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SUSE S.A. - Analyst Conference Call Q3 Results 2021

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PRESENTATION

00:02 Operator

Good afternoon. Welcome to the SUSE S.A. 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 a listen-only mode. After the presentation, there will be an opportunity to ask questions. If any participants have difficulties hearing the conference, please press * followed by 0 on your telephone for operator assistance. I will now hand the call over to Jonathan Atack, Investor Relations, who will lead you through this conference. You may begin, Sir.

00:42 Jonathan Atack

Thank you, Operator. Good morning or afternoon, and welcome to our presentation of SUSE's results for the third quarter of the 2021 financial year. I'm Jonathan Atack, Head of IR at SUSE, and I'll shortly hand you over to our CEO, Melissa Di Donato, and our CFO, Andy Myers. We're 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 2 of the presentation, which contains important notices on the information provided in the following presentation? Melissa, over to you.

01:19 Melissa Di Donato

Jonathan, thank you. And welcome, everyone, to Q3. This is Melissa Di Donato, the CEO of SUSE, and I'm very happy to speak to you all today, to share some of the details and highlights of SUSE's third-quarter performance. When we presented back in Q2 in July, which feels like ages ago, some questioned how we were going to hit our guidance in the back half of this fiscal year. Some even questioned if we were going to be able to accelerate our growth. And I think what this quarter has shown is that the answer is absolutely yes. I'm pleased to share that today we're not only reconfirming our full-year guidance, but we're also strengthening it in some very important respects. That is because we delivered on the growth that we committed to you. I'm very proud of how well the SUSE team has executed this quarter. In SUSE, we have a business with great forward-looking visibility, a suite of compelling products that our customers, they rely on, they depend upon, and a team that has rich insights and a strong hold of our net new sales pipeline along with that of our renewals.

Q3 has been very eventful. It's been a very successful quarter for us here at SUSE. As you well know, in May of this year we listed on the Frankfurt Stock Exchange, making SUSE the largest enterprise software IPO in Europe this year, 2021. I had the great honor and extreme privilege of becoming the first woman to take a multi-billion euro business public on the esteemed Deutsche Börse. I did say first, but I'm absolutely confident and sure that I will definitely not be the last.

Let me touch on a few highlights, if I may, for SUSE during this quarter. First, we delivered game-changing innovation for our customers. We've announced a number of enhancements to SUSE Linux Enterprise Solutions, to SUSE Rancher Container Management Solutions, as well as a host of new cloud-ready and cloud-native solutions for edge and hybrid IT environments. Next, we continue to directly shape our Core and our emerging technologies with a number of cutting-edge open-source projects, staying deeply engaged within the variety of our open-source communities.

Our commitment to the success of our customers, we've seen firm recognition. For the third time in a row, our customers gave us another increase against our net promoter score, once again ranking SUSE and our experience for our customers well above the industry average. We've received a number of awards, accolades, recognitions, perhaps maybe even more than ever before, across our brand, various SUSE team members, and even for our SUSE flagship event called SUSECON, where we were all recognized and award winners continued throughout our quarter.

Last but not least, to keep up with the fast pace of growth. We've doubled down on hiring, talent development, and focus on delivering an unprecedented employee support program rolled out globally. I think we'd all say that across the board

Q3 all points to signs of SUSE being a strong, sustainable, predictable and thriving business. We are excited about SUSE's performance and we are absolutely humbled by the encouragement that we've received from our colleagues, our customers, our partners and across our global community. Without further delay, allow me please to deliver and dive straight into the headlines of the quarter’s trading performance.

First, let's talk about the key metrics, to highlight the strong performance of our quarter. Q3 2021 was a strong quarter for SUSE. As guidance, our ACV growth rate accelerated, as promised in Q3. We delivered 39% ACV growth, driven by a significant increase in Core growth and a continued strong growth in our emerging business. Year to date, we've delivered 25% ACV growth. Our ARR accelerated from Q2 to grow by 20% year over year to $555 million. As you would expect from SUSE, this growth was delivered while generating a very strong 43% adjusted cash EBITDA and an 89% cash generation. Based on this strong performance and our ongoing momentum, we are going to be strengthening our revenue guidance to the top half of our range. We are also raising our adjusted cash EBITDA guidance and expect it to be above the top of the pro forma range that we previously released. We are happy to confirm that the remainder of our previously communicated FY ’21 guidance, as well as our medium-term outlook will stay intact, as promised.

