

## **SUSE**

Q1 FY23 Results

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Transcript

**Speakers:**

Melissa Di Donato

Andy Myers

Jonathan Atack

Jonathan Atack

Thank you, Operator. Good morning and good afternoon to you all, and welcome to our presentation of SUSE's results for the first quarter of the 2023 financial year. I'm Jonathan Atack, Head of Investor Relations at SUSE. I will shortly hand over to our CEO, Melissa Di Donato, and our CFO, Andy Myers, who are going to take you through a few prepared remarks before we move to Q&A.

Before I do that, can I remind you of the disclaimer on page two of the presentation, which contains important notices on the information provided in the following presentation. Melissa, over to you.

Melissa Di Donato

Thank you, Jonathan, and hello, everybody. Today, I am pleased to share the details of SUSE's first quarter performance in the 2023 financial year. We've made a strong start to the year, demonstrating the value of the mission criticality of the subscription software in what we call right now a macroeconomic environment that continues to be challenging.

During Q1, we made important changes to our sales structure and launched Rancher Prime, which together will support our continued growth. Before I present our financial highlights, let me start with a reminder of the structural strengths that make our business model so resilient.

The results we're reporting today again demonstrate our ability to deliver high revenue growth, high profit margins and high cash conversion. We operate in a rapidly growing market, driven by global mega-trends, delivering infrastructure software solutions for our customers. We have a strong business model built on subscription revenue and a diversified enterprise customer base. I am confident that this will continue to underpin sustainable growth well into the future. Let's now move on to our financial highlights.

In Q1 FY23 SUSE delivered strong and solid revenue growth, strong margins and high cash conversion in the first quarter, enabling us to reiterate our full-year guidance. We're reporting a 9% growth in Adjusted Revenue, which was 10% at constant currency. Our Adjusted EBITDA margin was very strong, at 40%, during a period in which we continued to increase our R&D spend, retaining our commitment to product innovation and our commitment to first-class technical support.

ACV was up 2% for the quarter, and up 5% at constant currency, largely reflecting the available renewable pool. More importantly, total ARR of \$655 million was up 11%, demonstrating the continued strength of SUSE's subscription-based business, and underpinning our future

revenue growth. Finally, we delivered strong unlevered free cash flow of \$74 million, equivalent to a conversion rate of 110%.

Let's now spend some time on our key operational headlines for the quarter. We continue to develop our business to capitalise on the growth in our markets and maintain our competitive edge. In Q1, we delivered innovative new products and implemented our new sales structure, which we described with our Q4 results.

We made further progress in developing our Rancher business following the launch of Rancher Prime in December, driving higher sales in Q1, underpinned by increased adoption, with cross-selling and further improved customer support. Earlier in March, we launched Rancher Government Carbide, which delivers cutting-edge capabilities to support the US government's federal compliance requirements.

In Edge-related developments, we launched our Adaptive Telco Infrastructure Platform, a telco optimised solution that enables telco companies to accelerate and future-proof modernisation of their networks. This development was in close collaboration with the leading European operators, such as Deutsche Telekom, Orange, Telecom Italia, Telefonica and others.

As announced with our Q4 results, we simplified and we refocused our sales organisation at the start of Q1. This now comprises four sales teams, including a newly created specialised sales force dedicated to acquiring new Emerging customers, and a renewed focus on our largest existing customers through our Customers for Life team. The new organisation is building momentum, underpinning growth in the quarters and the years ahead and enabling efficiency gains across our company.

Finally, we are maintaining our disciplined approach to costs while continuing to invest in our future. In Q1, we continued to expand our R&D functions, with a focus on product innovation and first-class technical product support. SUSE's markets continued to expand, driven by global mega-trends, and our competitive position and continued investments ensure that we are well placed to capitalise on this growth.

Now let me talk you through some of the key deals we secured in the quarter. Q1 was another quarter in which SUSE signed important deals with new and existing customers. This short, small selection of deals highlights SUSE's continued leadership in the SAP market, supported by our vast experience and close partnership with SAP, and

the early momentum that we've already gained with Rancher Prime.

First, a global leader in agriculture and construction machinery reiterated their trust in SUSE to support their SAP applications with a significant and large renewal. Second, a Swedish telco leader chose Rancher Prime, expanding from free to paid-for usage in a clear demonstration that our adoption-led strategy and approach is working. This deal was underpinned by our longstanding relationship and telco-specific offerings.

Third, one of the largest banks in Latin America renewed a high-value SLES contract to support their ATMs and branches across the country with a custom-build operating system. Finally, a leading investment bank in the US chose Rancher Prime for its flexibility, scalability and ease of implementation, enabling significant automation and efficiency gains. With that, if I can, I'll hand it over to Andy, who will now take you through the details of our financial performance.

Andy Myers

Thanks, Melissa, and good morning, good afternoon to you all. Q1 was another quarter of robust delivery for SUSE, with solid revenue growth in line with expectations, and strong margins, allowing us to reiterate our guidance. We reported Adjusted Revenue growth for the quarter of 9%, and 10% at constant currency.

