Transcription

SUSE S.A. - Analyst Conference Call Q1 Results 2022

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PRESENTATION

00:03 Operator

Dear ladies and gentlemen, welcome to the conference call of SUSE S.A. At our customer's request, this conference will be recorded. As a reminder, all participants will be in a listen-only mode. After the presentation, there will be an opportunity to ask questions. If any participant has difficulties hearing the conference, please press * followed by 0 on your telephone operator assistance. May I now hand you over to Jonathan Atack, who will lead you through this conference? Please go ahead.

00:30 Jonathan Atack

Thank you, operator. Good morning or afternoon to everybody, and welcome to our presentation of SUSE's results for the first quarter of the 2022 financial year. I'm Jonathan Atack, Head of Investor Relations at SUSE. I will shortly hand you 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 open up the floor 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.

01:05 Melissa Di Donato

Jonathan, thank you very much. And hello, everybody. Good afternoon. Happy St. Patrick's Day today. I'm pleased to speak with you all and to share the details about SUSE's first quarter of the FY22 financial year. It was another strong quarter in delivering our product roadmap and our strategy. I want to particularly highlight that, notwithstanding some challenging conditions in global markets, including the invasion of Ukraine, SUSE remains dedicated to delivering on its ambitious goal strategy. We're delivering innovative open-source, interoperable, mission-critical software to our global customer base. SUSE benefits from a number of mega trends driving the growth of our markets, including the digitalization of the world, and in fact, the increasing shift on going to the cloud. We continue to apply many growth levers and invest in product development, acquisitions, headcount, all to drive future growth. But let's first turn to our Q1 financial performance headlines.

I'm waiting for a moment for the slide to change. It doesn't seem to be going, but I'll go ahead and go forward. SUSE continues to perform well in our first quarter of the 2022 financial year, reporting a strong 16% growth in adjusted revenues, 17% at constant currency, and a 34% adjusted EBITDA margin. ACV grew by 5% in Q1, 8% at constant currency, mainly due to the impact of our multi-year deals signed in the prior periods, therefore already captured last year, and along with the rundown on some legacy products, which Andy will explain in more detail later. As you can see, hopefully, when the slide rolls up here, cash flow remains strong, with a conversion rate of 85%. I am very pleased to reaffirm our full-year 2022 guidance. This is on the back of continued growth in the cloud and our multiple growth levers delivering strong outcomes.

Let's spend some time first on our key operational headlines. To the team and the operator, the slides don't seem to be moving. I'm going to carry on forward but hopefully folks can follow along. Before we get into our Q1 highlights, I'd like to refer to the events in Russia and Ukraine, which are unfolding in front of us every single day. You will already be aware that SUSE is responding to all sanctions and has taken the further step to suspend new sales in Russia. We do indeed very much hope for a swift end to the hostilities in the region. In terms of impact of this on our business, SUSE has very limited direct exposure to the Ukraine and to Russia, with less than $5 million annual contract value sold through a third-party distributor. We actively track and respond to all sanctions as they're issued. And of course, our heartfelt thoughts go out to the millions of people affected by what's going on in the region today.

Turns to our operational highlights from the quarter, allow me to start with our continued investment in growth. We made nearly 200 net new hires in Q1, an increase of almost 10% of our workforce, up from a strong 17% year over year. In a recruitment market that remains, as everyone knows, highly competitive, it is a testament to the opportunity and the culture that SUSE represents. We're able to attract and retain the very best talent necessary to support our growth. As part of that growth, we invest in a 50% boost in our sales development representative team, leading to increased pipeline creation for Q2, and well beyond into our fiscal year.

You might ask about NeuVector. The integration is going well. Our Rancher–NeuVector integrated product plan is on track for a May release, by which time all of SUSE will be able to sell, service, and support the newly enhanced NeuVector product line. In January 2021, previews of the source code and the OSS images were published. The interested parties can view the source code and try our product. In doing so, we were able to turn NeuVector into the industry's very first end-to-end open-source container security platform. It's also worth noting that SUSE published the open-source code just three months after our acquisition. Open sourcing NeuVector not only makes it the technology of choice for open-source communities, but it also provides an even greater level of transparency and assurance to our customers in very and highly regulated industries. Those industries include, but are not limited to, governments and federal customers, as one example. We have an active and growing community, having already seen more than 24,000 downloads of NeuVector and its preview images.

