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SCWX - Q1 2019 SecureWorks Corp Earnings Call

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JUNE 06, 2018 / 12:00PM, SCWX - Q1 2019 SecureWorks Corp Earnings Call

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**Rob Owens** *KeyBanc Capital Markets - Analyst*

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## PRESENTATION

### Operator

Good morning and welcome to the Secureworks first-quarter fiscal 2019 financial results conference call. (Operator Instructions). Now I will turn the call over to Teri Miller, VP and Chief Accounting Officer. You may begin.

### Teri Miller - *SecureWorks Corporation - VP & Chief Accounting Officer*

Good morning, everyone, and thank you for joining us today to review Secureworks' financial results for the first quarter of fiscal 2019. This call is being recorded. This call is also being broadcast live over the Internet and can be accessed on the Investor Relations section of Secureworks' website at [investors.secureworks.com](http://investors.secureworks.com). The webcast will be archived at the same location for one year.

This morning Secureworks issued a press release announcing results for its fiscal quarter ended May 4, 2018. You can access this press release on the Investor Relations section of the Secureworks website.

During this call management will make forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, but are not limited to, guidance with respect to GAAP and non-GAAP revenue and net loss per share, as well as adjusted earnings before interest, taxes, depreciation and amortization.

Our forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from those anticipated by these statements. You can find a description of these risks and uncertainties in this morning's earnings press release and in the Company's annual report on Form 10-K for the year ended February 2, 2018, which is also available on our Investor Relations website and on the Securities and Exchange Commission's website.



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All forward-looking statements made on this call are based on assumptions that we believe to be reasonable as of this date, June 6, 2018. We undertake no obligation to update our forward-looking statements after this call as a result of new information or future events.

Some of the financial measures we use on this call are expressed on a non-GAAP basis. These non-GAAP measures exclude stock-based compensation, the impact of purchase accounting, amortization of intangibles and the related tax 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. Also as a reminder, all financial information discussed is non-GAAP and growth rates are compared to the prior year period unless otherwise stated.

With us on today's call are Michael Cote, President and Chief Executive Officer of Secureworks, and Wayne Jackson, Chief Financial Officer. Following their prepared remarks we will take your questions.

We would appreciate you limiting your initial questions to two so that we may allow as many of you to ask questions as possible in our allotted time. In the event you have additional questions that are not covered by others, please feel free to re-queue and we will do our best to come back to you. Thank you for your cooperation on this. Now I'd like to turn the call over to Mr. Cote.

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### **Michael Cote** - *SecureWorks Corporation - President & CEO*

Thank you, Teri. And thank you, everyone, for joining us this morning for our first-quarter 2019 earnings call. I am pleased to report that we've had a strong start to fiscal 2019. Revenue in the first quarter was \$126 million, which was above our expectations and up 11% year over year. Our monthly recurring revenue also grew 11% year over year to \$35.5 million.

After a very strong Q4 we had the best first-quarter sales in our history, up 50% over the prior year, evidence that the total team effort put forward to help our clients combat evolving threats. I would like to thank the entire team for their focus on protecting and serving our clients and executing on our objectives.

In the first quarter, we saw strong demand across the board, a 94% year over year increase in the total value of deals closed greater than \$1 million. Our leadership position in the industry allows us to continue this trend as we compete across the global market. Our momentum internationally continued to accelerate growing 57% year over year.

As a reminder, the EU's General Data Protection Regulation, or GDPR, went into effect May 25. Over the past year and a half we implemented the necessary steps to enhance our global privacy program to address GDPR requirements.

We also saw increased demand for incident response engagements as the number of high-profile breaches grows and the shortage of security talent in the market continues. As a result, the mix of our sales in the first quarter was more weighted towards our strategic risk and consulting business that our subscription business compared to historical levels.

Over the last four quarters approximately 50% of our signed business represents clients who purchased both consulting and subscription solutions in the same quarter. This represents a 25% increase over the same metric in the prior four quarters.

We deliver benefits to our clients in many ways including simplifying a client's ability to buy complete security solutions from us. We've recently launched the Secureworks Managed Detection and Response offering, a powerful solution that brings together several of our advanced detection and response solutions to form a comprehensive security offering, all in a simply priced package providing predictability and scalability.

Streamlining the detection and response functions, Secureworks' MDR pinpoints real security threats, lightens the burden of investigation for staff, and gives clients enough context to timely take the right action to stop and remediate threats. Clients continue to place their trust in us and, as a leader in our industry, our value proposition remains strong.



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We've made notable progress (technical difficulty) I want to recognize the impressive results delivered during a period of transition as our new Chief Revenue Officer, Geoff Haydon, joined the team at the beginning of the first quarter. The continuity of the regional sales leadership team remained a key growth driver in the first quarter as the EMEA and APJ teams converted strong demand into solid results.

In North America we had good results in both our small and medium business and our state, local and education teams while our enterprise team nearly doubled its prior year production. The sales engineers and solution architects, a key investment area during fiscal 2018, also played a pivotal role in advising enterprise clients on risk effective solutions.

From a market perspective, as clients continue to develop their strategies to operate in a digitally connected world, cloud technology is playing an important role. Our unique ability to secure clients across environments, including on-premise and public, private and hybrid cloud, presents continued market opportunity for us. Last year we launched our AWS and Office 365 monitoring capabilities and we have seen encouraging year-over-year growth in these solutions.

