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Third Quarter 2022 Results

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Transcript

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Andy Myers, CFO

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Jonathan Atack

Good morning and welcome to our presentation of SUSE's results for the third quarter of the 2022 financial year. I'm Jonathan Atack, Head of Investor Relations at SUSE. I'll shortly hand you over to our CEO, Melissa Di Donato, and our CFO, Andy Myers, who are going to take you through a few prepared remarks before we open up the floor to Q&A.

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

Melissa Di Donato

Thank you, Jonathan, and hello, everyone. I'm pleased to speak to you today and share details of SUSE's third quarter of our 2022 fiscal year. But before I present our financial highlights, let me start with a reminder of the many strengths that propel us and our business model going forward.

The results and reporting today demonstrate our ability to deliver high revenue growth, high profit margins and high cash conversion. We're capitalising on the strength of our mission-critical infrastructure solutions and rapidly growing markets by developing relationships with existing customers, at the same time as attracting new ones.

With our subscription model, diversified enterprise customer base and multiyear contract with up-front payment, we have a strong business model, which is driving long-term and sustained growth. This is particularly relevant at a time like we are today of macroeconomic uncertainty.

SUSE has delivered robust revenue and profitability in Q3. We're reporting a 13% growth in adjusted revenue and 15% at constant currency. Looking at the first nine months of the year, this growth is even higher at 16%, or 17% at constant currency. Our adjusted EBITDA margin was strong at 38%.

ACV was down 4% in Q3, or 1% at constant currency. This decline in total ACV was driven by an 8% decline in core, which was largely expected and reflected a number of key factors. First, a large retroactive and retrospective consumption contract in Q3 of prior year, our usual sales cycle, the available renewal pool in Q3 2022 and then lastly a foreign currency strong headwind.

We delivered strong unleveraged free cash flow of 62 million, equivalent to a conversion rate of 94%. Furthermore, I am reiterating our guidance for adjusted revenue and for our adjusted EBITDA margin this year. We are, however, seeing slower growth in our emerging ACV, exacerbated by the macroeconomic uncertainty in today's economy. I'll elaborate on the dynamics in this business shortly.

This macro impact is less marked in our core business, where a smaller portion of that business is new, given the very strong existing subscription base, but nonetheless having a relatively small effect.

It's important to note that we are reiterating our medium-term guidance, reflecting the growth outlook in the market and SUSE's competitive position. Let's spend a few moments now on the key operational highlights and headlines.

In terms of product development in Q3, we announced several significant enhancements to SUSE Rancher, SUSE NeuVector and SUSE Linux, highlighting our commitment to cloud-native security. These enhancements were well received by our existing and prospective customers.

In early September, we announced a new strategic collaboration AWS, Amazon Web Services, to support its seamless migration of customers' SAP landscape to AWS. This is a multiyear agreement, expanding on our existing relationship with AWS, and involves integrated go-to-market activities all across sales and marketing, shared channel enablement, engagement and training and dedicated personnel worldwide.

In Q3 2022, we continued to grow as a company. We added 69 people to our workforce despite an extremely and highly competitive hiring market.

Following a bit of elevated churn in our sales force earlier this year, I'm pleased to say that the actions that we've taken have softened and have returned dividends on our hiring market and have led to a more stable workforce with lower churn. We also made focused investment in sales people specifically dedicated to container management, container management sales and product development.

ESG, as you well know, it's the heart of our business and sustainable growth. We continue to make progress towards achieving these targets. We have received our sustainability rating with EcoVadis, which is one of our commitments from earlier this year. We were awarded a silver medal for our ESG practices, placing SUSE amongst the top 25% of the rated companies.

Let me talk you through some of the key deals that we secured in Q3. In Q3, we continued to win important business through cross-selling use cases and across the business supporting our high net retention rate, and by consistently expanding our presence across industries and across geographies.

This short list includes three descriptions of deals won in the quarter, reinforcing SUSE's strong value proposition around the world. First, a Fortune 500 US sports apparel giant chose our enterprise-grade, reliable and stable Linux product set. This large value renewal win demonstrated further expansion into a world-famous sports brand.

A global leader in sensors, logistics and manufacturing automation chose SUSE Rancher for its flexibility and for our responsiveness to customer needs. And then lastly a prominent Indian banking and payment institution chose SUSE Liberty specifically based on their positive experiences with SUSE Rancher. This represents the first large-scale SUSE Liberty win in India, supplementing an existing SUSE Rancher subscription.

Let me talk to you now about the current market dynamics and some important changes that we're going to be making. The mega-trends that are driving the growth in our market remain unchanged. Across the world, computing workloads continue to grow, and customers are increasingly deploying these workloads in the cloud and at the Edge, underpinning demand for Linux and container management products.

