RingCentral

Will Wong, RingCentral, Inc. – Vice President, Investor Relations

Thank you. Good afternoon and welcome to RingCentral's third quarter 2023 earnings conference call. Joining me today are Tarek Robbiati, CEO, Vlad Shmunis, Founder and Executive Chairman, and Sonalee Parekh, CFO. Our format today will include prepared remarks by Tarek, Vlad, and Sonalee, followed by Q&A.

We also have a slide presentation available on our investor relations website that will coincide with today's call, which you can find under the Financial Results section at ir.ringcentral.com.

Some of our discussion and responses to your questions will contain forward-looking statements regarding the Company's business operations, financial performance, and outlook. These statements are subject to risks and uncertainties, some of which are beyond our control, and are not guarantees of future performance. Actual results may differ materially from our forward-looking statements and we undertake no obligation to update these statements after this call. For a complete discussion of the risks and uncertainties related to our business, please refer to the information contained in our filings with the Securities and Exchange Commission, as well as today's earnings release.

Unless otherwise indicated, all measures that follow are non-GAAP with year-over-year comparisons. A reconciliation of all GAAP to non-GAAP results is provided with our earnings release and in the slide deck. For certain forward-looking guidance, a reconciliation of the non-GAAP financial guidance to the corresponding GAAP measure is not available as discussed in detail in the slide deck posted on our Investor Relations website.

With that, I'll now turn the call over to Tarek.

Tarek Robbiati, RingCentral, Inc. – Chief Executive Officer

Good afternoon. I'm excited to be on my first earnings call as RingCentral's CEO. We had a good quarter, as we exceeded our guidance across our revenue and operating profit metrics.

Sonalee will provide more financial details shortly, but the key takeaway is that RingCentral continues to win and innovate in a competitive market.

We win because we have an industry leading product that is mission critical to many customers. In particular, within the SMB, mid-market and consumer facing verticals, RingCentral is the de facto choice for many businesses given our leading reliability, product integrations, and commitment to innovation. This theme was apparent throughout the many conversations I've had with customers and partners since I took on the CEO role in August. It is also why I am optimistic about our goal of driving sustainable, profitable growth.

As CEO, I will be focused on delivering a plan to help us realize that goal. Today I'd like to share a few of my initial observations as well as areas I will be targeting to unlock growth opportunities and drive increased productivity and profits.

First, regarding my initial observations about our business operations.

As I alluded to earlier, RingCentral is an innovation leader. Vlad and the R&D team have been busy over the last few years building out an AI platform that we are now leveraging to infuse AI across our entire portfolio.

Combined with our UCaaS leadership built over the past 20 years, we are now transforming into an AI-first, multi-product company with proprietary offerings in UCaaS, CCaaS, Conversation Intelligence, Sales Analytics and Events, Webinars and Meetings. Vlad will discuss in more detail our recent product developments and focus areas going forward.

Additionally, Sonalee and her team have done a great job of delivering increased profitability. In 2023, our operating profit dollars have increased over 70% year to date, through actions such as more disciplined spending, reducing organizational spans and layers, consolidating vendors, and driving down customer acquisition and retention costs.

The key takeaway is that we are doing many things well, and RingCentral's foundation is strong. I believe we can build on that foundation to unlock further growth and productivity.

Moving forward, I will be focused on a few areas to deliver on this potential. They include:

1. Continuing to innovate and build a multi-product business
2. Focusing more deeply on customer segments and key verticals
3. Expanding partnerships
4. Growing internationally, and
5. Increasing operational productivity

First, let me share with you on a high level our plan to build a multi-product business.

RingCX, our RingSense AI platform, and RingCentral Events are starting to gain strong traction, as they are a natural extension of our core. For example, a Fortune 500 company partnered with RingCentral this quarter to solve a critical internal communications use-case for its employees that involved the purchase of over 25 thousand MVP and one thousand RingCX licenses. Using a combination of RingCentral MVP and RingCX, we were able to help them reliably connect drivers with dispatchers, while integrating seamlessly into their other technology workflows.

