SUSE
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Transcript

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Matt Jones Good morning to you all, and welcome to our presentation of SUSE’s results for the second quarter of 2023 financial year. I’m Matt Jones, Investor Relations at SUSE. I will now hand over to our new CEO, Dirk-Peter van Leeuwen, and our Interim CFO, Jonathan Atack, who are going to take you through a few prepared remarks before we move to Q&A.

But 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. DP, over to you.

Dirk-Peter van Leeuwen Thank you, Matt, and good morning, everybody. It’s a great pleasure to be here today for my very first call as the CEO of SUSE. I’ve obviously known SUSE for many years, first of all as a peer, as a competitor, and now I’m here as the CEO because I really see the significant opportunity that we have to accelerate our growth in order to create value for our customers.

SUSE has a very long, strong culture and an industry-leading talent with deep expertise and a comprehensive product portfolio. However, I can also see that SUSE has not yet reached its full potential, and this is in part a result of the internal challenges we’re having.

In our primary market, Linux, we are one of the two players in a global arena where I do know that customers want and need a choice. The container market is continuously growing and is strong. We have industry-leading products here. So there’s a tremendous opportunity for SUSE in our market. It depends on us making the right moves to unlock this.

I will share more details of my initial perspectives and priorities shortly. But first, I would like to hand over to Jonathan, who recently took over as our Interim CFO following Andy Myers departure. He will take you through the details of our Q2 performance. I’d like to take this opportunity to thank Andy Myers for his dedicated service to SUSE and wish him all the best in his future endeavours. Jonathan, over to you.

Jonathan Atack Thank you, DP, and hello, everyone on the call. As you saw from our trading update, trading was weaker than expected in the second quarter. We continue to operate in a challenging macroeconomic environment, which is driving customers to manage their cost bases and to conserve cash.

Furthermore, earlier in the fiscal year, we executed a sales force reorganisation, which led to some distraction during a
critical period and, with hindsight, has not delivered the expected benefits. While still a high-growth channel, growth through our cloud route to market was also lower than expected, reflecting the wider slowdown in the cloud as customers seek to optimise their own infrastructure costs.

Together, these challenges have led to downward pressure on our ACV, revenue and cash flow. We are reporting 1% growth in Adjusted Revenue in Q2, the same at constant currency and 5% for the first half. Our adjusted EBITDA Margin was 32%, reflecting continued discipline in investments across the business, including an increase in R&D spending to drive product development. For the first half, our margin was 36%.

ACV was down 6% for the quarter, impacted by the external and internal challenges. Total ARR of $658 million was up 6%, driven by higher ARR from both new and existing customers. Our Net Retention Rate was 102%. Finally, we delivered Unlevered Free Cash Flow of $18 million, equivalent to a conversion rate of 34%, impacted by lower ACV and by some customers seeking shorter contract length to preserve their cash flow. In the first half, conversion was 77%.

Now, let’s spend some time on the operational highlights. SUSE continues to leverage its open source business model to drive innovation, and we recently announced new capabilities across our product stack, primarily focusing on security.

Our latest version of Linux, launched in June, is designed to deliver high-performance computing capabilities which are essential for AI workloads. It is also the first edition of our Linux distribution to support the entire spectrum of confidential computing, a new approach which allows customers to process fully encrypted data in the public cloud and at the edge, supporting innovation delivered by the major chip manufacturers.

In parallel, we released SLE Micro 5.4, our lightweight operating system, which is purpose-built for containerised workloads, making it the optimal choice for edge devices. And in April, we launched a new version of Rancher, SUSE’s leading Kubernetes management platform, offering users and independent software vendors the capability to create customised user experiences, significantly enhancing their ability to manage increasingly complex Kubernetes environments.

We also added new paid-for components to enhance the value of Rancher Prime. Prime customers now have access
to SUSE’s customer engagement platform, SUSE Collective, which includes exclusive support materials, and Rancher Prime’s AI assistant will provide real-time support to customers via the Rancher Prime Slack Channel. We also continue to make progress with our plans to enhance our cloud route to market, and we’ll be adding NeuVector to the hyperscaler marketplaces later this year.

At SUSE, ESG is fundamental to our plans for sustainable growth, and we’ve made good progress over the first half of the year in this respect. In June, our emission reduction targets were approved by the SBTI. During a period of significant change, our employee NPS has remained stable and on target. This is also reflected in our voluntary attrition rates, which have declined over recent quarters.