Open-source Linux, including SLES, is taking share from competing operating systems due to its stability, higher security, lower downtime, better performance and versality across cloud, on premises and hybrid environment.

The rising need for multi-cloud support and portability is driving container usage, which is predominantly a Linux technology. There's a huge potential for market growth, as only 5% of applications were containerised by 2020. And as a result, the container management market is expected to grow 44% per year between 22 and 25.

In Rancher, we have a market-leading container management platform, and we continue to see strong downloads and unique usage and users, reflecting the rapidly growing market that we reside in. We now have over 40,000 unique users, and this is an order of magnitude higher than the number of customers we've converted to subscriptions so far.

Let me tell you what we're going to do now to have faster growth to capture this market.

Whilst Rancher sales have grown significantly over the last two years, the business is currently performing, as you can see, below our expectations, and we are determined to take the necessary actions to fully benefit from the market growth and from our competitive position, even in tumultuous macroeconomic times.

We're developing our business to capitalise on the significant opportunity. We're addressing any issues in the economy that could be impacting our growth today.

First, as I mentioned last quarter in Q2, this current macro uncertainty continues to particularly impact our Rancher business, with slower purchase decision-making for new contracts and some customer project delays.

Second, potential new Rancher customers are more willing to extend the time they run unsupported with free versions of the software, as their focus on cost has intensified.

Third, despite the competitive hiring market, we've continued to grow our sales force, but following on the earlier churn in the year, this is now a less experienced sales force that we have as we enter Q3 and therefore have been less able to convert deals faster into actual sales per the past, but specifically in the current economic environment.

Then, number four, lastly we're enabling better sales support and accelerated product development.

In order to address these challenges, we're taking the following steps.

First, later this year, we're going to be introducing new security and compliance capabilities for Rancher to specifically serve the evolving needs of enterprise customer. This leverages the experience we've gained from our established SUSE Linux model and will serve as the platform for future value-creating innovation.

Second, and parallel with this evolution, to further differentiate from the free version, we are rebuilding and enhancing our go-to-market platform. What we're doing is we're expanding our team and we're now developing that specialised Rancher sales force to improve our ability to deliver a technical value proposition to customers even in this macroeconomic environment.

Lastly, we're also increasing Rancher's capability and Rancher's capacity specifically for product development and technical sales support to ensure we can deliver our new capabilities, maintain our current market-leading position and provide increased support to sales teams throughout the sales cycle.

This three-point plan will allow us to capitalise on significant pipeline generation and specifically the conversion of the pipeline of opportunity that we've been building over the last nine months in a rapid growing market.

With that, I'll hand it now over to Andy, who will take you through the details of our financial performance.

Andy Myers

Thanks, Melissa. Good morning and good afternoon to you all. Q3 was another quarter of robust delivery for SUSE, with high revenue growth, profitability and cash generation. We delivered adjusted revenue in Q3 of 171 million, up 13% and up 15% at constant currency. This growth is also shown in our group ARR, which was up 14% supported by a strong net retention rate of 108%, demonstrating that our customers continue to renew and grow their subscriptions.

Furthermore, we delivered a high adjusted EBITDA margin of 38%, supported by our strong cost control, and cash conversion of 94%. Whilst we are delivering high revenue, high profitability and high conversion, ACV is not performing as we hoped for the reasons Melissa set out.

I will now explain to you the details of our ACV delivery. Group ACV was down 4% and down 1% at constant currency, given the impact of exchange rate headwinds, primarily a strong US dollar. We continue to see strong growth in cloud sales, offset by lower ACV in other areas.

The decline in group ACV to 114 million was driven by a decline in core ACV of 8%, which is 5% at constant currency. This is largely as expected and reflects our usual sales cycle, our available renewal pool in Q3 22 and a high level of retrospective consumption contracts in Q3 2021.

Emerging ACV for Q3 was 21 million, up 21% and up 25% at constant currency, reflecting continued strong Rancher renewal, partly offset by lower new business, which has been impacted by the current macroeconomic environment and higher churn in our workforce earlier in the year.

The macroeconomic environment has exacerbated the normal quarterly lumpiness and led some uncertainty around the timing of when deals will be signed, with fewer deals closing in the important final weeks of the quarter than we expected this time round.

Moving to performance across our geography, growth in APJ and Latin America remain strong, with growth of 20% and 21% respectively. North America was down 6%, driven primarily by the small renewal pool.

Our performance by route to market included 4% growth in our end user ACV, including the cloud route to market, driven by strong growth in sales across all CSPs, and a decline of 41% in our independent hardware vendor and embedded route to market, driven primarily by the smaller embedded renewal pool.