Q1 ACV was up 2%, and up 5% at constant currency, reflecting the available renewal pool and some deal slippage in the quarter. Group ARR was up 11%, supported by growth in both Core and Emerging ARR. And our net retention rate of 105% demonstrated that our customers continue to renew and grow their subscriptions with us.

Furthermore, we delivered a high Adjusted EBITDA margin of 40% for the quarter as our disciplined investments in the business were more than offset by foreign exchange movements and a significant foreign exchange gain. Excluding these foreign exchange effects, our margin increased year on year. Finally, cash conversion was very high, at 110% for the quarter, including a working capital inflow driven by customer collections from contracts signed late in Q4 and paid in Q1.

I'll now talk you through our KPIs for Q1 in more detail, starting with revenue. Total revenue in the quarter was up 9% to \$169 million and up 10% at constant currency. This comprised Core revenues of \$138 million and Emerging revenue of \$32 million, up 6% and 28% at constant currency respectively.

Our revenue growth has been impacted by the run-off of legacy products and suspension of sales to Russian customers over the past year. Excluding these headwinds, Core revenue was up 7% and Emerging revenue up 38%, both at constant currency.

Group ARR grew to \$655 million, up 11% year on year, driven by a higher ARR from existing customers and by ARR from new customers. Finally, our net retention rate of 105% demonstrates continued growth from existing customers in a challenging macroeconomic environment, including slower cloud growth.

NRR was impacted by around two percentage points by the suspension of sales to Russian customers and the run-off of our legacy products, which we no longer develop or support, except in a few exceptional circumstances. Foreign exchange movements also reduced NRR by around two percentage points. Our weighted average contract duration on a last 12 months basis remained strong at 20 months, flat versus the prior quarter. Let's now turn to our ACV performance.

Group ACV was up 2%, or up 5% constant currency. As you know, this metric can be quite lumpy on a quarterly basis, reflecting the available renewal pool, and Q1's performance also reflected some deal slippage. Core ACV was down 1%, and up 1% on constant currency, and Emerging ACV was up 19%, and up 21% at constant currency.

Core ACV performance was driven by lower renewals, the suspension of sales to Russian customers and challenging market conditions in Greater China, offset by higher sales through cloud service providers. Whilst we continue to see strong growth through our cloud route to market, growth is slower than in prior quarters, reflecting the wider slowdown in the market, which we believe will accelerate again once the macro uncertainty reduces.

Emerging ACV growth was supported by higher renewals. ACV was also impacted by the run-off of SUSE legacy products and the suspension of sales to Russian customers. Excluding these effects, Core ACV was up 2%, and Emerging ACV was up 22% at constant currency.

Our ACV performance by geographies also follows the same trends we see in Core and Emerging ACV. Our performance by route to market included 3% growth in our End User and Cloud ACV, driven by growth in sales through cloud service providers, partially offset by lower renewals. ACV from Independent Hardware Vendors and Embedded customers was down 2%, similar to the prior quarter, driven

by hardware shortages and a shift to selling through other routes to market, primarily through cloud services providers.

Our strong top line performance has allowed us to continue to make disciplined investments, as can be seen on the next slide. Total operating costs decreased 3%, \$89 million in Q1, as investments in people across R&D and G&A functions were more than offset by efficiency gains enabled by our sales force reorganisation, foreign exchange movements and a significant realised foreign exchange gain. At constant currency, cost increased by 2%.

Sales, marketing and operation costs decreased by 2%, as a return to more normal levels of business travel was offset by lower headcount and foreign exchange movements.

R&D costs increased by 4%, driven by continued investment in R&D functions focused on product innovation and technical support. Our investments have allowed us to make significant new product announcements since the end of FY22, including our adaptable Linux platform, SUSE Edge 2.0, Rancher Prime and ATIP, our telco-optimised edge stack, whilst continuing to improve our customer support.

G&A costs decreased by 11% as investment in G&A functions was more than offset by the realised foreign exchange gain. Adjusted EBITDA grew 28% to \$67 million in Q1, driven by solid revenue growth and lower operating costs, resulting in a margin of 40%, up six percentage points versus the prior year.

Now let's look further at how our profits have been converted to cash. Our cash conversion was a strong 110% in Q1. Change in Deferred Revenue, which is a lumpy metric on a quarterly basis, was \$2.5 million. The quarter included a couple of multi-year contracts with annual payment terms, which will drive future cash flow. These contracts have driven a 49% year-on-year increase in our Remaining Performance Obligation, which represents committed business that'll be invoiced in future.

The Change in Deferred Revenue led to an Adjusted cash EBITDA of \$70 million. Q1 Adjusted unlevered free cash flow was \$74 million, up 65%, representing conversion of 110%. This was primarily caused by a working capital inflow related to the contracts signed late in Q4 and paid in Q1. Note that our full-year guidance for cash conversion remains in excess of 80%.

