Transcription

Analyst conference call Q2 results 2021

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PRESENTATION

00:04 Operator

Good afternoon. Welcome to the SUSE's conference call hosted by Melissa Di Donato, Chief Executive Officer, and Andy Myers, Chief Financial Officer. For your information, this conference will be recorded. As a reminder, all participants will be in 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 a 0 on your telephone for operator assistance. I will now hand the call over to Jonathan Atack, SUSE Investor Relations Director, who will lead you to this conference. Jonathan, you may begin.

00:38 Jonathan Atack

Thank you, operator. Good morning, everybody, or good afternoon and welcome to our presentation of SUSE's results for the second quarter of the 2021 financial year. I'm Jonathan Atack, the Head of Investor Relations at SUSE. Before we start, I would like to draw your attention to the disclaimer on page two of the presentation, which contains important notices on the information provided in the presentation. Today marks our first results release after the IPO, which we successfully completed on the 19th of May. I'll now hand it 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. Melissa, over to you.

01:23 Melissa Di Donato

Jonathan, thank you very much, and welcome everyone to our call. Hello. First of all, thank you very much for joining our first earnings call. We're all quite excited and very happy to speak to you today and share some more details about SUSE's second quarter. During our second quarter, we've continued to develop and grow our business in line with expectations. Shortly after the quarter ended, SUSE, as you well know successfully listed on the Frankfurt Stock Exchange, which catapulted us into the world stage as Europe's largest enterprise software IPO of 2021 so far. We've been humbled by the success of our IPO and by the performance that we continue to deliver. We have also been inspired by the messages of encouragement that we've received from our colleagues, our customers, our partners, and of course, as you might expect, from members of our open source community. But today, it highlights a very special day for all of us, as we share our Q2 business results for the very first time as listed company. Let's dive into those results.

Q2, FY21, it represented another strong quarter for SUSE. Let me bring this to life just a little bit by sharing a few highlights. First, we delivered 11% ACV growth on a reported basis, benchmarked against an exceptionally strong Q2 FY20. At the same time a year ago, in Q2 FY20, we had an exceptionally large deal, as you may have seen, representing the largest deal of that year. Excluding this, our underlying growth was 22%, in line with our H1 '21 growth of 19%. Our ARR grew by 16% to reach 519 million. Within this number we have our Rancher business, which grew an astonishing 91%. As we remain committed to profitable growth, we've also achieved 40% adjusted cash EBITDA. With that, we have achieved 98% cash conversion for the first half of this year. Based on this strong performance and our ongoing momentum, I am pleased to confirm our previously communicated FY21 guidance, as well as our medium-term outlook.

As you may remember, we identified five key areas to drive growth outperformance versus the market. I'm pleased to report that SUSE is delivering, and we're making progress in all five areas. Starting with commercial excellence, we continue to invest in our digital hub by adding more people who are now actively building our sales pipeline. We've also completed the first phase of our pricing initiatives, which we launched on the first of July. Additionally, we've extended our contract length with our existing customers on average and on aggregate. Our underserved markets has continued to be a strong focus of ours, particularly in North America, Latin America, Asia-Pacific and Japan. I'm delighted to share that each of these geographies saw their ACV increase by at least 30% in Q2.

Moving on to our accelerators, our cloud route to market continued to deliver outstanding growth. Over the quarter we successfully recruited and enabled more than 60 new MSPs, managed service providers, which will continue to drive growth in the cloud route to market. Finally, we also launched the SUSE Rancher government services, which we previously had called Rancher Federal. And that will put us in a key position as an important partner of the US government.

Now, with Rancher fully integrated into SUSE, we’re demonstrating the value that is unlocked as a combined company. For example, we've been able to significantly cross-sell into our customer base, which has supported 73% ACV growth for our emerging business. Rancher also signed its very first ISV deal with a total commitment of 2.4 million, all while achieving targeted cost synergies.

Finally, edge. There's been increased customer traction in our edge solutions, where we see a substantial opportunity for growth. And we've signed sizable contracts with big names in a number of key verticals. And we also finalized our SUSE Linux Enterprise microproduct, which has subsequently launched at our customer conference called SUSECON earlier last month, May 2021.

What I've just described is only the beginning of a journey that we had talked about during and before IPO. The slide you're looking at now serves to remind you that our business is competing in three large, but rapidly growing markets: first Linux, container management, and lastly, edge. We have many growth leavers in place that will enable us to capture an even greater market share of these expanding markets. Executing against these drivers and outperforming will enable us to deliver on an exciting growth number that we have committed to in our guidance, but also in our medium-term outlook. Our growth numbers, as you may recall: mid to high teens ACV growth for core and in excess of 50% annual growth ACV for emerging.

I'd like to walk you through three case studies to highlight our recent successes that are indicative of exactly what our future looks like. First, as you can see the positive momentum that we're seeing in the business has translated into a number of new customer wins, with over 120 net new logos being added in Q2 21 alone. These three customer studies across our suite of products and geographies in which we operate are all examples where SUSE has successfully displaced incumbent providers to become the customer vendor of choice. Whilst the reasons for choosing SUSE are numerous, we see the same things recurring again and again. Our customers value our technological leadership, our technology, our core solution set, the interoperability of our solutions with no vendor lock-in, the ease of implementation, and our strategic relationship with SAP, just to name a few examples.