Sales to IHV were also lower versus the prior year, driven by hardware shortages and a shift to selling through other routes to market, primarily through CSPs.

Let's now turn to revenue. Total revenue in the quarter was up 13% to 171 million and up 15% at constant currency, underpinned by continued strength in cloud revenue. Like our ACV, this growth was impacted by the higher level of retrospective consumption contracts signed in Q3 2021.

Revenue was up 16% for the first nine months of the year, 17% at constant currency, in line with our full year guidance. Growth was supported by the unwind of deferred revenue and more rapid recognition of high cloud ACV, given their shorter contract length. Overall, weighted average contract length on the last 12-month basis remains stable versus the prior quarter at 20 months.

Group ARR grew to 640 million in Q3, up 14% year on year, driven by continued demand for our subscription-based products and services.

Finally, our net retention rate remains strong at 108%, reflecting that our customers continue to renew their subscriptions with SUSE and are willing to pay a higher price or purchase a more expensive product selection.

Our strong revenue performance has allowed us to continue to invest in our growth whilst maintaining high margins, as you can see on the next slide.

We continue to have a resilient and high gross margin of 92% in line with the prior year. Sales, marketing and operation costs increased by 15% in Q3, as we continue to invest in our sales force and in marketing focused on pipeline generation and qualification.

Research and development costs increased by 7%, driven by continued investment in engineering and product management, with significant funding directed to our container management products.

General and administrative costs increased by 5%, driven by headcount investment to meet the demands of our growing organisation and being a listed entity and adverse realised foreign exchange movements.

Our adjusted EBITDA grew 18% to 65 million in Q3, as SUSE's revenue growth was further enhanced by strong cost control and a positive overall impact from foreign exchange movements.

Having added significant numbers of people to our workforce throughout this year, we will maintain strong cost control as we move forward, particularly given the current macroeconomic environment.

The result is a margin increase of one percentage point versus the prior year despite the high inflationary environment.

Now let's look at profit and how it's been converted to cash. Over the first nine months of the year, change in deferred revenue was positive 39 million, as we continue to sign new contracts with a total value higher than the revenue we recognised.

In Q3, change in deferred revenue was negative 18.9 million, down from positive 9.8 million in the prior year, driven by higher revenue recognition and lower ACV in the quarter. Our low capex and low cash tax business model enabled us to drive continued high cash conversion of 82% for the year to date and 94% in Q3.

Our strong cash flow supported our continued deleveraging, and net debt at the end of third quarter was 604 million, a reduction of 50 million versus the prior quarter. As a result, our leverage ratio was 2.3, flat versus the prior quarter, and well within our commitment to keep the ratio below 3.5.

Now let's move on to look at our last 12-month KPIs, which demonstrate the robustness and stability of our business model. These charts show our key metrics on a last 12-month basis, demonstrating our track record and providing a picture of consistent performance over time.

Whilst on this basis our ACV has seen a quarter-on-quarter reduction, the year-on-year growth remains strong at 13%. Our last 12-month revenue continues to grow steadily, up 16% versus the prior year.

Weighted average contract length on a last 12-months-basis remains stable versus the prior quarter at 20 months. And finally we have consistently grown our ARR with an NRR that remains strong at 108%. This is a key foundational block for our future growth.

Moving now on to guidance for the full year, which we are providing before the impact of exchange rate movements, as we have done previously. Starting with our P&L, I'm pleased to reaffirm our full year 2022 guidance for adjusted revenue and adjusted EBITDA margin.

We are, however, seeing slower growth in our emerging ACV, which has been exacerbated by the macroeconomic uncertainty for the reasons Melissa described earlier. The macro impact is less marked in our core business, where a smaller proportion of our business is new, given the strong existing subscription base.

But nonetheless it is having some effect. As a result, we now expect core ACV growth around 10% and emerging ACV around 20% in 2022. We also expect adjusted unleveraged free cash flow conversion to be in excess of 80% in 2022, which has been impacted by the lower ACV.

Exchange rate movements, particularly the stronger US dollar, are reducing reported ACV, adjusted unleveraged free cash flow and, to a lesser degree, adjusted revenue, given we carry a significant proportion of revenue into the period in US dollars as deferred revenue on the balance sheet.

Our reported adjusted EBITDA margin is supported by a positive exchange rate impact.

Finally, we are reiterating our medium-term guidance, reflecting the continued growth outlook in the market and SUSE's competitive position. We expect to build steadily toward these performance levels over the coming years, subject to the market and macroeconomic developments. With this, I will hand you back to Melissa to close.

Melissa Di Donato

Thanks, Andy. In closing the formal part of the session, I'd like to remind you of the resilience and the strength of our business. We do in fact, and have always done and will continue to deliver mission-critical infrastructure software within rapidly growing markets.