Capex, commissions paid and leases paid were broadly in line with the prior year. Cash taxes were down 46%, related to the timing of tax payments.

A strong cash flow supported our continued deleveraging. Our net debt at the end of the quarter was \$535 million, a reduction of \$154 million versus the prior year. As a result, our leverage ratio was two, significantly lower than the prior year at 2.6, and well within our commitment to keep this ratio within 3.5.

Let's now move on and look at our last 12 months KPIs, which demonstrate the robustness and stability of our business model. These charts show our key metrics on a last 12 months basis, highlighting our consistent performance and strong track record.

ACV, ARR and revenue on an LTM basis are all higher in Q1. NRR remained solid at 105% and within SUSE's normal historic trading range, after adjusting for the suspension of sales to Russian customers, the run-off of legacy products and foreign exchange movements.

Moving now to our guidance for FY23 and beyond. Given our strong performance in Q1, as we continued to deliver solid revenue growth, high margins and high cash conversion, we are pleased to reiterate our full-year and mid-term guidance.

As we mentioned at Q4, and driven by a number of initiatives, including the restructuring of our sales force and launch of Rancher Prime, we expect delivery of our revenue guidance to be more weighted towards the second half of the year. With this, I'll now hand you back to Melissa.

Melissa Di Donato

Thank you, Andy. Before closing the session, I'd like to emphasise why SUSE remains a robust business. First, we deliver mission-critical infrastructure software in a rapidly growing market. Our subscription-based model and diversified customer base ensures sustainable and recurring earnings over the long term. We've launched Rancher Prime and have been through a significant overhaul of our sales force that will make us more focused and more effective as we move forward.

Economic conditions do, in fact, remain challenging, but given the market opportunities and the actions that we've already taken, we are well placed to maintain and accelerate our growth trajectory. This concludes today's presentation. Thank you all for attending. If I may, I'll now turn it over to the Operator, who will start the Q&A.

Operator

Ladies and gentlemen, at this time, we will begin the question and answer session. Anyone who wishes to ask a question may press star followed by one on their touchtone telephone. If you wish to remove yourself from the question

queue, you may press star followed by two.

In the interests of time, please limit yourself to two questions only. If you're using speaker equipment today, please lift the handset before making your selections. Anyone who has a question may press star followed by one at this time. One moment for the first question, please. Our first question comes from the line of Laura Metayer with Morgan Stanley. Please go ahead.

Laura Metayer

Hi, Melissa and Andy. Thank you for taking my question. So three questions from me, please. Firstly, when you have customers coming from Red Hat or other competitors, what are their typical reasons for switching to SUSE? Secondly, what makes you confident you can achieve your 2023 revenue guidance, given the Q1 ACV growth? And does the revenue growth guidance assume an improvement in the macroeconomic environment throughout the year? And lastly, what was the Q1 Adjusted EBITDA margin excluding the realised FX gains and FX tailwind, please? Thank you.

Melissa Di Donato

Hi there. Sure. So I'll answer the first question, then Andy, perhaps you might want to answer what gives us the confidence in 2023 guidance around revenue and then the Q1 Adjusted EBITDA minus forex. So let me go into the competitive landscape and the typical reasons why we are seeing customers coming to SUSE rather than not.

So what happens in the market today, pretty much since the COVID days, agility and adaptability is really what's winning the hearts and minds and wallet share of our buyers. The one thing that we continue to talk about, and why we were so sought after and why we're confident in our business model, is because our business has always been interoperable. It's always been open, and not just open in the sense that we're open source but open in a way that is interoperable.

So Rancher is adaptable and could be used with any Kubernetes distribution and with any operating system. It doesn't need to sit inside of just a SUSE operating system, as an example. It's a platform that's completely agnostic. The same with NeuVector. NeuVector is our container security platform that sits on top of any Kubernetes distribution as well.

So it could be used on top of any SUSE system but also anything else for that matter. It can work on top of Tanzu or OpenShift or any other container solution. The same goes with our core Linux products. So the biggest reason, the one that we find the most important for our customers, is that interoperability. That's number one.

The second thing is that we are built in a secure and highly available environment. When it comes to security and when it comes to interoperability, when it comes to mission-critical workloads, that's the only area and focus that we've ever had. We don't sit underneath websites or inside of webpages or email systems or anything of the like. It's very much geared toward that high availability, highly complex, mission-critical workload set, and that's also why we see customers migrating over to SUSE.

I think when it comes to SAP, we've had very strong relationships with SAP for many, many years. We've co-developed all of our SLES for SAP solutions together with SAP. So they've been a very important partner with us. And in fact, all of SAP's development runs on SUSE as well, so that is another big reason why SAP customers, as an example, come over to SUSE.

I think the last thing that I'll say, and then I'll hand it to Andy, around typical reasons, is it really revolves around ease of use, particularly around our Emerging products. They were always built to be less complex, less mundane than the other solutions in the market, whoever it may be with and against.