You will remember that we've identified, back in May, and even in July, five key areas to drive growth, to outperform against the market. I'm pleased to report that we've made progress on all five. First, our commercial excellence lever. We rolled out Phase 1 of our commercial initiatives. We've also successfully set up SUSE’s first ever pricing excellence team, set up to better serve our customers in a way that SUSE customers want to buy. We've also focused on training, pricing, discounting changes, and finally, the continuing stabilization of our contract length. Next was underserved markets. We talked again about tremendous growth across all of our regions, but you can see in our numbers on this slide that there was significant growth achieved across all of the underserved markets, in line with all the investments we made and talked to you about in May. Next are accelerators. We saw strong growth of the hyperscalers. Our continued investments in headcount, certifications, and innovation have contributed to solid growth also in our federal business. The Rancher growth story continues. Our fourth lever was dedicated to ensuring that we had strong cross-sell opportunities. We've achieved a growth rate of 78% for emerging ACV and we've seen exactly this: our cross-selling initiatives skyrocket with success. Finally, on edge, we set up our first ever edge Center of Excellence, focused on strategic customers, business development, and pipeline generation. We've also seen increased momentum with the launch of our SUSE edge offering. Whilst we relentlessly focus on delivering on the organic opportunity, we'll also going to continue to actively pursue strategic enhancements and acquisitions and tuck-ins, to further accelerate our growth.

What would SUSE be without focusing on customer success? It's been a successful quarter for SUSE in terms of not just renewals, but also net new customer wins. We saw over 140 net new logos being added to our successful roster in Q3 FY ’21 alone. Our wins are spread across a suite of products, and all of our geographies, all the geographies in which we operate. On this slide here you can see three great examples of some of our Q3 wins, including, on the far left, a US-based Red Hat VMware competitive takeout, a leading public global player in robotics and automation, an EMEA public sector player, one of the most established public sector organizations in Spain and – you can see on the right – one of the largest and actually the most prestigious retail companies in Australia. Now, all of these have utilized the cross-sell opportunity, in particular right now in Australia. We not just sold the core of SUSE Linux Enterprise, but now we're working on cross-selling that SUSE Rancher and products to them as well. And we're constantly engaged in what we consider very competitive tenders. We didn’t win all of them in Q3, but we are proud of what we did win. We see the same themes as to why our customers keep coming back and why our customers keep choosing us. And that really revolves around interoperability, no lock-in from any single vendor, and the ease of doing business with SUSE. The overall customer experience that we deliver helps us to stand out from all of our competition.

In addition to the success of bringing in new logos to our roster, we've also focused on launching emerging and core technologies to promote innovation. At the heart of our strategy is our company's commitment to delivering open interoperable products and solutions to our customers. I mentioned when I opened just the start of this call, that in Q3 we made very strong headway in terms of product innovations. We initiated innovation and releases across Linux Enterprise, and also the container management platform for SUSE Rancher. I've also mentioned that we launched a host of cutting-edge open-source projects. One of my favorites – we've got a number, but one example – is Harvester. It's our very first open source hyperconverged infrastructure (HCI) solution that's built entirely on Kubernetes. I had the privilege of seeing a demo of Harvester from one of our engineers, and I'm really excited about what this opportunity could bring to SUSE. If you have a chance, you should definitely check it out. It's pretty cool. It essentially manages both VMs and containers, enabled cloud workload migrations, and hybrid cloud management across all of the hyperscalers. It could be a real disrupter, as just one example.

I would be remiss if I didn't mention, of course, wrapping all of this technology, all of the innovation being delivered and served up at SUSECON, which is our flagship customer event. It was a huge success in Q3. Our attendance was up 89% over the prior year. And it's worth noting that both events were delivered digitally. So we're seeing a real desire to learn more about SUSE, to integrate and be part of SUSE and part of our community.

Let me wrap on my section before I hand it over to Andy to talk about ESG. This is a series of initiatives that are quite close, not just to my heart, but everyone here at SUSE. Our commitment to ESG is genuinely not a checkbox exercise. It's meaningful and important for every one of us; it's a big part of our culture. We made progress in all three transformational pillars that we set up for ourselves, which are climate action, diversity and inclusion, and Open Source for Good. Climate action, we've already begun to reduce – and successfully reduced – carbon emissions in five of our key locations. And we continue to add every day more and more the use, for example, of electric vehicles to our fleet. Diversity and Inclusion is picking up with pace. Actually, I just ran a report and found that, as we as we exited in August, for the first time ever we had the most of women in our company ever in our history. The Women In Tech network is really becoming very meaningful across our company. Three out of every four SUSE women are a member. And it was launched alongside our very first early-career mentoring program, focusing on introducing young girls to technology and embracing young talent at SUSE and growing them throughout their career. And then finally, Open Source for Good. We awarded more than 300 scholarships via the SUSE Udacity cloud-native course. We had more than 4,000 learners from over 100 countries that completed our course. In Q3, we also launched SUSE’s fourth employee network, the Open Source Employee Network.

To round this all off, I must veer off course for just a moment, a couple of minutes, just to talk about the importance of our employees and their wellbeing. That continues to be at the heart of everything that SUSE does. Every decision we make and everyone we hire, we'd like to put at the paramount, at the heart of care for SUSE. In Q3, we launched a series of wellness initiatives aimed at supporting our colleagues, and really enabling them to give back and give forward to their community. This is by no means where we stopped, but we continue every day to find ways to support our thriving culture and our global employee network. And I’d like to think that our employee culture is very unique and second to none. With this, I'm going to hand it over to Andy, who will take you through the details of our financial performance. Andy, I'm going to hand it to you.