Our subscription-based model and the diversified customer base ensure sustainable and robust recurring earnings over the long term, upfront payment on our multiyear contracts drive high cash conversion, and we remain well placed to drive value creation in the years ahead.

This concludes today's presentation. Thank you all for attending. I would like to now hand it over to the operator to start the Q&A.

Operator

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

If you're using speaker equipment today, please lift the handset before making your selection. Anyone who has a question, may press star followed by one at this time. And the first question is from the line of Laura Metayer from

Morgan Stanley. Please go ahead.

Laura Metayer: Hi, there. Thank you for taking the question. I have three questions, please. First one is, your midterm guidance implies that you gain market share. Could you give us some insights into whether you're gaining market share at the moment, and if so, what the drivers are?

Second one is you say customers are willing to run an unsupported version of container management software for longer. Does that comment apply to all types of customers, even larger ones?

And three, you had a large ACV decline in China. What is the outlook there, please? Thank you.

Melissa Di Donato: Hi, Laura. Thanks for the question. The first is about the midterm guidance with regard to market share. I don't know if you want to reiterate midterm guidance as a part of this conversation. But let's talk about how we take market share. When you look at the 44% growth that we have anticipated for the container market, as an example.

That CAGR is based on revenue, and our revenue growth in emerging has been 59% in Q3 and 65% year to date. So we're growing faster than the market. Inevitably, it points to the fact that we are taking a higher growth. We are taking market share specifically in that segment.

As it relates to Linux's business, it's the same thing. The Linux business grows somewhere between 10% and 12%, give or take. With our business being predominantly traditional, subscription-based and install-based growth, we are also taking market share there. The market share percentages, we can probably research and give out.

But I hope that gives some perspective and actual real numbers. If the market is growing 44% per annum and we're growing upward of 59% and 65% for the year, then you can see how fast we're growing, taking market share from other competitors.

Just with regards to willing to support unsupported version of all types, there's a couple of things going on with containers right now. We only have one enterprise free version of Rancher, and that we offer at no cost in a very traditional open-source model. What customers pay for is support.

We started and the original founders of Rancher started that business but on the premise of the adoption-led strategy. And what adoption-led means is that you have to get mass adoption to actually get as many users as possible utilising the software. And in doing so, as they're adopting the software, if you will, there're very few engineers and support experts in the industry.

So what happens is the pendulum eventually begins to shift in this adoption-led strategy, which means the market is going to be much more flooded with a lot more support engineers. So the need to pay for support is not as urgent as it once was, let's say, two years ago or even one year ago because the critical mass has been achieved in the adoption strategy.

That being said, mission-critical workloads are still being paid for in way of support, and so it's not really about customer size because there's plenty of large customers, enterprise Fortune 500 customers, that are using the container portfolio products and not paying for them.

Perhaps they're not the mission-critical workload and perhaps they're not in production yet. But eventually they will be, and typically what happens is, if they adopt the technology, they utilise it in a development space. But you can't have a version of the same software sitting in a container that is unsupported and then another version that's not in a container and then not supported.

Eventually all the usage will be driving into a paid version of the software. The message here really is that as long as adoption is increasing, usage continues to increase, regardless of customer size that eventually will tell you what's going to be happening with future revenue of the product. It's not just one user type or customer size or even region for that matter.

Andy, do you want to talk about ACV? Specifically, it's decline in China.

Andy Myers: Yes, thanks, Melissa. I think we talked about China before. There is strong guidance from the government, a strong guidance and a requirement for businesses, to buy locally. And whilst we continue sell there and whilst we continue to win some new contracts, it is a difficult market for that reason. I think we've spoken about that before.

Laura Metayer: Thank you.

Operator: The next question is from the line of Frederic Boulan from Bank of America. Please go ahead.

Frederic Boulan: Hi, good afternoon, Melissa and Andy. Two questions on my side, actually three questions, if I may. First of all, to go come back on the core business. We've seen some slowdown in ACV. That's a business that's usually extremely defensive. Can you discuss a little bit more what's driving that slow ACV growth? You mentioned the cycle for emerging is also problem in that business.

Secondly, to follow up on the previous question on CMP, how do you reconcile the current ACV trend with medium term? Any elements you can give you the confidence on the midterm growth outlook that you have?

In particular, you talked about unsupported venture take-up. Is there anything you can share with us in terms of what you seeing on that front that we noticing and that give you that confidence into that level of growth in the medium term?

And then lastly, if I may, around margin. If you can share your views on where we can expect margin to develop in the medium term considering the efforts you've been doing around investment in the sales force. You have a target of 40% medium term. How do we get there from your 2022 level? Thank you very much.