I'd like to spend a few moments reflecting on how SUSE has been received as a newly listed company on the stock exchange. But before I do that, I'd like to add some context and share what we wanted to accomplish with an IPO, in addition to, as you might imagine, the obvious benefits of being a PLC. In a nutshell, we wanted our employees and our future talents to be excited about our journey ahead. We wanted to drive greater brand awareness. And we wanted to ignite excitement across the open source community. I'm super happy with the results and very pleased to say that our colleagues have been more energized by our IPO than perhaps even I could have predicted, or even forecasted, they remain highly engaged. And now, with two thirds of our staff participating in our LTI, our Long-Term Incentive Plan. They're directly involved in delivering our shareholder value. Additionally, our latest employee satisfaction survey saw a response rate of more than 86%, and our colleagues contributed to over – it's a lot – 5,500 comments. And to put that into context, this is the equivalent of nearly three comments per employee. Our colleagues are energized, they're excited, they're engaged, and they're ready to invest in In their company. I mentioned earlier 63% are now invested in our LTIP. And this is up from the 25% that was invested pre-IPO. And we're in the process right now, as we speak, of establishing an ESPP, an Employee Stock Purchase Plan, to give every employee the opportunity to own shares in our company.

But what's equally important to me is that we continue to see support and engagement from our community. They've rallied behind SUSE, and like us, they're exceptionally excited about what we can achieve as a publicly listed company. For example, our annual flagship event, SUSECON, that's now called SUSECON Digital, also took place during the actual week of our IPO. We saw a fantastic engagement from our community, we had over 64% year-over-year increase in attendance, and 92% year-over-year increase in content consumption, and an absolutely astonishing and outstanding 721% year-over-year increase in social media engagement. As of yesterday, our IPO video, which premiered during our listing celebration, as another example, has surpassed 1.6 million views in less than one month, showing an absolutely incredible sign of the interest in SUSE. And I know that this number will continue to grow.

As a listed company, we strive – and we continue to strive – to embody the highest standards of corporate governance. Our new supervisory board is in place, with eight highly experienced board members, of whom four are independent members, including our Chair of Audit Committee, and our Vice Chairman. We know that our directors have SUSE and our shareholders' best interests at the heart of everything that they do and every decision we make, and they will provide invaluable steering as we continue on our growth journey.

SUSE continues to remain hyper-focused on ESG, which is also now fully integrated into our daily business. Very happy to report that we're continuing to make great strides and incredible progress in ESG. Related to the environment, first, we're committed to climate action. We have just completed our greenhouse gas emissions measurement for 2019 and for 2020, and we're now developing a roadmap towards net zero. Our Employee and Social Matters Organization has set some ambitious goals, including our DNI target of at least 30% female leaders by 2026. We are partnering closely with HR to create a realistic work plan to increase female representation in leadership across our business in all geographies. We're also focusing on digital inclusion, as part of our "'Open Source for Good" pillar. As an example, we've launched a cloud-native program with Udacity, and have awarded more than 100 scholarships to underrepresented groups. And lastly, governance. In Q2, we set out to realign corporate governance to our new status as a publicly listed company. We overhauled internal policies management and we redrafted key policies, like the code of business ethics, and the diversity and inclusion policy, which I'm very proud of. As I mentioned in the previous slide, we also reviewed our supervisory board and implemented governance mechanisms that are expected and required from a publicly listed company. Additionally, a new reporting process has been set up, and enhanced public disclosures will be made from early 2022 based on GRI, or Global Reporting Initiative sustainability standards. With this, I will now hand over to Andy, who will take you through the details of our strong financial performance. Andy.

14:31 Andy Myers

Thank you, Melissa. Good morning. Good afternoon. This is Andy Myers, CFO of SUSE. Before we go into the detail of our Q2 '21 financials, I'd like to stress some of the performance highlights which demonstrate the strength of our business model. SUSE delivered strong growth, with ARR of 16% and ACV of 22% on an underlying basis. We've continued to deliver high margin and cash generation, with our Q2 cash EBITDA margin of 40% and cash conversion of 98% in H1. We therefore fully confirm our FY '21 guidance and our medium-term outlook. In order to help you with interpreting our performance, we have prepared the quarterly numbers on a pro forma basis, including Rancher on a coterminous basis in the prior year and in the current year, as if we'd acquired the business at the start of the year, so not missing out the one month of November that's missing in the statutory accounts. The numbers in this presentation have also been prepared using adjusted performance metrics, as we did in the IPO prospectus. The half-year report, also published today, is prepared on a statutory IFRS basis, and we have included reconciliations between the two sets of numbers in the appendix to this presentation and in the Q2 statement. I'd note revenue is shown excluding the impact of deferred revenue haircuts, and other P&L and cash flow items exclude the impact of share-based compensation, as well as non-recurring items. I will now take you through the numbers following the same sequence from ACV to revenue, then profits and cash flow as we did in the IPO presentation that many of you will have seen. So let's, first of all, look at ACV.

Our ACV reached 109 million in Q2 '21, up 11% versus last year. The 11% growth reflects particularly challenging comps in Q2 '20 due to the renewal and upsell of a major core contract in EMEA, the largest contract signed in 2020. On an underlying basis, ACV growth was 22%, very much in line with H1. As we report quarterly, it will be a feature of our numbers that there will be some lumpiness. So I'll always try to point this out as we go along, so we you have the best visibility on the underlying trends in the business. This can result from large contracts, as well as the timing of the signing of contracts within the quarter, which may distort the trends of ACV and revenue in any one quarter. In this case, our performance for longer periods and some of the other metrics that we disclose will help to give a smoother view of our progress.

