

**SUSE S.A.**

Q4 2022 Results Analyst Conference Call

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Transcript

**Speakers:**

Melissa Di Donato

Andy Myers

Jonathan Atack

Jonathan Atack

Good morning, and welcome to our presentation of our Q4 results. I'm Jonathan Atack, Head of IR at SUSE, and I will shortly hand over to our CEO, Melissa Di Donato, and our CFO, Andy Myers, who will take you through a few prepared remarks, before we move to Q&A. Before I do that, can I remind you of the disclaimer on page two of the presentation, which contains important notices on the information provided in the following presentation. Melissa, over to you.

Melissa Di Donato

Thank you, Jonathan, and hello, everyone. Today, I am pleased to share the details of SUSE's fourth-quarter performance in our FY22 financial year. SUSE continued to deliver strong revenue growth and high profitability in Q4, demonstrating the sustainability of our mission-critical subscription software business in what is known as a very challenging macroeconomic environment.

I would like to thank my colleagues, our open-source communities and our partners for all their hard work and their achievements, which have contributed to our success this year. Before I present our financial highlights, let me start with a reminder of the many strengths that make our business model so robust.

The results we're reporting today, they 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 in rapidly-growing markets by developing relationships with existing customers whilst, at the same time, attracting new ones. With our subscription-based model, diversified enterprise customer base and our multi-year contracts with upfront payments, we have a very strong business model which is driving long-term and sustainable growth. I am confident that we are positioned very well against this troubled economy.

SUSE delivered robust revenue growth and high profitability in FY22. We're reporting 14% growth in adjusted revenue, which was 15% at constant currency. Our adjusted EBITDA margin was strong, at 37%, as SUSE maintained our disciplined approach to investment, to balance growth and profitability. ACV was up 9% for the year, or up 13% at constant currency. Total ARR of 646 million, up 12%, demonstrates the continued strength of SUSE's subscription-based business. Finally, we delivered solid unlevered free cash flow of 188 million, equivalent to a conversion rate of 78%.

We continued to build the business in order to deliver on its growth potential, including further product innovation and evolving our organisational structure. We recently announced several significant enhancements to our product portfolio. We

launched Rancher Prime, the very first differentiated and paid-for Rancher product. We also released our Adaptable Linux Platform, or what we call ALP. Also, SUSE Edge 2.0 was released, which highlights our commitment to cloud-native solutions.

In November, we simplified and refocussed our sales organisation, to optimise our go-to-market approach for Rancher Prime. This is to meet the demands of our growing large enterprise customer base, and to ensure we are well-placed in the future. The changes included the creation of a specialised sales force dedicated to acquiring new Emerging customers, as indicated in our previous quarter, which I'll cover in more detail shortly.

Following a rapid headcount expansion earlier in our financial year, we have stayed broadly flat in our headcount in Q4, reflecting our disciplined and measured approach to cost control. We increased our capacity for Rancher innovation and technical support by focusing on expanding our research and development teams to complement the restructuring of our sales organisation.

And as we know, ESG is at the heart of our business and our sustainable growth. This year, we delivered against all our ESG commitments, including climate action and information security, and we were recognised externally for the progress that we've made.

I'll now turn to some important wins in the quarter. In Q4, we continued to win important business, both through upselling and cross-selling, supporting our high net retention rate, and by consistently expanding our presence across industries and across geographies. This short list of examples highlights Emerging wins and includes three deals won in the quarter, reinforcing SUSE's strong value proposition around the world.

First, a prominent US enterprise software leader chose NeuVector to manage their end-to-end customer and container security, and there is significant expansion potential in this account going forward. Next, a large German multinational engineering and technology customer extended their Rancher subscription five-fold in addition to their existing Linux solutions. Lastly, a major global investment bank in Japan chose Rancher, including our priority support, deployed on AWS and on-prem. They selected Rancher for its truly open approach, zero vendor lock-in and cost-effectiveness, after what was a long and competitive process.

As we look forward, we continue to look to innovate everywhere. Relentless, cutting-edge innovation is fundamental to our strategy for sustainable growth, and in recent months we've

made significant announcements covering our major product segments: Linux, Containers and Edge. In October, we launched a prototype, a next-generation Linux, which we are calling the Adaptable Linux Platform, or ALP.

ALP is a modular Linux that will allow users to run workloads seamlessly across data centres, the cloud and the edge. Industry watchers, including the press, have reacted very positively towards ALP, describing it as, and I quote, an offering that could enable SUSE to seize a strong lead in Enterprise Linux, end quote.