Moving on to our new products, we've seen Harvester. We’ve talked about that last quarter, but it's now been released for production use. It's an open-source, modern HCI – or hyperconverged infrastructure solution – that integrates with SUSE Rancher and is built on the foundation of cloud-native solutions. It is our first brand new product release since SUSE’s acquisition of Rancher Labs.

SUSE Liberty Linux is also now available. It is a new technology and support offering that provides customers with a unified support experience for mixed Linux environments, including CentOS. This mitigates the challenge of managing mixed Linux environments, which can often prove difficult for administrators. Support contracts with multiple vendors are not just costly, but they're also complicated. SUSE Liberty Linux provides the simplicity and the choice that customers want and need without the expense and without vendor lock-in. It continues to strengthen our vendor-neutral, open, and interoperable value proposition. We also want to mention another strong quarter for SUSE Rancher’s government services. As part of North America's excellent quarter, SUSE RGS shows continued growth year over year due to consulting and product expansions.

Before we review customer wins, I'd like to touch upon a few positive developments in one of our cornerstone products, and that's edge. Recent innovation is enabling new edge customers, including Q1 agreement worth more than $1 million in ACV with an international retail giant to provide lightweight Kubernetes in more than 2,000 stores. We're also working on multiple new projects with additional retail, telecom, and automotive companies, among others.

Let's now go into some of the new deals that we've won. We've had a strong quarter, winning customers in all of our product groups, both through cross-selling which supports our high NRR, and also by consistently expanding our presence across industry and markets, and geographies. You can see – if you can see the slide – three examples of Q1 key new business underlying to SUSE’s strong value proposition that reaches to every corner of the world. One of the most prominent us chain stores with thousands of outlets across the country chose SUSE Rancher over competitive offerings for its interoperability, its ease of use, and adaptability from cloud to data center and to the edge. They're also sold on SUSE’s ability to support any future business requirements. The next example is a major public sector institution in Germany, for whom SUSE’s created a stack consisting of SUSE Linux Enterprise and SUSE Rancher, together providing flexibility, adaptability to customers’ response, while providing Kubernetes architecture expertise that has become pivotal in the customer deployment of their new platform. And then lastly, a publicly listed leader in the petrochemical production space in India, they chose SUSE Linux Enterprise for SAP applications for its interoperability, but also for its future-proofed platform, which enhances their scope for innovation.

Allow me, lastly, to move on to talk about our key commitments for FY22 around ESG – as I hope you all know by now, essential not just to me as a passion but also absolutely pivotal and central to SUSE and our business, as we strive for sustainable growth. In Q1, SUSE defined its ESG roadmap for the year, and we started delivering on our key commitments for FY22. They include, first, climate action: the setting of science-based emission targets to limit global warming with a detailed work plan for delivery. Second is around information security, which is strengthening our information security management by implementing processes and protections in accordance with ISO 2700 series. Disclosures: last but not least, publishing our FY22 annual report in January, which includes considerable ESG disclosures. The report is in line with GRI standards and with the EU directives for corporate sustainability reporting. Lastly, around external assessments, where we are evaluating our material ESG performance and the impact it has with the help of an independent rating agency. We will continue to be transparent about our ESG efforts and we were recently listed on the Deutsche Börse ESG visibility hub, providing further transparency on our ESG performance and the impact which it has. We at SUSE are only one of 15 companies that have done so thus far. With this, Andy, I'll hand it over to you to take us through the details of our financial performance.

11:47 Andy Myers

Thanks, Melissa, and good morning and afternoon to you all. We continue to deliver on our strategy in the first quarter of FY22. Large multi-year contracts signed last year led to a lower quarter for ACV growth. We reported a 16% growth in adjusted revenues and 17% on constant currency. Group ARR was 17% year on year and 19% on constant currency, while NRR remained strong at 110%. We've continued to deliver high profitability and cash generation, with a 34% adjusted EBITDA margin and a cash conversion of 85%, allowing us to maintain our leverage at 2.6 times LTM adjusted cash EBITDA, in line with the year-end.