Recent activity in the cloud space includes: the addition of Microsoft Azure monitoring to our cloud security solutions portfolio; the launch of our Managed Detection and Response package, which includes cloud security monitoring, helping provide a unified view of a client's environment and keeping clients safe across their endpoints, network and cloud deployments; and development of a new managed solution that leverages VMware's AppDefense technology to protect applications running on VMware vSphere-based virtualized and cloud environments.

Leveraging AppDefense we are able to properly respond to a threat, whether that be blocking malicious behavior, quarantining the application or taking a snapshot of the virtual machine. In addition, the technology's runtime learning and behavioral modeling capabilities make tuning policies smarter and more efficient over time.

We continue to see organizations grapple with measuring the risk and effectiveness of their security program as they strive to prioritize their security investments in the most effective manner. We help our clients through this challenge by delivering technology led solutions that prevent attacks, detecting those that cannot be prevented, responding rapidly and predicting where the threat actors are going next.

We recognize that velocity is critical in our industry. Our technology innovation is focused on continually improving speed and context that directly translate to better client security outcomes. We have launched our first set of automated playbooks and are encouraged by the powerful effect these automation efforts have in a variety of areas including: higher fidelity detections, increased investigative context, reduced time to remediate, and increased security analyst productivity.

I look forward to updating you on our progress in this area as early indications show this will be a step function increase in the efficiency and effectiveness of detecting and remediating threats.

As I previewed last quarter, we are also prototyping a security applications framework that enables the rapid creation of high-value security applications leveraging machine learning across diverse data sources. Initially we were focused on the development of a set of applications that enabled end-to-end threat detection and response.

The technology allows us to leverage localized data while also leveraging both our proprietary technology and best-of-breed technologies to power faster, higher fidelity and more accurate detection, investigation and response. There is a lot to do but I am encouraged by our progress to date.

At Secureworks we are uniquely positioned in the industry. Our solutions are based on years of cyber attack data and machine learning-based solutions that are the foundation of our Counter Threat Platform. Investment in technology innovation allows us to stay ahead of the threat actors and protect our clients, which is key to continued top-line growth; growth that enables us to realize the significant operating leverage in our business model.

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

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### Wayne Jackson - SecureWorks Corporation - CFO

Thanks, Mike, and good morning, everyone. In the first quarter revenue was \$126.2 million, a 10.8% increase over Q1 FY18 and a 4.2% increase sequentially. Our average annual subscription revenue per client increased to \$98,000 this quarter, an 11.7% increase over the prior year and a 1.3% increase sequentially.

As Mike noted, sales results for contracts greater than \$1 million were up 94% year over year as we continue to reap the benefits of our sales investments in the enterprise space as well as in our international markets.

A couple of notable examples of new large deals that we signed in the first quarter include a \$4.2 million, three-year agreement with a global lighting solutions Company. This win is a prime example of coordinated security solution package providing the protection and intelligence the client needed to enhance their security position.

A second notable example was a \$2.9 million, two-year deal with a large global diversified industrial company. This win is representative of our solutions aligning to the growing market demand as this client is expanding more into the Internet of Things space with an increased focus on how to secure their operations as they evolve. This win is also an example where our relationship with Dell Technologies played an important role in the sale.

We exited the quarter with monthly recurring revenue, or MRR, of \$35.5 million, an increase of 11.3% over the prior year and 0.6% sequentially. As previously mentioned, we had strong demand this quarter for consulting services and our SRC revenue comprised 21.8% of total revenue.

We anticipate our consulting to subscription revenue mix will remain at a similar level for Q1 for the next few quarters. Over time we expect the mix to revert to our historical norm of MSS representing approximately 80% of the total. In the near-term we are leveraging our SRC capabilities as an important component of a comprehensive security solution for our clients.

Revenue retention in the period was 100% versus 96% in the fourth quarter and 99% in the first quarter of last year. As a reminder, revenue retention measures how well we have maintained revenue from clients we had on the first day of the year. This metric reflects only subscription revenue as of the beginning of the year and excludes backlog.

For the quarter, revenue outside the US grew to 20% of total revenue for the quarter, up from 14% last year on the consistently strong growth in the UK, Middle East and Japan. Gross margin was \$69.3 million in the first quarter of fiscal 2019, or 54.9% of revenue, compared with \$64.5 million or 53.3% of revenue in the fourth quarter.

The fourth quarter of last year included on approximately 150 basis point impact for severance and higher incentive compensation expense due to fourth-quarter performance metrics. Prior year first-quarter gross margin was \$53.9 million, or 55.9% of revenue. On a year-over-year basis gross margin as a percentage of revenue is lower primarily due to the impact from the consulting business.

Moving down the income statement, our first-quarter operating expenses totaled \$75.2 million compared to \$73.8 million in Q4 and \$71.9 million last year. While an increase in absolute dollars, we continue to leverage our operating expenses as OpEx decreased 350 basis points year over year.

Research and development expenses increased to 16.9% of revenue in the quarter, up from 16.4% last year, as we continue to invest in innovative technologies to meet our clients' evolving needs. We will continue to make incremental R&D investments in fiscal 2019 to further advance our automation and new applications framework Mike mentioned. We do, however, expect our investments to taper back down in the second half of the year.

Sales and marketing expenses this quarter were approximately 27.8% of revenue, down from 31.6% last year, as we leverage the investments and organizational changes made in fiscal 2018.



