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SCWX - Q4 2017 SecureWorks Corp Earnings Call

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PRESENTATION

Operator

Good morning and welcome to the SecureWorks fourth-quarter fiscal 2017 financial results conference call. (Operator Instructions). As a reminder, a recording of this conference call will be made available on the SecureWorks Investor Relations website. I would like to turn the call over to Rebecca Gardy, Head of Investor Relations. Miss Gardy, you may begin.

Rebecca Gardy - *SecureWorks Corporation - Head of IR*

Good morning, everyone, and thank you for joining us today to review SecureWorks' financial results for the fourth quarter of fiscal 2017. This call is being recorded. This call was 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 February 3, 2017. 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, or EBITDA; and forward-looking statements involving risks and uncertainties that could cause actual results to differ materially from those anticipated by these statements.

You can find a description of these risks and uncertainties in this morning's earnings press release and in the Company's quarterly report on Form 10-Q for the quarter ended October 13, 2016, which is available on our Investor Relations website and on the Securities and Exchange Commission's website. Additional information also be set forth in the Company's annual report on Form 10-K for the fiscal year ended February 3, 2017 and its other SEC filings.

All forward-looking statements made on this call are based on assumptions that we believe to be reasonable as of this date, March 29, 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 effects of those 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. 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 all our best to come back to you. Thank you for your cooperation on this and I would now like to turn it over to Mr. Cote.

Michael Cote - *SecureWorks Corporation - President & CEO*

Thanks, Rebecca. Good morning, everyone, and thank you for joining us today. We had solid financial results for the fourth quarter. We generated a record $119 million in revenue, exceeding the high end of our guidance. Our gross margin hit its highest level in the last 12 quarters and we narrowed our reported net loss per share to $0.09, well ahead of expectations.

As you know, SecureWorks provides an early warning system to help organizations of all sizes and in all industries prevent cyber security breaches, detect malicious activity in near real-time, prioritize and respond rapidly to security breaches and predict emerging threats. We have a powerful multi-tenant SaaS based counter threat platform, or CTP, that enables us to deliver a portfolio of managed and monitored security solutions.

The power of the CTP is that it becomes smarter, more robust and more agile every day. The CTP ingests intelligence data amassed from the security devices of our nearly 4,400 clients and 61 countries and is augmented by our proprietary threat detection and prevention capabilities. We also provide threat intelligence based on our understanding of the threat actors and security risk and consulting services, including an incident response practice.

We take a vendor agnostic stance in the delivery of our solutions. It is intrinsic to our value proposition and an essential component of the network effect CTP provides for our clients. It means that we integrate with, monitor, manage and apply our intelligence to numerous third-party products, allowing us to analyze network data from many different security devices, tools and software running in our clients' environments.

It also means that we help our clients maximize the effectiveness of their existing security architecture by coordinating and enhancing the value of disparate point products making the most of what they already have in place.

We believe SecureWorks is well-positioned to bring a higher level of effectiveness, efficiency and coordination to organizations as they look to reduce their vulnerabilities, improve their ability to identify real threats, expedite the containment and eradication of those threats and optimize their existing security investments.

We are excited about the global opportunities for SecureWorks as cyber security remains a key imperative at the highest levels of organizations and with Boards of Directors. Our solid results this quarter reflect our success in serving as a close trusted partner in information security solutions to our clients. We are committed to continuing to drive this level of security.

In Gartner's January 2017 Magic Quadrant for Managed Security Service Providers, Worldwide, SecureWorks was once again positioned in the leaders quadrant, making this the ninth time we have been recognized as a leader in the report. We believe we have consistently achieved placement in the Leaders Quadrant based on the depth of our offerings, our focus on client service and our global presence.

From a sales perspective, although our domestic opportunity remains vast given the highly fragmented marketplace, our international operations, specifically our European and Asian Pacific sales teams, exceeded our expectations this year. In fiscal year 2017 approximately 13%, or $54 million, of our revenue was international.

Some of the larger deals we closed this quarter include a $3 million three-year deal with a FTSE 100 energy company in Europe; a $2 million three-year deal with a UK outsourcing company; and a targeted threat hunting engagement valued at $0.25 million with a well-known Japanese manufacturer.

It is undeniable that having a global footprint is increasingly important as threat actors know of no geographic boundaries and as our clients' ecosystems are increasingly global in nature. The intelligence we gain from having a broad perspective and visibility into all types of threat actors makes our solutions more valuable to our clients.

Let me share with you some of our technology developments from the fourth quarter. We announced the Managed Detection and Response, or MDR solution, combining our advanced threat detection and incident response capabilities. In order to be resilient to the threat from an advanced adversary, an organization must have integrated capabilities to respond to previously undetected threats that have breached their networks and removed them.

The unparalleled visibility of the CTP and the context we have across our entire client base and the intelligence and insight of our counter threat research team allows us to deliver an MDR solution more effectively than any other security provider.

We have amassed nearly 17 years of knowledge of the tools, techniques and procedures used by threat actors to infiltrate and move laterally within client networks. We can proactively detect the attackers, disrupt the malicious activity and help clients reduce the time it takes to eradicate the threat actors from their security ecosystem. And as I mentioned we are vendor neutral, so we provide MDR solutions within the scope of a client's existing security architecture.