In December, in line with our commitment, we launched Rancher Prime, the very first differentiated paid-for Rancher product. Rancher Prime focuses on industry-leading security and compliance capabilities. This launch was a very first step towards creating a differentiated experience for paying Rancher customers. Finally, we also launched SUSE Edge 2.0 in October. This was the world's first 100% open-source, cloud-native solution to manage Kubernetes, Linux and virtual machines at the edge.

Across the world, computing workloads continue to grow. Customers are increasingly deploying these workloads in the cloud and at the edge, underpinning strong demand for container management and Linux products. Our Emerging business, powered by container management and security products, delivers fast growth based on gaining new customers in these rapidly-growing markets.

This growth is mostly driven by customers introducing more containers into their multi-cloud environment. Our Core business, powered by mission-critical Linux, delivers sustainable growth based primarily on leveraging our existing large enterprise customer base and their needs for additional capacity and growth. These market dynamics have guided the changes we've made to our sales organisation covered in the next slide.

In Q3, we announced the forthcoming simplification of our sales organisation to better focus on our biggest customer opportunities and our growth levers. In November, we had successfully completed all of these changes. We've created a new sales team to focus on Emerging sales, primarily Rancher Prime. This team specialises in acquiring net new customers, managing existing Emerging customers, and also has the responsibility for upselling and cross-selling into our large base of existing customers.

Our Customer For Life team, which is a second team, focused on our largest existing enterprise customers, ensuring that they get the maximum value from all SUSE offerings. In addition, this team delivers consulting services and support for all lines of

business. Third, our commercial team, which manages key partnerships, focusses on net new customers with and through partners, and helps customers optimise the management of their SUSE subscriptions.

Finally, we have a new team coming to SUSE that was started in November of this year, the Global Sales Productivity team, which will underpin the new structure, driving productivity improvements, new tools, data and also utilising best-in-class analytics.

The sales teams will work closely with our established general managers and product teams which we announced earlier in FY22, covering our existing enterprise customer and container management business, business-critical Linux and edge.

This new structure ensures we're absolutely aligned to the markets in which we operate, and it accommodates the different sales approach required across our Core and Emerging solutions. It will enhance our ability to manage cross-sell, upsell, renewals, partnerships and expansions across all product lines. Furthermore, accountability for distributor relationships now resides under a single sales leader to improve productivity and efficiencies.

Now, let me talk you through the improvements we've made to Rancher in the quarter. We're moving forward with the talked-about three-point plan we introduced last quarter that will better differentiate Rancher in the marketplace and support it with a more focused and effective organisation. In December, we launched the very first differentiated, as I said, paid-for version of Rancher, called Rancher Prime. Rancher Prime is used to directly serve the evolving needs of enterprise customers. This will serve as a platform for the future, value-creating innovation that will be delivered out of Rancher.

In parallel with this evolution, to further differentiate from the free version, we've created a specialised salesforce dedicated to acquiring new and managing existing Emerging customers. This has proven to improve our ability to deliver a technical value proposition to our customers. We also increased Rancher's capacity for product development and technical sales support, to be sure that we can maintain our market-leading position.

Let's now move on to ESG and the achievements from the past year. ESG, as I've said, is at the very heart of our business, and it's at the very core of our sustainable growth. This year, I am very pleased to say that we delivered against all our ESG commitments. Starting with climate action, we have developed emissions targets aligned to net zero standards, and we've built a road map for achieving these with clear priorities for the next three years.

In Q4, we submitted these targets to the Science-based Targets Initiatives for validation. We further strengthened our information security and data privacy management solutions and systems, having already enhanced our practices to comply with relevant ISO standards. We continued to improve our disclosures, as we published our now second sustainability report. And finally, our ESG performance was consistently ranked amongst the top 25% of companies, as rated by EcoVadis and Sustainalytics and ISS. We will continue to make progress towards our ESG goals in FY23 and beyond. With that, I will now hand over to Andy, who will take you through the details of our financial performance. Andy?

Andy Myers

Thanks, Melissa. Good morning, and good afternoon, to you all. Q4 was another quarter of robust delivery for SUSE, with high revenue growth, profitability and cash conversion. Q4 ACV was up 11%, and up 16% at constant currency. We reported adjusted revenue growth for the quarter of 11%, and 12% at constant currency. Group ARR also grew strongly, up 12%, supported by a net retention rate of 106%, demonstrating that our customers continue to renew and grow their subscriptions.