15:22 Andy Myers

Thanks, Melissa. Good morning and good afternoon to everyone. As Melissa has already said, we have a strong Q3, allowing us to strengthen our FY ’21 guidance. We are delivering on the acceleration of our ACV growth rate in H2, hitting 39% in the quarter. Our ARR year-on-year growth rate is accelerated to 20% from the 16% we saw a quarter earlier, which demonstrates the underlying strength and growth of our subscription base. And we have continued to deliver high margins and cash generation, allowing us to delever the business to 2.6x LTM-adjusted cash EBITDA.

From a preparation basis, I want to make sure everyone is clear on the following. All numbers are prepared on a pro forma basis, reflecting 12 months consolidation of Rancher in FY ’20 and their FY ’21. For clarification, we have included today the revised guidance, including 12 months of Rancher. I would also highlight our quarterly pro forma figures for FY ’20 have been made available on our website. I'll now take you through our KPIs.

Group ACV growth of 39% in Q3 ’21 and 25% year to date, which is consistent with our medium-term outlook. Core ACV up 36% was driven by upselling and renewals, including a number of multi-year contracts. Emerging ACV was up 59%, with significant net new customer gains versus competitors. Notably, all geographies contributed to growth, with special mention to North America and China. North America benefited from strong momentum in SUSE Rancher and a large renewal in Core. China reached $10 million ACV for the first time, having signed two major contracts. On an RTM basis, end user and cloud performed well, with continued strong demand from hyperscalers. And after a 2% drop in Q2, IHV grew 8% in Q3, thanks to strong demand from embedded solutions. All in all, we are pleased with Q3 ACV performance, which will provide a sound basis for revenue growth in FY ’22.

Now let's move to revenue. Total revenue of 21% to $151 million. Core was up 16%, reflecting our momentum in the cloud RTM in North America and EMEA. Emerging grew 65%, reaching a record revenue figure of $18 million. This starts to reflect SUSE Rancher's extended footprint in the cloud and IHV routes to market, as well as good progress with our cross-selling initiatives mentioned by Melissa. I would also note that SUSE will not benefit from FX tailwinds this quarter. Group ARR reached $556 million in Q3, up 20% year on year demonstrating the strength and growth of our subscription base. NRR reached 111% for SUSE excluding Rancher, and 143% for Rancher. This reflects our customers willingness to use renewals as an opportunity to increase their business with SUSE.

Let's now look at our cost base. We continue to have a resilient gross margin at high levels, with margin erosion this quarter due to the strong momentum in Rancher’s government services business, SUSE continues to invest for growth by reinforcing key R&D and sales functions. Most changes in the cost base, therefore, relate to a higher headcount in sales and marketing, and R&D, compounded by some salary inflation. Adjusted EBITDA margin stood at 36.6% this quarter, and 38.9% year to date.

Now let's look further at our profitability. SUSE, once again, delivered very high adjusted EBITDA and adjusted cash EBITDA margins. Our adjusted cash EBITDA margin was 43% in Q3, and 53.7% in year-to-date nine months to 2021. The Q3 ’21 change in deferred revenue inflow of $9.8 million and the nine-month 2021 change of $62 million comes from the growth of our business and demonstrates our success in signing multi-year contracts. This ongoing momentum has allowed us to strengthen our adjusted cash EBITDA guidance. It will also support revenues in coming quarters. Adjusted PBT reached $44.5 million in Q3, and $118 million for the nine months year-to-date ’21.

Now let's move to cash flow generation. Our nine-months 2021 cash conversion was 89%. It is lower than the H1 ’21 level at 98%, as it reflects the increase in debtors at quarter-end, linked to the timing of billings.

I'd now like to cover share-based compensation. I wanted to provide a brief update on our share-based compensation. The IPO triggered an existing scheme that resulted in $166 million one-off expense booked in the nine months year-to-date numbers, and is now closed. Going forwards, we anticipate about 1.2 million shares will be granted every year, with phased vesting over three years. The expected ongoing quarterly charge will be approximately $9 million for the combination of the one-off transitional scheme and ongoing scheme.

Now let's move to leverage. Post IPO, we have continued to delever the business, and it now stands at 2.6x LTM adjusted cash EBITDA compared to the pro forma ratio of 3.1x shown in our Q2 release. The deleveraging is driven by our continued growth, high level of profitability, and cash flow generation.

I’d now like to move on to guidance. Following Q3, we have now strengthened our guidance as follows. We have revised our revenue range to the top half of the pro forma range. We now expect to exceed the upper end of the pro forma adjusted cash EBITDA range. Our guidance on ACV has not changed for FY ’21. Our performance in Q3 and our visibility of Q4 will deliver our original guidance. And our medium-term outlook, as outlined at IPO, remains the same. For clarification, FY ’21 guidance shown at the IPO only included 11 months of Rancher. In this release, we have prepared a pro forma version, including 12 months contribution from Rancher. I'll now hand it back to Melissa.