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General and administrative expenses totaled 15% of revenue compared to 15.2% last year. We anticipate that we will continue to gain some additional leverage related to G&A expenses in the second half of the year.

Our adjusted EBITDA loss narrowed to \$2.6 million or 2% of revenue for the quarter from \$5 million or 4.4% of revenue last year. Our net loss for the quarter also narrowed to \$4.5 million from \$5.5 million last year as the margin on higher revenue offset the increased R&D investments I just highlighted. Non-GAAP net loss per share was \$0.06 for the quarter compared to \$0.07 last year.

Moving on to cash flow and balance sheet items, cash used in operations was \$18.4 million in the first quarter compared to \$19.7 million use of cash last year. Recall that first-quarter cash flow from operations is negative due to the payment in the quarter of annual bonus compensation.

We finished the quarter with cash of \$77.3 million. Our net accounts receivable totaled \$146.8 million at the end of the quarter, down from \$157.8 million in the prior quarter. DSO decreased 10.9% sequentially. We invested \$2.2 million in the first quarter in capital expenditures to support our growth.

Now for FY19 guidance, which reflects the impact of ASC 606 and its related standards, which Secureworks adopted for its fiscal year ending February 1, 2019 using the full retrospective option.

As a reminder from our last call, as most of our subscription revenue has always been recognized over the life of the underlying contract, there was an immaterial impact on revenue of adopting ASC 606. However, with the application of this new standard we will have lower expenses due to the requirement to defer and amortize client acquisition costs including sales commissions and certain installation costs.

As it relates to guidance, a significant portion of a contract with our largest client is up for renewal at the end of our second quarter. Our guidance reflects our current view of the outcome of these discussions.

For the second quarter of fiscal 2019 we expect both GAAP and non-GAAP revenue to be in the range of \$127 million to \$128 million, and we expect non-GAAP net loss per share to be in the range of \$0.05 to \$0.06 based on approximately 80.8 million weighted average shares outstanding.

We have updated our full-year fiscal 2019 guidance and now anticipate the following. We expect GAAP and non-GAAP revenue to be in the range of \$515 million to \$518 million. We expect our adjusted EBITDA loss to be in the range of \$3 million to \$7 million. We expect our non-GAAP net loss per share to be in the range of \$0.15 to \$0.19 per share with 80.8 million weighted average shares outstanding. All improved measures compared with prior guidance reflecting our higher Q1 revenue and EBITDA performance and continued sales momentum.

Additionally, we expect GAAP net loss per share to be in the range of \$0.59 to \$0.63. This represents an increase in our net loss per share compared with our original guidance for the year due to a lower tax benefit now anticipated based on a fuller understanding of the impact of the new tax laws.

For modeling purposes, we estimate that the tax benefit rate will be approximately 23% for each of the next three quarters and, when combined with the first-quarter tax benefit, the overall rate for the year is about 22%.

We expect our MRR to be in the range of \$38 million to \$39 million at the end of the fourth quarter of fiscal 2019. We are introducing cash flow guidance for the first time and expect cash flow provided by operations to be in the range of \$15 million to \$20 million for the full fiscal year 2019, up from roughly \$1 million in fiscal 2018. I will now return the call to Mike.

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### **Michael Cote** - SecureWorks Corporation - President & CEO

Thanks, Wayne. This quarter's positive performance shows we continue to make progress on our plan to accelerate our growth trajectory. Our clients trust us. It is a core value and foundational to all we do and we will fight to keep their trust and confidence every day. We have a strong executive leadership team, positive momentum and I'm eager to continue executing against our fiscal 2019 plans. I look forward to providing further details on our progress next quarter.

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Before I turn it over to the operator for questions I want to again express my gratitude for the hard work and dedication our team members bring to the table every day 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 cyber security partner and our other stakeholders for their continued support. Chelsea, you can now open the line for questions.

### QUESTIONS AND ANSWERS

#### Operator

(Operator Instructions). Jonathan Ho, William Blair.

#### Jonathan Ho - William Blair & Company - Analyst

Hi, congratulations on the strong quarter. Just wanted to start out with your commentary around some of the large deals and the 94% growth year over year. Can you give us maybe a sense of what drove that? Was it more sort of the client composition or more products being selected? I just wanted to get a better understanding of what that dynamic is.

#### Michael Cote - SecureWorks Corporation - President & CEO

So Jonathan, this is Mike. Thank you for the question. The real underlying answer to your question is the sales transition work that we began last year, which Geoff and his new team -- and his team I should say; he brought in a couple of new leaders and the existing team that is in place really focusing on executing from a sales perspective.

The primary focus that we are leaning towards is, or we are working on, is regarding people, the right folks and the right sales leaders and solutions architect and sales support. So productivity, it really falls into three big buckets -- let me back up: talent, coverage and quality of sales. So talent being the people, coverage being the appropriate coverage in the area, productivity and the sales things -- and the things we can do to help support them and then messaging and methodology.

So, as I mentioned, we saw strong performance -- continue to see strong performance in EMEA and APJ, our state, local and enterprise team and our SMB team performed very well in the quarter and our enterprise group, which was a group that had been struggling historically, actually doubled its productivity in Q1.

So, our basic hope and belief, now that we have sort of put two dots together between fourth-quarter performance and the sales perspective and first quarter, is that we can continue this trend going forward. So we have got good geographic diversity, good industry diversity and holistic security programs and solutions for our clients.