I'll now take you through our KPIs, starting with ACV. Group ACV grew by 5% from the prior year, which was 8% on a constant currency basis. As indicated in our Q4 disclosure, a number of large multi-year contracts were signed in Q1 ’21, which have contributed to the revenues in Q1 ’22 but do not reoccur in ACV. This has led to a lower rate of ACV growth in the quarter across both core and emerging. Core ACV for Q1 was $120 million with a growth of 8% in actual FX rates and 11% on constant currency. The emerging business includes some legacy products, which are being phased out following the Rancher acquisition, and this included one large legacy contract that did not renew in the quarter. This caused a reduction in the reported emerging ACV to $24 million, a year-on-year decline of 9%. Excluding the effects of this discontinued legacy business, growth in emerging ACV was 14%. I would also note that Q1 ‘21 emerging ACV is based on pro forma numbers for Rancher, including their previous December year-end, which benefited from a Q4 peak in sales, typical of many software companies. This created a tough compare for this now Q1, which did not benefit from the year-end sales drive.

If I now look at ACV by region, EMEA ACV growth was impacted by the emerging contract I mentioned, combined with a lower renewal pool due to the impact of multi-year contracts signed in Q1 ‘21. Very strong growth was seen in North America, where there was a larger renewable pool, and Rancher government services continue to grow strongly on a relatively small basis. Following a strong 87% growth in Q4, which saw substantial renewal activity Q1 in Asia-Pacific saw a slight decline year on year. Latin America delivered strong growth of 62%, in line with the prior year growth, as the new sales organization continues to gain traction. End user growth of 5% was primarily driven by growth in the cloud channel, which exceeded 25%, and growth in Rancher government services. IHV in embedded continue to be impacted by hardware shortages. Importantly, we remain committed to our guidance for both core and emerging ACV growth for the full year, given our renewable, our pipeline, the continued cloud growth and our ongoing investments.

Let's now turn to revenue. Total revenue in the quarter was up 16%, to $155 million as the revenues for the quarter included the benefit of the multi-year contract signed in prior years. This strong growth, in line with our guidance for the full year, reflects the ongoing delivery of our strategy, benefiting from the continued migration to the cloud, the growth of our sales force and demand for our products. Core was up 10%, driven by the end user route to market and growth in cloud. Emerging saw 60% growth in Q1 due to the ACV growth in FY21 now converting to revenue and the contribution from Rancher government services. As stated at the time of the FY21 full-year results, we are now moving to one SUSE figure for ARR and NRR, as the customer base is now fully merged, and customers are now purchasing both SUSE and Rancher products. Group ARR reached $574 million in Q1, up 17% year on year and 19% at constant FX, demonstrating the strength and growth of our subscription base. NRR was 110%, broadly the same as last year and the previous quarter, demonstrating a consistent ability to build on and expand existing customer relationships. Our strong revenue performance has allowed us to continue to invest in growth. And you can see that on the next slide.

We continue to have a resilient and high gross margin. We saw a small reduction in Q1 to 92% due to the growth in Rancher government services consulting, which deploys a third-party delivery model. A key factor driving the growth in operating costs, up 39% to $91 million in the quarter, was the increase in headcount, as SUSE invest in additional resources to drive growth in product innovation, customer support, and sales. Headcount grew by almost 200 to 2,242 in Q1, up 17% with the majority of the net new hires in sales and customer care. Sales, marketing, and operating costs increased by 37%. Key drivers were recruitment, an increasing marketing spend, and a gradual return to travel. In Q1 ‘21, we also had a one-off favorable IFRS15 commissioned accrual adjustment resulting from the acquisition of Rancher. Research and development costs increased 23%, primarily due to increased headcount, with some pay award to align to market conditions. General and administration costs increased by 77% to $21 million, of which $4 million came from FX movements. Normalizing for this, the cost increase was 45%. This was driven by investment in headcount to support the business and third-party costs, some of which relate to the impact of being a public company. We delivered adjusted EBITDA of $52 million, with a margin of 34%. This compared to 45% in Q1 ‘21, which was a hind quarter in the context of a full-year margin of 37%, due to the one-off cost credits from the IFRS adjustment, realized FX, as well as a lower travel and marketing cost due to the pandemic. Now let's look further at our high levels of profitability and how our profits have been converted into cash.