22:47 Melissa Di Donato

Andy, thanks. As a conclusion of this session, I'd like to leave you with just the final few remarks. At first, we are keeping the commitments that we've delivered and made to you during our IPO. We're saying laser-focused on the success of our customers. And we intend to keep carrying on supporting our customers, growing our customers, and really carrying through the innovation that's needed across the industry. And we're doing exactly what we said we would do. We're take market share in our expanding TAM. We're continuing to power mission-critical workloads. We're strengthening our multi-channel go-to-market platform. We're demonstrating growth. We're proving profitability at scale. And we've definitely demonstrated that SUSE is the platform for growth investments. And we're achieving all of this whilst we continue to remain highly engaged, with an incentivized and passionate, aware and determined workforce. This concludes today's presentation. Thank you so much for attending. And I'd now like to turn it back over to the operator so we can begin the Q&A.

Q&A

23:57 Operator

Thank you. We will now begin our Q&A session. If you have a question for our speakers, please dial 01 on your telephone keypad now to enter the queue. Once your name has been announced, you can ask your question. If you find your question is answered before it is your turn to speak, you can dial 02 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 we've received is from Adam Wood from Morgan Stanley. Your line is now open, Sir. Please go ahead.

24:35 Adam Wood

Hi. Good afternoon, everyone. Thanks for taking the question. And congratulations from me on that really sharp acceleration in the third quarter – very impressive. Maybe, in classic analyst fashion, I'll pick up on one of the kind of small negative things in the release to ask the question about, first of all. Just on the Rancher side, there was a little bit of a slowdown in the third quarter on the ACV side. Could you maybe just talk a little bit about what you're seeing on the cross-selling there, and maybe as importantly, the pipeline that you've got, the larger deals that you'd hope to close as those cross-selling initiatives really start to work?

Secondly, I'm seeing the guidance is raised, but when we look at that, we look at the fourth-quarter implied growth. It implies a reasonable slowdown again in the Core business. I mean, I guess we had some puts and takes that complicated the second and third quarter in terms of looking at year-on-year growth. Can you just help us a little bit with what there is in the fourth quarter to help explain why that Core business comes down a little bit from the implied fourth-quarter number?

And then maybe just finally, a lot of SAP's partners are talking positively about the S/4 uptick. Could you maybe just give us a quick update? I know that two of the three customer wins that you flagged were SAP-related. Is that coming in as a meaningful driver of the Core Linux business? Thank you.

25:58 Melissa Di Donato

Hi, Adam, nice to hear you. Let me talk a little bit about Rancher. I'm going to ask Andy to pipe in on the Q4, and the implications and the drivers in Q4. And I'll close up the question around SAP RISE, the conversion over to S/4 etc., if that's okay.

So a little bit about Rancher first. Rancher is delivering very strong growth. We're very pleased with the performance. Very visible that we reported ACV growth of emerging 58% for the quarter, 78% for the year. ARR is up 115%, net retention rate 143%, revenue for Rancher as a whole is up. So we don't see any negativity at all, particularly when it comes to Rancher. But what's really great about Rancher is that we've seen a significant number of net new logos for SUSE Rancher. In fact, we've signed our very first ever airline customer and won several contracts for SUSE Rancher away from traditional incumbents, if you will. The strongest growth for emerging for us was in North America. Lots of large renewals, particularly in financial services and tech, including our win with UiPath. We were just recently in their press release, and we talked a little bit about them as well. So, the cross-sell has been very strong for us, Adam.

In Q3, we saw the emerging ACV growth driven from cross-sell is quite high, significant, towards 40%. For Rancher specifically, a lot of the Rancher revenue was delivered specifically by the customers deploying Rancher for the first time. So I think when it comes to the Rancher business as well, meaningful wins, besides UiPath, a number of others: the Ministry of Justice of a large European state, as well as a large APJ retailer that's now cross-selling as it relates to SUSE Rancher. UiPath was a big one. We're going to leverage effectively Rancher Kubernetes management to provide deployment options for UiPath customers to leverage the UiPath platform. So that's really innovative technologies. So I think we've seen strength.

Operation 400 – we talked about in the IPO – is going at strength, as you can see. The initiatives of cross-selling are skyrocketing for us. The key Rancher synergies are really, really paying off. It's not just about cross-selling, but it's also about deal execution for us. We've put in the commercial excellence to-- Rancher was originally a startup, but putting in place and driving a cadence that's much faster than they traditionally have had before. So yeah, we're seeing and continue to see a high interest of the existing customers as they move towards the technologies offered by Rancher. And they originated specifically because of the cloud data, the container management innovation that we've seen. So hopefully that answers the question on Rancher. Andy, do you want to cover anything else that I may have missed on Rancher Q4? And then we'll come back, if you don't mind, and talk a little bit about SAP?