RingCX is just one example of a new product we've recently introduced. Going forward, we will be focused on continuing to invest in our new products as well as their related go-to-market rollouts to ensure they will be successful.

In addition to these new products attracting new customers, they will also provide an opportunity to expand our footprint within existing customers. Our net retention, at roughly 100% today, is below where I think it can be, particularly because we now have more to sell. Additionally, new products also create more stickiness, as the more a customer adopts our differentiated offerings, the more likely they will remain a customer.

Second, regarding developing a deeper focus on customer segmentation and key verticals. One area I am investing more in is the SMB and mid-market, which was 57% of our business in Q3. These cohorts have traditionally been underserved by larger vendors, and thus are not encumbered by the bundling dynamics that may influence larger customers' decisions. Also, within this market, voice remains the primary method of communication for these businesses, and they pick RingCentral given our clear leadership in cloud voice. By driving incremental focus on the SMB and mid-market, it provides us with a significant opportunity to sell our full suite of communications tools.

We have also seen good progress in key verticals such as healthcare, education, financial and professional services and public sector. For example, the top four dental service organizations run on RingCentral. Thousands of other healthcare organizations have also selected us for our proven reliability, deep integrations and commitment to innovation. This quarter, Boston Medical Center Health System, the largest safety-net hospital and busiest trauma center in New England, selected RingCentral to modernize their business communications. With RingCentral's joint UCaaS and CCaaS offering, Boston Medical Center Health System will have one integrated voice platform for both internal and external communications, which should improve their provider and patient experiences.

There is more we can do to capitalize on our success in these gold verticals. One way is by tailoring our solutions even more in both the Enterprise and SMB/Middle Market. For example, we continue to invest in attaining certain government certifications for the public sector, and are developing other specific integrations and go to market strategies for industries for which voice is mission critical.

There are also many ways we can bifurcate the Enterprise segment with a specific GTM motion to better address customer needs. For example, for enterprise customers with a Teams deployment, we can sell RingCentral for Teams 2.0. This motion allows us to provide voice functionality and potentially attach other products such as Contact Center to our offerings.

Now, moving to partnerships. Our current partnerships with global service providers such as AT&T, BT, Telus and Vodafone, and strategic partners NICE, Avaya and Mitel-Unify, provide us with the broadest reach in the industry and are a key differentiator. We will also focus on other partnership opportunities that expand our partnership ecosystem, including new relationships with other services partners and ISVs, that can help us expand our reach. More to come on this in further quarters.

Moving to geographic expansion. International has remained roughly 10% of our business for the last two years. It has the potential to be much higher. I'm focused on how we can leverage our distribution channels and partner network to grow outside of the U.S., with a particular focus on Europe, where we have go-to-market operations and several partner and GSP relationships.

Last but by far not least is my focus on materially increasing productivity. One area that is high on my radar is stock-based compensation. We are fully committed to and are taking tangible steps already towards materially reducing stock based compensation.

Another key area for me is sales and marketing expense. We have seen sales and marketing spend increase only 2% year to date, while subscription revenue has grown 12%. However, as a percent of revenue, this is still above where I think it should be in the current environment.

I am reviewing our go to market motions, both before, during and after the sale, to ensure that the cost of acquiring and maintaining a customer is optimized. I realize that while some costs such as residuals have a longer tail, there are opportunities to better align our sales and marketing investments to the value they create.

There has been some good early traction with initiatives such as our new channel program, Ignite that is aimed at reducing dependence of resellers on RingCentral's own salesforce. This has direct impact on improving overall productivity and lowering sales and marketing costs.

We are now taking an additional step to adjust and optimize our cost structure, reallocating resources across the company and routes to market over the next few months as we operationalize these productivity initiatives.

I hope my initial observations and focus areas are helpful to you in understanding RingCentral's key differentiators as well as opportunities for advancement. While the macro has had an impact on our business, there are also areas that are in our control and that we can enhance. There's a clear plan, and we must now execute on these priorities. I believe the combination of our solid core, strong team and exciting and disruptive new products positions us well for the future.

I also want to take this opportunity to thank everyone at RingCentral for delivering a solid Q3.