The change in deferred revenue was a strong $41 million. This demonstrates our strong sales performance and an increase in our weighted average contract length from 19 to 20 months, securing more revenue for future periods. Adjusted unlevered free cash flow for the quarter was $45 million compared to $39 million in the prior year. This is largely due to the lower trade receivables. Cash conversion was 85% for the quarter versus 64% Q1 ’21, and we fully expect to deliver our full-year guidance.

Now let's move on to look at our LTM KPIs, demonstrating the robustness and stability of our business model. Following the introduction of the LTM ACV quarterly evolution in Q4, we wanted to expand the explanation of our business dynamics to provide a broader profile. Due to both seasonality and the lumpy nature of contract wins, ACV and revenue can be volatile in any given quarter. These LTM charts demonstrate our track record, providing a consistent picture of stable growth over time. Similarly, we have consistently grown our ARR, with an NRR that remains very stable at a high and value-added 110% average, a strong foundational block for our future growth.

Now, let me take you through the confirmation of our guidance that Melissa mentioned. I am pleased to reaffirm our guidance both the full year and the medium term. We expect to see ACV core continue to grow at a rate of mid to high teens percent per year, while ACV emerging should continue to grow in excess of 60% in FY22 and in excess of 50% per year in the medium term. We expect to adjusted revenues to grow at mid to high teens percent in FY22, thereafter with growth around 20% per year in the medium term. The adjusted EBITDA margin is expected to be in the mid 30s percent in FY22, allowing to some dilution for NeuVector, but it will then grow in the medium term towards 40%. Adjusted unlevered free cash flow conversion is expected to be stable to slightly increase from the FY21 level, measured as a percentage of adjusted EBITDA. In Q1, we expect to see a return to good growth across core and emerging, with stronger growth in the second half – a similar pattern to FY21. With this, I will now hand back to Melissa to close.

22:34 Melissa Di Donato

Thank you, Andy. In closing this session, I want to leave you with some final remarks on SUSE’s unique value proposition. We are staying focused and continue to deliver for our customers and our shareholders. The market opportunity for our products is both large and it's fast growing, driven by ongoing digitization across industries, and of course, along with the trend moving towards the cloud with Linux Kubernetes as the basis and the leading software choice. By providing the best enterprise-grade, mission critical, interoperable, open-source software, we are able to grow our highly profitable share and an expanding TAM. We do this by being entrusted with power mission critical workloads, by strengthening our multi-channel go-to-market platform for customers and industries of all sizes, showcasing SUSE as a proven platform for growth investments, and for retaining high levels of recurring revenues. And we are achieving all of this whilst maintaining our commitment to sustainable development and to growth. Altogether, this leaves us well-placed to drive value creation in the months and the years ahead. This concludes today's presentation. Thank you very much for attending. I'd now like to turn it over to the operator, so we can begin the Q&A.

Q&A

24:06 Operator

Thank you. Ladies and gentlemen, we will now begin our question-and-answer session. If you have a question for our speakers, please dial 0 and 1 on your telephone keypad now to enter the queue. Once your name has been announced, you can ask a question. If you find your question is answered before it is your turn to speak, you can dial 0 and 2 to cancel your question. If you are using speaker equipment today, please lift the handset before making your selection. One moment, please, for the first question.

And the first question is from Stacy Pollard at J.P. Morgan. Your line is now open. Please go ahead.

24:43 Stacy Pollard

Thank you very much. A few questions for me, as usual. First of all, what gives you confidence in hitting the emerging ACV target of plus 60% for the full year? You obviously now have Q1, which is a bit of creating a drag. And even underlying, it was sort of 14% when you take out that large contract non-renewal. So maybe what's the pipeline looking like there?