And finally, we are proud to announce our AAA rating from MSCI, the highest possible, and our Prime status from ISS, recognising our exceptional ESG performance and disclosures. Looking ahead, we remain committed to advancing our ESG agenda and driving positive change within SUSE and beyond.

Now let me talk you through some of the key deals we secured in the quarter. Q2 was another quarter in which SUSE signed significant deals with customers. These deals included cross-selling Rancher, NeuVector and Harvester to a leading semiconductor design company, an existing Linux customer; a renewal with upsell with a major German automotive manufacturer expanding their relationship with SUSE, based on our best-in-class support; and finally, two of Japan’s largest banks chose to renew their SLES subscriptions, continuing our longstanding partnership of over ten years.

Let me now take you through the details of our financial performance, starting with revenue. Total revenue in the quarter was up 1% to $162 million. This comprised Core revenue of $132 million and Emerging revenue of $30 million, down 1% and up 11% respectively. Movements are the same at constant currency.

Group ARR grew to $658 million, up 6% year on year, supported by continued growth from new and existing customers. Our revenue was impacted by the ongoing macroeconomic uncertainty, slower cloud growth and lower than expected traction from the sales force reorganisation earlier in the year. The slowdown in cloud growth has been widely observed in the marketplace as customers react to market conditions, and we have seen the impacts of this with slowing growth in our cloud revenues.
In our Core business, we have continued to see the resilience of our mission-critical customer base, with upsell continuing to make a significant and strong contribution. However, we are seeing some offsetting reduction in revenue from downsell and churn.

Emerging continues to see growth driven by new business and upselling, albeit under some pressure. Furthermore, the suspension of sales to Russian customers and legacy product run-off reduced our revenue growth by one percentage point.

Our Net Retention Rate of 102% demonstrates continued upsell to our existing customer base. Foreign exchange movements, the suspension of sales to Russian customers and legacy product run-off reduced our ARR growth rate and NRR by around two percentage points. Let’s now turn to our ACV performance.

Group ACV was down 6% to $131 million, comprising Core ACV of $108 million, down 5%, and Emerging ACV of $23 million, down 10%. Movements are the same at constant currency. ACV performance was impacted by the internal and external challenges I referred to earlier.

The external challenges put pressure on new business in particular, where potential customers are exercising more discretion on when to initiate projects. This was compounded by the sales force reorganisation, resulting in lower sales and rep productivity in the period and reduced focus on new and smaller deals. Additionally, there is an apparent trend towards customers looking to reduce contract lengths to preserve cash, and we have seen this particularly in end user renewals.

Looking more broadly at the first half, Emerging ACV was up 4% and Core ACV down 3%. Performance by geographies was mixed, reflecting the dependence on quarterly ACV growth on the available renewal pools.

ACV grew strongly in Europe, Middle East and Africa, including a significant renewal with upsell at a longstanding customer. We did have strong growth in Asia-Pacific and Japan, which was also supported by some large renewals, and in North America, phasing of renewals and fewer net new customers led to ACV declining by 12%.

Our performance by route-to-market included a 2% decrease in our end user and cloud ACV, driven by lower sales through the end user route-to-market, partly offset by continued growth in cloud.

ACV from independent hardware vendors and embedded
customers was down 25%, driven by lower hardware shipments in the broader market, a shift to selling through other routes, primarily through cloud service providers, and challenging market conditions in Greater China. We continued to make disciplined investments to drive innovation and future growth, as can be seen on the next slide.

SUSE’s Q2 Adjusted Cost of Sales grew broadly in line with adjusted revenue versus the prior year, resulting in a consistently high Adjusted Gross Profit Margin of 92%. Total operating costs increased by 8% to $97 million in Q2, or 11% at constant currency, driven by investments in people across R&D and G&A functions and differences in timing of spend versus the prior year, partly offset by a lower headcount in sales following the reorganisation in the first half.

Within these movements, sales, marketing and operations costs decreased by 4%, reflecting the lower sales headcount. R&D costs increased by 17%, driven by continued investment in product development, yielding the new versions of Linux and Rancher which we announced earlier in the year. G&A costs increased by 27%, driven primarily by differences in timing of spend versus the prior year and some wage inflation, in line with market conditions.