I also want to share how we are enabling clients to fortify their cyber defenses in the cloud. As I have mentioned on prior calls, securing the cloud for our clients remains a strategic imperative. As organizations consider moving workloads to a cloud environment security is a key part of those decisions; ensuring that mission-critical data is not vulnerable to malicious threat actors is a real concern.

Cloud providers have been clear: security is a shared responsibility model, thus leaving many companies exposed. Our cloud security solutions leverage the CTP regardless of where in the continuum clients are as they migrate to the cloud.

I spoke earlier of our vendor neutral stance; SecureWorks is also environment agnostic. Whether our clients have their workloads on premise, on a public cloud, a private cloud or in a hybrid cloud, we offer comprehensive, seamless security solutions from the initial evaluations and architecture to ongoing assessments and monitoring all through a single pane of glass.

In recent months we previewed the newest offering of our Cloud Guardian portfolio, our Cloud Security Configuration Management solution that leverages our knowledge of threat actors to detect vulnerabilities in the configurations of cloud infrastructure. Our Security Configuration Management solution offers both manual and automated remediation options to help clients have informed, defensible and secure configuration of AWS. We expect to make this solution available to clients this quarter.

Fiscal 2017 was an important year for SecureWorks. It was our first year as a public Company and we had many successes that I discussed on prior earnings calls. Over the last two quarters we had challenges with sales momentum. Those challenges are reflected in the leading indicator of our financial performance, our monthly recurring revenue, or MRR. We have faced these challenges head on and have implemented key changes to regain momentum.

On our last earnings call we announced the addition of our new Chief Revenue Officer. He joined us from Dell EMC about two months ago and has already affected many positive changes. He brings to SecureWorks a deep commitment to value-based selling, significant global enterprise experience and a proven record of helping companies grow revenue to $1 billion and beyond.

Our entire Company is concentrated on accelerating our sales momentum. Earlier this week we held our annual sales kickoff meeting bringing together our nearly 500 person sales team from around the globe. Our sales team is truly energized as we make several adjustments to our sales organization, including rolling out a best-in-class simplified sales methodology that we believe will lead to larger deals, shorter sales cycles and greater sales opportunities.

In the last 60 days we have also redistributed our enterprise sales resources within North America to optimize territories and to get our teams closer to our clients and prospects. Our North America enterprise sales teams will now be responsible for both acquiring and growing client relationships.

In addition, as we increased our sales capacity we have added key talent to our sales team, including bringing on board several new frontline managers, a key leader in the Middle East, a global sales engineer leader and a global sales channel leader.

We are also driving client service excellence which we expect will be reflected in our improvements to our revenue retention rate. We are laser focused on meeting and exceeding our clients' expectations through our client retention, renewal and expansion initiatives. Our operations team is leading improvements in client on boarding and making continuous improvements in how we communicate and interact with our clients each day.

Alongside that effort our new Chief Marketing Officer is driving greater clarity in communicating our value proposition and overall branding message. Looking ahead we see tremendous opportunity for SecureWorks across the board with new and existing clients.

We expect that the hard work I just described will bear fruit in the second half of fiscal 2018. To that end this quarter we are adding MRR to our guidance metric in order to provide greater visibility into our expected performance. In addition, MRR is now a key component of our management and employee incentive plans.

As I wrap up my comments I would like to thank our over 2,300 team members for their hard work and for their unwavering passion for staying ahead of the bad guys in order to protect our clients from malicious cyber activity.

I would also like to thank our clients for allowing SecureWorks to be their trusted partner and advisor in cyber security. Together we are solving broad security challenges, optimizing existing security investments by implementing a unified comprehensive security strategy, reducing their risk and allowing them to focus on their business.

As we bring this year to a close, while there will always be lots to do to help our clients fight cyber threats, our Company is in a promising and dynamic market. We have a great platform, we are strengthening our team and we are excited about the future.

With that I will now hand it over to Wayne to share more details on the fourth quarter and fiscal 2017 and to lay out our expectations for the first quarter and fiscal 2018. Wayne.

Wayne Jackson - *SecureWorks Corporation - CFO*

Thank you, Mike. Good morning, everyone. My financial review today will cover the non-GAAP financial results for the fourth quarter and fiscal year ending February 3, 2017 and guidance for next year. Please recall that fiscal 2017 had 53 weeks of operations with the fourth quarter having the extra week.

Our fourth-quarter financial results punctuated a solid fiscal 2017. Here are a few highlights. First, we had a solid year-over-year revenue growth in the quarter as we expanded our client base and increased revenue per client. Next, we had positive fourth-quarter adjusted EBITDA and narrowed our net loss. And lastly, we ended the year with two consecutive quarters of positive cash flow from operations.

Starting with our top-line results, fourth-quarter revenue was $119.2 million, a 25.7% increase year over year, or a 16.3% increase when normalized for the extra week. At the end of the fourth quarter our subscription count was approximately 4,400 with each client generating an average of 86,000 in annual subscription revenue.

Throughout the year SecureWorks has maintained an approximate 80/20 split between subscription and professional services revenue respectively. Monthly recurring revenue, or MRR, is our leading indicator of subscription-based revenue. At the end of the fourth quarter MRR was $31.6 million, a 10.5% increase over the prior year and a sequential 2.6% increase over the third quarter of fiscal 2017.

We believe the focus we are placing on simplifying our go-to-market sales process and driving client service excellence will positively impact this metric by the second half of fiscal 2018.