#### Jonathan Ho - William Blair & Company - Analyst

Got it. And then you talked a little bit about GDPR being a driver inside of EMEA. Can you talk about how GDPR is maybe impacting your business either from a willingness to spend perspective or some of the actions that you took to I guess prepare your systems for that transition?

#### Michael Cote - SecureWorks Corporation - President & CEO

So thanks, Jonathan. In my prepared remarks what I was really trying or what I really refer to is that we are -- Secureworks is GDPR-compliant and had a lot of focus internally over the prior 18 months to ensure that we were compliant internally.



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From a market perspective it has clearly been a key part of a conversation with every client in Europe and has helped -- I think it's helped put focus on security. Our ability to represent and tell them that we are compliant and actually being in a good position from that perspective.

We have helped a lot of clients and advised them on the things that they can do from our experience and expertise in that area. And it's resulted in a lot of interest from -- on the sales perspective in discussions. So I would say it has clearly been a help for us in Europe and was a net positive.

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**Jonathan Ho** - *William Blair & Company - Analyst*

Thank you.

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**Operator**

Saket Kalia, Barclays.

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**Saket Kalia** - *Barclays Capital - Analyst*

Hey guys, thanks for taking my questions here. Maybe starting with you, Wayne. Nice bounce back in the revenue retention rate. You touched on it a little bit in your prepared remarks, but can you remind us how that formula works?

And what were some of the puts and takes in what drove that improvement, whether it was an improvement in service churn, perhaps an improvement in customer churn? Maybe a little bit more detail on what drove that improvement in revenue retention.

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**Wayne Jackson** - *SecureWorks Corporation - CFO*

Sure, good morning, Saket. Thank you. So for this quarter 100%, as I discussed in the prepared remarks -- and just a reminder, it is the book of business as of the beginning of the year and that stays constant. And then there's two things that impact that similar to same-store sales. It's either additional cross sales into a client or it's not renewing that client.

And in Q1, we had both our -- our renewal rate was probably not where we wanted it to be but not too far off for first-quarter results. First quarter is -- generally we see in dollar terms a bigger impact on our book than in Qs two through four.

So the primary reason -- to answer your question directly, the primary reason is we had strong cross sales into our existing client base, that was the driver. And we were happy to see that because we had discussions over the prior several quarters that the sales momentum impacted both new sales and cross sales. So we were happy to see increasing cross sales.

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**Saket Kalia** - *Barclays Capital - Analyst*

Very helpful. For my follow-up maybe for you, Mike, a question I like to ask you quarter to quarter -- in your conversations with customers, how are they sort of balancing the decision of doing more security in-house versus leveraging an MSSP like Secureworks? I mean based on 94% growth and \$1 million plus deals it feels like maybe the scale is starting to tip one way versus the other. But I'm curious about what you are hearing from customers on that trade-off of in-house versus an MSSP generally.

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**Michael Cote** - *SecureWorks Corporation - President & CEO*

So thanks for the question. A couple of things. When we talk about this let's first think about clients that say do-it-for-me, which typically tend to be sort of the smaller clients, those with a smaller security staff, not necessarily smaller in revenue, and that is a part of the market.





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In the do-it-with-me sort of segment of the market, which is a big market. That part of the market is basically going to look and balances between how much of an investment they want to have internally as we work with them and the value associated with our network effect, with our intellectual property around our machine learning and our algorithms, with our ability -- in some of my prepared remarks I touched on -- to help them orchestrate and actually take the appropriate actions.

The other kind of key component that has come into this, and again, I kind of alluded to this in my prepared remarks, that's becoming more and more of a conversation is clients are looking -- and the industry I think as a whole is looking to understand and measure the effectiveness of their security program. Are they really for their spend reducing their risk and how are they reducing it to protect the appropriate assets?

And we end up coming into play a role with showing them, if you will, the efficacy of the technology that they are using and helping advise them on how to optimize their security spend in the best manner.

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**Saket Kalia** - *Barclays Capital - Analyst*

Makes a lot of sense. Thanks very much.

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**Operator**

Rob Owens, KeyBanc Capital.

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**Rob Owens** - *KeyBanc Capital Markets - Analyst*

Great, thank you guys for taking my question this morning. You mentioned that the industry remains resource constrained overall from a headcount perspective. And so, I guess my first question is really around pricing. And given the lack of qualified headcount out there, how is that impacting your pricing I guess on a year-over-year basis if you were either to look at deal size or any metric you can give on that front?

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**Wayne Jackson** - *SecureWorks Corporation - CFO*

Good morning, Rob. This is Wayne. From a pricing perspective it really touches a little bit on what Mike just talked about. We have different prices for the do-it-with-me and do-it-for-me. And then in the enterprise space the pricing, as we move up and deal with procurement and CFO offices, the pricing gets a little bit different as well.

But just, we take into account what -- the value we bring and then we look at our investments and how efficient we can be in those investments either in orchestration or automation, and that helps drive from our perspective how we price in the marketplace. Does that answer your question?

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**Rob Owens** - *KeyBanc Capital Markets - Analyst*

Not really. Is there (multiple speakers).

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**Wayne Jackson** - *SecureWorks Corporation - CFO*

Maybe ask it -- sorry, Rob, go ahead.



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**Rob Owens** - KeyBanc Capital Markets - Analyst

That's okay. I only get two questions, so hopefully this still counts as number one. I guess if I'm looking on a year-over-year basis, and the industry remains more and more resource constrained, are you able to find any price leverage within the customer base, or do you feel you are still a price taker at this point?

