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PRESENTATION

Operator

Good morning, and welcome to the Secureworks Third Quarter Fiscal 2018 Financial Results Conference Call. (Operator Instructions)

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

Rebecca Gardy - *Secureworks - Investor Relations Officer*

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

This morning, Secureworks issued a press release announcing results for its fiscal quarter ended November 3, 2017, and you can access this press release on the Investor Relations section of the Secureworks website.

During this call, management will make forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, but are not limited to, guidance with respect to GAAP and non-GAAP revenue and net loss per share as well as adjusted earnings before interest, taxes, depreciation and amortization. Our forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from those anticipated by these statements. You can find a description of these risks and uncertainties in this morning's earnings press release and in the company's annual report in Form 10-K for the year ended February 3, 2017, which is available on our Investor Relations website as well as on the Securities and Exchange Commission's website. Additional information also will be set forth in the company's quarterly report on Form 10-Q for the quarter ended November 3, 2017, and in 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 date, December 6, 2017. We undertake no obligation to update our forward-looking statements after this call as a result of new information or future events.

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

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

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

Michael R. Cote - *Secureworks Corp. - CEO & President*

Thank you, Rebecca, and thank you, everyone, for joining us this morning on our third quarter fiscal 2018 earnings call.

This quarter, we continued to see positive results, with revenue growing 10% to $118 million and gross margin continuing to expand as we realized scale in our delivery model.

In addition, our adjusted EBITDA loss improved for the second consecutive quarter, narrowing to $4 million. Our monthly recurring revenue grew 8% year-over-year to $33.4 million, our largest quarterly increase in MRR in 2 years, demonstrating that our sales changes are taking hold. The growth in MRR included a meaningful contribution from our new solutions such as Advanced Endpoint Threat Protection, or AETP, which was launched mid-third quarter and has already resulted in over $1 million in new sales.

We had a solid quarter overall, and we are on track to finish in line with our prior revenue and EPS expectations for the year.

As I did on our last quarter earnings call, I will share a few additional metrics as we continue to execute on our go-to-market strategy. We saw a 27% sequential increase in the total value of closed deals greater than $1 million, although the absolute number of deals in this group remained essentially flat. We are making progress in North America, especially with enterprise clients, where year-over-year, sales increased over 20%. And our sales momentum in EMEA and APJ continued to accelerate this quarter, as our sales execution continued to improve and our sellers in those regions become more tenured. Both regions saw sale -- saw record sales quarters, with Japan in particular more than doubling over last year.

Our revenue retention rate for each of the first 3 quarters last year was greater than 100%. Although our revenue retention rate -- improved sequentially this quarter, during the past 4 quarters, it has been between 96% and 99%. In addition, although our sales productivity has improved in each of the last 2 quarters, we are not yet at the productivity levels we expect in North America. We have a clear path forward to continue to grow sales and improve revenue retention.

As announced earlier in October, I am in the midst of a search for a new Chief Revenue Officer. I am excited about the caliber of the candidates, both internal and external. Our interim leaders are highly respected and experienced individuals. They are well known to clients in their respective territories and did a nice job closing out the third quarter.

We have a deep bench of tenured sellers and the changes we have discussed in prior quarters, talent, coverage and quality of sale, are yielding results. We are a client-centric company and our clients' success is paramount. We have 3 key priorities in this area: excellence, engagement and continuous innovation.

One of the hallmarks of our company is our passion to provide excellence and the value we deliver to our clients as we protect them in today's digitally connected world. We strive to be the best security partner and we consistently seek to raise the bar by delivering solutions with the highest level of quality. We are measuring client satisfaction on a regular cadence and are consistently looking for ways to elevate our game. Our sole focus is making our clients as successful as possible in realizing value from our solutions.

Earlier this year, we started a client success organization to ensure deep engagement with each of our clients so that they remain at the center of everything we do. The security industry is constantly evolving as adversaries change their tactics, techniques and procedures. The commitment to continuous innovation is thereby imperative as it ensures our solutions are providing the most value to our clients as they combat adversaries across their security environments. My prior comments on our success with AETP is one example.

This quarter, research and development expenses were approximately 15% of revenue, bringing our year-to-date investments to over $56 million. These dollars have been deployed in the broad areas to fuel technology innovation with near-term benefits, such as orchestration and remediation and cloud solutions. We also carved out a portion of our R&D spend for initiatives with long-term -- longer-term horizons. We developed our Counter Threat Platform by automating the delivery of our detection through algorithms and machine learning-based solutions. As a natural next step, we are extending automation into response by programmatically validating, prioritizing, containing and eradicating threat activity.