It is really a solution that was meant to be installed relatively quickly, with as little hand-on, deep technical knowledge as possible. And that's one of the reasons, early on, that we had a significant and big spike in the number of usage. In fact, since we acquired Rancher, we've had double the number of users in our community. So it's really substantial.

And the whole approach around that adoption-led strategy has proven, for our whole Emerging base, that the solution sets around NeuVector and Rancher are not just interoperable and open, but they're much easier to use, which means that the time to benefit is much faster. Those are the primary reasons.

Andy, can I had it over to you to talk about our confidence in 2023 revenue guidance as well as the Q1 Adjusted EBITDAs minus the forex?

Andy Myers

Yes, sure. Thanks, Melissa. Hi, Laura. Yes, look, our ACV in Q1, yes, it was impacted by the renewal pool available, and as I said, the up-sell and cross-sell that comes off that. And look, we allowed and we anticipated some impact from our sales force reorganisation. So overall, our ACV in Q1 was broadly where we expected it. We also saw some softening in cloud growth year on year, but still good cloud growth, good revenue growth from the cloud.

As I said, we do expect growth to be weighted to the second half of the year, as noted at Q4. And what's going to drive the growth in the second half is the initiatives we've talked about. It's the reorganisation and the refocusing of our sales force, the launch of Rancher Prime and, as Melissa mentioned, also Carbide for our US federal business, and we have a number of other initiatives that we have taken and are driving that'll lead to acceleration of ACV and revenue acceleration in H2.

No, we haven't implicitly assumed any change in the macroeconomic, whether that be up or whether that be down, although clearly we know it remains relatively volatile. And as I say, our commercial initiatives on top of those big ones are things like some initiatives we have around the cloud, on pricing, and these will culminate in an acceleration of revenues in the second half of the year.

With regard to the margin, if we reverse out the FX impact, our margin is between 37% and 38%, a broadly pretty much 1% improvement over the prior year, and obviously in line with the guidance that we've given for the full year. I hope that answered your question.

Laura Metayer

Thank you.

Operator

The next question comes from the line of Frederic Boulan with Bank of America. Please go ahead.

Frederic Boulan

Hi. Good afternoon, Melissa. Good afternoon, Andy. Maybe, first of all, a follow-up on the previous question around demand environment. If you can maybe give us an update on how things have been evolving post the January close and how we should think about that ACV pick-up. A lot of initiatives from a sales perspective and product perspective, so is this something we should expect to see impacting ACV in the next few quarters?

Last quarter, you mentioned some elongated sales cycles. Maybe if you can give us on this year as well, in terms of specific segments or end markets where you see actually that phenomenon taking place.

And then, lastly, if you can give us an update on Rancher Prime and any feedback on the take-up here, what kind of uptake you're seeing for customers, traditional OS customers actually adopting the product. Thank you very much.

Melissa Di Donato

Sure. Hi, Frederic. So let me talk about Rancher Prime first, since that was the last one, then we'll talk about the demand environment, and then overall cycles in markets. I'll let Andy pipe in as well. So let me talk a little bit about Rancher Prime

and the adoption from free users to paid users.

So as you know, we launched our first version of Rancher Prime in December. It wasn't what I would call a hugely differentiated version. The one that is really beginning that differentiation between free and prime is really coming out only in February, so it was just released last month.

So the first differentiated, paid-for Rancher product, which focused on pretty much additional security and compliance to really motivate customers to upgrade, was launched December, and more momentum is forthcoming. We're guiding at greater than 25% Emerging revenue this year because of the support and uptake of Rancher Prime. Both free adoption and paying customers are both increasing, so that's good news.

I think the other bit about Rancher Prime is that we continue to enhance and deliver a deep technical support, with further improvements around things like customer response times. Customer satisfaction scores have gone up in Q1. All in all, it's really meant to track and deliver and increase adoption in both segments, the adoption of free and paying customers. That's what's going to sustain our long-term growth.

Now, we track adoption of Rancher through a number of different items. One is unique users, and that's a good high-level way to track usage, to calculate an approximate conversion matrix based on the total numbers of paying customers we have against the increase in number of unique and active users.

So in Q1, we're seeing exactly this. We're seeing both adoption of Rancher feeds in our pipeline growing, so paying customers and free users. It ensures that our continued community engagement, that really is an important part of the development of the product, really continues to accelerate, which is important for us.

In Q1, we saw the growth on both sides, adoption and paying customers, and that's really driving our sales and our pipeline, which is going to nicely position us for the future. And Q1 Rancher downloads remained strong, and given that now we have more and more greater visibility to active users, this is what's really continuing to give us comfort around the pipeline development but also the conversion rates improving.

So there's significant development and significant release around security and compliance and functionality that comes in Rancher Prime that we have a high level of

confidence on. So that answers two questions, both the Rancher Prime question as well as the demand question as well.