**Wayne Jackson** - SecureWorks Corporation - CFO

We do find price leverage. As you see, our ARPU is up 12% year over year. We find price leverage when we provide solutions that the client look at and says, this helps me in my overall security position. So yes.

**Rob Owens** - KeyBanc Capital Markets - Analyst

Okay, let me sneak a second one in then, which is maybe third, maybe second. Relative to the large deals and the success you are seeing there, are these greenfield opportunities in and around expansion? Are they replacement opportunities as you spoke to, people who might have been doing it themselves that are switching over? Or are they competitive displacement opportunities? Maybe you can characterize what you are seeing at the higher end of the market.

**Michael Cote** - SecureWorks Corporation - President & CEO

Thanks Rob, it's Mike for your second question. I don't have the actual specifics on the deals that I referred to in the first quarter, but I would tell you anecdotally -- I would tell you that it's probably more greenfield, say a little more greenfield where it's mostly new clients -- well, it's all new clients that we are getting in from the growth perspective.

Most of it is new clients that are doing most of this in-house and are really looking to figure out, as I kind of referred to and I mentioned earlier to Saket, the industry for the first time is beginning -- or over the last 12 months is beginning to look at their spend from a security perspective and ensure that they are spending in the right areas, depending upon where the hackers are going, where their risk is and their base of assets, and trying to make sure that they are measuring the reduction of risk as they are spending in the various areas.

So, I think that is driving some of the new clients we are picking up. There are displacements, there are probably, plus or minus, a third of the new growth we are getting is displacements of competitors.

**Rob Owens** - KeyBanc Capital Markets - Analyst

All right. Thanks for your answers.

**Operator**

Howard Smith, First Analysis.

**Howard Smith** - First Analysis Securities - Analyst

Yes, good morning. Thank you for taking my questions. First question has to do with the Dell sales force. If I remember correctly, their ability to get quota altered a little bit this year to your benefit and you did reference their help in one of your major sales.

But more broadly, I'm just curious, do you feel you are getting the full benefit of that or is that something that ramps over several quarters? Maybe you could just address that dynamic a little bit.



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**Michael Cote** - *SecureWorks Corporation - President & CEO*

Howard, this is Mike. Thanks for the question. I'd summarize it at a high level and say we made progress and it was better, but it's not where it needs to be. So, it has the focus from the top of the Dell Technologies organization across all of Dell Technologies. And I think we were pleased in Q1, there was more deals and a larger percentage of our overall closed deals, but it is nowhere near where it should be for the opportunity that lies ahead.

So, we are -- and I would answer the second part of your question that I would expect it to continue to ramp up and take a little bit of time before on a global basis we are really beginning to feel the full impact.

**Howard Smith** - *First Analysis Securities - Analyst*

Okay, and the second question deals a little bit with your -- and you hinted a little at the -- in the prepared remarks. But you've talked about automating and getting more efficiency in some of your remediation efforts. And where do you stand on those processes and getting the gross margin on that line of business, if you will, to where you ultimately think it can get to?

**Michael Cote** - *SecureWorks Corporation - President & CEO*

This is Mike again and thanks for the question. We basically partnered with Ansible and the Red Hat team and rolled out the first few playbooks. And it's not just on the remediation part, there are some things that we are going to do and are working on from a detection perspective. And we are very excited about the early results relating to that.

I wouldn't tell you that you can see in the gross margin today, but that it will basically be a big key to our scale and allowing us to get faster and better client results. And I would expect the margin to go up over time into the future as we continue to make the investments in that area.

**Howard Smith** - *First Analysis Securities - Analyst*

Okay, thank you.

**Michael Cote** - *SecureWorks Corporation - President & CEO*

The good news there just to add on the end -- I'm sorry, Howard. I was just going to say the good news there is I think what we have been excited is that we have seen some real results there working with clients and substantial productivity improvements. It's just going to now mean continuing to roll it out across a lot more playbooks and across the organization.

**Howard Smith** - *First Analysis Securities - Analyst*

Okay, sounds promising. Thanks for taking my questions.

**Operator**

Sterling Auty, JPMorgan.



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**Ugam Ghamet** - *JPMorgan - Analyst*

Hi guys, this is actually [Ugam Ghamet] on for Sterling this morning. You mentioned in your prepared remarks that you had some incident response engagement this quarter which increased your SRC revenue. Just wondering whether this was with the new or existing customers. And if they were new, is there a potential to convert them into MSS clients?

**Michael Cote** - *SecureWorks Corporation - President & CEO*

So great question and this is Mike responding. I would tell you that I don't have an answer across the full spectrum of our incident response engagements because we do probably somewhere in the neighborhood of 300 or 400 a quarter I am guessing.

But there were some big incident response engagements in particular that were all with new clients. And most of them, as I mentioned in the prepared remarks, 50% of our sales in the quarter were both consulting and subscription. So most of the incident response engagements do lead to the ability to pick up subscription business as well.

**Ugam Ghamet** - *JPMorgan - Analyst*

That's great. And as a follow-up, if you look at the competitive landscape, we are seeing more product vendors in security overlay managed services, case in point is like FireEye. Can you throw some color around how it changes your conversations with customers and if there is any impact on the business at all from that particular transition?