Melissa Di Donato

Frederic, thanks. Let me talk about the core business first. The core business is a slightly different model than that of the emerging business. The core business is less affected by the macroeconomic uncertainty around us.

But nonetheless what's specifically addressed in core and being impacted by the macroeconomics is not the renewal and up-sell business. Our renewal business remains very strong, and Andy can talk about the NRR associated with that business just a little bit more clear in just a second.

But the net of the core business, the vast majority of the customers that we're selling into are existing customers that are really contained in the Fortune 500.

What's happening in that market is that when we sell to new, again a small percentage, the macro pressures are putting a lot of pressure on things like savings and further investment in new technology.

So rather than installing new application for new usage and new use cases, perhaps they'll just delay that decision that's driving a slightly softer net new business on the core side. But it's relatively small in way of impact.

We're not losing deals in that line of business, nor in containers. It's really about decision-making, and in fact, when we look at the Q3 results and the last two weeks of the quarter, which is obviously, as you well know, vast of majority of software companies have quite a big spike at the end of the quarter. Much of those slipped deals particularly in containers have already now since closed.

It's not that we're losing them to competitors or they're going some place else. They're just postponing and preserving cash in way of doing projects which are not necessary.

On the CMP side, how are we going to turn unsupported versions and take-up into actual revenue? We're the only real CMP provider in the market today for enterprise container management in the ECM market that focuses on offering a single version of the software.

We don't have a differentiated product. Our software is offered for free. You could take it up and use as many nodes as you want at no cost. Now, what's been happening in this economic environment is that it's much more considered a beneficial technology, and it's not a mandatory technology, like it is in Linux.

Buyers and CFOs, CIOs, etc., have just delayed the decision-making because they can still use the software, they can still have uptake and they can still have a lot of usage without having to pay for it. And eventually that pendulum will shift, when it comes into production, when there's mission-critical workloads, as we're seeing more and more.

The uptake. that adoption-led strategy will into not just pure unique users and usage of the software, but the requirement to have a paid version of the software as well. What we see is often a leading indicator of the health of the business, of the future outlook of the business, and we track that every single month.

And uptake is getting stronger. Unique user is getting stronger, and the sheer number of downloads is increasing, even when we don't have a recent version of the software that requires the download to happen in the first instance. So it really is increased adoption in usage.

If I can, Andy, the question around margin, I'll allow you to answer that, if that's okay?

Andy Myers

Yes, I'll just follow up on the core element… Sorry, afternoon, Fred. On core, our renewals remain very, very strong as a business, a net retention rate, 108%. And we're seeing no movement in our renewals at all with good, as I say, retention rates.

If we come on to the margin, we expect in the medium term… Our medium-term guidance hasn't changed, and the reason for that is, as you've seen from Q3, we have very strong cost and we continue… Although going forward, yes, we will continue to invest, but we will benefit from some scaling of the business and from growth.

	But we will continue to be selective in our investments with again continued strong cost control, and we believe that that will allow us to maintain our margins and deliver on our medium-term guidance.
Frederic Boulan	Thank you both.
Operator	The next question is from the line of Charles Brennan from Jefferies. Please go ahead.
Charles Brennan	Good afternoon, everyone. Thanks for taking my questions. I'm going to go with three as well if I can. Firstly, can I just labour the point around market share dynamics? In particular, it looks like Red Hat's delivering faster growth than you. How do we get comfortable that in the areas that you operate you're not losing market share? Secondly, just on the margin, I know you just addressed the medium-term margin outlook there, Andy, but can you talk to next year specifically? You've been increasing investments this year into slowing ACV environment. The slower ACV this year will presumably have a dampening impact on revenue next year. Do you see any scenarios in which margins next year actually fall year on year? And then thirdly just a detailed question on the numbers. Can you remind us where the contract assets come from in your business? Just looking at the numbers, it looks like revenue is up about $20 million year on year, but the contract assets are up about $30 million.
Melissa Di Donato	Sure. Let's talk about market share dynamics first. Just to be very clear that Red Hat, since you specifically talked about their business, they combined all the lines of business into one. Their emerging products, which are driven by OpenShift, as you well know, are in a more rapidly growing market than Linux, as we all know, because of the division between Linux and containers. And they make up a larger proportion of Red Hat's total business than SUSE's emerging products, which is primarily Rancher. So it looks like on paper that it leads to higher overall growth for Red Hat than SUSE. But again that's because of the mix and where the products are distributed and reported. You can't read too much into that. But we believe we're taking market share because we have a differentiated strategy. We've always focused on the ease of implementation, interoperability. We've always focussed on mission-critical environments and workloads. Since Red Hat was an independent company for most its life, unlike us, it grew faster in the beginning. But now that

they combined both businesses, they're effectively emerging products that combine with Linux, it's really hard to distinguish how much market share we're taking from them and how much market share in general over them.