The rapid growth in our subscription-based managed detection and response, or MDR, and Advanced Remediation solutions further builds the case to progress into orchestration as we see strong market demand. We have automated several playbooks from our extensive library and are testing them against real-world use cases. As we continue to automate more of our playbooks, our clients will see a marked reduction in the complexity of repeated tasks and an increase in the speed of the response to threat events.

We designed our Cloud Guardian portfolio to help organizations take full advantage of cloud computing benefits in a secure way. This portfolio provides end-to-end solutions and coverage of all stages of cloud deployment. From initial evaluation and architecture to ongoing assessments and monitoring as well as threat remediation.

An example of one of our latest solutions is the Cloud Security Configuration manager. With a few clicks, clients can apply and enforce best practices to their existing cloud accounts and feel confident that the security hygiene of their accounts will be optimized. Another example is the significant growth we have seen in our solution to secure Office 365 environments.

In our innovation road map, we will be further developing our capabilities to rapidly and properly detect malicious activity, respond on behalf of our clients or to provide information, enabling them to easily respond and to deploy this information to prevent attacks that can be prevented and predict future threat activity. I am excited and optimistic about the future, and we have several projects on the horizon to tackle complex challenges faced by our clients.

Recognizing the quickening pace of machine intelligence in cybersecurity, we have dedicated a portion of our current and future R&D spend to accelerate the next generation of our Counter Threat Platform. We are prototyping a new platform that would allow for the rapid creation of high-value security applications like machine learning and analytics across diverse data sources. This new design meets our clients' needs for greater control over data access, including where data resides. Our top goal every day is to protect our clients and we remain committed to aggressively addressing the market and emerging trends.

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

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

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

For the third quarter, revenue grew 9.6% to $117.7 million as a result of steady growth in our subscription business and a strong performance in our security risk consulting business. Revenues outside of the U.S. grew 17% of total revenue for the quarter, up from 13% last year. The overall percent split of revenue between MSS and SRC remained at approximately 80/20. Monthly recurring revenue, or MRR, was $33.4 million, an increase of 8.4% over the third quarter last year and a 3.4% increase sequentially. Our average annual subscription revenue per client was $90,000 this quarter, a 6% increase over the prior year.

In the third quarter, we began to see benefits of our sales investments through growth in the value of contracts sold. A few examples of 7-digit contracts sold this quarter include: a 3-year contract with a U.S.-based global industrial manufacturer for a suite of solutions which provides comprehensive managed detection and response; a 3-year contract with a medium-sized regional bank in North America that includes advanced endpoint and network threat detection and prevention; and finally, a 1-year contract with an automotive parts manufacturer to drive detection capabilities to their next-generation firewall solutions. This was our first $1 million-plus booking in Japan.

Revenue retention in the period was 97% versus 96% in the second quarter as installations offset non-renewing contracts. Though improved versus last quarter, we continue to experience overall renewal rates lower than historical averages. Our third quarter gross margin was 55.7%, an increase of 230 basis points compared to last year and 100 basis points over the prior quarter. This margin expansion came from profitable growth in our subscription solutions and reflects continued scale derived from our delivery model.

For the third quarter, operating expenses totaled $73.2 million compared to $61.7 million last year.

Research and development expenses have remained relatively consistent over the last 4 quarters at approximately 16% of revenue as we invest in innovative technologies to meet our clients' evolving needs.

Sales and marketing expenses this quarter are approximately 31.8% of revenue, up from 27.4% last year and compared to 32.0% in the second quarter as we continue to invest in our sales and go-to-market strategy.

General and administrative expenses were 14.5% of revenue compared to 15% last year and 13.1% in the second quarter, which included a onetime benefit for a jobs tax credit.

Our operating loss was $7.6 million for the quarter and adjusted EBITDA loss was $4.2 million or a 3.5% of revenue versus 1.7% a year ago and 3.9% last quarter. The increased adjusted EBITDA loss was primarily driven by increased investments in our businesses, which was partially offset by higher gross margins. In addition, the third quarter includes a $1.7 million benefit from a decrease in performance-based compensation expense.

Our net loss for the quarter widened to $5.2 million from $1.2 million last year, primarily due to increased sales investments. Based on 80.355 million shares outstanding, net loss per share was $0.06.

Turning to the balance sheet, we had cash and cash equivalents of $100 million at the end of the third quarter. Our net accounts receivable totaled $137 million at the end of the quarter. The increase in AR for the third quarter was primarily attributable to the timing of our billings and collections as a result of the company's conversion in this quarter -- system conversion in this quarter as well as our continued revenue growth.