With that I want to turn the call over to Vlad, who will discuss in more detail one of the key pillars of our plan: innovation and new products.

Vlad Shmunis, RingCentral, Inc. – Founder, Executive Chairman
Thanks Tarek. As I've said before, AI, the mother of all megatrends, is upon us. With Tarek on board, I can now work even more closely with our product teams to ensure RingCentral remains an industry leader in this new era. My day to day focus is now to infuse AI across our entire portfolio to improve caller, employee and customer service agent experiences, before, during and after each interaction. Our vision and commitment is to be the AI-first business communications leader.

We have made good progress towards this vision with the launch of our RingSense AI platform earlier this year. We have rapidly innovated to infuse RingSense AI into all our products. This includes our native, AI-first, omni-channel contact center platform, RingCX, our Conversation Intelligence platform, RingSense and RingSense for Sales, and Hopin, which we acquired in July and are rebranding as RingCentral Events.

RingCX and RingCentral Events will be joining RingCentral's industry leading Cloud PBX MVP solution, RingCentral Contact Center, RingCentral Video Meetings and Webinars, and RingSense for Sales, thus turning RingCentral into a true multi-product, AI-first company.
Let me give you some more detail about the progress we are making on some of these new products.

First, RingCX, which is now in controlled availability and is expected to be generally available later this quarter. In Q3, we embedded our RingSense AI and other technologies into RingCX to enable smarter conversations before, during and after each interaction.

In addition to being AI-first, RingCX adheres to our core brand values of trust, reliability, openness and ease of deployment, use and ownership. RingCX deployments are measured in days or short weeks and not months or quarters. To be clear, RingCX is not strictly limited to the SMB and mid-market. In fact, there are also larger customers whose particular use cases line up well with what RingCX has to offer. This includes a one thousand plus seat win from a Fortune 500 company that Tarek mentioned earlier. RingCX is a good complement to our RingCentral Contact Center offering, that is generally aimed at more complex use cases and larger deployments. While still in controlled availability, we already have approximately 50 customers who have selected RingCX.

In addition to RingCX, we are also working hard at reintroducing Hopin Events as RingCentral Events. This product already powers some of the world's most recognizable brands' internal and external events. This includes Spotify, Reddit and many other of the world's most recognizable names.

We will be providing more detail on both RingCX and RingCentral Events at our upcoming RingCentral Innovation Event that will take place on November 14th. It will of course be hosted on our very own RingCentral Events. We hope you can join virtually to learn more about our latest innovations as well as hear directly from customers about how they are benefiting from these products.

In conclusion, never before has RingCentral had such an extensive and fully built-out product portfolio. We are making great progress in embedding AI into the entire portfolio, creating even more value for our customers. I could not be more excited about our future. With that, let me turn the call over to Sonalee.

Sonalee Parekh, RingCentral, Inc. – Chief Financial Officer

Thanks Vlad. I'll now provide highlights from the third quarter, and then discuss our business outlook for the fourth quarter and full year.

Subscriptions revenue of $531 million was up 10% year over year and above our guidance range. ARR of $2.26 billion was up 11% versus last year. On a year over year basis, currency was a modest tailwind, but on a sequential basis, currency was a roughly $10 million headwind.

Growth was led by the enterprise segment, where we continue to see strong contact center attach rates. We again saw more than 60% of our large, million dollar plus TCV deals include both UCaaS and CCaaS, including a recent UC+CC win with the San Francisco Giants.

Now, moving to profitability. I'll be referring to non-GAAP results, unless otherwise noted.

Our subscription gross margin was 82%, consistent with last quarter. Overall ARPU was again above $30. Our new products - while disruptive in pricing relative to the market - should be accretive to our overall ARPU over time. Our solid ARPU supports our strong gross margin.

Operating margin rose 560 basis points versus last year to 19.1%, driven by operating leverage and continued efficiencies. Our third quarter operating margin was solidly above our outlook for 18.0% to 18.5%. While we invested back into the business to support our new products, primarily through sales and marketing initiatives, we were able to drive increased productivity from our current workforce instead of hiring additional headcount, which resulted in savings that flowed through to the bottom line.