**Michael Cote** - *SecureWorks Corporation - President & CEO*

So another good question. It's interesting that they are looking to move into our model where the first thing we do from a sales perspective would be to pull out the Gartner Magic Quadrant to show them the leader position that we sit in. But I think once you take the next level down from that and have the conversation with the client, or the prospect, either way, the next thing that's important is that we are vendor neutral.

So we are not -- matter of fact, we can give them the efficacy of the various security products that they now want to work with because we see a lot of that across our client base. And we come in with this being a focus on all that we do working across the spectrum of their security devices.

So, I think from the over 15 years of creating the intellectual property to do this, we can clearly show clients the incremental value. Most of the, or at least the -- when people ask about FireEye, we have not seen them competitively on the MSS side of the business or the subscription side.

**Ugam Ghamet** - *JPMorgan - Analyst*

Awesome. Thank you, guys.

**Operator**

Alex Henderson, Needham.

**Alex Henderson** - *Needham & Company - Analyst*

Thanks. So I think you had said on the call that you expected your consulting business, which has obviously increased as a percentage of your business in recent orders, to, quote, roll back over. And I was wondering if you could talk a little bit about the timing of that and the magnitude impact that that would have on the quarterly results if it were to revert back towards the prior 25% of purchases being down from the 50% of purchases that you are currently seeing.



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**Wayne Jackson** - *SecureWorks Corporation - CFO*

Hi, Alex, good morning, this is Wayne. I will take that. So there is two phenomena there as SRC becomes a larger mix, one is our margin in the managed security space is greater than it is in the consulting space, so that obviously impacts -- improves our gross margin and our EBITDA. I'm hearing a break up here.

And then secondly, from a mix perspective, a sales mix perspective it goes in our recurring base, which we always -- which we like as well. So it helps our MRR and the subscription model. As far as timing, I know your question was around timing. We expect it to improve later this year as our sales effort gets back to more the traditional mix that we've seen over the last two years.

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**Michael Cote** - *SecureWorks Corporation - President & CEO*

This is Mike. I just want to make sure -- I assume, just to make sure, because you had stated some numbers that I'm not sure we were aligned on. So when you mentioned 25% and 50%, the SRC, our consulting business has historically been around 20% of our revenue and this quarter I think it was 22%, Wayne?

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**Wayne Jackson** - *SecureWorks Corporation - CFO*

That's correct.

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**Michael Cote** - *SecureWorks Corporation - President & CEO*

So it was up a little bit. From a sales perspective part of what we mentioned is in the last -- this is the first statistic we've given of this nature, but in the last four quarters approximately 50% of the signed contracts had both consulting and the subscription business in it and that 50% is up 25%. So it is up 25% higher than it was a year ago for the same thing, meaning a year ago we were selling more consulting business as a percent of what we sold in sales.

I'm sorry -- we were selling more contracts with just one solution in it. In this quarter, from a sales perspective, there was a higher mix that will turn into revenue, but there was a higher mix that related to consulting or had a consulting component. Does that help?

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**Alex Henderson** - *Needham & Company - Analyst*

Just to be clear, when you say 25% improvement, is it going from 25% of contracts sold with consulting services in them to 50% with consulting practices, which is actually a doubling of that percentage? Or is it a 25% increase --?

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**Michael Cote** - *SecureWorks Corporation - President & CEO*

No, no, no. It went from 40% to 50%.

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**Alex Henderson** - *Needham & Company - Analyst*

It went from 40% to 50%. That's better clarification. Thank you. Just going back to the point of the original question, should we anticipate some softening of the top line as that rolls back down to a more normalized environment? Does that cause an offset on the top line?

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**Wayne Jackson** - *SecureWorks Corporation - CFO*

No, no, it's not -- it's all about mix. It's not the softening of the top line at all.

**Alex Henderson** - *Needham & Company - Analyst*

Okay, great. And just one other (multiple speakers).

**Wayne Jackson** - *SecureWorks Corporation - CFO*

And our guidance -- go ahead.

**Alex Henderson** - *Needham & Company - Analyst*

Just one other question if I could. So you talk a lot about the lack of available security employees out there. And you guys have had a very great retention rate on your employees because of the programs you've established around that. But I was wondering if you could talk about wage rate versus your pricing pass-through of increasing wages.

Have you seen wages increasing for security employees at a faster rate than you are able to pass-through or a slower rate? Can you give us some sense of that? I know you have automation as an offset to it, but if you could help us on that it would be great.

**Michael Cote** - *SecureWorks Corporation - President & CEO*

Yes, this is Mike. I would say that we have employees that are here for a host of reasons and probably the most important of which is they have a vested interest in wanting to protect our clients. And there is a career path for them here because this is all we do.

And for example, in the technical route we have fellows that we have in the security area that are -- move up from a technical perspective. We do have a comprehensive plan or program in place to ensure that we are compensating folks well, both from a cash perspective and the other variables that tie into a compensation perspective.

To answer your question directly, I would say that we have not overall seen wage increases in excess of the price increases we are putting in place. And you are right in the last part of your statement that the real excitement that we have and the opportunity is the automation things that we can do to make it so that both our front-line employees, that are working in our security operation centers to protect our clients, and our security center of excellence are focused on spending their time in the areas that have the largest impact and are working with our clients in their respective security operation centers to have the biggest impact.

And I think the automation, as this industry continues to see more and more threats, is really the key effort. You are not going to be able to do this with people.

**Alex Henderson** - *Needham & Company - Analyst*

Thank you very much for your answers.

**Operator**

Gabriela Borges, Goldman Sachs.