As we have discussed during our previous calls, we define our revenue retention rate as revenue from clients as of the beginning of the year divided by the revenue for those same clients as of the end of the year. Our goal is a retention rate at or above 100%.

For the calculation of the retention rate we historically have included operational backlog similar to our MRR calculation. However, for the fourth quarter and [prospectfully] we will not include backlog in the calculation of retention rate. We believe this is a more direct measure of revenue retention.

Pursuant to this new calculation revenue retention for fiscal year 2017 was 98%. As a point of reference, the revenue retention rate as now calculated was 102% in Q1 and 101% in both the second and third quarters of fiscal 2017. We have disclosed the revised calculations for fiscal 2016 and fiscal 2015 in our Form 10-K that will be filed later today.

Gross margin improved to 55.8% of revenue during the quarter, a 450 basis point increase compared to the fourth quarter of fiscal 2016 and a 240 basis point increase sequentially. This improvement in margin was primarily related to strong revenue growth and efficiencies as we continue to leverage our global service delivery model.

Operating expenses were 57.6% of revenue, down from 65.9% in the fourth quarter of last year, an 830 basis point improvement.

With this quarter's earnings release, and as we committed on previous calls, we are reporting operating expenses using classifications more closely aligned with our peers. We reclassified certain expenses previously included in general and administrative into research and development and sales and marketing.

The two largest reclassifications related to the allocation of IT facilities to R&D and sales and marketing, as well as moving product management related expenses to R&D. The effect of these reclassifications on historical periods is included in our earnings release. Additional details are included in our Form 10-K.

Now let me break down operational expenses by category.

Research and development expenses were approximately 15.5% of revenue versus 19% in the fourth quarter last year. Maintaining and extending our technology leadership is important to our growth. Over the last two years absolute dollar investment in R&D has been consistent as we leverage our global footprint to increase our development capacities.

Our sales and marketing expenses declined to 27.6% of revenue in the current quarter from 30.6% of revenue in the fourth quarter last year on solid revenue growth and a decline in sales momentum. In the first half of fiscal 2018 we expect to increase our investments in people and initiatives to accelerate sales to new and existing clients.

General and administrative expenses in the fourth quarter were 14.5% of revenue versus 16.3% of revenue in the fourth quarter last year. In FY18 we do not expect meaningful scale in G&A as a percentage of revenue as we make strategic investments in systems to support the overall growth of the Company.

Our fourth-quarter non-GAAP net loss narrowed to $1.6 million or $0.02 per share compared to a non-GAAP net loss of $9.2 million or $0.13 per share in the fourth quarter last year.

Weighted average shares outstanding, both basic and fully diluted, were 80.009 million for the fourth quarter.

The Company's adjusted EBITDA in the fourth quarter was $0.8 million versus an adjusted EBITDA loss of $11.1 million in the fourth quarter of last year. This is SecureWorks' first quarter of positive adjusted EBITDA since becoming a public Company. Our expectation, however, is that as we increase spending to regain sales momentum and improve renewal rates the Company may see adjusted EBITDA losses during the first two or three quarters of fiscal 2018.

I will now quickly highlight our profit and loss results for the full year fiscal 2017, again all on a non-GAAP basis.

Total revenue was $430.4 million, an increase of 25.7% compared to fiscal 2016. Full-year revenue growth when normalized for the extra week was 23.1%.

Gross margin was 53.9% and our net operating loss was $26.1 million compared to a net operating loss of $59.2 million in the prior year. Net loss per share was $0.19 for the year based on 77.635 million shares compared to a net loss of $0.62 based on 70 million shares in fiscal 2016.

We have a strong cash position of $116.6 million in cash and cash equivalents as of the end of the quarter. Also we have an untapped $30 million credit facility and no indebtedness. After the end of fiscal 2017 our credit facility was extended on the same terms for an additional year.

Cash flow provided by operations was $11.8 million in the fourth quarter. For the full year we used $6.8 million in operating activities versus a use of $9.8 million in fiscal 2016. Overall cash flow used by operations decreased as our net loss improved, partially offset by the timing of working capital items. We invested $6.9 million in the fourth quarter in capital expenditures to support our growth bringing year-to-date CapEx to $20.2 million.

Now let us turn to the first-quarter and full-year guidance. For the first time we will be providing annual MRR guidance to provide greater visibility to our long-term revenue expectations. Our guidance reflects the impact on MRR from the investments we are making throughout the Company in FY18 but especially in sales and marketing.

In this context, and based on the Company's performance through the end of the fourth quarter, the items we have highlighted on this call and current market conditions we expect the following results: for the first quarter revenue on both a GAAP and non-GAAP basis to be in the range of $110 million to $111 million; net loss per share to be in the range of $0.14 to $0.15; and non-GAAP net loss per share to be in the range of $0.05 to $0.06.

The Company expects approximately 80.075 million weighted average shares outstanding during the first quarter of fiscal 2018. And for fiscal 2018 we now expect revenue on a GAAP basis to be in the range of $457 million to $463 million and $458 million to $464 million on a non-GAAP basis; net loss per share to be in the range of $0.52 to $0.56 and non-GAAP net loss per share to be in the range of $0.18 to $0.22; net loss to be in the range of $42 million to $45 million and adjusted EBITDA loss to be in the range of $12 million to $17 million.