Furthermore, we delivered a high adjusted EBITDA margin of 39% for the quarter, as we maintain our disciplined approach to investment to balance growth and profitability. Finally, cash conversion was 67% for the quarter. For the full year, we're pleased to have delivered against our original guidance for revenue and profitability, despite the challenging macroeconomic environment. Constant currency adjusted revenue growth of 15% was in line with our guidance, and our adjusted EBITDA margin of 37% was at the top end of our range. Cash conversion was 78% for the full year, slightly below our guidance due to a working capital outflow driven by the timing of customer collections, which will reverse in the coming quarter.

I'll now talk you through our KPIs for Q4, starting with ACV. Group ACV was 11%, and up 16% at constant currency, given the impact of foreign exchange rate headwinds, primarily a stronger US dollar. The increase in group ACV to 138 million was driven by strong renewals and higher upsell, and while selling to new customers remains challenging, ACV from new customers increased quarter-on-quarter. Core ACV was 102 million in Q4, up 4%, and up 8% at constant currency. Emerging ACV was 36 million, up 37%, and up 43% at constant currency.

Moving to ACV performance by geographies, Europe, Middle East and Africa grew strongly in Q4, up 13% despite foreign exchange headwinds, supported by several large renewals and good growth in sales through cloud service providers. North America, up 14%, rebounded after a lower renewal pool contributed to the modest decline in Q3. Latin America, up 7%,

continued to show growth underpinned by strong renewals. And lastly, Asia-Pacific and Japan declined 5%, primarily due to the phasing of renewals.

Our performance by route to market included 12% growth in our End User ACV, driven by strong renewals and upsell to end users, and continued strong growth in sales through cloud service providers. And a decline of 2% in our Independent Hardware Vendor and Embedded route to market, driven by continued shortages in hardware and a shift to selling through other routes to market, primarily through cloud service providers.

Let's now turn to our revenue performance. Total revenue in the quarter was up 11%, to 170 million, and up 12% at constant currency, comprising 140 million in Core and 30 million in Emerging. Revenue was up 14% for the full year, up 15% at constant currency, in line with our full year guidance. Growth was supported by the unwind of deferred revenue and more rapid recognition of higher cloud ACV, given the short average contract lengths. Overall, weighted average contract lengths on an LTM basis remained stable versus the prior quarter, at 20 months.

Group ARR grew to 646 million in Q4, up 12% year on year, demonstrating the continued robustness of SUSE's subscription business, supported by growth in both Core and Emerging. Finally, our Net Retention Rate remained relatively strong, at 106%. This was down 4 percentage points year-on-year, due to a combination of the loss of SUSE legacy business early in the year, the maturing of the Emerging customer base, lower ARR from a small number of Core customers, the impact of the Russian sanctions, and foreign exchange headwinds.

Our strong revenue performance has allowed us to continue to invest in growth whilst maintaining high margins, as can be seen on the next slide. We continue to have high gross margins of 93%, broadly in line with the prior year. Total operating cost decreased 4%, to 92 million, in Q4, despite adding over 350 net new employees throughout the year. Hiring across sales, research and development and administrative functions was more than offset by the impact of foreign exchange rate movements.

Sales, Marketing and Operating costs decreased by 1%, to 45 million, in Q4, as our investment in headcount was more than offset by the impact of foreign exchange rate movements and marketing cost savings.

Research and development costs increased by 5%, to 26 million, driven by continued investment in Emerging product development and technical support, partially offset by the impact of foreign exchange rate movements.



General and Administrative costs decreased by 17%, to 21 million. Investment in people to meet the demands of our growing organisation and an adverse realised foreign exchange movements were more than offset by lower consulting fees and movements in foreign exchange rates.

Adjusted EBITDA grew 39%, to 66 million, in Q4 as SUSE's revenue growth was further enhanced by strong cost control and a positive impact from foreign exchange movements, resulting in margin expansion of 8 percentage points versus the prior year. For the full year, our adjusted EBITDA margin of 37% was at the top of our guidance range.

Now, let's look further at how our profits have been converted into cash. For the full year, adjusted cash EBITDA was 295 million, up 6% as the growth in adjusted EBITDA was reinforced by a positive change in deferred revenue of 53 million. Adjusted unlevered free cash flow of 188 million was down 6% for the full year, as the higher adjusted cash EBITDA was more than offset by a larger working capital outflow, increased capital expenditure and higher cash taxes. This resulted in cash conversion of 78%, slightly below our full year guidance, primarily due to the working capital outflow which we expect to reverse in the coming quarter.

Our strong cash flow supported our continued deleveraging. Our net debt, at the end of the fourth quarter was 558 million, a reduction of 163 million versus the prior year. As a result, our leverage ratio was 1.9, significantly lower versus the prior year, at 2.6, and well within our commitment to keep this ratio below 3.5.