Second question, you mentioned the SUSE Rancher government business several times, for example, the impact on gross margins. So just how large is that business? Is it all consulting? Or how much is consulting? And how should we think about the impact on gross margins going forward?

And then third question, all three of your main cost lines grew well above the ACV and revenue growth this quarter. That was that some sort of quarterly anomaly because last year's Q1 margin was outsized? Basically, I'm asking, do you expect a more steady margin through the quarters this year?

25:46 Melissa Di Donato

Hi, Stacy. Let me answer, if I can, touch a little bit on the first two – RGS and what gives us comfort – and then I'll hand it over to Andy for the quarterly margin anomaly or not, as the case may be. So let me talk about the first quarter. You well know – software is the same, right? – how strong the cycle of software, especially enterprise software, runs from Q1 to Q4. The comparison is also really hard, right? I mean, you look at the Q4 of Rancher last year, in the last quarter that they were independent before they came over to SUSE, you couple that with an incredibly strong exit year that we had in our Q4, and it makes the compare really hard. So yeah, 14% growth. It's not surprising that, that we would have a hard compare year over year, quarter over quarter, depending on how you compare. Now we we've guided to reiterate, reaffirm the year' s guidance that we've given. We have a lot of comfort. We've got comfort, because we guide based on the view of the likely outcome for the year. We have insights into renewals, as you know. We've got insights into our pipeline. We've got insights to product releases. We're seeing adoption downloads in the communities. You can track to see how the performance of the business is underpinning the strength, the guidance that was delivered. So the second half of the year in particular is going to be experiencing higher growth anyway, as in a normal software situation. So we're very comfortable. We're very comfortable for the outlook and confident in the guidance that we've given. When dealing with subscription base as well, Stacy, you know very well that you have better insights than you would in normal business. So we're very comfortable there.

You mentioned RGS. RGS, we've mentioned a couple times because of the importance that we've placed on that, during the IPO as one of our reportable important levers for growth. We talked about the fact that, even when I started, there was really no one covering the US federal government. And we've really ramped up business with leadership, with a proxy board and with all the components to really create a true, fast-growing, sought-after US federal business. We're at the back end of the certifications required to deliver into the cloud and into the services that we must deliver. You mentioned, is it mostly services? No. It's definitely a combination of the two. But particularly because the US government requires a bit of hand hands-on services, that's why it might feel like, perhaps, we have more services in our business than you would traditionally have. But there's no impact that we're looking at that's necessary around gross margin. It's not a services-led business; it's a product-led business. But certainly we still have some of the final hoops to jump through now on the back end of the certifications. So I think you'll see you're not going to see an increase in services. You'll see definitely an increase, obviously, on the product side, so nothing to worry about there. Andy, can I have you comment on Stacy's third question, please?

28:51 Andy Myers

Yeah, sure, Melissa. Stacy, I think that your question was about the progression of the overhead costs, the SG&A, marketing, etc. So if we look at SG&A first, Q1 was an unusual compare, in that we weren't a public company. There were some effects movements, realized FX movements in there, and this one IFRS adjustment relating to the Rancher acquisition on commissions. When you take those into account we're broadly in line with quarter on quarter. SG&A has increased a little within our increase of 200 people in the quarter, but actually, most of that incremental headcount has gone into sales, R&D, and customer care. So look, I've just pointed back to the cost basis exactly as we expected it to be. You will see further progression during the year, particularly around sales/R&D. And clearly, as our revenues grow, we will put more customer care people into what is effectively the gross margin. So then I'll just bring you back to the fact that we have reaffirmed confidently our margin for the year of mid 30s.

30:07 Stacy Pollard

So it should be broadly smooth through the quarters in terms of margins?

30:13 Andy Myers

Yeah, broadly smooth. Yeah, it should be broadly smooth. Obviously, there will be a little impact of FX. If the FX is a little against us, our top line becomes a little lower, but our bottom line grows a little bit. We've got quite a nice FX balance there. So yes, it should be broadly level moving towards our year-end commitment.