Emerging saw a 73% ACV growth, reflecting the success of SUSE Rancher, with our first ever ISV deal secured, positive cross-selling momentum in SUSE's customer base, and rapid uptake in underserved markets. Core saw a 5% ACV growth due to the demanding comp space already described. The change in exchange rates had a positive impact on our reporting ACV growth. Adjusting for euro–dollar exchange rate movement, our only significant currency exposure, the increase in reported growth is approximately 4%. We will now move on to revenue.

Our adjusted revenue reached 137 million in Q2 '21, up 9% versus last year. The 9% growth and gain reflects a challenging comparison basis of Q2 '20, which benefited from a one-off royalty true-up of 4.5 million. For H1 as a whole, revenue growth was 13%. Emerging saw a 47% revenue growth. Core saw a 6% revenue growth, impacted by the absence of the royalty true-up seen in 2020. FX also had a small positive impact on the reported revenues, having added around 1% to the overall growth.

Given the quarterly lumpiness that I referred to earlier, I would now like to move on to the ARR, which is an important metric to demonstrate the reality of the strong growth that underlies our figures and the delivery of the business growth levers that Melissa has highlighted. SUSE's combined ARR reached 519 million, up 16% year on year, with continuous strong customer economics reflected in our NRR of 109% and 125% for SUSE and Rancher, respectively. Within this, the SUSE business delivered a 11% increase in ARR to $469 million at the end of this quarter, and Rancher surged ahead with 91%, to contribute 51 million to ARR, noting, of course, that ARR numbers are reported on a one-quarter in arrears to allow for backdated royalties.

Now, moving on to our cost base, it is fair to say that it reflects our continuing investment to support future growth, whilst remaining cost-conscious. Our cost structure is also slightly impacted by a negative mix effect, linked to the rising relative share of Rancher, which is a less profitable business at the moment for SUSE. I would also like to point out a few specific elements. Cost of sales increased to 7.7% of revenue due to our higher mix of consulting arrangements in the Rancher government services, our US Federal business, supported by third-party contractors. Sales and marketing operations was slightly down as a percentage of revenue, whilst general and administrative costs increased, resulting from the increase in headcount following the separation from Micro Focus, and moving off the transitional services agreement. We also saw an increase in recruitment and training costs, as we invest for growth.

Now let's look at profitability. SUSE's business model continues to deliver high levels of profitability. Q2 adjusted EBITDA was 35%, down from Q1 levels due to our headcount investment to support growth, notably Rancher government services. Despite continuing to invest ahead of the curve, we delivered an H1 margin of 40%, and year on year delivered a 25% improvement in absolute adjusted EBITDA for H1. After a very strong change in deferred revenues into Q1, Q2 saw a lower inflow of 6.2 million impacted by the large multi-year contract renewal in 2020. Overall, this results in a total inflow of 53 million in H1. These elements drove our adjusted cash EBITDA margin to 40% and 60% in Q2 and H1, respectively. And our adjusted PBT reached $22 million and $74 million in Q2 and H1 2021, respectively.

Now let's look at another key strength of our business model cash generation. We have high levels of cash from conversion, as a result of which SUSE generates very attractive cash flows. In the first half-year, we achieved 98% cash conversion, with adjusted unlevered free cash flow reaching 106 million. To note, on this chart, adjusted cash EBITDA reflects the full impact of a six month consolidation of Rancher. Other items only capture five months of Rancher, with a combined impact from the missing month of Rancher consolidation of a minus 1.8 million. We will now move on to our balance sheet and leverage.

Our successful IPO translated into net proceeds of $503 million to SUSE, which were applied to reduce leverage. Whilst this happened after the end of Q2, it brought our pro forma net debt down to $702 million and pro forma leverage to 3.1 times, at the lower end of our target. Gross proceeds were used to repay our second lien term loan facility, the partial repayment of our 2026 senior loan facility, and payment of the cash elements of [inaudible]. Both of our rating agencies, S&P and Moody's, have upgraded our ratings following our IPO, and we are now rated BB- by S&P and B1 by Moody's. And the outlook is stable for both. We expect to further reduce leverage as the business generates cash, giving us greater headroom to fund M&A. And we continue to review potential toking acquisitions. And we remain committed to keeping leverage below 3.5 times LTM-adjusted cash EBITDA over the medium term.

I wanted to update you on a few key metrics after our successful listing in Frankfort. Total gross proceeds were €1.1 billion, including €549 million primary, 18.3 million shares, and €514 million second-rate, 17.1 million shares post-Greenshoe. SUSE today has 168.3 million total shares outstanding and 170.2 on a fully diluted basis. Our free float stands at 23.2% with Marcel Lux III at 76.8% ownership. We are pleased to confirm both our FY ’21 guidance and medium-term outlook. As a reminder, our FY ’21 guidance is based on $550–570 million revenue, $245–265 million adjusted cash EBITDA, and cash conversion in the mid ’90s as a percentage of adjusted EBITDA. It is important to know that our guidance assumes an 11-month contribution from Rancher, and hence differs from the pro forma basis that we've presented today. Beyond FY21, we expect annual core ACV growth in the mid to high teens, while emerging is expected to grow above 50% annually. We expect stable adjusted EBITDA margin from FY21 before a gradual increase towards 40%. Our cash conversion is stable to slightly up from FY21 levels as a percentage of adjusted EBITDA. I'll now hand you over to Melissa for closing remarks.