Cash flow provided by operations for the quarter was $5.2 million, primarily as a result of the collection of tax receivable this quarter offset by the increase in accounts receivable.

Before turning to guidance, I want to remind you last year's fourth quarter contains 14 weeks. The upcoming fourth quarter will have 13 weeks, affecting year-over-year comparisons.

Now on to guidance. Our financial guidance takes into account our financial performance through the first 3 quarters of the fiscal year, and the type of forward-looking information that Rebecca referred to earlier.

For the fourth quarter of fiscal 2018, we expect GAAP and non-GAAP revenue to be in the range of $117 million to $118 million, and we expect non-GAAP net loss per share to be in the range of $0.08 to $0.09, based on approximately 80.362 million weighted average shares outstanding.

For fiscal year 2018, we expect GAAP revenue to be in the range of $464 million to $465 million and in the range of $465 million to $466 million on a non-GAAP basis. We expect our GAAP net loss to be in the range of $51 million to $52 million and our adjusted EBITDA loss to be in the range of $22 million to $23 million.

Lastly, based on approximately 80.282 million weighted average shares outstanding, we expect net loss per share to be in the range of $0.64 to $0.65 and non-GAAP net loss per share to be in the range of $0.29 to $0.30.

We expect our total capital expenditures will be approximately $18 million for the full year.

Based on our year-to-date sales performance, our revenue retention rates and visibility into expected sales in the fourth quarter, we are narrowing our guidance for MRR to be in the range of $34.4 million to $35.0 million at the end of the fourth quarter of fiscal 2018.

Before I finish, let me address ASC 606. We currently expect to adopt this accounting standard and its amendments using the full retrospective option, beginning in the first quarter of fiscal 2019. We will disclose additional information regarding the adoption during our year-end earnings call.

I'll now return the call to Mike for his closing remarks.

Michael R. Cote - *Secureworks Corp. - CEO & President*

Thanks, Wayne. This quarter's solid performance shows we are making headway on our plan to accelerate our growth trajectory. Change of this magnitude is not easy and takes time. While we have made a lot of progress this quarter, we are not where we want to be, especially in light of this year's investments in the business. We have a clear path forward and we will execute against our plans to accelerate growth while efficiently deploying resources. 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 express my gratitude for the hard work and dedication our team members put in everyday to keep our clients safe in a digitally connected world. I'd also like to thank our clients for allowing Secureworks to serve as their trusted cybersecurity partner and our other stakeholders for their continued support. I hope you have a happy holiday season.

Operator, if you could now open the line for questions, we'd be happy to take them.

QUESTIONS AND ANSWERS

Operator

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

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

So Mike, just kind of curious with the departure of the Chief Revenue Officer, did that actually have impact in North America because you mentioned the productivity not being where you would like it?

Michael R. Cote - *Secureworks Corp. - CEO & President*

So Sterling, I would say that we -- as I mentioned in my prepared remarks, the existing team did a great job closing the quarter out and I was pleased with where we ended the progress. Clearly, a change of a Chief Revenue Officer in the midst is going to have some impact. And we're more kind of cautiously optimistic about what the future will hold. So we're in pretty good shape. I will -- while I'm on the Chief Revenue Officer, I will say that I have been pleasantly surprised with the number and quality of individuals who have shown interest in the position. And I am working diligently, as one would expect, to work through this, and hope to be able to have an announcement in the near future.

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

And then the one follow-up would be, as you've gone through that hiring process, made some changes to the sales organization already, would you expect that whoever comes in will just kind of continue the path that you've got or will you allow them to make additional changes, which may take several quarters to feel the full benefit of?

Michael R. Cote - *Secureworks Corp. - CEO & President*

Sterling, a couple of ways I'd answer that. Number one, we have not lost any of the new management team members and the new leadership that has been brought in, particularly in North America. And I believe that most of that team, who I've mentioned did a really good job in closing out the third quarter and getting us on a path going forward, the conversations I've been having with the leading candidates for the Chief Revenue Officer position have centered around the changes that we made earlier in the year and we put in place through the year. I will clearly allow this individual some latitude for things that they want to do in running the organization, but I'm happy to say that most of the folks that I've talked to would agree with the process and changes that we've made and, quite frankly, would like to just continue to accelerate that on a go-forward basis.