This resulted in an Adjusted EBITDA Margin of 32%, down four percentage points versus the prior year. More broadly, our margin trajectory remains strong, underpinned by our growth and our disciplined approach to costs. And in the first half, our margin was higher than last year.

Although not included here but referenced in the Appendix, our share-based compensation costs remained flat versus the prior quarter, at $12 million in Q2, and below our previous guidance of $15 million per quarter, following the sales reorganisation earlier this fiscal year.

Going forwards, we are taking a more targeted approach to share-based compensation, reflecting wider market conditions, and expect the non-cash P&L charge to be less than $12 million per quarter in the second half, and reducing to less than $10 million per quarter in the next fiscal year. These estimates are before the impact of potential wage inflation.

Now let’s look further at how our profits are being converted into cash.

Our cash conversion in the first half was 77%. The Change in Deferred Revenue of negative $4.2 million was impacted
by the lower ACV, but also by one large multi-year customer moving from full payment upfront to annual payment terms in the second quarter. Future payments are committed but do not appear in deferred revenue or our cash flow this year. Instead, the commitment is shown in our Remaining Performance Obligation, which was up 15% year on year to $142 million.

The move to annual payments also impacts our weighted average contract length as this only considers the proportion of contracts which are paid upfront. Without this change in payment terms, our average contract duration would have been 19 months versus 18 months on a reported basis.

More broadly, we are seeing some customers requesting annual payment terms as they look to conserve cash.

The decrease in Adjusted EBITDA and a negative Change in Deferred Revenue led to Adjusted Cash EBITDA of $115 million, down 32%. This lower Adjusted Cash EBITDA was partly offset by lower commissions paid and the core working capital inflow versus an outflow in the prior year.

Capex, cash taxes and leases paid remained broadly similar to the prior year. This resulted in Adjusted Unlevered Free Cash Flow of $91 million in the first half, up 11% and representing cash conversion of 77%.

Moving now to our guidance for this year and the beyond.

With our recent trading update, we reduced our guidance for fiscal year 23. Given the continued uncertain environment and the changes that we are now making in the business, we believe that the revised guidance is appropriate under the circumstances.

At this point in time, a major part of our full year revenue is underpinned by business that has already been booked. As we look ahead, the biggest swing factors that remain are the cloud revenue and retrospective consumption contracts, which can vary significantly from quarter to quarter and have a direct impact on reported revenues.

As a result, I am reiterating our guidance today. As indicated in our Q2 trading update, we now expect reported Adjusted Revenue growth for the year to be mid-single-digits percent, and the same at constant currency. This comprises Core revenue growth of low single-digits per cent and Emerging revenue growth around 10%.

Given the available renewal pools and high visibility of our H2 pipeline and our normal sales cycle, we expect the second half to be back-end weighted. As a result, we expect
similar Q3 Adjusted Revenue to Q2 across both Core and Emerging solutions, followed by a stronger Q4 to deliver our fiscal year 23 guidance. We expect our Adjusted EBITDA Margin to be in the mid-30s percent range, with a slight headwind from exchange rate movements since fiscal year 22 which are increasing reported opex.

We expect Adjusted Unlevered Free Cash Flow Conversion to be in excess of 50%. This cash conversion includes the impact of the specific customer’s change in payment terms we saw in Q2 and assumes some softness in upfront payments for the remainder of the year.

Our medium-term guidance remains unchanged, and we expect to build steadily towards these performance levels over the coming years as the fundamentals of our business model and market growth rates remain strong. With that, I will hand over to DP, who will now share his initial perspectives and priorities.

Thank you, Jonathan. So yes, talking about my initial perspectives, I’ve been in this business for over two decades, with experience in leadership positions in the open source software. Most of the time actually was spent as a market leader, as most of you know, in the role of General Manager in several global regions, where I drove significant growth. So these are global markets that I know very well.

However, I’ve got to say, of course, being CEO of SUSE is new to me. But I spent my first two months getting to know SUSE and its key stakeholders, so I want to talk a little bit about that. In those first 60 days, I visited six offices around the world, hosting town hall meetings and learning about what attracts people to SUSE.

I’ve met over 55 customers and partners, held over 50 one-on-ones with colleagues. I’ve combined this feedback with my existing experience of working in the open source community. And therefore, today, I’d like to share my initial perspectives of SUSE from this journey.

First of all, our product portfolio is uniquely positioned to evolve with the changing needs of our customers. There’s an unstoppable demand for fast and more agile and more secure data processing and workload management. And customers need to be able to deploy their compute power where their operations demand it.