26:43 Melissa Di Donato

Andy, thank you very much. I think what you can probably hear from the strength of both of our voices is that we're definitely very proud of where we've gone. We're very proud of our recent milestones, everything from listing on the Frankfurt Stock Exchange to becoming the largest enterprise software IPO of 2021. And of course, more recently, with our Q2 results, and forward-looking results, to meet guidance. The economy runs on SUSE. We've said it before, and we'll continue to talk to you about how we power some of the world's most mission-critical workloads for companies of all sizes, large and small. Our business is high-growth. Our business delivers high margins and high cash flow. We continue to take share in our total addressable market. Our employees – not just Andy and I, of course – but we're two of the 2,000 employees that are some of the most passionate, energized, and creative people you will find. Our open source industry is the most effective software development model in the world and it powers innovation for our customers at scale. But this is all just the beginning. I can tell you that we will not stop, nor will we rest. I'm honored to lead this company, and we will continue to share more in the time ahead. This concludes today's presentation. Thank you all so much for attending. If I may now, I'd like to hand it back over to the operator and perhaps Jonathan, to help us start and moderate the Q&A.

Q&A

28:25 Operator

Thank you. We will now begin our question and answer session. If you have a question for our speakers, please dial zero and one on your telephone keypad now to enter the queue. Once your name has been announced, you can ask the question. If you find your question is answered before it is your time to speak, you can dial zero and two to cancel your question. If you're using speaker equipment today, please lift the handset before making your selection. One moment, please, for the first question. The first question is from Adam Wood, Morgan Stanley. Your line is now open. Please go ahead.

28:59 Adam Wood

Hi, good afternoon, everybody. First of all, congratulations on the successful IPO and amazing set of results. I've got two questions, please. The first one is really just looking at what you need to do in the second half of the year in order to hit guidance. So, if I look at the revenue growth, you're guiding to – apologies, I'm using numbers in our forecasts, pretty roughly in line with your guidance – it looks as if you need to do about 11% growth, which looks pretty reasonable versus the 13% that you did in the first half. When I look at the ACV, though, when I look at the percentage growth, it looks a lot more challenging. There's a pretty significant uplift needed, that we go from high teens in the first half and 11 in Q2 up to around sort of high 20s in the second half of the year. So on the percentage change it looks demanding. When I look at absolutes, though, it basically means you need to do a little bit less in the second half than you did in the first half of this year. Where I'm getting to with this is, could you help us out a little bit with what the base looks like in the second half of 2020? Because I think that's one of the issues today is, obviously, you had a very tough comp in the second quarter. But could you just talk a little bit about how the business performed in the second half? Was that impacted by COVID? To what extent? And therefore how easy is that base comp as we look into the second half of this year, to give us a feel whether we should be looking at percentage changes on the ACV growth, or really focus on those absolute numbers, because that's what you're going to be able to deliver? That was the first one.

The second one was just around shorter contract length last year, as people renewed. Could you maybe just talk a little bit about how that's impacted salespeople's ability to focus on new business this year? Have they been quite focused on making sure that that higher number of renewals converts this year, and that's distracted them a little bit? If so, when does that change? And just a little bit of insight into that would be helpful.

And then finally, just on Red Hat, there's been management change there. I think anecdotally, as well, we pick up bundling of products and more audits from that company. Could you just talk a little bit about what you're seeing in the market from them and the dynamic change very much over the last few months? Thank you.

31:06 Melissa Di Donato

Adam, I knew you were going to throw three questions at us. I knew it.

31:12 Adam Wood

I could have gone for one in three parts. But actually, I was sort of honest and said it was three.

31:21 Melissa Di Donato

Okay, so I'm going to make sure I heard the three questions right. Andy, I think the first one was the compare from FY20 and then how does the result of the second half of FY20 affect the second half of this year, FY21. But also, what does it leave us? Looking at the actual evidence and numbers in the first half, what do we have to do in the second half to get the base case? I'm going to let Andy- hopefully I got that right.

The second question was the focus around the sales teams pivoting, lengthening the term of deals, and what the net impact was. there, how that turned around so strongly. And the last one was about competitive landscape with regards to what we're seeing with Red Hat. Is that broadly accurate? I think I caught it right, Adam?

32:13 Adam Wood

Yeah, yeah, that's perfect. Thank you.

32:14 Melissa Di Donato

Okay, cool. All right. Maybe since I've got the mic, Andy, I'll do number two and number three, perhaps, and I'll let you answer and number on, if that's okay, Andy Meyer.

So let me let me talk to you a little bit about what's happened around the revision, I guess, like we talked to you about, Adam, in the IPO. We've made a lot of substantial go-to-market changes from last year going into this year. The sales team was split into two halves. I think I'd mentioned this once before. Essentially, we've got hunters and we've got farmers. We created a whole new team called Customers for Life. And that Customers for Life team focuses sycophantically on customer success, creating those long term relationships, for life. In doing so, in separating those two teams, we've really been able to focus on creating long-term viable, successful relationships with our customers around renewals. So what is the existing install base that we have? How do we nurture? How do we build? How do we create strong relationships that really grow over time, not just renew, but actually grow over time? And also, how do we really launch innovation to that customer set? There is long-standing relationships and they're very valuable relationships with our customers. And they've been the ones to really take on an enormous number of new products with us. We have cross selling and upselling, with the synergies obtained from Rancher. So that whole channel and approach to servicing our customers in the first half has proven very successful. Customers love the fact we have a new way of managing customer success. We have an integrated model, and they're able to buy more with bundled solutions together and getting more from SUSE, with SUSE/Rancher products together. So the contracts have naturally elongated. Now, keep in mind that Rancher before SUSE only did 12-months yields. We've completely flipped that model on its side, now having completed the first half with Rancher, and the second quarter specifically with them being as part of a unified business. We've taken all the 12-month contracts and, as they renew, they're renewing for longer term on the Rancher side. But also, obviously, as I said, on the SUSE side as well with the Customer for Life model, the contract terms are getting longer again post-COVID without a sacrifice or discount structure in the way of cost.