We also expect 80.349 million weighted average shares outstanding during the fiscal year 2018. We expect capital expenditures to be approximately $18 million to $20 million for the full fiscal 2018; monthly recurring revenue to be in the range of $34.4 million to $36.4 million at the end of the fourth quarter of fiscal 2018. From a cash flow perspective, in the fourth quarter of fiscal 2018 we expect to receive approximately $25 million for the utilization by Dell of our tax attributes.

To wrap up, the fourth quarter capped a solid fiscal 2017. We expanded our client base, increased per client revenues, expanded our margins and narrowed our net loss. We start each day with one goal: help protect our clients. We are confident our dedication and focus on our current and future clients will be the key to our continued success.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Sterling Auty, JPMorgan.

Sterling Auty - *JPMorgan - Analyst*

I want to make sure that I understand the dynamics in terms of the guidance here for fiscal 2018. Given the guidance for the first quarter, can you give us a sense of how much of this is actually a reflection of the sales changes versus any loss in market share versus any fall off in demand?

Wayne Jackson - *SecureWorks Corporation - CFO*

Sterling, hi, this is Wayne, I will take that. First of all, for Q1 guidance we have to normalize Q4 of 2017. So, and to do that we take the $119 million and do some quick math, you would take out about $9 million of revenue, so you start Q4 at $110 million. So year over year it is about a 10% growth sequentially, it is flat with Q4. So just to level set the math, it is really a reflection of the metric that we have discussed before, the install rate, the revenue retention and new sales coming through the pipeline.

Michael Cote - *SecureWorks Corporation - President & CEO*

Let me try and add though to that, this is Mike, Sterling. Thanks for the question. To answer some of your questions, we don't see any change in demand and feel really good about what is in front of us. We see no change from a market share perspective. And from a competitive perspective, there is competitors that come in and out of the space, but I wouldn't tell you that this is a reflection of anything competitively.

Sterling Auty - *JPMorgan - Analyst*

Okay and then one follow-up question. I thought I heard you say in terms of some of the changes that were made in sales, are you guys reorganizing so that your sales are actually both hunters and farmers rather than kind of splitting? So just maybe help us understand what you are expecting out of the new sales structure.

Michael Cote - *SecureWorks Corporation - President & CEO*

That is correct. Our new enterprise sales structure in North America will be -- they will be hunters and farmers. So they will have accounts that they will create relationships with and, instead of selling them and then moving on from an enterprise perspective, they will look to expand the relationships within those organizations and may take on one or two where they can -- new clients they can add over time.

So they will be -- (inaudible) somewhat still hunters and farmers because they won't just have a small base, but -- because they will continue to look to expand that base of new clients. Does that make sense?

Sterling Auty - *JPMorgan - Analyst*

It does. All right, thank you, guys.

Operator

Saket Kalia, Barclays Capital.

Saket Kalia - *Barclays Capital - Analyst*

Maybe first for you, Wayne, you mentioned the revenue impact of an extra week in the quarter. Can you just level set what the MRR impact was with that extra week just so we can normalize?

Wayne Jackson - *SecureWorks Corporation - CFO*

So, MRR is as of the end of the period. We didn't -- if you think about it, whether it is 13 weeks or 14 weeks it is our installed base, our annual sales contract value as of the end of the 14th week, we didn't normalize that, if you will. Does that make sense?

Saket Kalia - *Barclays Capital - Analyst*

Okay, yes. So it is really just revenue that got the impact, not MRR -- or got the benefit I should say.

Wayne Jackson - *SecureWorks Corporation - CFO*

That is right.

Saket Kalia - *Barclays Capital - Analyst*

Okay. And then for my follow up, it seems like we have got revenue growth slowing into sort of the mid- to high-single-digits next year, slower than the MRR growth that you kind of guided to by the end of the year. It sounds like it is maybe going to be a little bit weak in the first half and we get a little bit of the benefit from some of the sales changes in the second half.

But just to level set, can you talk about how the SRC business might trend next year to help maybe reconcile a little of bit of that -- that disconnect between MRR and revenue growth?

Wayne Jackson - *SecureWorks Corporation - CFO*

Saket, this is Wayne again. First of all to speak about MRR, think in terms of acceleration. As we invest in the sales force and the sales momentum we do see MRR accelerating, the growth accelerating. But again, to remind everyone, our MRR is both installed revenue plus operational backlog. So as the new sales come through, whether we install them or not, as long as we have signed the contracts by the end of the year that would be included in MRR.

Relative to SRC, we see the 80/20 split in revenue being about the same. And we see the -- and we have included in our guidance for MRR the assumptions that our split between SRC and MSS will stay about the same in our sales model as well.

Saket Kalia - *Barclays Capital - Analyst*

Got it. That is helpful. Thanks very much, guys.

Operator

Melissa Gorham, Morgan Stanley.

Melissa Gorham - *Morgan Stanley - Analyst*

I just want to follow up on the sales force changes. Mike, is this sort of still an ongoing exercise or have the changes already been made and now we are just kind of waiting to see the improved sales productivity? Just wondering where we are in this cycle of sales transition.

Michael Cote - *SecureWorks Corporation - President & CEO*

As I mentioned, our new -- first of all, thank you for the question, Melissa. The new Chief Revenue Officer just started roughly 60 days ago and I would say that we have made a lot of the changes that I -- well, almost all the changes I described in my prepared remarks. Part of this will be implementing some of the incremental changes as far as in particular hiring new and more sales force around the world from a growth perspective.