I think that the sales cycle, nothing has gotten worse and nothing has gotten better, I would say. Things are probably about the same as they were the last time we spoke to you. So when it comes to overall demand, we're in exactly the same position. What I would say is that the demand is getting better. Our conversion rate, again, for the Core products as well as the Rancher products and Emerging products, is getting better. It's improving.

By implementing the reorganisation of our sales team in November, that really helped us to put in place best practices and really top-class enterprise sales procedures, really making it on the high end of the scale around professionalism to selling into the enterprise.

By putting a lot of focus on net new for Rancher, a lot of focus deep in our top 700 customers, that is allowing us to service them in a very different way, thereby increasing our productivity as well as increasing our conversion rate, as well as increasing our efficiencies within sales.

So we need, for Q2 and beyond, less of a pipeline, because we have better conversion rates. But it doesn't change the fact that you can imagine that we still focus on, since the post-January close, what we can do to increase our forecasting accuracy and our pipeline development for the current quarter plus two, even going plus three. And that's been strong.

So things haven't changed. The ACV is going to pick up, as Andy said, the back half of the year, but our pipeline continues to grow. Nothing has changed. Deals just take longer. Everything is going to the CFO now, like they were when we talked to you last time. That's not really improved. It's not gotten worse.

But we remain optimistic and strong with our pipeline development, and our pipeline continues to grow for the year, and our conversion rates continue to have good coverage. So that's what gives us confidence. Andy, anything around, anything else I missed, sales cycles and the markets or anything you want to touch on?

Andy Myers

Yes, no, all I'd say is... Hi, Fred. All I'd say is that, look, as we said, Q1 was impacted by the available pool, and we did anticipate some impact of the sales force bedding in over Q1. We had a number of slipped deals. They were in the mid-single-digit million Dollars, and approximately half of

those have now closed in Q2.

And look, I won't go over in the end, but on top of all the product changes across Prime, Edge, Carbide, etc., look, our sales force have been now focused and have much more focus on our top 700 installed base customers, driving account plans, and ultimately, better sales execution.

Also then on the Emerging side, clearly we've got a huge focus on it. We have a specialised sales force on that. And again, all of that in the sales force leads to improved qualification and leads to better execution, and as Melissa mentioned, better conversion rates. And we have in front of us a solid pipeline to work on.

So I think the culmination of those, and as I said, look, there are a myriad of other actions that we're taking across pricing and across, yes, a number of areas, that we will see impact in the second half of the year on revenue, and we will therefore deliver our FY23 revenue, and we're confident of it.

Frederic Boulan

Okay, thank you very much.

Operator

The next question comes from the line of Charlie Brennan with Jefferies. Please go ahead.

Charlie Brennan

Oh, great. Thanks for taking my questions. I'm going to go with three as well, if I can. Firstly to you, Melissa, you mentioned SAP earlier on. I noticed an announcement from Red Hat about a month ago that some of the SAP internal systems were shifting onto Red Hat. Do you think it's just conservative and prudent to assume that your very high market share with SAP will naturally erode over time?

And then just a couple for you, Andy. There's obviously some one-offs in the Q1 margin performance. Can you help us understand how many of those are likely to reoccur through Q2, Q3 and Q4? And is there any way you can help us out with a full-year margin range?

And then thirdly and lastly, is there anything we should be aware of in terms of changing contract structures? If I look at the RPO, you've got very, very strong growth there. If I look at the contract asset balances, it looks like the non-current proportion is growing faster. It looks like contract duration is going up, but you say it's stable at 20 months. What am I missing in that equation? Thanks.

Melissa Di Donato

Hi, Charlie. So SAP, that's a good one. We absolutely and fundamentally do not believe that the SAP Red Hat announcement will have a material impact on our growth rates of our own, SUSE's, SAP business. We've been a co-

development partner with SAP for the better part of the last 28 years, and continue to do so going forward.

SAP has always been transparent, frankly, about their dual OS vendor strategy. The announcement that you probably saw should not come as a surprise and it should not at all serve as an indication of any decreased opportunities for us. It's not going to increase usage necessarily for Red Hat, and it's not going to decrease opportunities for SUSE.

It's worth noting that there have been various other announcements from SAP and IBM regarding their joint business, as well as RISE, over the last 12 months. And none of them has impacted our business at all, and we continue to dominate and continue to accelerate our market share for SAP.

I would say, as a company, we continue to focus on serving our joint customers in the best possible, most reliable, dependable way. We've accumulated vast amounts of data, knowhow and relationship and partnership around the SUSE products for, like I said, more than 25 years.

We are indisputably, in fact, the leading OS vendor for SAP when it comes to developing new solutions and operating them for our customers successfully, at scale. So there's zero, no learning curve when it comes to the SAP teams and their abilities to work with SUSE as well as the customers.

The new announcement is really restricted, what we could find, to new business for RISE, whereas the SUSE business has always maintained the largest market share for SAP business due to our continuous innovation and quality and all the things that we've talked about so much, reliability, security and everything else.