I think that when we look at the compensation model – those were the farmers, the hunters, the net new logos I just mentioned – those deals are getting longer. I mean, the days of COVID are a little bit more every day, I hope, God willing, behind us. And customers are willing to sign up for longer-term agreements. They want to sign up. They want the security and the stability of having longer-term agreements with SUSE. We're seeing much longer term that we did a year ago with COVID concerns and a lot of risk associated with cash flow and that sort of thing. So from our hunter side of the team, they've done extremely well. And we put in place very specific compensation models to reward not just ACV, but TCV as well. And we had taken another way to focus on ACV, as we got through COVID. We didn't want our customers to feel the pressure of having to pay upfront for longer-term agreements during unknown navigation through the waters, if you will. So the compensation plans that have been altered and changed this year in the first half has proven to be very successful, allowing us to lengthen our contracts, both for net new but also for our existing install base renewal base customers. They're renewing for longer.

Let me just comment on the Red Hat situation and I'll give it back to Andy. So, things have not been great with IBM and Red Hat in the last year, at least from a customer or even community perspective. The changeover and Jim leaving, as well as the termination of the support for CentOS has been very good for us. What we saw on the market is, even though IBM has tried to, as they've called it, incubate and isolate the Red Hat business, it is being overwhelmed and has succumbed to the IBM management structure, which has proven instable. It's proven that instability has caused issues with the community, has caused issues with our customer base. And on the flip side, what we've been able to prove is our customers are signing up for longer agreements, are signing up for more products, and they're signing up for the stability that a PLC with SUSE has been able to offer. We have become the stable and secure solution set, particularly in mission-critical workloads, that unfortunately for IBM, Red Hat has not been able to offer, not just with the recent changes of management, but also with some of the decisions they've publicly made to the community and to their customer set. That has been that's been proven for us quite well, as you can see from our numbers. Andy, I'm going to hand it over to you to address number one, which was a comparison to FY20 second half, as well as what momentum that we've gotten in first half has enabled us to create a strong base going into the second half.

37:34 Andy Myers

Thanks, Melissa. Thanks, Adam, for doing a little bit of my homework on the first point in terms of absolute numbers. Yes, if I'm looking at H1 at 246, I'm looking at an implied H2 expectation around the 245 mark. So yeah, a slightly smaller second half, which is relevant. Just thinking of a little bit of 2020 or comparative to H2, did we have some small impact from COVID? I believe we did. I mean, we commented previously that we didn't think that was overly material, but we did have some impact. And, and to be honest, it's always a little difficult to tell what it would have been if we didn't have COVID. So did 2020 get impacted? Yes, to a small degree, I would suggest. However, what I'd really like to focus on is the 2021 H2 and the growth acceleration. It is backed up by a very high visibility. We obviously have great visibility in SUSE. We have a very strong renewal pool, which has a significant growth in it year on year. So that is the foundation to that growth. So we have that, and you've seen our net retention rates and our growth that we deliver off that.

The pipeline, we can see being driven by our growth drivers. So Melissa has already talked about the underserved markets. You've seen in Q2 North America, a substantial market for us, growing at 31%. And that's a combination of our US Federal, and also all the growth drivers we are deploying in North America. Smaller markets, again, LatAm, APJ, both growing successfully because of our growth drivers. We've also then got the acceleration, a strong Rancher pipeline and the growth we're seeing from that, and our success in cross-selling to SUSE customers. And then, to really evidence this, we've seen, you can see in the numbers that year on year ARR growth is 16%. That really, I think, does give evidence of the real revenue run rate acceleration we're seeing in the business. Does that answer your question, Adam?

40:05 Adam Wood

That's very helpful. Yeah, I appreciate that. That's great. Thank you.

40:12 Operator

The next question is from Julian Serafini, Jefferies, Your line is now open. Please go ahead.

40:19 Julian Serafini

A couple of questions from me, as well. I think, number one, Melissa, I remember during the IPO, you were talking about an effort to cross-sell Rancher to the top 400 accounts? I know you mentioned some work on cross-sell. But can you talk a little bit about those top 400 accounts and how that may be progressing or not? And then on the numbers as well, I think what you're saying around contract duration makes a lot of sense. However, when we look at the cash flow statement in Q2, change in deferred revenue looks the same this year as last year as well. So is there's something in the numbers that we're missing, or just that large deal from last year is skewing things a little bit? It would be helpful just to understand that dynamic as well.