But net of it is that when you look for dollar for dollar, line by line and break apart the product line, like we do, purely mathematically we're taking market share because we're outpacing the growth of the market.

When it looks at revenue and looking ACV, particularly around revenue, which is the leading indicator, and KPI for market share, you can see that we're outpacing the market growth. We also have customers that either publicly or not publicly have given us success stories of takeaway from our competitors. We don't have many the other way round.

So I think we can successfully conclude that purely based on mathematics and the numbers and revenue growth and CAGRs presented by the industry, that we've actually delivered, we would be taking market share away from competitors.

Andy, do you…? I think margins and the overall deep dive in the numbers is over to you.

Andy Myers

Sure. Hi, Charles. I'll give you our view of 2023. In the short term, we expect the macroeconomic environment to continue, obviously, I think we all do, to have an impact and to have an impact on our new business. We don't know how long this will last, and clearly we can't speculate on that.

As you've heard today, we have taken and are taking actions to drive increased demand through product development and sales execution. We expect this to start to impact our business over the coming quarters. This will take time, but it will give a positive impact.

The current macroeconomic uncertainty, the build-up of our differentiated products and sales force motions make it difficult for us to guide you on what 2023 will look like at this particular point in time. Yes, the lowering of 2022 ACV guidance will impact 2023 revenue, lowering the deferred revenue we enter 2023 with by circa 30 million, although we will still carry very significant deferred revenue into 2023.

However, our underlying markets remain strong, as we said, and we expect to deliver healthy growth in 2023, as we build back to our medium-term guidance over time. We also expect our margin to be similar to that in 2022.

If I can just then go on to your contract asset question. The contract asset, Charles, is the IFRS 15 adjustment, and it's the build-up… As we've grown in the year, it's the build of commissions that effectively get cashed out and taken over future circa seven years. So that's what the build-up of that is, as we grow.

Charles Brennan: Thank you.

Operator: The next question is from the line of Mohammed Moawalla from Goldman Sachs. Please go ahead.

Mohammed Moawalla: Thank you. Good afternoon, Melissa and Andy. I had two actually. The first one was… You talked about some of the attrition issues in the sales force and execution issues. I'm just curious to understand where close rates have now shifted to or pipeline conversion and also the pipeline growth and what are the assumptions you built in your revised guidance.

And the second question links back to the margin. Do you feel you need to reinvest back into particularly around the container management business and the sales force to try to drive that reinstallation? And then on that container management or emerging growth, should we see that recovery of the growth to be perhaps more back-end loaded in terms of the time horizon? Thank you.

Melissa Di Donato: Sure. Let me take a bit of that if I may and then I'll let Andy talk about growth or return to growth timeline.

When I look at the sales force, I think the biggest learning that we've obtained in the last, call it, six months from the macroeconomic pressures of the economy have really been around the criticality around having an experienced sales force that can sell a differentiated product or sell support when there's no differentiated product and the differences of that approach.

When there's economic pressure to sell a product that's differentiated with things like certifications and security enhancements, etc., they'll always be bought first. The impact that having an inexperienced sales team and being able to sell or offer a free product with no differentiation and just support where adoption has been highly increased over the last year has been difficult.

And what's happened is that the sales force, both the attrition earlier part of year in Q1 plus the investment we made in new sales people. We talked about in Q1 and Q2 a significant investment in sales. Them still being new has had an impact not in just simple ramping but ramping in an economic time that's extremely volatile.

So how do you get customers to actually pay for support when they can run the software for free and the market is much more saturated with skills than had once been, let's say, two years ago?

With Rancher, the commercial product capabilities are the same. The commercial capabilities are the same, sorry, product capabilities are the same for the only version we got, which is the free product.

The difference is that with Rancher, we're only selling enterprise support and having a new sales force that is predominantly focused on, by pure numbers, on being able to sell value against a differentiated product. The ramp time has just been a little bit longer. We always said it was going to be six months, but with the economic volatility, it's just been even longer.

We've already overhauled the entire sales force, retrained them, recertified everyone to be able to sell not just support to Rancher but support for free version of software in an economic volatile period that we're in now.

So how to really sell the value of the support. We're better able to position the customer, value, differentiate eventually, which will happen next year on a new version of Rancher that's got additional enterprise capability that's going to mimic that of Linux in way of the exact model. Security, certification and really we've invested - you said it yourself - we've invested a lot in the early part of this year in creating a robust and solid and technically secure Rancher product. Perhaps so secure that it's stable and in a such way that doesn't necessarily require a whole lot of support because it's been operating so well. That's been really, really good news for us.