Operator

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

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

Maybe just to start on the 4Q EBITDA guidance and the 4Q MRR guidance. I wanted to ask two things, the first just on MRR, slightly lower at the midpoint relative to where you thought you'd be coming into the year. Mike, you touched a little bit just now on the CRO transition, any other factors that are impacting the MRR outlook for 4Q? And then I'll ask a follow-up on EBITDA.

Michael R. Cote - *Secureworks Corp. - CEO & President*

Okay. Yes, Gabriela, I would -- so I'd summarize it this way. Q3 was a strong quarter, as I mentioned, in terms of the value of the contracts we signed, and in particular some of the larger contracts. And we made progress in North America in the enterprise deals that we signed and productivity across our sales organization. The MRR growth in Q3 was the best that we've seen in 2 years. Having said that, I think we're trying to -- I would say I'm pleased but not satisfied. And even though it was a solid quarter, we're trying to be -- have a cautious outlook on our future. And I think we need to get to the point, as I mentioned, with Sterling's question, to solidify the CRO position and the sales leadership as we move forward.

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

That's helpful. And the follow-up is coming into 2018, the expectation had been that investments would be a little bit higher this year. There were some things that you wanted to accomplish from a sales organization standpoint. As we now close out the fiscal year, could you maybe just level set us on when you think you might be back at breakeven EBITDA?

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

Gabriela, this is Wayne. Thanks for the question. So we have talked in -- earlier this year about getting EBITDA positive on a quarterly basis, sometime in fiscal '19. That was in Q1. I think as we made the investments in the sales and marketing initiatives, we still believe and we still expect to become EBITDA positive in the future. And I'd like to defer answering that question directly until we get to the end of Q4. As Mike said, we've made great progress in the sales and marketing, we're seeing the investments pay off. And we know that the path to profitability is very important to us, so I'd like to defer that to the fourth -- to our earnings guidance next year.

Operator

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

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

Just wanted to start with the gross margins. Can you talk a little bit about sort of the cost savings that you were able to drive? And maybe how we should think about the gross margin going forward?

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

Jonathan, it's Wayne. Thanks for the question. So gross margin has improved year-over-year as we talked about, 230 basis points. The way we gross margin is -- and it went up 100 basis points for the -- sequentially. We're still focused on long-term gross margin expansion. It's still the areas we've talked about before. We have seen the return on the investments on the technology side. This quarter, we're seeing -- and Mike talked about the success we're having in EMEA and APJ or really rest of the world. We're seeing those margins in those regions expand as the revenue -- as the sales health and revenue increases. That was part of the plan as well. And then the third area that I keep referring to is basic blocking and tackling on the things we do from an operations perspective to deliver our solutions. We continue to see opportunities there as we put it up this year and head into next year. So it's still the same 3 areas. Long-term, we still -- we're still focused on continued margin expansion -- gross margin expansion.

Michael R. Cote - *Secureworks Corp. - CEO & President*

Just to touch on what Wayne said or add a little color, I think it goes back, Johnathan, all the way to the IPO roadshow where we had said we made initial investments going into the IPO for the long-term growth of the business. And as Wayne mentioned, as we've seen the accelerated growth outside North America and some of the automation, things that we've put in place in North America, we've continued to and would expect over time to continue to see those yield benefits.

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

Got it. And then with regards to the sales restructuring process, can you maybe help us understand what inning we're in, in terms of that improvement process? And just aside from the CRO issues, maybe why has North America lagged some, relative to your expectations?

Michael R. Cote - *Secureworks Corp. - CEO & President*

So let me do -- let me address your question in the 3 focus areas of talent, coverage and quality of sales because I think that's really the key areas. In talent, I would say we've done a very good job and it's been the largest focus area of getting the right people in the right positions, particularly in North America. And that ties almost been into coverage, so I'll put those two together, right? Closer to where their clients are, where our clients are and working the relationships there. So on a talent and coverage perspective, I would say we're in the later innings of the game. If you put it into a baseball game. The quality of sale perspective, I would say, we're probably still in the fourth, -- third, fourth, fifth inning, middle innings. As we're working through, we spent the first part of the year bringing the right people onboard, ensuring the right people are in the right places and getting their relationships with the clients. And we've done a lot of that at this point. And we're now spending a lot of our time on the sales messaging, the value proposition, the consistency and quality of the way we're going into the sales organizations. And again, as I mentioned, Jeff and Ian and Ryan have done a really good job in leading our sales organization and ensuring that we did not miss a step as we closed out Q3. And I think it's now continuing to drive this execution into the early part of next year.