29:28 Andy Myers

No, I think, Melissa, you covered it very well. We're obviously very pleased with our acquisition of Rancher, very pleased how it's moving along. So maybe if I can, Adam, just address your Q3/Q4 growth rates. I think that's the heart of the question. We reiterated our ACV guidance for FY '21. We expect growth to continue in Q4. And it will look like it's slightly lower rates, but when you allow for the fact that Q3 '21 had retrospective consumption contracts in the sort of mid-single digit level in ACV, that also drops through to revenue. And you then consider that we had a similar-sized retrospective consumption contract in Q4 2020. When you allow for these, you end up with very similar growth rates across both ACV and revenue. And I guess in summary, Adam, we are delivering what we said we would do at the time of the IPO. Melissa?

30:40 Melissa Di Donato

Maybe I'll talk about SAP. SAP customers, as we all know, are striving for innovation. They need innovative infrastructure to support their transformation of SAP. They need the innovation to continue to propel them with their digital transformation journey. We've been seen as the preferred vendor to support that cloud transition. As more customers move towards SAP, S/4HANA, or S/4HANA Cloud, they need a certified Linux operating system, regardless of where they run. So whether they run on-prem, in a cloud, in a hyperscaler, that's almost irrelevant for them as it pertains to the operating system that needs to underpin the technology itself. We know that SUSE Linux is the leading platform for SAP. We deliver outstanding uptime performance. We ensure reliability across all the workloads. And that's delivered for SAP. It's delivered for SAP customers. More than 80% of SAP HANA installs are running on SUSE.

When we look at the accelerated transition to the cloud, we look at SAP RISE, we look at the hyperscalers, this relationship that we've had, this co-development relationship, co-innovation has put us at the forefront. In fact, as you well know, Adam, I think we talked about it last time, but the SAP salesforce is now incentivized to position and sell SUSE. And so we're not just an innovation partner, but we're actually a go-to-market partner for them as well. Now, when we look at RISE – there was just a release, I think yesterday or the day before – RISE is geared at existing ACC or S/4HANA customers on prem. And this is moving them to the hyperscalers or, in fact, to their own cloud. And predominantly even their own cloud is all powered by S/4 and by SUSE. And I think that, if we look at the number of RISE customer – I think they're forecasting about 1,000 by the end of the year – this is a significant percentage: 75%, I think, of all S/4HANA orders are coming in through RISE. And when you consider that it's no longer just mid-sized companies, but they're actually going to the large enterprise customers we're seeing in their recent release, like AMD, and Siemens, and Etihad airlines, which is the core of what we sell (more than 80% of our customers are S/4 customers that sit on top of SUSE), it's a really good opportunity. So we continue to be successful in selling and promoting S/4 in conjunction with SUSE's LES. And we continue to monitor, co-innovate, and co-sell with SAP. And it's continued to be a rich ecosystem, valuable for them and also valuable for us, and moreover, most valuable the customer. Hopefully that helps.

33:38 Adam Wood

That was very clear and very helpful. Thank you.

33:43 Operator

The next question received is from Johannes Schaller of Deutsche Bank. Your line is now open, Sir. Please go ahead.

33:49 Johannes Schaller

Thank you very much, and then also congratulations on the good results from my side. A few, if I could. Forgive us if we already start asking questions maybe on next year, but obviously your fiscal year ends in October. I know you have a mid-term guidance out there and you guided for 2021. Could you at least give us some qualitative feedback, maybe not guidance, but a bit of a feeling of how we should be looking at the next fiscal year? Andy, I think you were clear on the revenue growth, but maybe also anything you see on the ACV side and any kind of deal momentum, anything that's already visible, and the margin trajectory we should be thinking about when we look at the next year.

And then Melissa, you talked about M&A, and obviously your leverage has come down quite a lot now. So could you give us a bit more of an update on how close you may be are to doing your first deal post IPO, where the process stands?

And then as a quick last one, you got some great progress in China obviously. Just maybe give us a quick update on the strategy. And also, would you say maybe from a competitive standpoint they're a little bit easier for you than in the US and EMEA, given that maybe some of your US competitors are struggling a bit more in that market? Thank you.

35:19 Andy Myers

Thank you, Johannes. You're right. We have reaffirmed our midterm guidance. And obviously, I will refer you back to that. What I would say, look: as you can see from our Q3 results, as you can see from our guidance for FY '21, we have positive momentum in the business. And as I say, you can see that from our numbers. So I can't really comment much more about 2022 other than, yes, we have reiterated our guidance. You specifically referred to margin, and on margin, obviously, our original guidance was mid-30s adjusted EBITDA, mid 30s, I think, with then just slightly some movement upwards over the medium term.