SUSE’s product stack allows our customers, partners and open source communities to rely on us for comprehensive solutions, ensuring that they can run their applications safely and securely, whether they are in the cloud, in data centres
or on the edge.

Secondly, we have a strong company culture, with an industry-leading talent mix. SUSE attracts people who are passionate about working on open source communities. For many of these, it’s more than a job, and that leads to great innovation and deep expertise.

The open source model is critical to the success of our company, and we are in the middle of a new digital transformation. Software consumers want to move from owning to experiencing software. Ownership of software is often based on the proprietary software, intellectual property undertakings, with sales based around features and functions.

Experience, however, is based on the usage and the availability where and when you need it and on open source code. This is an undeniable trend which we are benefiting from. In an open source world, code is freely available to all. This enables sharing and cooperation, and it delivers the best solutions, as we believe in meritocracy where the best idea wins, which leads, therefore, for exponential innovation.

This is why I believe so strongly in the open source model and why it is so critical to our success. At SUSE, we are experts in turning open source projects into Enterprise products. That is our particular skill, taking freely available code to deliver solutions that our large enterprises can rely on for their business-critical operations. That’s why our customers pay for support, for certification, security and safety.

Now, bringing this together, notwithstanding the recent performance, I can see tremendous opportunity for growth, especially now that we can make the right moves to unlock it. So let me therefore address some immediate opportunities.

So the strength of our product portfolio, our culture, expertise, has given SUSE a solid foundation, but we haven’t reached our full potential. Yes, we’ve been operating in an uncertain macroeconomic environment for some time now, but many of our challenges are internal. And addressing these gives me the opportunity to accelerate our growth.

So what are these challenges? Well, first of all, we need to improve our customer intimacy by working with customers and partners. Rather than as product salespeople, we need to engage deeply with our customers and help them develop
their architectures so that it truly is more than just an item on a bill of materials but, rather, a partner in designing the best technological solutions for our customers.

Secondly, we need to move closer to our customers and empower regional leadership, focussed local expertise and presence to build trust and remove some of the barriers and complexities of doing business with SUSE.

Thirdly, we are not effectively leveraging SUSE’s whole product portfolio. We need our reps to be capable of selling the full portfolio. They need to have the right incentives and skills and they should be backed up by industry-leading product specialists.

Now, to capitalise on these opportunities, we have already taken some swift actions. I have simplified and strengthened my leadership team, reducing the number of positions and ensuring clear and purposeful accountability.

Part of this transition is that I’d like to welcome our new Chief Revenue Officer, Werner Knoblich, to SUSE. Werner has been a senior commercial leader in the open source for more than two decades, including 18 years at Red Hat, where we grew the EMEA business from $20 million to $1.5 billion.

I’m also making changes to our organisational structure by implementing a regional model. This will enable the customer intimacy which is so important to me and to our customers. This model comprises of four regions, Asia-Pacific, North America, Latin America and EMEA. And we have already appointed strong general managers to lead these regions.

So moving beyond these changes, on the next slide, we will continue to set up our organisation for success over the coming quarters. So the stages towards accelerated growth that we’re talking about here are the following.

For the second half of the current fiscal year, achieving our guidance is our number one priority. We’ll also continue to evolve our organisational structure to ensure it is at industry standard and ready to scale. Beyond this, we’ll develop and execute our long-term vision in collaboration with our customers, our partners, our employees and the open source communities.

Underpinning this plan is the strength of SUSE’s business model today which is enabling us to invest and make the right moves to unlock future growth. This model is based on delivery of mission-critical open source infrastructure software in rapidly growing markets, our subscription-based
products with a diversified enterprise customer base, and multi-year contracts with upfront payment to drive high cash conversion.

We are making the right organisational changes, our markets are growing, we have a strong product portfolio, we work in a truly customer-focused open source model which has proven to deliver the best innovation. I am therefore very confident that we are well placed to deliver on our long-term potential. So that concludes our presentation for today. I’d like to now hand it back to the Operator for 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 and one on their touchtone telephone. If you wish to remove yourself from the question queue, you may press star and 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 comes from the line of Toby Ogg from JP Morgan. Please go ahead.