The new RISE customers represent a very small proportion of the total number of SAP deployments. So we have to look at the bigger picture, and that is that if the announcement is to be a relationship for the small newcoming customers to RISE, which is a very, very small proportion of the total usage, that SUSE is still preferred by SAP customers and SAP, regardless of their deployment landscape.

So we are not, absolutely not looking to erode over time and erode our market share, which has continued to be... The SUSE Linux Enterprise is the leading Linux for SAP HANA, with 85% market share, 100% of market share on SAP Business One for SAP HANA, and 70% of all SAP applications running on Linux run on SUSE. So absolutely not, it is a normal announcement that is not unique, and there's been many of them like that.

So I'll leave it to Andy now to go talk about margin as well as the contractual structures in terms of an RPO and contract asset basis, please, Andy.

Andy Myers

Thanks, Melissa. So I'm just going to ask you just to clarify the last bit of the question, Charlie, but let me just look first at where you were talking about margins for the year. Look, as you know, we guided for in excess of FY22 margins. Yes, that's our guidance. That still is the guidance.

Look, we clearly have a reasonably volatile macro that can cause variability in our ACV but can cause variability in our revenues. And there, I particularly think about cloud and the impact it has on cloud, because a high percentage of the ACV in cloud is an impact on revenue straightaway.

So look, there's that variability that we have, quarter by quarter, but we remained disciplined and have always remained disciplined in our cost control and where we invest. We're continuing to invest for growth in predominantly innovation on the products.

And therefore, with our ability to manage cost and with the growth that we are expecting in a consistent macro situation, we expect to deliver our guidance of in excess of FY22. There will be variability in areas like cloud and also things like retrospective consumption contracts. They can be quite lumpy, and they can cause some lumpiness in our bottom line. So at the moment, we are not providing a range. We're just guiding to the in excess of FY22.

In terms of stability of our 20 months, can you just come back to me with the question again? I wasn't quite clear of the question, Charlie.

Charlie Brennan

Sorry. You've got 50% growth in RPO, which is significantly in excess of the growth of ACV. If I have a look at the contract asset balances, the proportion of contract asset balances related to the non-current elements is growing faster. Those two elements suggest to me that contract duration is getting longer, and yet you're saying contract durations remained at 20 months.

Andy Myers

Charlie, look, the RPO, just for clarification, 50% growth in RPO. RPO does not come in to deferred revenue, and therefore is in RPO, but it's not in the deferred revenue. It doesn't come anywhere in our balance sheet. It is our contract weighted average lengths, only taking account of contracts that have been invoiced and fully paid for.

So whilst our deferred revenue includes those, whilst our weighted average contract includes those, the RPO increase is not anywhere in our weighted average contract,

because it's not been paid for. So that increase you're not going to see in the contract length.

And as you know, the dynamic on contract length is cloud continues to grow, the average in cloud is substantially lower than the 20 months, but we are maintaining that 20 months because, in end user, we are growing the average contract length of our end user.

With regard to the contract asset balance, sorry, I think... Are you referring to the one that actually...? Two seconds. Charlie, just give me two minutes. Let me just have a quick look at something.

Yes, Charlie, I think, look, I stand to be corrected. Apologies. I don't think I've got this wrong. The contract asset balance is the balance of commissions that are deferred into future periods. I need to go and double-double check that, but that's not related to contract length. Hopefully that answers, and if I need to qualify and come back on that, I will do, Charlie.

Charlie Brennan

Fine, thank you.

Operator

The next question comes from the line of Mohammed Moawalla with Goldman Sachs. Please go ahead.

Mohammed Moawalla

Great. Thank you. Afternoon, Melissa, Andy. Two from me. First of all, could you remind us of your exposure to the financial services vertical and if there is any sort of material exposure into the US and regional banks? And how can I view provision for that in your outlook?

And then secondly, just coming back to some of the initiatives around the sales force changes, the specialised sales force, how should we think about the improvement in ACV and revenue growth? Should this become more visible in fiscal 2024?

And lastly, just on the slippage point, what were the specific reasons around the slippage this quarter? Was it just a deferral of sign-off higher up? And what gives you the confidence that the guidance for 23 sufficiently captures that perhaps recurring over the next couple of quarters? Thank you.

Melissa Di Donato

So let me get the first one, and we'll talk about the sales force, we'll talk about slippage, and then I'll let Andy jump in as well. So our exposure to the financial services vertical is something that we don't really have. And I'll let Andy give the equivalent, but we don't have any exposure to US regional banks that would impact our outlook for FY23 at all.

We do have some transactions with some banks underlying

some of the core banking systems, but it's relatively small and it's not necessarily in the US. So we have not done anything in way of mitigating any risks associated with that segment, because it's not a segment that we've invested in or have any significant momentum in. So it doesn't really affect us at all. So that's negligible from an outlook perspective.