So to answer your question, I would say that we are -- everything that I -- almost everything I discussed has been implemented. And we are probably, from a sales transformation perspective, most of the way to implementation and we are now in the phase of actual production in watching the sales come in.

Melissa Gorham - *Morgan Stanley - Analyst*

Okay. And then just wanting to get a little bit more color on the cross-selling activity in the quarter. I think in previous quarters you talked about maybe a little bit of a lower cross sell I guess adoption than your expectations. I am just wondering if there has been any improvement and what you are seeing in terms of the pipeline.

Wayne Jackson - *SecureWorks Corporation - CFO*

So Melissa, good morning, this is Wayne. I think our revenue retention rate of 98%, again it is down from 102% in Q1 and 101% in the last two quarters. And you will see in our 10-K it was 108% as of the end of last year. I think our revenue retention is reflective of the slowing momentum. We have retained a lot of our clients, but we have not necessarily sold new solutions into those -- new services into those clients. So the sales momentum impacts not only new clients but also our revenue retention.

Michael Cote - *SecureWorks Corporation - President & CEO*

Melissa, this is Mike, a couple things I would add. One is that I think we see a lot of opportunity there. And as we are allocating sales executives to continue -- instead of the transition, to the question Sterling asked earlier, instead of a sales executive for example in the enterprise space selling an account and then we have been transitioning them off. Since we see the cross sales opportunities in those clients they are going to keep those relationships that they worked so hard to develop and have the ability to continue to cross sell into those clients.

So, we see no decrease in demand or opportunities. Quite frankly it is the opposite. I spent time at the annual sales meeting yesterday and through last night. And it was probably the most energized and excited I have seen the sales organization. And the sales training they went through yesterday actually gave the gentleman a standing ovation at the end of the sales call, which I thought was interesting as far as the passion.

And you could clearly -- I could clearly feel them leaning into and taking a much more offensive, aggressive position to what we are looking to do from a sales perspective. So I am excited about the prospects and look forward to the implementation.

Melissa Gorham - *Morgan Stanley - Analyst*

Great, that is helpful color. Thank you very much.

Operator

Jonathan Ho, William Blair.

Jonathan Ho - *William Blair - Analyst*

Just wanted to start out with the MRR calculation. I just wanted to understand if you could just maybe walk through the relationship mathematically between MRR growth and how we should think about revenue growth going forward. Just given the expectations that MRR is going to pick up and that the MRR did slow last quarter, which was maybe potentially an indicator of 2018 revenue a little bit earlier.

Wayne Jackson - *SecureWorks Corporation - CFO*

So good morning, Jonathan, this is Wayne. So if I understand your question it is how are we going to get from $31.6 million to $36.4 million in MRR?

Michael Cote - *SecureWorks Corporation - President & CEO*

No, no, no. His question was how does MRR -- I believe, how does MRR relate to revenue. Mathematically how does the MRR calculation relate to revenue in the future.

Jonathan Ho - *William Blair - Analyst*

Right.

Wayne Jackson - *SecureWorks Corporation - CFO*

Okay, so the math for MRR is we -- as you take our -- which math are we talking about? So it is MRR times 12 divided by 0.8 gives you the forward-looking revenue.

Jonathan Ho - *William Blair - Analyst*

Got it. And then (multiple speakers). But relative to the ability to predict future growth, I mean the MRR last quarter, I believe the growth was 9% and that -- is it fair to say that that would be potentially a better predictor of forward revenue than maybe prior revenue growth?

Wayne Jackson - *SecureWorks Corporation - CFO*

Okay, got it. So let me maybe walk you through historically what our MRR has done over the last three years. The MRR at the end of fiscal 2015 was 28 point -- was $22.7 million, that grew by 26% to $28.6 million at the end of fiscal 2016. And then we saw that growth in MRR, which included both the install base plus the backlog, we saw that flow-through with strong revenue growth in fiscal 2017. And then we went from $28.6 million to $31.6 million.

So we saw -- and then going into fiscal 2018 that is an indicator of slower revenue growth as a point in time. But then as we look out, given that we see a very strong market, we are still very optimistic about the opportunities for us we are forecasting a larger MRR growth by the end of fiscal 2018.

Michael Cote - *SecureWorks Corporation - President & CEO*

I think the point to his question is, it really relates -- it's a leading indicator, as Wayne has walked through, of the recurring revenue nature into the future.

Wayne Jackson - *SecureWorks Corporation - CFO*

Right.

Jonathan Ho - *William Blair - Analyst*

Got it, got it. And just as a quick follow up. When you went through the reclassification process, can you talk a little bit about why you made the decision to reclassify now? And just kind of walk-through what the implications here are from a spending perspective in terms of each of those lines.

Wayne Jackson - *SecureWorks Corporation - CFO*

Okay, so the reclassification was really -- this conversation goes back several quarters. It is really how do we compare to our peers from a sales and marketing, R&D and G&A perspective. As we did the carve-outs from Dell, which has different classifications for their P&L, for their financial statements versus our industry, the first thing we did was break out sales and marketing -- break out SG&A from R&D. And then we broke out sales and marketing.

And then as this year went by we began to capture at a more detailed level and do benchmarking to see how our peers treated the things that I discussed earlier that we reclassified, product management, IT facilities allocations, etc. So it is really to have more clarity compared to our peers.