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**Gabriela Borges** - *Goldman Sachs - Analyst*

Good morning. Thanks for taking the questions. Mike, I wanted to revisit the commentary you made on some of the new leadership in the sales organization. Now that Mr. Haydon and the two leaders in sales ops and enablement have been on the ground for a few months, can you just give us an update on whether they are making any incremental changes to optimize the go-to-market and try to get the productivity to be a little bit better? Thank you.

**Michael Cote** - *SecureWorks Corporation - President & CEO*

So Gabriela, thanks for the question and good morning. The answer to your question is yes, they are making incremental improvements from a productivity perspective in particular. The packaging that we mentioned was a joint effort with the new sales enablement leader across our product management organization and our marketing organization. We are doing a lot of work in revamping our sales enablement and training and really putting some best practices in place.

I would tell you that culturally Geoff and his two new hires in sales ops and sales enablement, along with the sales leaders that I've mentioned over time in North America and EMEA and APJ, have really come together as a unified team. And I've been -- I was extremely excited and impressed as we rolled into the -- I'll say the third month of Q1 and into the beginning of Q2 with regard to the cultural changes they are making and the excitement that exists in the organization.

So, it's really bouncing off of the things or enhancing the things that we did in refining our model over the last year with a real focus in measurement and focused on the people, the coverage and the quality of sale from a training and executing perspective. So it really feels very different.

**Gabriela Borges** - *Goldman Sachs - Analyst*

Very good. The follow-up that I have is on your comment on prototyping applications around the Counter Threat Platform and some of the unique IP that you have there. Could you just give us a little bit of a sense as to timeline there? How close do you think you are to being able to monetize that? What does the monetization model look like? And how can we try to start thinking about the size of the opportunity? Thanks.

**Michael Cote** - *SecureWorks Corporation - President & CEO*

Thanks for the question and we are right now in the process of where we will be bringing on some beta clients in say over the next 90 to 120 days that we will work with. And the plan is to be GA in the back half of this year. And I think as we get to that point we will give you a little more insights on how we think it will change our business model and hit the financial model.

**Gabriela Borges** - *Goldman Sachs - Analyst*

Thank you very much.

**Operator**

Fatima Boolani, UBS.

**Fatima Boolani** - *UBS - Analyst*

Good morning, thank you for taking the questions. One for Mike and one for Wayne if I may. Mike, if my math is correct, the US business was up 2% to low single digits. I am wondering if you can kind of talk through some of the challenge and opportunities you are seeing domestically.



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**Michael Cote** - *SecureWorks Corporation - President & CEO*

Great question. As I mentioned in the prepared remarks, the Europe and APJ market grew and our performance there was very good. We have had struggles over the last 18 months or so with execution in particular in the enterprise space. And we were excited with the performance and, again, as I mentioned in my prepared remarks, that the SMB space and the state, local and education performed very well in Q1 and the enterprise space actually doubled its performance in the quarter.

So, we are optimistic at the continued production and having an ability to improve our productivity in North America and the current momentum we've put in place and the opportunity that exists for us there.

**Fatima Boolani** - *UBS - Analyst*

That's helpful. And maybe for Wayne, as I think about the business mix maybe even temporarily shifting to SRC, incremental investments in sales and marketing, how should we, A, think about the gross margin leverage over the next couple of quarters, and then, B, your path to going EBITDA positive? A timeline or a path there would be really helpful. Thank you.

**Wayne Jackson** - *SecureWorks Corporation - CFO*

Thank you for that. So the mix -- the sales mix short-term does impact the margin, as I said in my prepared remarks, for this quarter. I think two things, on the sales side, sales motion we believe will get back to the normal mix we see in the marketplace. And then secondly, I think timeline as to path of EBITDA positive, we guided \$3 million to \$7 million for the year. We had the results we had this quarter. So we are very focused on that.

I don't want to come out and say which quarter yet, but we are very focused. And the reason I don't is very simple. Once we rollout the EBITDA positive path, the next question or the next question in our mind is how do we sustain it and then how quickly do we grow it. So we will stick with the guidance for now and talk about that a little bit more in the third quarter.

**Fatima Boolani** - *UBS - Analyst*

Thank you.

**Operator**

Walter Prichard, Citi.

**Walter Prichard** - *Citigroup - Analyst*

Hi, thanks. A question for you, Mike. On the endpoint security market, we haven't heard about Red Cloak a little bit. Could you update us on that offering and how that is driving demand? Or is that a market that is more challenging on your -- both from your own IP as well as the services you are offering around the general market?

**Michael Cote** - *SecureWorks Corporation - President & CEO*

Walter, thanks very much for the question. I'd answer your question at a high level and basically say that demand in the endpoint has been very, very good. It's typically part of a larger solution as you look at the -- and again, look at the market or think about the market in the do-it-for-me versus the do-it-with-me.



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And Red Cloak fits in parts of that market better as a standalone solution for them. Whereas we partner with and work in a vendor neutral manner where we can apply our Red Cloak analytics to do more than just the Red Cloak but other endpoint providers, which we will probably be rolling out some others that we are going to work with on a vendor neutral manner from client demand.

So, to answer your question at a high level, Red Cloak continues to be a key component of our intellectual property and value proposition in the analytics that we are getting from Red Cloak and can drive both -- taking some of that analytics and driving it across the network layer as well as the endpoint layer.