Let me now move on and look at our last-12-months KPIs, which demonstrate the robustness and stability of our business model. These charts show our key metrics on an LTM basis, highlighting a consistent performance and strong track record. ACV, ARR and revenue on an LTM basis are all higher in Q4, and NRR remains strong at 106%.

Moving now to our guidance for FY23 and beyond. First I'd like to point out a couple of changes we're making in our guidance framework. FY22 marks our first full financial year as a listed business. Our experience since our IPO in May 21, and feedback from the capital markets, has led us to evolve the way we set expectations for future performance. SUSE introduced ACV at IPO to provide insight into our order intake and as a lead indicator of revenue. However, by guiding on ACV, we have focused the market's attention on quarterly ACV performance, and we know ACV growth rates on a quarterly basis are very lumpy, driven by multi-year renewals, with the lumpiness exacerbated in Emerging ACV growing from a small base. We have therefore decided to move our focus onto revenues and,



going forwards, guide on both Core and Emerging revenue growth, rather than ACV development.

In FY23, given the growth outlook in SUSE's markets, its competitive position and disciplined approach to investments, we expect to deliver adjusted revenue growth of 11% to 13% at constant currency in FY23, with reported growth around 2 percentage points lower based on exchange rates at the end of Q4. This comprises Core revenue growth of around 10% and Emerging revenue growth of around 25%, both at constant currency. Core and Emerging reported growth rates are expected to be around 2 and 1 percentage points lower respectively, based on exchange rates at the end of Q4.

In line with previous years, we expect revenue growth to be stronger in H2. This is driven by the cyclical nature of software deals and, specifically this year, by changes we're making to our Rancher business, including the launch of Rancher Prime and creation of a specialised sales force, which we expect to gain traction throughout the year. We also expect adjusted EBITDA margin expansion from FY22, as we balance investment in growth opportunities with strong cost control.

Based on exchange rates at the end of Q4, we would expect an FX tailwind to support EBITDA margins in FY23. We expected Adjusted Unlevered Free Cash Flow conversion to be in excess of 80% in FY23, reflecting the continued demand for long-term contracts with upfront payments.

Looking further out, we expect our markets to continue to grow strongly. The global megatrends that are driving this growth have demonstrated their resilience in the challenging macroeconomic environment, and support our confidence in the medium-term performance of our business, although naturally, in the current circumstances, we are taking a more prudent approach in our planning.

As our markets expand, particularly the nascent container management market, we expect the growth to slow, and have factored this into our latest medium-term guidance. In this guidance, and based on our experience so far, we continue to expect SUSE to gain market share. We expect growth in adjusted revenue of mid to high teens percentage, comprising of over 10% growth in Core revenue, and over 30% growth in Emerging revenue. As the business scales and we benefit from our expanded product offering, we will maintain our disciplined approach to investment to balance growth and profitability, and as such, we expect our adjusted EBITDA margin to be in excess of 40% in the medium term.

We expect to build steadily towards these performance levels over the coming years, subject to market and macroeconomic

developments. In the medium term, our business model will continue to generate strong cash flow, resulting in adjusted unlevered free cash flow conversion in excess of 80%. With this, I will now hand you back to Melissa to close.

Melissa Di Donato

Thanks, Andy. Before closing the session and moving over to Q&A, I'd like to emphasise why SUSE remains a robust business. We deliver mission-critical infrastructure software in what has proven to be a rapidly-growing market. Our subscription-based model and diversified customer base ensures sustainable and recurring earnings over the long term. Upfront payments and our multi-year contracts continue to drive high cash conversion. In summary, we do believe at SUSE that we continue to be extremely well placed to drive value creation in the many years ahead. This concludes this portion of the presentation. Thank you all for attending. I'd like to now hand it back over to the operator and Jonathan to cover some Q&A.

Operator

Ladies and gentlemen, at this time, we will begin the question and answer session. Anyone who wishes to ask a question may press star followed by one on their touchtone telephone. If you wish to remove yourself from the question queue, you may press star followed by two. In the interests of time, please limit yourself to two questions only. If you are using speaker equipment today, please lift the handset before making your selections. Anyone who has a question may press star followed by one at this time. The first question is from the line of Laura Metayer with Morgan Stanley. Your question, please.

Laura Metayer

Hi, Melissa, Andy, thank you for taking my questions. I have two questions, please. The first one is on the midterm EBITDA margin guidance. Can you give us a bit more detail on how you get 40%-plus EBITDA margin in the midterm? And is that going to be done by lowering R&D investment? Are you not afraid that it could potentially jeopardise the longer-term growth? And then the second question is could you please give us a qualitative update on the pace of customer conversions from the free to the paid version of SUSE Rancher? Would you say the data is stable, better, worse, or anything else you can share on this or the conversations you're having with customers? Thank you.