You will see both in the earnings release and in our 10-K a very detailed analysis of how we move the cost between the categories. We want to make sure everyone -- we are very transparent on what we did and how we did it. And relative to why in the fourth quarter, it is the end of our fiscal year. We restated all quarters in the 10-K, or in the press release, so you will be able to see it for all the historical quarters. And going forward we won't need to restate the fiscal 2016 quarters.

Jonathan Ho - *William Blair - Analyst*

Great, thank you.

Operator

Fatima Boolani, UBS.

Fatima Boolani - *UBS - Analyst*

A quick one for Mike. Mike, I was wondering if you could shed light on spending behavior or spending patterns from a vertical standpoint? I know you have sort of a larger presence and footprint within the financial services vertical. So I am curious if there is any patterns or changes you are seeing there and what the outlook looks like for the rest of this year. And a quick follow-up for Wayne, if I may.

Michael Cote - *SecureWorks Corporation - President & CEO*

So, Fatima, great question and thank you. I would say that what we are seeing is not much different than what we have historically seen where the financial services is clearly a -- meaning what we have seen over the last say 12 to 24 months. The financial services vertical clearly was an early adopter in security and is focusing and pushing on driving incremental security from a spend perspective.

Manufacturing, we are seeing a lot -- I actually mentioned some manufacturing comments and companies or clients in my prepared remarks. The high-tech field and healthcare are continuing to spend.

I think the biggest change I would tell you that I think I have seen in the last six to nine months is a maturing of the industry where buyers are looking to rationalize their spend and to ensure that they get a return on their investment. And understand what is happening from what the value is that the security point product or solution, in our case, is providing them, which I am very excited about. And frankly have got some early indicators of the opportunities that that is leading and bringing to us both through direct and indirect opportunities through some channel partners that have approached us.

So, I think the security industry, from a spend perspective, overall to me I think will be accelerating as we come into this year. And I think that there is just a pause that we have taken as clients and prospects are looking to make sure they are spending it in the right area.

Fatima Boolani - *UBS - Analyst*

That is helpful. Wayne, just a question for you on the deferred revenue. I know it is a little bit lighter than we were looking for. And understand that there was a relatively tough comp in the prior year period. But anything to read into with respect to the deferred revenue growth and specifically the sequential and year-over-year decline in the long-term piece. And that is it for me. Thank you.

Wayne Jackson - *SecureWorks Corporation - CFO*

Hi, Fatima. So deferred revenue in general nothing to read in it. We actually, as we disclose in the K, if you look at our both our accounts receivable and deferred revenue, maybe the relationship isn't what you may have thought it would be given our increased revenues. And part of that is the reason we use MRR as a leading indicator.

Our clients, some prepay, some don't, some pay monthly, some pay quarterly. And at the end of fiscal 2017 we had a very large client who last year had prepaid, this year we actually increased the value of the contract, but we change it from annual to monthly. Again, that is why we use MRR versus AR -- implied billings or BR.

Relative to long-term BR, there is a slight decrease in that amount. And what we are seeing there is some of our -- we still have average length of two years for our contracts. But we have fewer three-, four-, five-year contract -- or four- and five-year contracts. Some of those have fallen off and they are two- to three-year versus the five-year. So a slight decline in some extended contracts.

Fatima Boolani - *UBS - Analyst*

Helpful, thank you very much.

Operator

Tal Liani, Bank of America Merrill Lynch.

Dan Bardis - *BofA Merrill Lynch - Analyst*

Hey, guys, this is [Dan Bardis] on for Tal. Thanks for taking my questions. The first is I just wanted to drill into the decision to take backlog out at the renewal rate. Just wondering what is driving that and could it be related to some clients shifting from an annual contract to monthly?

Wayne Jackson - *SecureWorks Corporation - CFO*

So, Dan, this is Wayne. As we were looking -- first of all, we believe, as I --.

Michael Cote - *SecureWorks Corporation - President & CEO*

The answer to the first to last question is, no, it has nothing to do with clients switching in any way, shape or form from annual to monthly and it was just the one that Wayne had mentioned. So I don't want there to be a sense that there is a large change in that perspective. Sorry, Wayne.

Wayne Jackson - *SecureWorks Corporation - CFO*

That is okay. So relative to revenue retention, it was simply backlog was in there, theoretically you can debate whether backlog should or shouldn't. We wanted a more pristine reflection of our revenue retention. We have backlog in MRR and, similar to reclassifications -- internally we had discussed last quarter whether we should do it in Q3 or Q4, but we decided to do all of this in Q4. Lots of disclosure in the K around all of these metrics, so you will see full disclosure around them and historical impacts.

Michael Cote - *SecureWorks Corporation - President & CEO*

So, Dan, I would just add to that as well -- this is Mike again, and I'm repeating what Wayne said. But effectively revenue retention we took the stance should be revenue that is in our reported financial statements and that is why we are doing the calculation. Quite frankly, that is the similar calculation of what is done in the industry, at least with a lot of the organizations that we have looked at.

MRR is the leading indicator, as Wayne walked through in detail a few moments ago, and is a different calculation which really should include what we have sold but not yet installed or the operational backlog.

Dan Bardis - *BofA Merrill Lynch - Analyst*

Okay, thanks, that's helpful. And then for my follow-up, just wanted to drill into gross margins a little bit more. Impressive this quarter. Was wondering what drove the outperformance. Should we attribute that to scale in Japan and Europe mainly? Or is there any kind of new product success or anything else there that is noteworthy?