Operator

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

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

Mike, maybe just start with you. I think we called out a 6% increase in average subscription per client, which is great. Is that coming from customers signing on for more offerings in that preliminary engagement? Or is perhaps the mix of enterprise a little bit higher, which is taking that measure up? How do you think about the drivers for that 6% increase in subscription per client?

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

So this is Wayne, Saket, just to make sure we understand your question, you're talking about our average revenue -- subscription revenue per client up 6% to $90,000 this quarter?

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

Yes, that's right. That's right, Wayne.

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

Okay. What drives that is pretty much the enterprise clients, which is one reason we've pivoted to focusing on that over the last several quarters.

Michael R. Cote - *Secureworks Corp. - CEO & President*

So it would be a combination of -- I mentioned that we had the overall contract value of deals over $1 million is up 27%. So it's some bigger deals. And we -- it's some increased cross sales of some of the new solutions we have under our existing client base.

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

Got it. Maybe for my follow-up for you, Mike. Just more higher level, kind of anecdotal, can you just talk about where customers or where the market is in terms of feeling more comfortable with outsourcing more security functions versus handling more of that security in-house?

Michael R. Cote - *Secureworks Corp. - CEO & President*

So Saket, I think it's a great question. And it's been -- it's actually been a bit of a fascinating quarter when you go back and think about, if you will, Equifax and Uber which weren't necessarily -- I think they came out after our quarter ended, but during the same reporting period. And then the continued impact from GDPR. So I think there's a lot of questions and view from senior management getting engaged in what's going on, and ensuring that there is a return on the spend of security, meaning from my perspective, a reduction in risk for clients. And I think that we have found the world falls into 2 buckets. There are those executives who basically believe that they can do it better themselves; and there are those, within their closed universe, if you will, or world; and there are those that believe that there is value associated with working with partners, particular partner that has global experience and a lot of global clients. And from an anecdotal perspective, our sales pipe looks good and healthy. We're getting a lot of opportunities from larger organizations who are looking, in particular, for the analytics and intellectual property and the algorithms and machine learning and help, in trying to combat the threat. But I would caveat that with saying they also want to play roles. So when we talk about outsourcing, I would say it's more of a more co-sourcing type of relationship, because quite frankly those clients that we partner with knows their networks and their infrastructures better than we could, unless it's a small-to-medium-sized business where it's something that's easier for us to -- very simple network.

Operator

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

Walter H Pritchard - *Citigroup Inc, Research Division - MD and U.S. Software Analyst*

Two questions. First for Mike, on the renewal rate, can you talk about where those clients are going that are not renewing? I assume your gross renewal rate is lower than the 96%, 97% you're talking about. Where do those clients end up? Can you give us a little bit more detail there?

Michael R. Cote - *Secureworks Corp. - CEO & President*

Yes. I actually -- so Walter, thank you, because it's a great question. Let me clarify that it's not clients necessarily leaving Secureworks, it's often where they may be reducing their spend with us that reduces the client -- the revenue retention rate. So in other words, if we're doing $100 of work with a client, they may say we no longer want you involved in this part of our network and we'd like to shift it over to a different place from the network, if you will, to the endpoint. So we are retain -- most of the majority of the reduction in revenue retention rate relates to, if you will, solution churn or moving from one solution to another, not client churn. In fact, I think in our largest clients, say, the top 50, we have not lost any this year.

Walter H Pritchard - *Citigroup Inc, Research Division - MD and U.S. Software Analyst*

Great. And then for Wayne, just on the -- we saw the deferred revenue was down pretty materially, probably the most material reduction we've seen in deferred. I think you've warned us, even going back pre-IPO, not to expect that billings was a sort of meaningful metric. But what drove that I think it was a $9 million reduction in deferred, sequentially?

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

Walter, thanks for the question. So I will lead in or caveat by saying our deferred revenue is still lumpy. It varies from quarter-to-quarter. Part of that is we still have about 50% of our contracts that are prepaid or bill on an annual basis. So that introduces the lumpiness -- it's not unpredictable. The lumpiness. I will share one level of detail, since the number was larger this quarter, and that is at the end of the second quarter, I mentioned in my -- in our prepared remarks that we have a system conversion that impacted our accounts receivable balance. We anticipated, of course, that system conversion. So we did pre-bill some -- or sent out invoices pre-bill at the end of Q2, which of course drove our deferred balance higher and -- so that impacted that balance. And then we didn't have that same kind of pre-billing at the end of Q3. A lot more detail that I want to get into, but since it was a higher number, I thought I'd spend a moment on it. I hope that helps.