Melissa Di Donato

Hi, Laura. I'm happy to answer. Andy, do you want to talk about mid-term EBITDA, and then I'll cover the Rancher question.

Andy Myers

Yes, sure. Thanks, Laura, hi. Our midterm guidance around the margin isn't connected to... We're not backing off our investment. Just the opposite. You've seen us talk about ALP and Edge 2.0 and the investments we're making around Rancher Prime, so we're not backing off our investments. We believe, and we've seen it in our planning for 2023 and beyond, we can drive greater efficiency.

Some of that, candidly, comes out of the reorganisation of our new focused sales force, on our largest customers and on our Emerging customers. So we expect that to gain us efficiencies, but we continue to invest in the products that we've already spoken about. Yes, we expect the business to scale, so things like G&A, we always expected that to scale, but I think now we have a better handle and strong view and confident view that we can scale this business faster with the efficiencies we've identified.

Melissa Di Donato

Hopefully, Laura, that answers, and I'll talk a little bit about Rancher and how it's progressing. I think Q4 was a really good start. Q4 demonstrated significant progress versus, obviously, Q3, but, in the grand scheme of things, even against consensus. And the reality is that obviously the changes that we've just made will take a quarter or two to show some effect, but we've made progress. We've made progress against our plan to evolve - the one that we laid out in Q3.

Let me just go through a couple of points, and then we'll talk about conversion, which is still early days because Rancher Prime was only released in December, so we're only about five weeks in. But we've made progress in our plan that we announced in Q3. First, we launched the product, like I say, in early December, it's still early days. The reaction has been very positive to Rancher Prime. And the conversion rate, it's only been five weeks or so and it isn't easy to track, given the nature of an open-source product.

So we have some insights from the downloads, and Docker Hub is one example, but an organisation could very easily download a copy of the software and then recopy it many times over and over and over, or even download to and from another provider, so that kind of data we don't have, because we can't see when the systems are replicated. But based on the data we do have, we believe the conversion rate is very low still. The opportunities are high, but the conversion is low, which represents a big opportunity for us, five weeks in.

We're addressing this to make the conversion rate something that we can measure and deliver by way of KPIs for the business by the introduction of Rancher Prime with the sales team. So motivating customers to move to the paid product with a specialised sales team is a model that is still new, but we're very optimistic. And it will take some quarters to deliver specifically a conversion rate KPI as it pertains from Rancher to Rancher Prime. So that was the first bit.

The second part is we launched Rancher on AWS Marketplace for the first time, extending our go-to-market approach by allowing customers to really download seamlessly their

purchases of Rancher through AWS as they continue to evangelise, grow and extend their IT stack. So that's just been recent as well. And then of course I talked about the sales team as a big third pillar, that we now have a team dedicated to Rancher Prime and new customer selling, which is really important.

And then you touched on something with R&D. In Q4, we focused our hiring of R&D specifically on Rancher and Rancher capacity for product development - product development and technical sales support. So in Q4, we delivered a significant decrease in mean time to closure. That's one of the KPIs we use to measure our support cases. The mean time to closure for our support cases has been significantly decreased because of the increased investment we made in R&D in Q4. So all in all, the market remains strong, we've got an industry-leading product. I think with these four big changes and investments we've made, we're in a good place to capture the market going forward.

Laura Metayer

That's very helpful. Thank you, both.

Operator

The next question is from the line of Mohammed Moawalla with Goldman Sachs. Your question, please.

Mohammed Moawalla

Thank you very much. Hi, Melissa. Hi, Andy. Two from me. First one, Melissa, just curious to get a bit more from you in terms of the operating environment. I know the Core business, as you describe it, is mission-critical, has proven to be fairly resilient so far, are you seeing any sort of signs around that of potential macro impact? I know the cash collections were a little softer after the end of 2022, are you having to provide any other incentives to close business?

And the second question was around some of the sales reorganisation changes you made. I know, Andy, you said that the year would be more backend-loaded, how should we think about the first half? Should there be any big differences between Q1 and Q2 in terms of both Rancher but also overall growth profile? Thank you.

Melissa Di Donato

Hi there, sir. Andy, I'll take the first one around the operating environment Core, which has been proven to be resilient. It has proven to be resilient, and I think that as we look forward, for the Core business, it is a very stable lever for us as we look forward. What's gone on in the market, how is the operating environment? It is a hard operating environment as it pertains to the Core and evangelising net-new, but net-new remember comes mostly from the provider, like the cloud providers, MSPs and partners. No one's taking out their complete end-to-end Linux environment. What they're doing is diversifying it. And that's where we're seeing the most opportunity for SUSE Linux.