36:22 Melissa Di Donato

Okay, and I will talk a bit about acquisitions. Yeah, Johannes, you're right, we continue to evaluate our options. And we do see some potentially attractive opportunities. We were focused on a couple of key markets. I'll just remind you of those again, where we're focusing. We're looking at security, container security, edge, project management platform, and observability as it pertains to DevSecOps. Ideally, as we deleverage the business and the business continues to be strong, we would like to find and secure and hone in on the finalization of a tuck-in acquisition. We feel that tuck-in is a better position for us to quickly integrate with our existing business. We want something that could be an extension of our existing platform, be complimentary. It needs to be in line with our ethos as well. And I think it's really important, as we seek acquisition tuck-ins in these key areas, that if a product is not open source, we make it open source-compliant very quick. It needs to subscribe to the ethos of this company. If we can add innovation, investment, and cross-sell to our existing base, it's a good win, I would say. I think we did a really good job with SUSE and Rancher, and proven as a great precedent that we can be acquisitive. We can help accelerate our growth with the right kind of addition to our portfolio. So yeah, we continue to be bullish and to continue on this trajectory. And I think certainly, I hope that we'll have news when we do it. These things are never easy, as you know, but certainly in due course it's on our list of priorities.

When we look at China, there's no reason to assume that China is more important than the United States for us. I think the US and North America this quarter [is a] huge success. We've really focused, invested in, and prioritized the North American market as one of our underserved markets. And that investment that we've made has paid off for us. So that's really good news. And we're going to continue to invest there. But I think you're right. I think that a lot of our US competitors are struggling in China, and not just struggling, but in a lot of cases prohibited from doing business in China, with recent trade wars and such. So it puts us in a really nice position to be able to capitalize, with some big Chinese brands that we had relationships with for many years. In fact, we have staff in China. We've got an entity sitting in China. And this is not new. We didn't just enter China since our American counterparts have had difficulties. We've been in there for the better part of the last 10 years. So, it's been a great growth market for us. It's been, again, great return on the investments we've made, but we continue to evaluate. As governments and rules and laws continue to change, we must also make sure that we're adaptable, which is the core part of our company.

39:33 Johannes Schaller

That's great. Thank you, Melissa. Just to be precise, a quick follow-up on that. I mean, you have not been impaired in any sense in your activities in China or impacted by any kind of US regulator talking to you? We’ve seen that in other parts of technology with European companies that had issues to operate in China as well, even if they just had some small issue as operations, but that's not something you have to have seen already, I would assume.

40:06 Melissa Di Donato

No, it's not. In fact, we were awarded by Huawei last year their Partner of the Year. We were their infrastructure and technology partner of the year because of the investments and the partnership that we had with Huawei, as one example. But no, because we're a European business, there are laws, as you probably can imagine, with US persons working on systems that need to reside and be delivered in China. But because a lot of our developers, we ringfence to be able to service that market, we've had no issues. So we've been very fortunate, but we've been working closely with our partners, with our customers, with the entities inside of China to ensure that we're compliant, so that we can continue to accelerate.

40:49 Johannes Schaller

That's great, thank you.

40:55 Operator

The next question we’ve received is from Frederic Boulan of Bank of America. Your line is now open. Please go ahead.

41:01 Frederic Boulan

Hi, Melissa. Frederic from Bank of America. Congratulations as well from my side on the quarter. A couple of questions on my side. First of all, if you can discuss the agreement with UiPath and what it means, what's the business opportunity for SUSE in there.

Second, around some of the pricing initiatives you've put in place, if you can give us an update there and what it means for your pricing.

And maybe lastly, looking at your NRR growth, if you can give us a bit of color in terms of new customer wins versus increasing spend per customer, and if you are seeing different trends between SUSE excluding Rancher and the Rancher business. Thank you.

41:53 Melissa Di Donato

Yeah, sure. Hi. It's Melissa here. Thank you for the question. So let's talk a little bit first about UiPath. We collaborated with UiPath, and in fact, UiPath was an important win for us because, UiPath, we would use to displace our competitors there. UiPath chose Rancher, specifically to have an open, interoperable Kubernetes management platform, because they felt that they needed to provide additional open deployment options for their customers. The customers need to be able to leverage the UiPath platform across interoperable platforms and open technologies. And they felt that, for them, they needed that flexibility; they needed that additional deployment option for their customers, to be able to leverage the platform. So they chose SUSE to replace our competitors. And that's what we're doing with UiPath. It was a great win for us. Let me hand it to Andy to talk about pricing. Andy, if you can, the pricing initiatives, the successes that we've made, the momentum that we've gotten so far, but also then to talk a little bit about NRR growth.

43:11 Andy Myers

Thanks, Melissa. Hi, Frederic. Yeah, we are focused on making good progress with our pricing projects. We started to implement on the first of July our initial programs. And our focus at the moment is using data to improve our pricing decisions, as well as controlling our pricing, particularly with regard to discounting at different levels. We've made some changes, including some bundling, to provide more value to our customers and increase value to us. And this project is ongoing. I think I've said before, this is our sort of two- to three-year rollout of a program, and this will progressively deliver an improved result for us, but obviously in Q3, we had only just implemented some of the programs.