Toby Ogg

Yes, hi. Hi, good morning, and thanks for the questions. Firstly, Dirk-Peter, just from my side. So you talked a lot about some of the internal challenges there, and a lot of it sounds weighted to the sales organisation. So I guess the first question from my side, following your period of assessment over the last couple of months, is this really where you think the crux of the issues have been?

And then, secondly, just digging in a little bit more on the sales force component, you talked about lots of different elements there, improving customer intimacy, moving to a more regional model, solution selling and so on. Could you just talk a little bit about what the roadmap from here looks like in terms of implementing all these different things and any associated hiring as well that might need to come with that? Thanks a lot.

Dirk-Peter van Leeuwen

Yes. Thanks, Toby. Thanks for the questions. So it’s a two-stage question. You’re asking if the sales reorg was the crux of the issues, and then secondly, what we’re doing moving forward. So effectively, the way I like to phrase it here, and I’m with this company only 60 days, so bear in mind that I’m still learning as we go, but honestly, working in a sales organisation with an open source product line, it is very important that we’re super close to the customer.

And that customer intimacy is more than just about understanding the products. It is also understanding how
our customers architect their solutions and how then our full portfolio fits into that solution. And in order to do that, we need to be close to the customer. We need to have a relationship with the customers and we need to be a point of contact, and we need to be very early in the sales cycle.

So those are the things that we will focus on moving forward, as we are improving our presence and our ability to sell our full portfolio to our customers. I hope that answers both of your questions.

Toby Ogg

Yes, that’s great. Thanks a lot.

Operator

The next question comes from Laura Metayer from Morgan Stanley. Please go ahead.

Laura Metayer

Good morning. Thank you for taking my question. Two questions from me, please. The first one is you mentioned a slight increase in churn. Could you please clarify if that increase in churn is coming from customers moving from paid to free products of SUSE or moving away from SUSE products or a combination of both?

And then the second question is around the slight revenue decline that you’ve seen in the Core segment. Could you please give us more colour on the downsell that you’re seeing and give us an idea of where the NRR stands in Core? I guess if the group NRR is 1% or 2%, the Core revenue NRR must now be negative. And are you seeing customers moving from the paid version of Linux to the free version of Linux, like you’re seeing in Rancher? Any colour here would be great. Thank you.

Dirk-Peter van Leeuwen

So Jonathan, can I ask you to take this question?

Jonathan Atack

Thank you, DP. Yes, of course. So Laura, you asked about the increase in churn and the reasons for that. There can be a number of reasons why customers move away from us. It can be the end of a project. So if they simply run a project and they decide not to continue, then that happens.

You asked about the move from paid to free. We don’t necessarily have great visibility on that, but that certainly is the case in some instances. So you will, for instance, see a customer has not been actually requiring the support, so they decide not to pay for it and they decide to adopt it themselves. In some cases, they can also reduce the volume of the products they’re using or they may move to a different channel or route of consumption.

If they’ve been using a product that’s towards its end of service life, they may move to another more current product, and that can have an implication as well, although that
probably can go into downsell and not churn. I think that comes into downsell.

So all of those are features that play through it. And there’s no particularly strong pattern. There are a variety of those in the mix that we’ve seen. Overall, downsell is probably our most significant contributor to the slowdown in the growth that we’ve seen. There is some churn.

But having said that, I would stress that upsell does continue to remain quite strong. That’s an important part of the growth. The mission-critical nature of the products is absolutely true. And when we look at our key contracts, the vast majority coming to renewal, we see increases in ACV and we see increases in pricing. And across the board, we’re seeing an average reduction in discounts. Is that enough for you, Laura?

Laura Metayer: Yes.

Jonathan Atack: Or DP, do you want to add anything to that?

Laura Metayer: Would you mind giving us an idea of what the NRR is for the Core business? Is it below 100% now?

Jonathan Atack: I think given the trends that we’re seeing at the moment, it may continue to reduce. But at the moment, I think it’s probably close to 100%.

Laura Metayer: Okay, thank you very much.

Operator: The next question comes from Frederic Boulan from Bank of America. Please go ahead.

Frederic Boulan: Hi, good morning. So a question to DP, first of all. Maybe if you can step back a little bit and discuss some of the differences in approaches that you’re seeing at SUSE versus what you’ve experienced at Red Hat over the years. You discussed some changes to the sales approach this morning. What about product development or monetisation strategy? Any other key areas where you think that the business could be optimised?