Sales force, let me talk about the new org a little bit. So the way that we serviced our customers needed to be updated post-COVID, to be honest, Mohammed. We hadn't really done that, and we hadn't allocated a new way of selling and servicing our customers based on the focus from net new on the Emerging and really continuing to build and accelerate the relationship we have with our top customers. And that's what the new organisation was set up to do.

We announced we were going to do it in Q4. We knew after Q3, it needed to be sped up, and we did the reorg on the second day of November of 2022, which is our Q1. Now, the new organisation is right. It's absolutely the right thing to do. It's building momentum. And we expect delivery and the positive effects of that delivery to happen as early as Q2.

It took us some time. Definitely, the reorg wasn't quick. With Christmas the following month, the end of month two of our quarter, it was a little bit difficult. We didn't get all the comp plans and the territories in the hands of people as fast as perhaps we would normally do, and we had our sales kick-off in early December. So it was a little bit of a lag, and that's also a part of some slippage from Q1 to Q2 for sure. But that's now largely complete.

The changes led to obvious disruption, as you can imagine, but the new structure is really important for us, to give us clear accountability. It allows us to better service our customers and our markets and to add value, not in 24 or 25 but actually in 2023. We're already seeing improved conversion rates as we go into Q2, as well as forecasting that impact successfully on Q3 and Q4. We're really seeing positive results in that regard.

So it's largely done now, and it was disruptive, but that's now past us, and everyone is marching very clearly to a successful Q2, Q3 and Q4. So that specialised sales force was important for us, and it needed to happen eventually. And the best time to do it, obviously, is the first month of the following brand-new year. So that's happened.

Now, slippage, I would say I'll give a couple of comments there and then allow Andy to comment. Yes, the problem with us is that when I look at Q1, something clearly stands

out, and that's that we had a couple of factors that led to a little bit lower growth than what we would have wanted in our Q1. And that really is not just macro and not just the renewal pool but also the sales force reorg.

And when you think about the fact that the sales force was reorged the second of November, and then you had Christmas the following month, with our sales kick-off the first week of December, it just didn't allow us a lot of time for selling in the regions with really clear account and strategy plans for the territories. So it took away from us a good four of five weeks, if not more, of selling.

So we have confidence in Q2 and beyond with the new organisation. And with the slippage that we've addressed, as Andy already commented, the ones from Q4 we've largely already closed in Q1, early in Q1, in fact, and then obviously not having all hands in the right place and in the right chairs in Q1, that's going to allow us to close early on in Q2 the slippage from Q1 because of the sales reorg.

So hopefully, that gives a little bit of insight. Andy, what have I missed in regards to exposures? We've already talked about slippage points and deferrals. Anything that you want to talk about?

Andy Myers

Yes, look, Melissa, I think you hit the nail on the head. Yes, look, we've got no concentration, broad-based customer base, geo and sector, and no concentration around financial services. So that's fine.

Slippages, yes, I'd just say, I'll just reiterate, look, there is ongoing volatility. We saw, in Q3, we were down. We saw, in Q4, we beat expectation. And it's almost like perfect delivery. And in Q2, yes, we did see some slippage. Yes, Melissa has mentioned about the sales force, but we did see some slipped deals. But I would just say, look, we're not seeing lost deals. We're seeing slipped deals. And that was the same as we saw at Q3 in FY22. So no, that's all from me, Melissa.

Mohammed Moawalla

Great. That was super helpful. Thank you.

Operator

The next question comes from the line of Toby Ogg with JP Morgan. Please go ahead.

Toby Ogg

Yes, hiya. Good afternoon, Melissa and Andy. Thanks for the questions. A couple from me. Melissa, perhaps just firstly on the sales force. And I know we've talked about it a lot and there was various things going on there in Q1. Is this all complete now, would you say, on the hiring side, or would you expect to add more sales headcount as we move through the year? And when would you expect the new

sales hires that you've already made to be fully ramped and building pipeline?

And then just on the launch of Rancher Prime. Again, I know we've touched on some of the dynamics in the quarter. But perhaps just on the functionality side, you talked about added security and compliance capabilities there. How should we think about the key functionality enhancements planned for the rest of the year? And is there anything within that, in particular, you think could move the needle on the demand side? Thank you.

Melissa Di Donato

Hi, Toby. Sure. Let me talk about Rancher Prime therefore first. So as you know, the first version of Rancher Prime was launched in December, and that really focused on some security and compliance capabilities. And that's what we really felt was the very first step in driving that, not just community support but adoption of a paid version of Rancher.

More recently, and we can also deliver a full roadmap which is publicly available, but we really focused on a couple of things. Both versions are obviously 100% open source. Both have the full Rancher platform experience. But the support of Rancher free, the support is by the community, whereas Rancher Prime, and this is quite a big difference, is that we have enterprise support.

So we're providing support only to the Rancher Prime version, which really focused around security and compliance, specifically around deploying from a trusted private container registry, which is new functionality. And also with Rancher Prime, we gave access to professional services, included as part of the solution set, during the go-live. And that's been really important functionality for our users.