44:11 Melissa Di Donato

Andy, do you want to talk about NRR?

44:14 Andy Myers

Yeah. Sorry, Frederic, I didn't quite catch that. You mentioned NRR and you mentioned also new customer wins. Can I just clarify what that third question was, please?

44:27 Frederic Boulan

Yeah. I just wondered, because you talk about new wins, you talk about upselling, if you can give us a bit of color on what's the mix between new wins through new customers and increased spend per the customer you're seeing across SUSE and across Rancher. So, is the growth you're showing to us mostly driven by customer wins or by higher spend per customer? And I'm sure it's a mix of both, but if you can give us a bit of color on that.

44:55 Andy Myers

Yeah, sure, sure. Look, we're seeing new wins in both areas of the business. We can obviously see Rancher is obviously considerably higher growth than our more mature businesses of Linux. So we are seeing considerable new wins across Rancher. And we're also seeing the ongoing acceleration of customers in adopting the Rancher product. So you can see those through all the growth numbers – ARR, NRR – for Rancher. SUSE, yes, we continue to see new wins. We tend to see a slightly lower level within SUSE Linux because we tend to win, and then land and expand. We tend to see these clients will come in at a relatively small level and then start to grow. But obviously, clearly, it is a lower growth market than the Kubernetes market.

46:01 Frederic Boulan

Okay, thank you.

46:06 Operator

The next question we've received is from Gautam Pillai of Goldman Sachs. Your line is now open. Please go ahead.

46:13 Gautam Pillai

Great. Thanks for taking my questions, and congratulations from my side as well. Well, my first question is on NRR, and especially on the Rancher business. At 143%, it's probably best in class across global software. Can you please comment if there was any potentially large upsell in the quarter? Or do you believe this is kind of a sustainable level at which Rancher can operate going forward?

And secondly, on the retrospective consumption point you made, Andy, just to clarify, on the Q4 2020 contribution, was that also in the mid-single digit range? And was your comment a flag that this is a potential issue going into Q4.

And finally on Q4 itself, on the pipelines, perhaps from a visibility standpoint, can you comment about the renewal opportunities in the pipe, what you have seen in Q3? Thank you.

47:14 Andy Myers

Thanks. With regards to the NRR Rancher, yeah, it is class-leading. I was looking at something the other day which had UiPath NRR rates and these are not dissimilar. I do expect it to remain high. Of course, it will vary a little, but I expect it to remain high, driven by, as I was saying, the accelerating adoptions of Kubernetes amongst our clients. With regard to Q2 2020, yes, the retrospective consumption contracts in Q2-- sorry, let me just qualify that. Was it Q3? Sorry, Gautam. I've written down Q2.

48:08 Melissa Di Donato

I think he was asking about Q4 2020.

48:12 Andy Myers

Yeah, sorry. I've written the wrong number down. So yeah, Q4 2020, it was a very similar sized, mid-single digit, retrospective consumption contract. So in 2021 Q3 and in 2020 Q4, the number impact was very, very similar. With regard to Q4 pipeline, as you know, as a business we do have strong visibility. And as I said at our previous session, we do in H2 have a strong renewal pool that's coming back. And again, that always gives us the ability to upsell and to cross-sell. So yes, strong visibility for Q4, hence the confirmation of our guidance at ACV level.

49:06 Gautam Pillai

Great, thanks so much. If we can squeeze in a quick follow-up on the partner ecosystem, perhaps from Melissa. You did comment about the UiPath relationship. You called it a strategic partnership in the race and also commented about strong hyperscale demand. Are there any kind of key trends you've observed in the quarter which stand out? And also, do you see any change in the competitive landscape, from a competitive vendor standpoint and also from a partner ecosystem development standpoint?

49:43 Melissa Di Donato

Sure, yeah, happy to. I think, when we look at our competition as well as our partner ecosystem, we see a resounding trend over and over again: the open interoperable products that we deliver without locking allows the agility and flexibility that modern decision makers require. There's no doubt about it. I mean, UiPath, we won against – you can maybe see it in the release, too – very clearly because the no lock-in. And the interoperable nature of our container solutions and our Core operating system solutions was critical. You can't have and allow our partner specifically to be able to release innovation that locks their customers in to a certain technology. And that's why we're winning. That's why there's a lot of takeouts that we've seen this quarter, and we're getting more and more momentum around our partners. And that applies the same way in the hyperscaler environment. In fact, we've been working very closely with all three major hyperscalers. What we're finding is that they're looking not to enter the Linux space, but rather to optimize the open interoperable solutions that SUSE delivers, to make them more competitive. And that's a key win for us.