Our increasing profitability translated into quarterly unlevered, adjusted free cash flow of $87 million, up from $33 million in Q3'22.

Moving to our balance sheet.

In August, we issued $400 million of 8.5% senior unsecured notes due in 2030. We used $154 million from this issuance to repurchase $166 million in debt, consisting of $125 million of our 2025 convertible notes and $41 million of our 2026 convertible notes. Including this transaction, we have used approximately $546 million of cash from our Term Loan A, the unsecured notes due in 2030 and our balance sheet to repurchase $586 million of the original $1 billion of 2025 notes, capturing a sizable discount.

Since I joined RingCentral last year, I have noted that addressing the 2025 convertible notes before they go current was a key priority.

We plan to utilize the remaining approximately $240 million of proceeds from our recent high yield offering, plus an additional commitment to our Term Loan A of $75 million, which we will have the option to draw upon within the next 9 months, and a portion of the free cash flow we expect to generate over the next fifteen months, to address the remaining $414 million of the 2025 notes.

Importantly, as the 2025 notes carry a 0% percent coupon and we are earning a solid return on our cash, we will remain disciplined and will balance note repurchase prior to maturity with the amount of discount we are able to capture.

In addition to addressing the upcoming 2025 convert, our leverage remains very healthy. Based on our third quarter results, our trailing twelve months net leverage ratio is 3x, and based on our current outlook we continue to expect to be below 3x in 4Q.

Before I provide our fourth quarter and full year guidance, I'd like to provide you with additional details on the macro trends we are seeing in the market today.

Macro trends are largely consistent with last quarter. Sales cycles remain elevated versus last year, and customer buying decisions continue to go through additional layers of approval. Linearity has also become more back-end loaded, and in many enterprise transactions, including this quarter, we have seen customers waiting until the last week or two of the quarter to close on deals.

We are also seeing less upsell within our existing base as customers have slowed hiring and rationalized their employee counts. Importantly, marketing driven lead flow remains consistently strong, demonstrating continued demand for on prem to cloud conversion.

With that backdrop, let me now turn to guidance.

For the fourth quarter of 2023, we expect:

- Subscriptions revenue growth of 8-9%
- Total revenue growth of 8-9%
- Non-GAAP operating margin of 20%, and
- Non-GAAP EPS of $0.82 to $0.83.

For the full year 2023, despite the incremental currency headwind, we are raising our revenue and operating margin outlook. We now expect:

- Subscriptions revenue growth of 11%,
- Total revenue growth of 11%
- Non-GAAP operating margin of 19.0%. This is up 660 basis points versus last year, and 25 basis points above the midpoint of our prior outlook.
- Lastly, we expect Non-GAAP EPS of $3.19 to $3.20.

Additionally, given our better-than-expected profitability as well as cash conversion in Q3, primarily driven by better working capital management, we now expect adjusted, unlevered free cash flow of $290 to $300 million in 2023, up from $270 to $290 million previously. Note this excludes $20-25 million related to restructuring and other payments that we have or expect to incur.

Lastly, we expect stock-based compensation of $426 to $431 million in 2023, or approximately 19.5% of revenue. While this is higher than our prior guidance, this is related to the recent management changes that we undertook in August. Additionally, we put in place Performance Stock Units this year to demonstrate alignment between management incentives and company performance. These PSUs are accounted for under an accelerated expense attribution model compared to Restricted Stock Units and thus resulted in higher stock-based compensation in 2023 versus our prior outlook. We would have been at the midpoint of our prior range excluding these items.

As Tarek stated, materially reducing stock-based compensation going forward is a key priority and we are implementing actions to materially reduce stock-based compensation over the next 12-months. We will share more on these actions and targets next quarter.

In summary, Q3 was a good quarter. We delivered on our guidance, we continued to invest for growth, and we demonstrated a proactive capital allocation approach. While the economic environment remains uncertain, we will remain focused and committed to executing against our priorities of delivering sustainable growth and profitability.

With that, let’s open the call for questions.