Because we're only focused on mission-critical workloads, we're less volatile as it pertains to the turbulent waters in the market. So it's been stable. It's not been easy as it has been in the past, workloads continue to grow, mission-critical workloads continue to grow, which gives us the optimism for the guidance that we've provided. So we remain steady on our Core business.

In general, I would say we're taking market share, we're not losing market share in our segment, which is the paid Linux for mission critical. We don't have market data yet on 22, but as we look back it looks like we're growing in line with the competition. But considering that our closest competition has a higher proportion of revenue coming from containers versus Linux, by proxy we're holding our own in a competitive market, and taking market share in Linux.

So it's not as easy as it has been, let's say, a year ago, but our workloads continue to grow. They continue to outpace the normal markets, we continue to take some degree of market share, and that's a very steady Core for us. So I think it warrants an opportunity for us to ensure some stability in our business going forward into 23 and beyond. Andy, I'll hand the second part of the question over to you, if I may.

Andy Myers

Hi, Mohammed. Just picking up on the tail end of the first question, you talked about cash collections for 22, it wasn't a macroeconomic impact, it was simply that some of the billing we did in Q4 was in the last month of the quarter, which meant we collect the cash in the first month or so of the next quarter. That's all. It was just billing timing that caused that increase in debtors at the year-end. No collection issues.

So just onto your second question, 2023 revenue growth, yes, we expect a pattern of revenue growth very similar to 2022, where absolute revenue steps up in H2 and there are no big jumps or large changes between Q1 and Q2. The revenue step-up in H2 is a factor of returning renewal pool that builds over Q1, Q2, and that starts to really deliver higher revenues in H2. And then obviously the actions we've taken around launching Rancher Prime, and then the new sales force, those will come in, progressively grow during the year, which adds further growth into the second half. Hopefully that helps.

Mohammed Moawalla

Yes, that's great. Thank you, both.

Operator

And the next question is from the line of Toby Ogg with J.P. Morgan. Your question, please.

Toby Ogg

Hey, good afternoon, Melissa and Andy. Thanks for taking the questions. Two from my side. Melissa, perhaps the first one for you, on the Core side of the business. Obviously, the new guidance, over the midterm, looks for growth in excess of 10%

versus the prior mid-to-high teens. Could you just help us understand the core drivers of that change, and specifically distinguish between anything macro-related and any other trends that you're seeing in that specific domain?

And then, Andy, you've mapped out a higher adjusted EBITDA trajectory here, obviously as we discussed relative to the prior guidance, could you give us a sense as to why you think this new higher margin trajectory is the right level for the margins? Given you talked about the investments flowing into various parts of your business, like Rancher Prime, the specialised sales force, why not invest more and really go for the market opportunity? Thank you.

Melissa Di Donato

I like the second question, I'll let Andy answer that one. The first one around the Core. That's a good one. So, the Core business, what's the slight reduction from the mid-teens down to in excess of 10%? We're trying to take a bit of a prudent approach to the future. Considering the unknown macroeconomic environment, we've seen a modest slowdown in growth in general from our existing customers. As the economy slows and our big enterprise customer businesses slow, the demand is slowing down too. I would say that if we see some relief in the macroeconomic environment, we see a more progressive, rapid evolution of the cloud, which we've also seen a slight slowdown in, as you read from the CSPs and the market providers, I think that can go gradually go up again, potentially.

Our customers continue to renew, they continue to expand, just not at the pace, because of the pressures from the macroeconomic environment that we saw. So we're just not moving as fast in the economy as we had originally anticipated. A lot of our workload in the cloud, MSPs and through partners, are really driven as workloads expand, so as more workloads go, inevitably, to the cloud, naturally you get more Core business driven with it. It's kind of like the drag that comes along with the expansion. If the economy doesn't expand and our customers' businesses don't expand, it requires less workload that will function on their mission-critical apps and workloads.

There's also been some impact on the business, as you saw from Andy's side, on the decline, because of IHV and Embedded, because of the chip slowdown and supply chain issues. If you can't produce machines and get them out, then obviously the lack of demand decreases for Core. So we've taken a bit of a prudent approach. We expect the short term to be okay, the midterm we just don't know, I don't know the impact of the economy.

It's a stable business, it's a robust business, it's a subscription business, so we're not worried about the subscriptions and the



customers and the stability of the business, but we're just taking a prudent approach on the ability for workloads to continue to expand at the same pace as we thought they would expand at the beginning of last year. But there's nothing particularly sinister, there's nothing that's concerning me.