40:52 Melissa Di Donato

Hi, Julian. Yeah, absolutely, I'm very, very happy to talk about Operation 400. So Operation 400 was the initiative you were referring to about cross selling and being able to utilize the relationships that we've had with Rancher as well as, obviously, on the SUSE side. We've gotten a significant amount of momentum. In fact, we're actually investing more in an operation where it's going to be more than 400 now, because we've seen such a strong uptake and positive movement with regard to cross-selling the SUSE solution to Rancher and vice versa. We've started to, for the very first time, bundle our solutions together, to make it really easy for customers to buy. That was a big push that we only just launched in July, as well, as we look forward, because we have to be able to make it easy for our customers to be able to buy. We saw a very, very large deal, a substantial retailer in the US, that had been a long-standing relationship with Rancher has now done a very large enterprise deal with SUSE. That has been a big deal for us in Q2, and there's more opportunity with that customer alone.

So we've seen great growth with Rancher since the acquisition. We've seen continued cross-selling opportunities, Like I said, in fact, we're investing more in Operation 400 because of the results that we've been getting directly from the cross-selling opportunities. So, as you can see from the numbers with Rancher especially being able to cross-sell into SUSE, it's performed a little bit better than we had even forecasted and expected, by the results you can see, specifically because of the integration of the two sales teams. We are fully integrated across both businesses, Julian, so we have SUSE team selling Rancher or Rancher selling SUSE. So the inevitability of us to be able to communicate across both existing install bases and be able to upsell is very, very strong. Andy, I'll allow you to answer the second question if I can.

42:58 Andy Myers

Yeah, sure. Thanks, Julian. Yes. In Q1, our deferred revenue movement was $46.4 million. And clearly in Q2, it was 6.2. You're absolutely right, Julian, again. The Q2 2020 deal was a 9.5 million deal on a three year basis. So it's just an a round 28 million deal that powered the prior quarter numbers. So you can see 6.2 is a pretty strong result, when you adjust for that large multi-year deal.

With regard to contract length, yes, we are making good progress. We are seeing outside of cloud, because cloud has an average contract length below our average, but that growth in cloud, despite being a lower contract length, is being offset by the growth of all our other contract lengths. So we are making good progress. And as I said previously, in part, due to COVID, but also in part due to the fact that for this year, we are incentivizing our team on multi-year contracts rather than just on ACV.

44:28 Operator

Next question is from Frederic Boulan, Bank of America. Your line is now open Please go ahead.

44:35 Frederic Boulan

Good afternoon, Melissa and Andy. Thank you very much for taking the questions. Two on my side. One is more of a follow-up on the previous discussion on the revenue shape. So when we look at Q2 ACV growth, I just want to focus on the core business for a second. So ACV and revenue growth, especially if we adjust for the FX boost you had, we are significantly below where I think you want to be in the medium term. So if you can spend a bit of time on the building blocks to help accelerate growth in OS, in particular. And if you can update this, I mean, you mentioned the US Federal, the progress of some of the initiatives you've implemented.

And then a second question around leverage. So you mentioned your ratings post-IPO. I can see Moody's, for instance, is basing their analysis on their own metric of 5.2 for this year. So it looks like they're not really using similar metrics than yours. Can we assume that you're comfortable with those ratings going forward? I can see a B1, for instance, is definitely an outlier versus other listed software names in Europe. But should we assume that you're comfortable with that? I don’t know if you have anything to add in terms of M&A framework or priorities versus [inaudible] IPO? Thank you.

46:15 Melissa Di Donato

Andy, do you want to take the revenue shape and rating and I can talk a little bit about M&A at the end?

46:22 Andy Myers

Okay, I can cover ratings, if you can cover M&A, Melissa. If you look at our core, core revenue for 2021 versus 2020, you’re looking at 121 to 115, 6% growth. Clearly, if we remove the royalty true-up that we talked about, then that's an adjusted underlying 10% growth. And then again, if I remove one percentage point of FX, then I'm looking at about 9% growth in core revenue in Q2. If I do the same for H1, then that does lower slightly. But if we look at the run rate revenue that we're seeing in ARR, you can see our core ARR is running at 11%. So I think that is supporting the revenue figure and the growth of our revenue for the second half. Again, just to reiterate, what's supporting the growth of that is all of the underserved markets, our pricing, our many actions that Melissa has covered. Those are the actions that are supporting the growth. But as I say, I come back to the ARR figure, which is showing 11% growth year on year.

If we look at talk about the ratings, look, yes, we improved our ratings. I think where they are at the moment, we will benefit as we deleverage the business. We will benefit, subject to M&A, but as we deliver the business, we will expect to improve. But at the moment, we think they're fairly representative for where we are as a business at the moment.

48:25 Melissa Di Donato

I'll just close on that question about M&A. The IPO was like a minute ago, it feels like. So nothing drastically has changed. We're still, of course, reviewing targets that will continue to help us reinforce our offering, technological ownership of our customer base, how we can expand, what kind of tuck-in technology can help extend the relationship that we've already got with our customers. As Andy said, we're going to remain below our communicated maximum target leverage of 3.5 times adjusted cash EBITDA. So any transaction, of course, we will disclose in accordance with regulatory requirements. But we're always looking and aware of what the market is developing, what the market is accepting, pushing and pulling. But since the IPO nothing, nothing material quite yet.

49:16 Andy Myers

Yeah, and Frederic, one point I should have mentioned that’s fairly foundational: for FY21, I think we said we're over 60% of when we did the IPO. At the end of last year, we have we have effectively banked 84% of our revenue for the year at the midpoint of expectation.

49:48 Operator

The next question is from Stacy Pollard, J.P. Morgan. Your line is now open. Please go ahead.