And just in particular on the pricing side, there was an issue in terms of upsell to the paid version of Rancher. Previous management was engaged in a multi-year pricing exercise. So any thinking on pricing strategy more broadly?

Dirk-Peter van Leeuwen: Yes. So generally, I’ll repeat the question, so the difference in the process between SUSE and Red Hat, and then secondly, product development and monetising on our business in key areas of optimisation really.

For me, and the reason, of course, why I joined this
company, it’s that the two companies are pretty similar companies and the technology is very similar. And one of the other things that I can tell is customers need choice, and therefore, it is important that there is a good alternative in the market.

And so with all the great stuff we’re having, I am seeing, with only 60 days into that basically, that the fastest way to optimise is work on our go-to-market. And that’s what I’ve been presenting that we’re doing right now. That’s where there is a lot of opportunity for us, but it equally takes some time to get it to the level that I want it to be.

And that really is about selling a full portfolio, not just selling one product but making sure that we understand the journey that our customer is on, and as an expert in the journey, I have the capability to position our entire product portfolio and make sure that our customers successfully implement it. So that is really where the focus is going to be.

As for your question around pricing, yes, I haven’t really looked into it, and that’s a historical thing. I don’t know if Jonathan wants to comment on that.

Jonathan Atack

Yes, look, I think certainly in the last two years, pricing has been an increasing area of focus for us. There’s a lot more discipline around that, and I think the processes we have in place enable a better level of review and a more consistent approach.

We have been able to... We have put through some price increases in the last year, and we’re also getting much better discipline around the discounting. So I think I mentioned earlier the general trend is for average discount levels to be reducing, and alongside price increases of around 7% to 5% in different product areas, we are seeing a benefit from that.

Obviously, at the same time, we are seeing some reduction in volumes through the other market mechanisms that we’ve discussed earlier, and we can continue to explore opportunities around differences in price elasticity. We have, in some areas, reduced prices with a view to driving additional volumes, and there are some channel differences as well, for instance, within the cloud mechanics.

And we’ve seen, whilst the cloud growth in revenue remains relatively strong, it’s slowing, and within that, we’re seeing a higher proportion of reserved instances. So again, better quality long-term business, but reserved instances tend to be at a lower overall price point than the pay-as-you-go contracts. And that proportion of reserved instances is, in
general, increasing. So a number of different dynamics going there, but overall, I think an area of focus, better quality analytics and some good progress.

Frederic Boulan

Okay, thank you.

Operator

The next question comes from Charles Brennan from Jefferies. Please go ahead.

Charles Brennan

Good morning. Thanks for taking my question. It’s really just one about the margin outlook, actually. I normally expect changes of strategy to cost some money, particularly when that involves reinvestment into a sales organisation where costs come before revenues. And yet, your full year margin guidance is unchanged, in the mid-30s.

Are we just so far through the year that you don’t have enough time to spend some money and implement the initiatives you want? Or should we be thinking that... I guess, mid-30s, it’s a wide range. Are margin scenarios lower than 35% considerably more likely than scenarios above 35%? Thank you.

Dirk-Peter van Leeuwen

Jonathan, you want to take it?

Jonathan Atack

Of course, DP, thank you. And Charles, thank you for your question. Yes, look, you make some very good points there. The outlook for the year and the forecast for the year are still very much predicated on the SUSE as is and the plans that we have at the moment. Obviously, we’ve reflected known changes, and there’s been a number of changes at the senior management and within the organisation, so that’s all taken into account.

We have also some ongoing assumptions about the investments that we’re going to make or expect to make in the rest of the year. That includes particularly headcount, and we have allowed for a certain degree of increase there. And again, this is all taken against the backdrop of the expected growth in revenue. So there’s the ongoing debate about the balance between growth and margin, and we have some flexibility for managing that in the rest of the year.

Obviously, with DP relatively newly on board, he’s looking at the changes that he will make and making plans, and there may be some further actions during the year. But at the moment, I think it’s still fair to say that the outlook is based on the current organisation, and the majority of the actions that the new executive leadership team will be taking will impact more significantly in the next year and beyond. DP, is that fair?

Dirk-Peter van Leeuwen

Yes, that’s a fair answer. And as I mentioned in my earlier
slide, the initial actions I took were really to take us through the year, and then, yes, the actions we’re currently looking at are setting us up for success in the following year. And that’s just simply going to take some time.