And not getting into guidance for gross margins, but the revenue is a little bit weaker than we had expected for first quarter and then next year. So should we expect the revenue downfall to pressure gross margins from this level or should we expect it to kind of keep improving from these levels? Thanks.

Wayne Jackson - *SecureWorks Corporation - CFO*

So thanks for the follow-up. So let's talk -- your first question or first part of your question, one relative to Q4 and the 200 basis point improvement, 210 basis point improvement for the year. It was the same things we had talked about before. It was international scale, it was leveraging our technology, leveraging our global delivery model in SRC, so it was all those things. And that in Q4 same story.

From a flow-through perspective, if you take the whole year, revenues increased $88 million, gross margins increased $55 million. So there was -- from a gross margin percentage that is around 62%. So flow-through was accretive to margin, which makes sense given the overall increase. And then relative to next year our margins -- we will continue to focus on the things I just highlighted, same items as we have talked about before, scale and leverage.

Michael Cote - *SecureWorks Corporation - President & CEO*

This is Mike. If you go back to sort of what Wayne walked people through on the road show back when we were going public almost a year ago now, part of what we talked about was the investments that we had made prior to going public in automation and looking to increase our gross margin over time. And clearly through the last four quarters you can see that come to play.

Dan Bardis - *BofA Merrill Lynch - Analyst*

Okay, great. Thanks, guys.

Operator

Gabriela Borges, Goldman Sachs.

Gabriella Borges - *Goldman Sachs - Analyst*

Mike, maybe just one for you on the MRR number and how that forecasts for the end of the year. I guess -- we appreciate the forecast; I am trying to understand how you derived it and whether you're counting on a function of spending resuming or the sales force change is bearing fruit. Just essentially trying to understand how much visibility you have into what MRR can be exiting the year. Thanks.

Michael Cote - *SecureWorks Corporation - President & CEO*

So, great question. And clearly we have a bottoms up budget with an over allocation across our sales organization around the globe. And we looked at our sales pipeline and the opportunities in front of us and built it up. The further out you go clearly the less, if you will, visibility we have. In the nearer term we have clearly got a lot more visibility.

I guess the other comment I would have would be there is clearly a lot of larger deals that we've been working on for quite a while, some of which we have positive indications. But these are not opportunities on a global scale that are that we would hope we get done in the near-term but are not things that move quickly.

So, I feel cautiously optimistic about both the short- and the long-term opportunities in front of us and energized from the sales meeting I was in yesterday and the changes that we are putting in place.

Gabriella Borges - *Goldman Sachs - Analyst*

That is helpful, thank you. And as a follow up, if I could, at a higher level -- would love to understand how you are thinking about the ability of the business model to drive consistent EBITDA positive and free cash flow positive over the long-term. Maybe you could remind us what your longer-term targets are for EBITDA margins and what you think needs to happen in the business model profile to be able to deliver that consistent leverage. Thank you.

Michael Cote - *SecureWorks Corporation - President & CEO*

Let me -- I will start and then turn it over to Wayne on the question and basically say that we I think have shown the ability to generate positive cash flow as in this quarter in the business from operations. And are looking to create a much larger Company because we believe that scale really matters in this business.

And are doing a lot in the indirect channel area that we talked about actually earlier through the road show perspective that would help us from a leverage on the sales and marketing. We are also clearly seeing leverage from a G&A perspective throughout the prior year and are excited about our future opportunities. I don't know what you would add to that, Wayne.

Wayne Jackson - *SecureWorks Corporation - CFO*

So hi, Gabriella. Wayne here. Relative to our long-term model, let's stay within fiscal 2018. I talked about -- we've talked about we are investing to accelerate sales, G&A relatively flat from an increase perspective or scale perspective based on our forecasted revenue. But that is fiscal 2018, we had over 800 basis points of scale in fiscal 2017.

So as Mike indicated, we know we can get to a positive EBITDA, positive operating income perspective or position. But for fiscal 2018 we are focused on investments, we are excited about the market opportunities. And we will talk about 2019 and beyond at some other point other than to say what I said in my prepared remarks, which is we believe we will exit the quarter with positive EBITDA -- or exit the full fiscal 2018 Q4 with positive EBITDA.

Gabriella Borges - *Goldman Sachs - Analyst*

I appreciate the perspective, thank you.

Operator

Rob Owens, Pacific Crest Securities.

Liz Verity - *Pacific Crest Securities - Analyst*

Hi, this is Liz on for Rob, thanks for taking the question. Just hoping you could maybe comment on, outside of the internal changes to the sales force, what you are seeing in terms of sales cycles and if those are still -- you are still seeing the longer sales cycles relative to historic. And what you are expecting that to -- how you are expecting to trend for 2018. Thanks.

Michael Cote - *SecureWorks Corporation - President & CEO*

So, Liz, this is Mike, thanks for the question. From a sales cycle perspective, let me start with sort of reiterating what I said a moment ago, which is I think that the industry or the buyers from my perspective are maturing and demanding more from security providers, point product providers and/or solution providers and in understanding of the value of what they are providing in their product or solution. In particular I think they are tired of having so many vendors and continuing to get hacked and having issues around it.

So as that slowdown or pause has happened over the last, if you will, six to nine months, I think it has been good for us as we have gotten positioned in a perspective of helping clients and prospects make sense of that. Right now from a sales cycle perspective it feels roughly the same as it has been, and I (technical difficulty) in the last 12 months and I see there being an increase from a demand perspective in opportunities for us.