49:54 Stacy Pollard

Hi, thanks so much for taking my questions. I think I'll have three, like Adam, if that's all right. Number one, how should we think about the quarterly progression of margins? And should we expect that to be quite lumpy in future years as well, potentially? Number two share this conference pretty high, presumably. So that was associated with the IPO, as well. So how should we think about that for the full year ’21, and then into the next few years? And then number three, you mentioned strong demand from the cloud and CSV channel. Maybe can you give us a little bit more color on that? I know you said 50%, growth in ACV in H1. Maybe any further thoughts on that core petition risk as well, in terms of what hyperscalers might provide that overlaps perhaps with your offering, once those apps get onto their platform?

50:47 Andy Myers

Melissa, do you want me to take the first one? I'd like some clarification on the second one. I didn't hear the second question too. And then maybe, Melissa, do you want to talk about the cloud? Okay. In terms of the quarterly margin, do I expect it to be lumpy quarter after quarter? It will change year to a degree. I don't expect it to be overly lumpy. But it will change. There's not a lot of seasonality in our costs. And obviously, it may change with some movements in revenue. It can change by a one off, if we have a --we expect a number of compliance claims in a year. And if we get a large one of low-ish to mid-single digit, then that number on the top line can obviously impact our margin because it goes straight to the bottom line. So we will see some movement, but not huge movements, I wouldn't expect to say. I think I've really missed question two. Could you just refresh that one for me?

52:02 Stacy Pollard

It was share-based compensation. How should we think of that for the full year ’21, and then into future years as well?

52:12 Andy Myers

Maybe if you can come back to Jonathan on that one, so we could address that outside of the call, please. So we can address those details outside the call. I mean, we have in obviously, for ’21, we've got the number shown in Q2 of 127 million. That was the calculation based upon the IPO. And then I think that's the major item for Q2. And it will be smoother going forward because we obviously have put in a RSU program across, I think it's over 60% of our staff. So it should be a lot smoother from there on in. Any further questions, please come back to Jonathan and we'll answer your questions.

53:13 Melissa Di Donato

I'll just pick up the last question around cloud. You're right. Cloud Q2, over 50% ACV growth, this was really driven by two main anchors: really strong performance of the hyperscalers, as well as signing up new significant contracts with more than 60 new managed service providers. So it was a very deliberate strategy that we went after and going after a lot of the niche or local players across the world, across the globe, but also the very, very strong performance of the hyperscalers. This last quarter, we also revised our pricing with the hyperscalers to be more price advantageous for them and their customers. And that's proven very well, it's stillness delivers strong performance and market. We have new innovation going on the hyperscalers. We talked about it, it was the most sought after question, I think in our IPO, which is, will the hyperscalers become competition for us? My thesis remains the same now as it did then. The relationship with the hyperscalers is getting stronger, particularly when we look at, for example, the SAP workload. You look at the SAP workload for S4, a number of customer are moving to the cloud for S4. 85% of those customers are going to SUSE and when you look at the workloads that integrate and work around SAP, the hyperscalers are quite keen to have SUSE come into the mix with SAP because it drives with it a whole series of workloads around it. So a lot of innovation going on with the hyperscalers, working a lot closer with them, both technologically speaking but also commercially, how we go to market, how we pitch, how we innovate is all very much aligned. So very strong route to market for us. In fact, one of the highlights, as we've mentioned already.

55:04 Operator

And the next question is from Gautam Pillai, Goldman Sachs. Your line is now open. Please go ahead.

55:09 Gautam Pillai

Thanks for squeezing me in. Firstly, just a follow up on the ACV acceleration for the second half, specifically related to the cadence on a quarterly basis. You're almost at the end of your fiscal quarter. How should we think about can seasonality between Q3 and Q4? And secondly, can I follow up on the competitive landscape comments you just made? I think most of the comments he made were on the core business, but how's the landscape shaping out? Has it changed in the last couple of months in the emerging business. IBM, I think, acquired a container business called BoxBoat recently. Has that changed the environment in any way?

55:57 Andy Myers

I can take the first one first, Melissa, if you want. Thanks for the question. Yes, on Q3 and Q4, our two largest quarters in our business are our Q4 and our Q1. So yes, you should expect Q4 to be a larger quarter than Q3 because I think, historically based on the fact that it was coming after our year-end. And hence, that's why we naturally have a higher Q4 than we see in Q3. I hope that helps.

56:40 Gautam Pillai

Can I just follow-up because we don't have much color on the sales growth from last year? In terms of growth, acceleration, I understand the absolute ACV will be more in Q4, but from a growth standpoint, is that more of an acceleration into Q3 and then into Q4 or is there anything which we should be aware of from last year?

57:05 Andy Myers

I think maybe there will be a little bit of acceleration from Q3 to Q4 growth, just looking at our pipeline, looking at our renewal pool all the items I mentioned earlier. So yeah, I would expect that. And of course including in that, you also got our expectation of acceleration of Rancher as well. So yes, a small acceleration between Q3 and Q4.

57:37 Melissa Di Donato

And I'll answer the question. I think we're going to run out of time very quickly, but the question on cloud and competitive landscape as it relates to the emerging space, why we're seeing that strong uptake, that strong momentum on cloud with our growth in Q2 more than 50% year over year? The same would apply to the emergence of the business. When you think about the amount of momentum we're getting and moving from on prem to the cloud, oftentimes, that's being positioned in being carried across in a container in the emerging technology space. So we don't compete, with Rancher as an example, against any container solution set as it pertains to more of the hyperscalers. Because customers need the required inevitability of being a multi-cloud solutions set. In fact, none of our customers today, even if they selfproclaim themselves to be committed to one hyperscaler, they will eventually acquire a business-required technology that inevitably will make them 100% multi-cloud. And they can be majority with a single cloud provider or hypescaler, but obviously, they will have over the evolution of the business, multi-cloud, for sure. And the ability to toggle between multi-cloud, multiple workloads, locations, that is being driven by the emerging technology space for SUSE. So that business has also seen an incredibly strong positioning as it relates to moving from on-prem to the cloud or moving workloads around the world in different environments.