It's been overall churn, but I think, when we look at the attrition, the new hires and sales force on average and what they're used to selling, the ones that were traditionally here, the Linux-based product that's highly differentiated, it's made that transition of giving the free product and selling support a little bit more difficult.

But the pipeline continues to grow. We talked about pipeline and the growth of the pipeline quite extensively in Q1 and Q2. The pipeline still exists. The pipeline is not declining, and the pipeline is oftentimes, like I said, a follow-on of a leading indicator, which is usage, download, unique users.

As long as we continue to drive usage, as long as we continue to drive adoption, unique users, download, that will inevitably continue to increase our pipeline and eventually continue to convert them into paid versions of the software.

We don't actually disclose specific close rate per se.

But Andy, shall I give next to you the second part of that question around conversion or close rates or anything else I might've missed?

Andy Myers: Thanks, Melissa. As Melissa said, the pipeline is… We have a strong pipeline, but what we saw at the end of Q3 was what we expected to convert didn't convert. And then a significant proportion of those have converted in Q4 already. And it's this delayed decision-making which made it particularly difficult in Q3 for us to predict.

We are not losing these deals. They're not going away. Where the pipeline is not being cleared out by customers walking away or alternative products being used, we're not seeing that. It's just taking us longer to convert the existing pipeline. As I say, the key thing is we're not losing to the competition here.

If I just move on to CMP ACV growth, we expect the actions we're taking to progressively take an impact over time, but clearly a big driver of this is going to be what's happening in the macroeconomic, and clearly that is a big driver in the future. As that eases, then that will again will aid our growth in the future.

You mentioned a little bit about margin, I think, and the expectation or the impact on our margin. We're already investing in sales and have done and already investing there. We've been investing in engineering and also in marketing, so we're already investing there. And some of those costs there are already in our Q3 statement.

We will, as I said, continue to specifically invest in certain areas, but we are very conscious of the macroeconomics at the moment. And that's why we have a very strong cost control at this moment in time.

Mohammed Moawalla: Thank you.

Operator: The next question is from the line of Vihren Jordanov from Cairn Capital. Please go ahead.

Vihren Jordanov: Hi, thank you for taking the question. Can you maybe let us know at this point in time how much of your revenue is generated by contracts that are paid up front and how much is generated by contracts that are paid on monthly or quarterly basis?

Melissa Di Donato: Andy, do you want to take that, how revenues are attributed? You might also want talk about cloud and cloud ACV and how that converts to accelerate our revenue. That's why we're seeing revenue continue to accelerate in

	alignment with cloud ramping. I'll let you answer that.
Andy Myers	A significant majority of our revenues come from one year plus contracts because we can sign up to… We've had some very long contracts, but between one to five years typically our normal end user contracts are. If you look at the cloud, which is a proportion of our business, we don't disclose the proportion. But it is a reasonable proportion of our business.
	The cloud is growing. The ACV and the cloud, the contract length has remained relatively stable. But the ACV and the cloud is a mixture of pay as you go, which is… Again, it continues and it keeps coming and it keeps growing.
	But that pay as you go and as customers go through the journey, usually around 18 months of having pay as you go, which is premium priced, they then convert to reserved instance between one and three years.
	And whilst it's discounted at a lower price, it then gives us the payment up front for those future years. But the cloud, it does effectively lower our average contract length. Having said that, our core business, our end user business, has seen longer contract length to offset that.
	I can't give you a split of the revenue, but I can tell you that the end of the day, a very, very high percentage of our revenues come from contracts in excess of one year.
Vihren Jordanov	But in terms of the actual payment timing, can you maybe just give us a ballpark split? What is up front, and what is recurring monthly or quarterly?
Andy Myers	The cloud revenues come at us… The pay-as-you-go revenue come at us in effect in arrears. A hyperscaler, for example, will report to us in arrears what revenues they've taken, and they will pay us in arrears. If it's a reserved instance or if it's non-cloud ACV, whether it's one year, two year, three year or five year, those contracts are paid up front. And those are contract lengths that we report.
	If you pay up front, we'll report the ACV, which is the one year, and then we put the deferred revenue for year two and year three, that will go into our deferred revenue movement and appear in our cash EBITDA. So as I say, most of our payment terms are in advance, with the exception of the pay as you go in cloud, where that is paid in arrears each quarter by hyperscalers.
Vihren Jordanov	Thank you. Got it.
Operator	Next question is from the line of Johannes Schaller from Deutsche Bank. Please go ahead.

Johannes Schaller

Thanks. Hi, Melissa. Hi, Andy. Melissa, I think you touched on this in a few bits of your answers here and there. But maybe could you just go back into the churn situation and the workforce again. Give us a bit more detail particularly around what you have now.