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**Walter Prichard** - *Citigroup - Analyst*

And then for Wayne, just on the automation side, high-level, how do we think about your interest in using automation to help you drive a more competitive price point long-term versus using it to drive gross margin leverage? Do you feel like it leans in one way or the other there?

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**Wayne Jackson** - *SecureWorks Corporation - CFO*

Well, I think it's both. So, from a margin perspective, Mike touched on it earlier, the results from an efficiency perspective are very compelling. But from a pricing perspective and a go-to-market perspective, it allows us to offer so much more for an attractive price. So it's incremental sales -- first of all it's incremental sales and then it's incremental sales at great margins. So we are pretty excited about both.

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**Walter Prichard** - *Citigroup - Analyst*

Great, thank you.

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**Operator**

Melissa Franchi, Morgan Stanley.

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**Angelo Ausha** - *Morgan Stanley - Analyst*

Hi, this is [Angelo Ausha] in for Melissa Franchi. Thanks for taking the question. I wanted to ask on international revenue, you spoke about it a little bit before. It was one of the strongest year-over-year quarters we've seen. Would you also attribute this largely mostly due to sales productivity or is it more a function of just the overall demand environment and it being just GDPR driving conversations?

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**Michael Cote** - *SecureWorks Corporation - President & CEO*

So great -- this is Mike. Great question. I would tell you that it is more sales productivity. The demand is there, in my opinion, across the globe. The US is clearly in the more mature of the market. Europe I have said before would be catching up to the US quickly and the APJ market is in the earlier stages of or a little bit behind the US and Europe from a market maturity perspective.

But the growth in APJ and EMEA in particular, the Middle East and Europe, is really a function of the sales leader that we have there, the sales training and enablement that were put in place a while ago and our sales productivity in that market. So there's some good growth going on in the market and we are executing against it very well in my opinion.



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**Angelo Ausha** - Morgan Stanley - Analyst

Got it. Thank you very much. That's super helpful. And just one more -- one modeling question. Thanks for providing cash flow from operations guidance. Just from a modeling perspective, should we expect similar linearity seasonality versus last year or is there anything we should just take note of?

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**Wayne Jackson** - SecureWorks Corporation - CFO

Seasonality compared to last year, that's correct. A very similar build back up of the accrual, bonus accrual which provides us cash flow from ops in the cash flow model. And then secondly, as you recall from last year, we collected cash from Dell for the monetization of our tax attributes. That's the second half of the year as well. Right now we have it in Q4.

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**Angelo Ausha** - Morgan Stanley - Analyst

Q4. Got it. Thank you very much.

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**Operator**

Matt Hedberg, RBC Capital Markets.

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**Matt Swanson** - RBC Capital Markets - Analyst

Thanks for taking my questions. This is Matt Swanson on for Matt. I know MRR is a metric that's guided quarterly, but can you give us a sense for how you feel about Q1 in relation to the full-year guidance?

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**Wayne Jackson** - SecureWorks Corporation - CFO

So Matt, thanks for the question. We actually guided annually and our thoughts on Q1 MRR, so there's two things. One, first of all, year over year it was over 11% growth, we are pleased with that. The sequential growth not where we wanted it to be. A big driver of that was the mix, the sales mix this quarter.

As you know, the SRC, the consulting part is not included in MRR. And then the seasonality, if you go back and kind of look at your models and our results, the sequential increase Q4 to Q1 over the last several years, we're not too far off from that. We would have liked to have seen it a little better, but the mix and seasonality, it wound up at 35.5.

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**Matt Swanson** - RBC Capital Markets - Analyst

Thanks. And then we've touched on this kind of in a few different ways, but when talking about incident response you mentioned customers trying to deal with the lack of cyber security talent on the market. Could you just talk about more generally how large of a driver this is for buying decisions and how long of a tail you see it having?

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**Michael Cote** - SecureWorks Corporation - President & CEO

When you say how -- this is Mike. I'm sorry. Matt (multiple speakers)?

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**Matt Swanson** - *RBC Capital Markets - Analyst*

Yeah, so the lack of cyber security (multiple speakers) well, more so the lack of cyber security talent on the market, just customers maybe trying to use software solutions to address not being able to hire the way they want to.

**Michael Cote** - *SecureWorks Corporation - President & CEO*

So that's a great question. The market has had statistics out there that there's anywhere between 1.8 million and 2 million shortage of cyber security talented people. And I don't think -- the second part of your comment or question where you said trying to find a software solution to the problem. This is not a technology problem. This is a problem where you have human beings who are threat actors or bad guys using technology as their method of attack.

So there is no -- there is not a way a product can evolve and respond on its own fast enough to obviate the need for expertise and visibility from a global perspective and on your -- taken from a client's perspective, in the client-specific infrastructure.

So, I think that the talent shortage and the fact that the threat actors are -- there is more of them and they are growing faster, is not something that will go away in the near-term and I think will continue to drive growth and opportunity.

And I think in particular one of the questions that was asked earlier is that some of the product companies are moving more into our space. I think the reason they are moving more into our space is that clients are looking for specific expertise to help them figure out how to get the best return on investment in managing their security spend.

**Matt Swanson** - *RBC Capital Markets - Analyst*

Thank you.

**Operator**

There are no further questions at this time. I will now turn the call back over to Teri for closing remarks.

**Teri Miller** - *SecureWorks Corporation - VP & Chief Accounting Officer*

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

**Operator**

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

**Michael Cote** - *SecureWorks Corporation - President & CEO*

Thank you.



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