I think it's not just the services and the support, but it really is around security. When we think about the container solutions and refactoring applications that sit inside of a hybrid cloud solution set, having that interoperable security solution that can straddle on the side of multi-cloud and hybrid cloud solutions is really what's the functionality that's going to be differentiating Rancher from everything else.

The technical support has been a big one in way of one of the benefits of Rancher Prime, and we're going to continue, in a very open way, to communicate the development roadmap as it pertains to Rancher Prime. So December was smaller, first release but smaller, and much more significant since February 14, where we included compliance and security functionality that the core and free solution,

supported by the community, just doesn't have.

The sales force. So the sales force now is predominantly in place and has been in place since all the hiring was completed in Q1. We typically expect to be fully productive within six months, which means that we're going to be developing pipeline and closing deals by the start of Q3, but it doesn't mean that the pipeline didn't exist before the sales reorg. It just means a new set of hands potentially could be touching that organisation and those opportunities.

So by Q3, start of Q3, we'll be fully functioning, closing deals that were generated out of the new sales org from Q1, but we're already now seeing success in the new sales structure even in Q2. We had good pipeline coming out of Q1, a bit of a backlog, I might say.

So what happens is, because we had a slower start in Q1, the backlog picked up pretty quickly from a grandfathering process and that sort of thing. So we expect to see the benefit of that in Q2 and the real productivity hitting in Q3. So the sales force reorg, which is now predominantly done, we wouldn't see any impact on that negatively for the rest of this fiscal year, but picking up real pace significantly in Q3 and Q4.

Toby Ogg

That's great. Thank you so much.

Operator

Today's last question comes from the line of Johannes Schaller with Deutsche Bank. Please go ahead.

Johannes Schaller

Yes, thanks for taking my question. I really only have one follow-up left. Melissa, you alluded to SAP obviously being a very important direct but more so indirect growth driver for you. Maybe walking away from the market share dynamics you already discussed, but can you just talk a little bit about the current demand momentum you're seeing there? Is it fair to assume that maybe the SAP-related projects have seen less slippages than other parts of your portfolio? And how do you look at those projects at the moment?

And then secondly, just if you're thinking about the longevity of that growth driver for you, SAP is already through two years of aggressive cloud transition now, how long will that be a significant tailwind for your growth? How do you think about that in the more medium term? Thank you.

Melissa Di Donato

So the current momentum, are SAP customers less affected by the macroeconomic push, I think that's the question. I can't speak on behalf of SAP. I can't allude to their core business, which we're not necessarily a part of, and I certainly couldn't purport to predict it.

But what I can say is that our customers that are running SLES for SAP or even the SLE version for SAP, that they continue to accelerate usage. And that has not slowed. We have not seen any kind of significant macroeconomic impact.

What we have seen on the SAP side is that not as many customers are moving to the cloud of the big, huge installs. With the macro pressures, a lot of customers are holding as they are and not necessarily making the big moves to the cloud yet.

So we think that actually, we haven't been in the forefront of the real big cloud transition. Yes, it's been two years and there's been a couple of years of RISE, but predominantly, when you look underneath the cover of those customers, it's the smaller, transactional net new customers that are actually making the transition to the cloud.

The big, substantial customers that we've been supporting for the last 20 years and are running their SAP systems globally, the more complex enterprise multi-national customers, are not in the race to run to the cloud that quick. So we actually feel quite optimistic that the opportunity to transition the big SAP installs of our traditional customer base is still forthcoming. We haven't hit that yet. The longevity is forward, not behind by any means.

And we feel that with the end of support coming near in three or four years' time now for SAP with S/4, sorry, with ECC, that S/4 is going to have a bigger uptake, and over the course of the next three to four years for sure. So I think that the opportunities and the momentum that SAP will see in moving to the cloud is ahead of us, and therefore ahead of us for SUSE as well.

So no, I wouldn't... We're getting momentum. SAP is getting momentum in the cloud over the last couple of years. But we still have a way to go to get those very large ECC installs off of on-prem and into a cloud-deployed environment, which traditionally had been always 85% of HANA on SUSE, and we are confident that it will continue to be, with great momentum coming forward.

So no negativity or macros have impacted the usage for us but maybe a slowdown in the transition to the cloud. But usage still contains high, and the opportunity remains ahead of us, not behind.

Johannes Schaller

Operator

That's very helpful. Thank you, Melissa.

There are no further questions at this time. I hand back to Melissa Di Donato for closing comments.

Melissa Di Donato

Thank you very much, everyone, for joining the results of SUSE's Q1 FY23. We hope that we've been able to give insight on our business model, why we are feeling very strong and confident in the outlook for the year as well as previous, from a successful Q1 close. Look forward to speaking to you all in our quarter two in a couple of months' time. Until then, thank you very much for joining and your interest in SUSE. Bye-bye, everybody.