30:39 Stacy Pollard

Okay, thanks. Thanks a lot.

30:45 Operator

The next question is from Lukasz Wojcik, Goldman Sachs. Your line is now open. Please go ahead.

30:53 Lukasz Wojcik

Hi. Congratulations on the results, and two questions from me. So the first one, I appreciate you've made the comment about the backend-loaded year, but second quarter has really easy comps. So could you maybe give us a little bit of color on how the pipeline is shaped versus renewals and new contract sizes? And maybe around the quarterly cadence, should we expect a sharp bounce-back in the second quarter? Or is it going to be a progressive acceleration?

And then second question, I know that you disclosed the net renewal rate for the whole business. But previously, you've been disclosing separate for emerging and core. So, if we exclude that contract loss from the SUSE core business and just take Rancher as a standalone, is it safe to assume that net renewal rate is sort of in line with the previous quarters at 140%?

31:47 Andy Myers

Hi, Lukasz. So first of all, renewal and pipeline. Look, in our quarter two, we expect to see good growth in quarter two. And then, as I said, acceleration in H2 very similar to 2021 H2. So that's the pattern that we expect to see on a quarterly basis. And that H2 growth is driven by the same factors as our H2 in 2021. We have our renewal pool returning. We have our strong net retention rate. We see our pipeline. And then again, we see the investments. And as you can see, there’s significant level of investment in Q1 that we've made in increasing headcount. So almost 50% of what you saw is an increase in headcount in the prior year. So that's what we expect to see.

When it comes to the natural tension rate, clearly, we have one customer base now. We have customers that are buying both SUSE Rancher and soon-to-be NeuVector. So rather than producing what is in effect NRRs for products, we are focused on the most relevant, which is about the net retention of our customers. So, on an ongoing basis, we expect to see a continued high net retention across Rancher. We will expect to see the core net retention, as I mentioned at the last quarter, in the medium term, I would expect to see some potential improvements there from our pricing project. And that’s because we are looking at lower discount levels and better net pricing, which over the medium term should allow us to see some progress in the net retention rate there. So that's how I see the net retention rate moving forward. As I said, the previous way we used to do it was not merging in core. It was obviously Rancher and SUSE. And the emerging contract was effectively a SUSE contract that we didn't renew in Q1.

34:07 Lukasz Wojcik

Thank you for that.

34:13 Operator

The next question is from Charlie Brennan, Jefferies. Your line is now open. Please go ahead.

34:19 Charlie Brennan

Great. Two questions from me as well, if I can. The first is just on this legacy contract. If I read the statement, it reads like Rancher is a like-for-like replacement for that legacy product. Is that the case? And I guess it begs the question, why the customer didn't just move to the Rancher version of the product. And you've described the Legacy product as effectively being discontinued. Are we now going to have this legacy drag that's an ongoing feature through the quarters of the rest of the year?

And then secondly, just as a financial follow-up and just as a modeling detail, can you just give us some guidance around what you expect the P&L tax charge to be and the cash tax charge? And just remind us of why there's a difference between the two.

35:15 Melissa Di Donato

Sure, Charlie. Hi. I'll let Andy answer a bit on the second part question, but let's talk about the legacy contract. So as you probably know – well, maybe you don't know, or maybe you’re not familiar with the fact that – we had a series of products which we have now created as legacy products, some of which Rancher is not a like-for-like comparison. So it was a storage contract, specifically, that we've decommissioned, that we don't have a replacement quite yet for. So it's not that we could have shut off the legacy storage product and then put Rancher in. It's not a like-for-like swap at all. So it's non-applicable. Now, if you take the history of why we decommissioned the product, and now it's become a legacy product and no longer selling, it's because we didn't have much of an installed base for that product. Now, having exited Q1, there's very little left that will be impacted. In fact, it's negligible of what it would impact in future quarters. So we're nearly at the other side of that now. So you shouldn't expect any further legacy products negatively impacting our quarterly results. It's just that one. So it's not a like for like; it's actually a storage product. And that's been now created the legacy product. Hopefully, that addresses that question. Andy, do you want to answer the second one?