Our hope is that with our new sales structure we can shorten those sales cycles by being closer to our clients and helping them to work through this, if you will, more quickly as their questions are coming up and I think as they are coming towards the end of the maturity cycle. We have not baked that into our assumptions for fiscal year 2018, but I think, particularly in the enterprise space, we would hope that decisions will begin to be made.

I sort of alluded to a moment ago that there are some larger opportunities we have been chasing for a while that we have positive indications but have not yet worked through the contract negotiations on them. And that is probably the reason why -- that is the reason why I am giving you the indications that I am.

Operator

Matt Hedberg, RBC Capital Markets.

Matt Swanson - *RBC Capital Markets - Analyst*

This is actually Matt Swanson on for Matt, thanks for taking my questions. You have seen a lot of success in the last two quarters out of Europe. Could you just talk a little bit about what is going so well there, whether it is just meeting the market if there is increases from the GDPR or if there is anything from the sales process that you could look to as helpful for the Americas market right now?

Michael Cote - *SecureWorks Corporation - President & CEO*

Matt, this is Mike and great question and thank you very much for it. It actually is -- it's the last part of your question. We installed a new sales leader General Manager in Europe about a year ago who came out of a larger organization and had some experience and has basically been implementing some of the new sales processes and methodologies that I discussed in my prepared remarks similar to what we are going to do across North America in the APJ market.

And we are clearly seeing fruit -- the fruit yielding from those efforts. And I spent some time with him last night and am excited about his opportunities. He has actually made a nice commitment to me for the first quarter of this year. So I am excited about it and it is really I think hopefully a foreshadowing of what we could see across the organization.

Matt Swanson - *RBC Capital Markets - Analyst*

Great, and then if I could ask one more on product. With the Cloud Guardian portfolio, I know there are some new capabilities that came out during the quarter. Could you just talk a little bit about what you are seeing from a demand perspective for those products and I guess how much of a driver it could be in the coming year?

Michael Cote - *SecureWorks Corporation - President & CEO*

We are seeing a lot of -- we are seeing a lot of demand from it and we are spending a lot of time with our sales organization this week training them on how to make sure they respond appropriately as inquiries come up. Because clearly all of our clients are moving in some way, shape or form, or thinking of moving or don't know it, but someone in the organization on the business side has moved to the cloud.

And this is an easy way for them to get a sense of what the best practices are with the playbooks that we have developed using the industry best practices as well as our knowledge of working with the cloud and the incident response engagements we have done to develop playbooks that allow them to see how they map up -- how they map against the cloud with the standards that they are putting in place.

And actually we can force automatically standards that they would like to have in place in the cloud. So it is a good way for us to enter into the environment and are seeing a lot of demand early on. As a matter fact I look forward to being able to potentially talk about it in more depth with the conversion rates we may have from the sales pipeline and the enthusiasm we have around the Company.

Matt Swanson - *RBC Capital Markets - Analyst*

All right, thanks for the time.

Operator

Sterling Auty, JPMorgan.

Sterling Auty - *JPMorgan - Analyst*

Wanted to follow up and try to talk in a little bit more detail around MSS versus the SRC. I know you don't break out in detail, but is there more color you can give, especially when it comes to the 2018 outlook? Just trying to do some rough math. It would seem like the SRC is having a much bigger fall off in terms of growth rate versus MSS. Is that truly the case and what would be the primary factors leading to that?

Wayne Jackson - *SecureWorks Corporation - CFO*

So, Sterling, this is Wayne. Actually our SRC growth is stronger in our forecast than our MSS. Still anticipating around an 80/20 split for the full year, but stronger overall growth but again 20% of the total. So less of an impact than MSS.

Sterling Auty - *JPMorgan - Analyst*

But looking -- anymore detail that you can give us around fiscal 2017, a little bit more granular -- because I guess I'm having a tough time. And maybe it is going all the way back to 2016. Just trying to reconcile are these really moving in lockstep or is there either bigger increases or bigger decreases in any of those time frames?

Michael Cote - *SecureWorks Corporation - President & CEO*

It is within a percentage or 2 each year 80/20 in all --.

Wayne Jackson - *SecureWorks Corporation - CFO*

Right for revenue --.

Michael Cote - *SecureWorks Corporation - President & CEO*

For revenue.

Wayne Jackson - *SecureWorks Corporation - CFO*

That is correct.

Michael Cote - *SecureWorks Corporation - President & CEO*

But SRC is clearly a smaller number. So from a percentage growth it is growing faster.

Rebecca Gardy - *SecureWorks Corporation - Head of IR*

Sterling, this is Rebecca, Head of Investor Relations. We can certainly kind of walk you through that off-line. I am afraid we are out of time on the call. But we would be happy to follow up with you.

Sterling Auty - *JPMorgan - Analyst*

No worries. Thank you much. I appreciate it.

Rebecca Gardy - *SecureWorks Corporation - Head of IR*

Thank you all for all of your questions. That is all the time we have for today, as I mentioned. Thank you for joining us.

Wayne Jackson - *SecureWorks Corporation - CFO*

Thanks, everyone

Michael Cote - *SecureWorks Corporation - President & CEO*

Thank you.

Operator

This concludes today's conference call. You may disconnect at this time.