at this time. So thank you all for joining us on this call and we'll look forward to speaking with you next quarter.

Operator

Ladies and gentlemen, this concludes today's call. Thank you all for joining and you may now disconnect.

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2016, Thomson Reuters. All Rights Reserved.