36:39 Andy Myers

Thanks, Melissa. Charlie, hi. If you look at our discontinued or legacy products, as we call it, just put it into context. 2021, there was about the order of $7 million in total ACV in that year. In Q1, a majority of that, almost $6 million of that, did not renew, and that was driven by the one material contract we talked about. That leaves of the order of a little over a million in the balance of this year, the balance of nine months, of the order of $300,000 to $400,000 a quarter over the next three quarters. So in our guidance, in our thinking, we've built in a conservative view of what will and won't renew of that, but in total, we're talking about just over $1 million.

If I look at the expected tax charge, yes, in our EPS, we look at a long-term tax rate of 28%, which is in effect an expected 26% plus some costs that are disallowed. That gives us our 28% that we put in there on a conservative basis. But the guidance that we gave at the IPO on tax, tax will remain low for the foreseeable future of the order of 5% to 8%. So the guidance has not changed from the time of the IPO.

38:18 Charlie Brennan

Okay, thank you.

38:25 Operator

And the next question is from Johannes Schaller, Deutsche Bank. Your line is now open. Please go ahead.

38:30 Johannes Schaller

Yeah. Hi, Melissa. Hi, Andy. Thanks for taking my questions. Just two, if I could. Firstly, sorry, I wanted to come back to the deal. My understanding is that this contract was basically a part of a larger framework agreement. So the customer is still existing and is still doing business with you, but just not on that legacy component. So could you maybe give us a bit of color on the discussions you had with that customer, and so on, what types of business that customer is doing on the core side, how that is growing, so we maybe get a bit of reassurance on that relationship overall?

And then, secondly, just wanted to clarify on the Russia impact. You stopped doing new business, but you still have a little bit less than $5 million of business running through third-party distributors. So should we expect that business is now coming out of your run rate over the next few quarters? Or how should we reflect that in our models?

39:33 Melissa Di Donato

Hi, Johannes. Sure, happy to address both. Let me talk about the deal a bit more. As you know, the emerging product category that we have here at SUSE includes some products that were in existence before we purchased Rancher. So it's not Linux OS core related that we put it into the emerging bucket. Now, some of these products, obviously Rancher aside, most of them, if not all, are what we would consider legacy. They're a legacy, part of the old products that we ran. They're not being developed. And over time, we've been wanting them down. We've been more focused on the ECM market, with Rancher and NeuVector. And a winddown has occurred, as I mentioned earlier, specifically around storage.

So we had this large contract within this legacy business. It was due to renew in Q1. It did not renew. In our forecasts at the time of our Q4 results, we assumed that they would renew because it was part of a much larger, bigger customer. That customer is a continued customer. They just had not ended the legacy products as part of the bigger bundle deal. They are primarily now a core customer. They'll continue to be a core customer. They're large, they're growing, as you could see reflected in the growth of our core. They didn't leave. They just focused on our core business. So the loss of the contract is just a one-off impact. It's not going to drag on, as Charlie was saying earlier from Jefferies, with regards to the lag of the products going past Q1. But you can see the strong quarter we have for core because of customers like this have decided to not leave SUSE but use more products in a different way. The remaining legacy business, like we had said earlier, is declining very rapidly. It's around $1 million per annum – nothing. It's not going to impact our numbers at all. So there's no further risk of us having an issue like we had in Q1 with legacy products decommissioned and impacting our emerging space. So you don't have to worry about that. We are very comfortable and confident in that area.

Now, what's happening with Russia? I would say that it's clearly uncertain what's happening in the global markets, given the events in Russia and Ukraine. It's impossible to say exactly how it will turn out for the world. But what I will say, it has limited order impact on SUSE. There are risks primarily when deals are going to eventually renew, which is not going to be impactful in this fiscal year. We have less than $5 million revenue per annum from Russia. That's less than 1% of our total revenue. There's no FX impacts, as another example for Russia, because everything there was paid upfront in cash in US dollars. So we are staying close and monitoring the situation, as you can imagine, but no, we don't see any impact to our top line at all with regards to Russia. If there's a small impact with the $5 million, and there happens to be an early renewal, which is not necessarily [the case], it would be very small. No, there's really no impact for us as we look forward for this year that we can see today.