Operator

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

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

I just wanted to follow up on Walter's previous question on the renewal rates or the retention rate. Mike, can you maybe just detail what would be a common catalyst for customers to downsize their Secureworks deployment?

Michael R. Cote - *Secureworks Corp. - CEO & President*

So Melissa, thank you. This is Mike Cote. As I sort of think it through, I'm trying to think if there's a common answer to that question that goes consistently across, because we -- in many cases, we will often meet with our clients to help re-scope based upon where the hackers are going and look and say we need to move the spend that you have on detection alert across your servers that are in a certain part of your network. And it'd be a more productive spend to reduce your risk greater if we move it, for example, to the end points where the hackers are currently focusing now. But if I looked at it, I would say that the -- remember, our retention rate went up, so we saw a positive movement this quarter versus second quarter. But if I looked at it through the year, I would say that the biggest implications are probably where clients are moving and reducing some of their spend around monitoring parts of their network and increasing the spend on endpoints would probably be the biggest issue I'd see at a broad brush. But if you want we can, in a follow-up call, get to a little more detail. But that's probably the biggest thing we've seen. And again, it's mostly -- most of the change in the reduction when we look at -- let me back up, when we look at our revenue retention for the year, with the way it's calculated is we look at the book of business from our clients at the beginning of the year and the recurring revenue we have with them. And at the end of each quarter, whatever clients are still with us, we look at the revenue that those clients have with us. So it's the reduction in what gets taken out less and then what gets added back in as cross sales. Most of the reduction relates to solutions, not to clients. And clearly, the bigger impact what's been fairly consistent is the SMB side of the house, the bigger impact has been fluctuations in the large enterprise side.

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

Okay. That's helpful. And then I just wanted to follow up on AETP, and just wondering if you can maybe give us an update on how that performs in the quarter relative to expectations? And when do you think some of these newer solutions like AETP will start to become meaningful enough to start to impact some of the top line metrics like MRR?

Michael R. Cote - *Secureworks Corp. - CEO & President*

Well, as I mentioned in the prepared remarks, our newer solutions had a meaningful impact on MRR, and the increase we had in MRR, which is the largest increase that we've had in 2 years. AETP came out of the gate very strong with, as I mentioned, $1 million after being released mid-Q3, so we were pretty pleased with how quickly it's come running out of the gate. The hope and cautious optimism is that, that growth accelerates as we continue to go into Q4 and fiscal '19. The other one that I mentioned is really our MDR, where we're -- MDR and I'll say Advanced Remediation. We're effectively now -- we are using automation and individuals to dig into our client. After an alert comes up, to actually do the appropriate levels of validation, prioritization, remediation and response. And we have a pretty meaningful book of business today that has grown rapidly in a 2-year period, roughly a 2-year period. And we are proposing that solution probably on almost every deal that we're involved in today. Deal, meaning opportunity, prospect. Enterprise deal, almost every enterprise deal it's in the proposal.

Operator

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

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

This is actually Matt Swanson on for Matt. So it sounds like it's another strong quarter for the international markets. Could you talk a little about your plans for investment heading into 2018? And then going into a point Wayne touched on earlier with the margins improving in the regions, can you give us a sense for just kind of how different the margin profile is for the international markets right now than North America?

Michael R. Cote - *Secureworks Corp. - CEO & President*

So this is Mike. Matt, thanks for the question. A lot of the investment that we did in the international regions, we really began on that journey probably 3 years, 4 years ago in preparation for the expanded growth that we were planning for in this period of time and into the future. So any

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incremental investments that I would expect us to make outside of North America from an operating perspective would, for the most part, not be significant or material or out of the ordinary from what we're doing. The increased investments should be continuing on the go-to-market front to meet the market demand in EMEA and APJ and the growth that we're seeing in those markets. So we -- they have been great highlights for us. In particular, as I mentioned, Q3 was the best quarters we had in both of those 2 markets.

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

And then, Matt, this is Wayne. On your question regarding the margin profile, U.S. versus rest of the world. As I touched on, maybe said a little differently earlier, the reality is as the revenue ramps in EMEA and APJ, the margin profile is getting to where we would like for it to be and expect for it to be. But it is still not where the margin profile in the U.S. is. So still room for margin improvement in those parts of the world.

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

And then from the prepared remarks, it sounds like large deals are maybe getting larger with the expanded product portfolio. Could you talk a little bit about how deal cycles trended and if this has any impact on that?