So that emerging space has continued to thrive in the competitive landscape, specifically in cloud. IBM did make a recent acquisition. I think that really echoes and really reiterates our model, doesn't it? I mean, we've been banging on and talking quite a lot about the importance of being interoperable and open, how critical it is for our customers to have the choice and the flexibility to be able to move not just between clouds, but utilizing technology, wherever it may be delivered across any platform. Our solution has been traditionally the only one that's been completely interoperable and open. And our closest competitor with Red Hat and OpenShift has not. You can only use one operating system as part of their container side. So I mean, the acquisition that IBM has made, the changes they've made in their business, has proven that our models is the right one, that interoperable, open wins. It wins in a technology perspective, it wins for our commercial model, and it wins for our customers as they go through that transformation digitally not just today, but moreover, every single day going forward.

1:00:19 Operator

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

1:00:26 Johannes Schaller

Yeah, thanks for taking my question. Hi, Melissa, hi, Andy. Two or three. So the SAP relationship is obviously quite important for you, both directly as a customer, but also probably more importantly, indirectly. One could maybe say it’s a little bit dependent on how well they are doing with their new strategy moving customers over to S/4HANA. When you called out a win-win with a US rate retailer related to S/4HANA, can you maybe discuss a little bit more broadly what momentum you're seeing in terms of S/4HANA upgrades in the market? How that is benefiting you? Is that gaining momentum also into the second half? And maybe also the more recent trends? Why would you describe that as a strong tailwind? Or how should we look at that?

That will be my first question. Second question. Andy, if I got you right, you talked about the renewals in the core business, and there should be a lot of upselling related to that. So you had a bit of a reduction in ARR here in Q2. Should we assume that to go back up in the second half? And then just the last quick housekeeping item, did I get you right that you said on the ACV side, the FX impact was actually a 4% percent tailwind, or did I get you wrong here? Thank you.

1:01:45 Melissa Di Donato

Let me address SAP first. I hate to use the word of because I don't think it's factual dependency. Dependency makes it sound like we're an SAP shop. And as you really well, no, we're not. So I must clarify the use of that word because it does, because it wouldn't be accurate to allow that word to be used in relation to our SAP Business. However, I would say it would be okay for SAP to use their dependency on SUSE. And let me explain to you why. As they have the criticality around moving their install base into more modern, contemporary applications in S4, there are only two certified technology partners to handle that workload. And that's Red Hat and it's SUSE. Those are the only two operating systems that are certified to operate S4. When you look at the movement in Sapphire and all the recent announcements around Rise, Rise is SAP’s movement to upgrade and bring their install base and legacy into modern contemporary applications in the cloud. And that cloud is S/4HANA enterprise cloud powered by SAP. That is the RISE initiative. That's probably the single biggest investment that SAP is making this year. Now the great news for SUSE is that we are going to see tailwind, you're right, in the second half because they're getting more and more momentum as it relates to customers upgrading and moving to the cloud. And in doing so 85% of those S/4 workloads are being run on SUSE. All of development for all the SAP innovations and applications are being built utilizing systems that are powered by SUSE, and the last most important bit is all of HEC and all of RISE is running on SUSE. So you may want to say yes, that if RISE doesn’t take off we will have a negative impact. No, we're not going to lose any customers. But does it offer even further opportunity? It absolutely does. Now, keep in mind that upgrading from R3 or ECC, there's a multitude of different operating systems that one could use as a customer. But for S/4, there are only just two, with the first position being led and being owned and run by SUSE to the tune of about 85% market share. So while we don't have a dependency, per se, I think SAP certainly has a dependency on our technology. And together, we will do our best to help really bring legacy SAP customers into modern times with cloud and RISE and HEC, all being powered by SUSE.

1:04:26 Andy Myers

First of all, we talked about net retention rates and renewals. Yes, the year on year was a 1.8% drop from the 110.4. But the Q2 numbers are absolutely consistent with the Q1 numbers, so they have remained stable quarter on quarter. I would also say, with 1.8% of our renewable, you're talking about low single digit million dollars. And all you need is one or two deals, one side or other side of end of the year. And that is quite a sensitive number to a couple of million dollars, for example. So I'm not concerned in any way, shape or form. We continue to have very strong NRR in both SUSE and SUSE Rancher. And there's nothing to read into the slight movement, a low single digit number in dollars between 2020 and 2021. When it comes to FX, yes, you're right, that we had a tailwind in ACV of the order of 4% in Q2. And against our guidance rate, it's a little less than that. So year on year. exchange rates, yes. 4%. Against our guidance rates that we used, it's a little less than that.

1:06:03 Melissa Di Donato

Okay, I think that's the last of the questions. Thank you very much for attending our first call with you all after being listed in Germany on the 19th of May. And I can I'll hand it back to Jonathan and the operator to close the line for today.

1:06:21 Operator

Thank you for attending today. This call is concluded and you may now disconnect. Thank you. Bye, everybody. Thank you for joining.