43:00 Johannes Schaller

Thanks, Melissa. That's very clear. Sorry, I have to ask one more detailed follow-up on that. I mean, if the storage product was essentially a kind of legacy product and Rancher didn't really have a modern alternative, why was your assumption that the customer would renew this contract? And maybe you cannot just disclose that, but I would just like to understand that a little bit better.

43:24 Melissa Di Donato

So they've been using SUSE for a very long time, and they're a very large customer for us. Now, what we're very good at here at SUSE, as you know, because of our customer success scores and our customer service scores being so high – in fact, leading the industry, and a key reason why customers choose SUSE – is because we always take care of our customers' needs first. Even though we are investing less, and we're decommissioning, and winding down the product, we thought we would need to support them a little bit longer. We don't pull a CentOS kind of action where one day everything shuts off. It's not like that. So we thought that they'd want to gradually wind down a bit slower than what we thought. They don't want to spend less with. They ended up spending more with us on the core side. So we're here to support our customers in what their business needs are. And originally, we thought they would just gradually wind down slower, but they picked up a little bit of pace to be able to move quicker and be able to expand their programs, frankly, to the cloud. So it ended up being a little bit different than what we had expected for them. That's all.

44:31 Johannes Schaller

That is very clear. Thank you, Melissa

44:38 Operator

And before we get to the next question, just as a reminder, if you would like to ask the question, please press 0 and 1 on your telephone keypad. And the next question is from Victor Cheng, Bank of America. Your line is now open. Please go ahead.

44:51 Victor Cheng

Hi, thanks for taking my question. Just one quick follow-up on the legacy product. Can you elaborate a bit on what it is? I believe you mentioned it's a historic product. So is it an area that you would like to expand in going forward through M&A? Why is it legacy? Is it because the product was not competitive? Or is it the kind of sub-segment that you don't see much opportunity to grow?

45:22 Melissa Di Donato

I was waiting for someone to ask me that question when I said it was storage. The history behind the storage product is that it's a very old product that was a part of a previous owner's M&A. So it was old and outdated. It's not ready, really, for modern technologies and the digitization across modern landscapes, particularly to the cloud. It was much more focused on an antiquated use of technologies, again, that we didn't build. It was embedded into SUSE as part of a former owner's acquisition. So it wasn't applicable for the path that we're taking our customers down. When we focus on modern technology and infrastructure and workloads, and helping our customers move in a nimble, interoperable way to the cloud, this product in particular was not built for that kind of purpose. And it didn't meet the ultimate principles of the services we're looking to deliver to our customers. Now, will we replace it with something else? Maybe. I mean, we don't like decommissioning one or creating a legacy around a product that was a replacement of another, like in the case of Rancher, or in the case of security. But right now, I don't have an answer for that. As we continue to gradually wind down the product, as we said, we're looking at alternatives. But for today, unless it fits into the thesis of a value that we're looking to achieve and delivering to our customers, which is that journey to modern workloads in the cloud, the flexibility, the interoperability, we won't put anything else unless it fits that strategy. And this product doesn't and didn't. And that's why we put it into winddown. But no, today, I have nothing to tell you about a hot new storage product, but we're always trying to keep on the forefront of what our customers need.

47:28 Operator

As there are no further questions, I hand back to the speakers for closing remarks.

47:34 Melissa Di Donato

I think that would be me, Jonathan, if I may. I think that close it down for today. Jonathan, if you have any last remarks before I close?

47:42 Jonathan Atack

No, absolutely not.

47:45 Melissa Di Donato

Okay, wonderful. Thank you, everyone, for joining, for all of the questions, all the insights into SUSE’s business in Q1. We look forward to sharing future guidance with you in the year to come. And thank you again very much for your interest in SUSE. And have a great day and happy St. Patrick's Day to everyone on the call. Bye-bye.

48:05 Operator

Thank you, all, for attending today. This call is concluded, and you may now disconnect.