Hopefully, we'll all see some relief, and once that releases and the pressure's off, I think you'll gradually see some more security and safety and the numbers even growing in the medium to midterm. Andy, do you want to then take the second question? I can answer that one but I'm not sure if it's appropriate. Give my opinion.

Andy Myers

Yes, I think, as you said, Melissa, it's very fair to say that whilst our markets are clearly growing very strongly and the global megatrends, we have been more prudent in our medium-term guidance, particularly where Emerging is concerned. There is going to be some maturing of that market. But we've been more prudent with our forward look, but still expect to take market share over this period.

When it comes to our margins, we've looked at, in great detail, our cost base. We've looked at the impact of our sales force restructuring, particularly where we've focused people on net new names. Net new names, you've got to grow your sales force. But on our installed base, we know full well that our Core installed base is just growing revenues year-on-year, and they stay with us, they're very sticky, and we believe we can absolutely drive sales efficiency.

We've invested particularly in engineering in our plan. We expect to invest in Emerging, Rancher, NeuVector at a significant level, and we're also increasing our investment, not as quickly as in Emerging but increasing our investment in engineering and Core. But then, if you look at the rest of our cost base, it does scale, and we expect it to scale. So it's a fresh look at our cost base that's driven the increase of our margin, and some of the changes we've made for the start of 2023 that's leading us to give confidence to those higher margins.

We have not compromised our growth level. Yes, some people say should you invest more to get more? I think in our plan we're investing in engineering, in innovation and the things we've already mentioned, ALP, Edge 2.0, etc., etc., and we've got new developments coming. We're investing in those, we're putting the right level of funds, we're not holding those back, but we will continue, as a business, just to have a balanced view of what the macroeconomic effect is, what the growth rate is in front of us, and we will manage our cost base accordingly. But we are not slowing down on our investments.

Toby Ogg

Understood, very clear. Thank you, both.

Melissa Di Donato Well said, Andy. I was going to say exactly the same. Slowing down is not something that SUSE's very good at. Operator, any more questions?

Operator The next question is from the line of Frederic Boulan with Bank of America. Your question, please.

Frederic Boulan Hi, Melissa. Hi, Andy. Thanks for the questions. Just a follow-up on the previous question around the driver of the lower mid-term growth outlook for the Core business. Maybe if you can update us on the level of competition in the OS segment? Is it fair to say that the reduction in the guidance is largely down to lower growth and lower macro and not really so much a result of competition? Or is there anything else here you want to flag or update?

Melissa Di Donato Absolutely, we only see predominantly or exclusively Red Hat in our accounts. We don't lose very much. I think we talked about it a couple of quarters ago, you can pretty much count on a hand, since I've been the CEO, of accounts that we lost to Red Hat. We may exchange, back and forth, workloads, tending to take on workloads because of our flexibility and interoperability has been more the mainstay and what we see more often, rather than losing. We very rarely lose to Red Hat.

It's much more about the economics of the economy. What we expect to build on is a standard level of growth. We are in a megatrend, in the middle of three megatrends that are driving usage and increased workloads. Those workloads have just slowed, and that's why we're taking the more prudent approach, but we very rarely outright lose accounts to a competitor. We really only have one. So it's not that at all. The economy is unknown and we'd rather just take a more cautious approach to ensure that we're going to meet the demands of the market of our customers and of the expectations of our investors. It's not about competitive landscape at all.

With the release of ALP and what we've been doing in edge over the last four years, that really does set us apart. We have a consortium of executives, and one of them stood up on Monday of this week and said, SUSE, you've really got the cornerstone, you are the leader in edge and that market. And as we see more devices moving to the edge and becoming more intelligent, that workload demand is going to inevitably increase. And that's the market that we demand - and that market requires a modular, flexible approach, a micro version of SLES, which is our Core operating system, and that's why we continue to win and see success and stability and robustness in our profitability and our cash conversion. And the robustness of the business continues to accelerate.

It may not have been to the speed that we all want and had expected a year ago, but that has everything to do with the

macroeconomic pressures and the workloads not growing as fast as we had expected. But eventually this will reverse. Got nothing to do with the competitive landscape, it's much more to do with the macroeconomic environment.

Frederic Boulan

Great. And then a quick follow-up, if I may, around the route to market. You talked about end customers and CSPs versus IHVs. Any impact this has around contract duration, cash collection, etc., or it's not really a factor?

Melissa Di Donato

No. There was a comment earlier about tough cash collection. That's never our situation. I can let Andy comment on cash collection. It's much more to do with timing. But our average contract length of about 20 months has stayed steady. It's been very strong and very steady for a number of quarters. So we don't see a decline there either.