When we look at the competitive landscape, it really hasn't changed that much, to be honest with you, except for the fact that we're seeing more focus and more attention being brought on an interoperable componentized nature of solutions to drive decisions. We see both Linux and container management platforms of our business growing above the standards of the industry, above the markets, because the CAGR for Linux is around 12% and double that, triple that, if you will, for container management. So we're going above that market. And we really feel that, as a result of the wins that we've gotten, specifically the takeaways and the strengthening of our partnerships, it's still around that same theme of interoperable, being open, having no lock-in, having flexibility that we've been able to offer. I mean, you couple that with the reinvention of the strategy around pricing for our partners, it's not just the pricing strategy program we're releasing for our customers; it's also a component for our partners. So that's also been well received and strengthened our relationships also.

52:11 Gautam Pillai

Great, thank you so much.

52:17 Operator

And the last question for today is from Stacy Pollard of J.P. Morgan. Your line is now open, Madam. Please go ahead.

52:24 Stacy Pollard

Thank you. Three questions from me as well. First of all, can you speak a bit more about the MSP opportunity? I know you mentioned 34 contracts. How long do those take to ramp up? And maybe, was that already part of your plans? Or do you think of that as something maybe incremental as well?

Number two, I'm sorry to come back to margins, but just on the midterm guide for gradual improvement, can you talk about any things that we might need to think about in a post-COVID? world? So, for example, are there any costs in virtual activities that might convert into higher cost in the physical world next year? Basically, how do we think about the balance of these items as we go forward?

And then the third question, the market share gains that you mentioned, where do you think you're taking those from? So I guess, presumably, Red Hat in the Core. Or were you more referring to open source versus proprietary OS? And then also on the container Rancher side.

53:32 Melissa Di Donato

Let's talk about MSP first. What we meant – Stacy, hi, it’s Melissa here, by the way – when we talked at IPO time on the roadshow, at that point we were just, to be honest, getting into the MSP space. And that was much more, believe it or not, of a pull to us in the space than us pushing our way in. We found that a lot of the MSPs, be it regional or geographic or industry-based, particularly MSPs, needed a non-competitive partner to go to from a technology perspective. So they were coming to us quite a bit in the early part of this fiscal year. Now we've got a whole team behind it. I think we're at the tip of the iceberg, I believe. We've embedded, of course, some of the wins. We didn't expect to accelerate quite as strong as we have been, but I think there's a lot of opportunity there for us, particularly as we go into next year. So MSPs has been an important progressive part of our strategy, to really enable and underpin a big part of the growth.

I'm going to hand it to Andy to talk about guidance a little bit more, if you can, but let me just touch quickly on market share. We don't compete in the free space. When it comes to mission-critical workloads, you don't see a lot of mission-critical workloads running on free, open source software, free proprietary software. So for us, it's really the paid Linux space. Now, one may compete on the paid space outside of open source, like you said, open source versus proprietary. And yeah, we are seeing a very monumental shift every day on the cultural ethos of open source. I mean, more and more governments and financial institutions and mainstream companies are making a certain part of their business mandatory to run on open source technology. So that's definitely been a strong benefit for us, but predominantly, where we're seeing the biggest amount of volume really is around the competitive landscape relating to our closest competitors, Red Hat and VMware, for sure. We don't see Canonical that much in the space. It's really predominantly around Red Hat and VMware, with a sprinkling of movement away from proprietary and locked in code, in preference for an open source model as a business. Andy, can I give it to you to talk a little bit about guidance?

56:10 Andy Myers

Sure. Hi, Stacy. First of all, I would note that our business during COVID has remained very resilient during that period. If I think about, in terms of your question, just some of the sorts of costs that may be reintroduced to a business, as you say, coming in part from a virtual world into a physical world again, the two key areas are going to be travel and entertainment. I'm expecting those to go back up progressively. And also then another one is going to be in-person marketing events, because obviously we do a lot of digital marketing events now. When we move to in-person, that will increase our costs there. Having said that, though, we've anticipated that within our guidance. And we expect our business to continue to scale and be in line with our existing guidance, which is obviously stable margins for FY ’21 before gradual increase towards 40% over the medium term. And I continue to expect that.

57:18 Stacy Pollard

That's great. Thank you.

57:23 Operator

As we've received no further questions, I hand back to the speakers.

57:30 Andy Myers

Melissa, do you want to say any final words?

57:33 Melissa Di Donato

Thanks very much. I think we'll close there. I'll close by saying a huge thank you to everyone that's joining the call in an effort to try and further understand SUSE's business, our successes, and where we're headed. I'm surely very, very pleased to have delivered this news of a successful Q3. And I'm very optimistic always about SUSE's future, but more so now than ever before. I look forward to sharing more details in due course, over the coming weeks, and then talking to you further on the one-to-one. Thank you very much indeed for the interest in SUSE.

58:08 Operator

Ladies and gentlemen, thank you for attending today. This call is concluded. You may now disconnect.