Michael R. Cote - *Secureworks Corp. - CEO & President*

So this is Mike, Matt. I don't know if I can tell you we have a trend in deal cycles moving one way or another. There has clearly been of -- an opportunity with larger deals that are going on shorter sales cycles than we clearly saw a year ago, for example. But then again, we've got some larger deals that seem to continue to move at a much slower pace than I would have anticipated. So I can't tell you that there's an overall trend. As I mentioned earlier, when kind of the Equifax and the Uber announcements have come out, and GDPR in Europe, create a flurry of interest and activity, but I almost think that this has been going on so long from the Target to Home Depot and the other ones, that we're getting a little immune to it, the world seems to be. So I think it really depends on the specific organization and that organization's either senior management team or Board of Directors and their interest. We've actually had some boards call us, asking us to help ensure that the organizations are safe as they believe that they may be. So long-winded answer to your question, I don't think that there's really a trend one way or another, it really feels kind of bifurcated.

Operator

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

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

Mike, maybe a question for you to start out with. As I look at your customer count, it's been fairly steady and stable at kind of the 4,400, 4,500 mark. I'm curious if you can speak to maybe the 1, 2 or top 3 things that today are the largest inhibitor to new logo acquisitions? And then a follow-up for Wayne.

Michael R. Cote - *Secureworks Corp. - CEO & President*

So thank you for the question. I think the first thing that's probably worth mentioning is that I don't -- we don't look to manage from a logo acquisition perspective. We are more focused on annual contract value or annual recurring revenue and the growth there. And I was very pleased with the increase from an enterprise perspective and the growth of 27% in the overall amount of value that we signed in larger contracts. And as we mentioned, we've got a bigger focus in -- if I broke it down by our North American sales organizations, we had a great quarter in EMEA, a great quarter in APJ. And on a North American basis, our enterprise organization has shown tremendous productivity... or good productivity improvement in Q3, and we're looking for that to continue. Our state and local education organization from a sales perspective is not where I would like it to be this year and they are focusing hard to show continued improvement. And our small and medium-size business group is doing really well. And they picked up their productivity, both in Q3 and I have some cautious optimism on the leadership team there and the management team in the small and medium-size business organization for us, which indirectly would end up increasing the -- where the real growth from a client perspective is going to come is the SMB organization in particular.

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

Fair enough. And just a follow-up to some of your earlier comments around the sales organization changes. You touched on 3 key pillars there, so the talent, coverage and quality of sales. Maybe if you can speak to your comfort level with the current sales capacity. Maybe several quarters ago, you kind of threw out a target of maybe 200 quota reps or something in that neighborhood. But if you can sort of speak to your comfort level with the sales capacity and the tenure that you have onboard and -- it would be helpful if you could give us a sense of what type of attrition you've seen in the last 12 months or so and then sort of what you're projecting as you close out the year.

Michael R. Cote - *Secureworks Corp. - CEO & President*

Hopefully, I'll -- you had a couple of questions in there, so I'll give you the -- but if I don't answer all, I mean, come back and hit me with any of them. But the -- let's see, I'll kind of work my way backwards. From a turnover in the sales organization perspective, we've seen a pretty consistent level in Q2 and Q3. It was up a little bit in Q1 as we went through the sales leadership changes at that point in time. But we have not seen a large change, and I don't think we're expecting turnover to be much different on a go-forward basis. We have the senior -- from a talent perspective, the senior leadership team is in place around the globe, and that was one of the things that we worked on earlier this year. And I don't expect -- that team has rallied well, done a tremendous job leading the organization from a sales perspective and we feel really good about the leadership team at that level. They're highly respected, as I mentioned in my prepared remarks, and experienced individuals who have relationships with the teams that they've hired and the clients in the regions where they are. From a quota carrying perspective, actually, we're looking to exit, I think this year, around 195. We're sitting today at around 171, and we will probably look to continue to make progress on the 171 sit closer to the 195, maybe 180 or 185. But to be honest, our bigger focus is on the productivity of the sellers that we have. We've got an 8% increase -- we have sellers with over 2 years experience that's up 14% over last year. So we're continuing to get more tenured sellers. We're continuing to focus on quality of sale and increasing the productivity. Quite frankly, I think a great example that can show how this would yield would be what we're doing in EMEA, with some of these changes that we put in place in North American enterprise earlier this year, the foundation was laid in EMEA a couple of years ago and -- by Jeff Longoria and Ian Bancroft because he's executing on that strategy in EMEA and is doing a really good job for us.