We don't have to give up to get. A lot of our competitors and a lot of technology businesses in the market today have to take haircuts on margin and have to increase discount and things like that. We've been very fortunate in the way that when you're dealing with mission-critical workloads, the ability to maybe do a very significant price increase is harder, but having to take haircuts on our pricing as it exists today is not an issue for us. So we're in a much different position. But, Andy, do you want to build on that answer a bit?

Andy Myers

Sure. We've been incredibly successful, our average contract length staying at 20 months, and as I've said several times before, our cloud is growing faster than other routes to market. Our cloud has lower average contract lengths, because of pay-as-you-go in there. That should technically, mathematically, be diluting our contract length. It hasn't, over recent quarters. In fact, I think a year ago we grew by one month.

Technically, in the medium term, if everything remained the same, then, yes, our average contract length, as cloud continues to grow faster than other parts and it becomes a bigger part of our business, technically, in the medium term, they will mathematically move down. But as I said, as Melissa said, in the last year we've offset that with the level of multi-year agreements we're signing with our customers.

Frederic Boulan

Great, thank you very much.

Operator

And the next question is from the line of Charles Brennan with Jefferies. Your question, please.

Charles Brennan

Thanks for taking my questions. I'm going to go with two, and I'm going to stick with the theme of the midterm guidance. It looks like you've down-ticked your expectations of cash conversion in the midterm guidance. Is there any change in the way in which you're writing the contracts that justifies that and we should be

aware of? And then secondly, just coming back to the topic of EBITDA margins, I think I struggle to think of any European technology company that's successfully delivered a margin improvement story and maintained top line growth expectations. Who's the biggest sponsor of higher margins within SUSE? Is it coming directly from you, Andy, and Melissa, or is it coming from maybe some of your larger shareholders? Thank you.

Melissa Di Donato

Andy, do you want to answer the first one, and then I can close with the answer on who's driving increased profitability?

Andy Myers

Yes, sure. Hi, Charles. Midterm cash conversion is very simple. Our cash conversion is about the increase in deferred revenues and the increase in cash from future periods. As we have lowered our growth rates, as we've lowered our future growth rates, then simply lower growth in ACV means lower growth, clearly, in TCV that follows, which means you're bringing less cash from the future to apply against your adjusted EBITDA margin in any one year. So it's simply mathematics - with slightly lower growth comes less cash from the future, which then takes the percentage down. It's as simple as that.

And just a bit to the second question, Melissa, maybe, our top line, we've been more conservative, we've already talked about that, more conservative for the reasons that we've said, so we've taken those growths and, independently, we've looked at our cost base and the efficiencies that we think we can drive. And we've got the appropriate cost to deliver future growth, and hopefully over-deliver. We haven't made a conscious decision to starve revenue just to get a higher margin. Melissa, over to you.

Melissa Di Donato

Yes, I think that's right. I think that we've got the right mix. Because we spent a lot of time, in the back-half of last year, ensuring that we have been agile and that we've been flexible, meeting the demands of our customers and the economy to better service the community as a whole. When we look, we are spending the right amount of money in the right places. We are absolutely confident that we're doing the right things, that we've invested in the right way and, because of the changes that we've made, starting in Q3 and now finishing up here in Q1, that we're going to gain further levels of efficiencies and productivity.

We know we can deliver with our prudent approach to the future, despite macroeconomic pressures, a very robust, highly profitable business. If we can offer more profitability to our investors, then I feel like we should. Andy and I both feel like that's the right things to do. We're not being pressured by anyone to change our operating model or expenses.

We are at the stage now where we can achieve a better level of efficiency and productivity with a significant amount of investment in the right areas to withstand the economic turbulent

times ahead, and also deliver a robust model. So why are we delivering an increased view on our profitability? Because we can, and we're ready to do it with the business model that we've now set ourselves up for.

Charles Brennan

Perfect, thank you, that's very clear.

Operator

There are no further questions, and I'll hand back to Melissa Di Donato.

Melissa Di Donato

Thank you very much for the questions and the time that everyone dedicated to hearing about SUSE and our business. I'm really proud of what we've sustained in the past year. We expected a certain level of revenue growth and profitability that we announced at a time when we had no idea that the economy was going to take the downturn that it did. And yet we still managed to deliver on our revenue and on our profitability and our margins back to the market. And I hope that you all feel that this is a continued strong, robust and high-growth business that it was a year ago, evermore so than it is today. Thank you very much again for joining. We look forward to sharing news, as it comes, in the next quarter, and throughout the year of FY23. All the best to you all for a very good year. Thank you for joining us here at SUSE.