In hindsight, identify the reasons for why people have left. Is it compensation? Is it the product, other challenges? And what you've really changed since then that gives you more confidence that the people you're hiring now will actually stay around and be more successful, also given that shortly before the IPO and one, two years you did a major overhaul also of the sales organisation already.

And then the second question. Just in terms of North America, that was also a region that was maybe a bit disappointing. Could you give a bit more detail here what happened in the quarter on the ACV side and also how we should look at that region going forward? Thank you.

Melissa Di Donato

Hi, Johannes. Sure, happy to do that. Let me answer around the churn and sales first. The churn that we're seeing was predominantly on the Rancher side in sales, and it was almost all of the reason for the churn that we had was, almost all of it was related to wanting to be part of a start-up business. These are folks that are used to being part of a start-up community with new products.

They almost consider themselves evangelists of product. Working inside of what would be qualified as a good-sized technology company with process and procedure and less flying by the seat of your pants and hips, I would say.

And the structure that we've incorporated for best practices of selling to create a world-class sales organisation, for a lot of the Rancher sales team was not commonplace. They were much more attuned to, used to, accustomed to and preferred to work at a start-up community. They are, like I say, much more… They call themselves evangelists more than salespeople.

We knew, going into the acquisition of Rancher, that we were going to have an issue retaining people in sales. We knew that the culture of a fast-growing, mature tech company was very, very different culturally than that of a start-up enterprise, and we knew that it would be difficult.

We retained some key talent, they're still here inside of the sales organisation, that were part of the original Rancher sales team and even folks from the original NeuVector team. We invested in them, we put in retention plans, and they're ones that really do want to stay at SUSE at the size and the growth and the trajectory that we have.

So it's not at all related to necessarily product or service or anything else like that. It's much more about the culture and style of running sales in a start-up, and probably, Johannes, it has a lot to do with the financial reward associated with taking the risk of working in a start-up than working with a large enterprise like SUSE.

I feel confident that the people that we've hired since then, we're hiring them into SUSE. We're not hiring them into a start-up. We went through a complete overhaul, as you said, a number of… Three years ago actually, not last year but three years ago, and then more recently added two leaders of sales, Imran Khan and Adam Spearing.

And then we just recently in June hired Colin Brookes to help us run part of the business as the chief commercial officer replacing Paul Devlin. Colin has only been here for a couple months, and even still the other two leaders have only been here for what it would amount to, in Q3, six months.

So we've hired the right people. They're committed to the emerging business or the ones we've continued to invest and hire for Linux continue to accelerate and develop and grow. And we've had really good luck in hiring some amazing people, as you can see from the numbers.

What happens now is the last two… Essentially, since June, we've seen a significant decline in the churn of our direct sales force, so we're now seeing the benefit of the stability of our business, which we didn't have in the first part of the year.

People are staying in. Churn is going down. People are being trained. People are more accustomed now to obviously to the SUSE culture and the way of selling and the way of world-class organisation.

I'm cautiously optimistic, and even looking at the economic times that we have today, we were just overall seeing less churn, but for us by far less in the sales team. So I think that that's been dealt with.

The North America disappointment, I'm going let Andy comment on ACV, but what I would say is that North America had a significantly small renewal pool this year, this quarter, excuse me, than we did last quarter, Q2, or even last Q3. We do have new leadership, relatively new, from earlier this year in North America.

But obviously if you look at the vision of the business and where the predominant volume of original Rancher sales folks sat, they were in North America. North America with the churn and the new people coming in combined with the macroeconomic impact specifically in the North American market and the lower renewal pool have impacted the results of North America.

But I am not concerned about North America. I don't have any worries about its ability to deliver to meet this year's guidance and medium-term guidance at all. We have the right people, the right leadership, and we've hired really, really good folks into that market to be able to propel us and lead us with the emerging business but also the core Linux business. So I'm not worried about North America.

Andy Myers: Melissa, I'll just add to that. It is, you're absolutely right there, the renewal pool. The other factor in there that's given a high compare is the retrospective consumption contracts that we… A high level of that was reflected in the 2021 ACV number in America, so it remains a strong market for us. But those are two key factors that have driven the result, but it still has a year-to-date result of 20% growth.

Johannes Schaller: Thanks, Melissa. Thanks, Andy. That's very clear.

Operator: There are no further questions at this time, and I hand back to Melissa Di Donato for closing comment.

Melissa Di Donato: We now close our Q3. I hope that we answered all the questions and perhaps any concerns you might've had before coming into this call. I hope that we reassured you of the resiliency and the strength of SUSE's business, that the KPIs and leading indicators are pointing to future growth as we reiterate our medium-term guidance and the results for this year. Thank you very much for joining, and we'll speak to you again next quarter.