Operator

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

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

So Mike, I was hoping you can touch on two things here. First, have you seen any sort of broader shift in the competitive landscape as other guys, like in MDRs sort of emerge a little bit? And then two, kind of following that theme a little bit, what have you seen in terms of the customers and their migration to the public cloud and how they're looking to secure that migration, has that any had sort of impact on your business and cost, any sort of shift in relative spend?

Michael R. Cote - *Secureworks Corp. - CEO & President*

Sure. Thanks for the question. On your first question from a competitive landscape perspective on the MDR space, I would say that most of the competition that would be in the MDR space is more going to be from an SMB perspective. And I would venture to say that the MDR work that we're now doing across our organization, we have a couple of hundred people dedicated to doing that work for our client base, in particular, in the enterprise space. And going down into some of the SMB, it's not been material in the deals that we've been involved in. So I think we've actually probably got a bigger presence in that space than most of the competitive landscape that we see. From a cloud migration perspective, I think it's created an opportunity for us, as I mentioned, with our Cloud Guardian portfolio. We've not seen any -- to my knowledge, we've not seen any reduction from a client retention or revenue retention perspective of clients moving to the public cloud.

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

That's helpful. And maybe one last question for me. As you kind of push into these new areas of security, orchestration, broader endpoint, et cetera, as you kind of look to become more of a vendor yourself of software, how do you think about the balance here of partnering with a lot of your key partnerships on the endpoint side, perhaps on the orchestration side, versus competition with those same players?

Michael R. Cote - *Secureworks Corp. - CEO & President*

Yes, so great question, and I think if you focused our core around detection, response, prevention, I'd say then prevention and predict, ours is the -- the core focus of what we're doing is around detection and response. And the things that we're doing around orchestration or remediation are not products that we're looking to sell. And quite frankly, the clients that we're looking -- or the clients that we're working with and the proposed opportunities we're having, they're looking for automation to be brought to bear to help them get the things that they want to have done. They're buying an orchestration product, if you will, we'd like to work with all of those orchestration products in a vendor-agnostic manner. We're actually rolling out the things we're doing from an orchestration perspective with Ansible and some things we're doing with Red Hat. But will it the work with the other orchestrator's -- orchestration products in the market? So we're not looking to change our -- necessarily change our go to market where it would be not vendor neutral, but to provide our solutions in a technology-enabled fashion, which would also help increase our gross margin over time.

Operator

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

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

So Mike, just to build on that point, is that what you're seeing in some of your solution churn at this point, where some of your customers are moving towards orchestration or automation capabilities, and so they're looking to you to perform other services? I'm still a little confused why some of your customers may churn from one solution to another.

Michael R. Cote - *Secureworks Corp. - CEO & President*

So let me give you an -- it's not the orchestration aspect of it that would drive it. Here's -- let me give you a great example. Somebody looks to close a data center, they have 15 data centers, they closed 1 down and go down to 14 or 13, then that part of the work that we're doing with them would be a reduction, right? It would be a churn. And the intent would be as we resolution with them to look to redeploy that in something that could add more value in the remediation and orchestration aspect of things to help them appropriately figure out how to respond.

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

Got it. So it's maybe more of a natural headwind just with network consolidation that's happening.

Michael R. Cote - *Secureworks Corp. - CEO & President*

Yes.

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

Okay. And then secondarily, why would you flow through the $2 million beat in the quarter? If I look relative to the midpoint of the range, I think you beat by $2 million. But just kind of tighten the range for the year, given I think you said SRC was at its typical 20-ish percent of the mix, I would assume that most of the SR came from subscription revenues. So is there anything about that fourth quarter outside of conservatism on your part?

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

So Rob, this is Wayne. So we had a -- so the revenue growth in Q3, solid revenue growth on subscription side. But SR -- our consulting revenue growth, as I talked about, was a little bit -- it was very strong. And as we look into Q4, SRC, the consulting is a little bit less predictable than the subscription side. So we came up with the range of $117 million to $118 million, which we feel very comfortable with.

Rebecca Gardy - *Secureworks - Investor Relations Officer*

So operator, I think we have no more questions, is that correct?

Operator

That is correct.

Rebecca Gardy - *Secureworks - Investor Relations Officer*

So let me just close out the call. Thank you again, everyone, for joining us and for all your questions. We appreciate your support and we look forward to our fourth quarter call in late March. If we did not get to additional questions during this section, please don't hesitate to reach out to us or follow up. And with that, best wishes to everyone for a safe and happy holiday.

Michael R. Cote - *Secureworks Corp. - CEO & President*

Thank you.

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

Thank you.

Operator

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

Rebecca Gardy - *Secureworks - Investor Relations Officer*

Thank you.

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