Charles Brennan

And can I just press you on the timelines there? Things like customer intimacy don’t come overnight. Those are relationships that build over time. Do you think about 23 as being the consolidation year, so 24 can definitively be the year of accelerating momentum? Or should we think about 24 as being another consolidation year, as you bed in some changes, and it becomes more of a 25 story?

Dirk-Peter van Leeuwen

Well, I think it’s going to be mixed. It’s definitely not the case that on the first day of the next fiscal year, this thing is all perfect. It’s going to take time. Let’s be honest about this. We have a lot of work to do, and if we want to achieve the level of customer intimacy, as we call it, that I am aiming for and that I know what good looks like, then I also know this takes time. We have to build these relationships. We have to train our people. And given that I’m 60 days in, you can expect, at a later point, probably our next call, that we have a more definitive outlook on how we expect this to then materialise into revenue.

Charles Brennan

Perfect. Thanks for your thoughts.

Operator

The next question comes from Johannes Schaller from Deutsche Bank. Please go ahead.

Johannes Schaller

Yes. Good morning. Thanks for taking my questions. Just one on the financial side on free cash flow. We’ve obviously seen a few customers moving from upfront payments to annual payments now. Can you just give us a little bit of a sense in terms of the customer breakdown or revenue breakdown, how many are paying still upfront? And is there any visibility you have on when that transition at some of your customers is ending? Do you see more asking to pay on an annual basis? Is that going to be an ongoing theme for a while?

And then maybe a slightly more higher-level one for DP, if I could. You obviously came from Red Hat with probably a certain expectation into SUSE in terms of what you would find and customer feedback, and you said you’ve spoken to quite a few customers already. What was it that you would say that surprised you the most in those customer discussions compared to the expectations you had? Thanks.

Dirk-Peter van Leeuwen

Thanks, Jonathan. I'll pass it on first to Jonathan for the question about the financials.
Jonathan Atack: Thank you, DP. And Johannes, yes, look, this is an important question and a sensitivity for us. There is a trend towards a number of customers asking to go onto annual renewals, even if they’ve got a longer-term contract. Annual payments, even if they have a longer-term contract. It’s not a big proportion at this point, and we don’t know if it’s a structural trend or something that is probably more temporary during the period of uncertainty that there is out there.

The impact of this has been a shortening of average contract lengths, and we see a lower ratio of TCV to ACV, which impacts the cash flow, as you said. In Q2, there was one very particular large renewal which went from a three-year contract paid upfront to a three-year contract paid annually. So that has had a more significant impact, particularly in Q2. And that is visible in the results and in the cash flow that we have seen.

So overall, it’s not a huge impact outside of that deal so far, and we are seeing a significant increase in the remaining performance obligations, which is the contracted but not paid part. So at the end of the day, it’s cash that we will get in the future, even if it comes with a little bit of a delay, so it’s not necessarily a bad thing, particularly as you probably get less of a discount with that kind of contract. So again, a number of dynamics there. But overall, the impact on the cash flow has probably been exaggerated in Q2, and so we’ll expect to see a slight improvement, moving forwards.

DP, I think…

Dirk-Peter van Leeuwen: Thanks, Jonathan. Yes. Johannes, the other part of your question was about, yes, coming from Red Hat, what surprised me the most. And yes, I can tell you that, of course, I was expecting a number of things, and then, looking at the go-to-market, I could see there is a huge opportunity for improvement there.

But honestly, what surprised me the most was the culture. It’s very much a very strong open source culture. There is a high level of inclusion. There’s a high level of collaboration. As well as the technology that we’re having. And we have a lot of great technology that I think we have a great opportunity to market to our customers and really to do a better job at branding ourselves and giving customers that alternative that they’re looking for.

Johannes Schaller: Great. Thank you.

Operator: As a reminder, if you would like to ask a question, please press star and one. The next question comes from Will Wallis from Numis. Please go ahead.
Will Wallis

Morning. Thanks for taking my question. Two from me. Firstly, you’ve given some guidance that you expect Q3 revenues to be sequentially relatively flat. That does leave quite a lot to be done in Q4 to get to mid-single-digit revenue growth. Obviously, that is quite a… There’s a range there. But say, to get to 5%, it does leave Q4 requiring pretty significant growth. I wonder, what gives you confidence in that?

And my second question for DP really. Can you give us your perspective on how significant the change in relationship with SAP that seems to have happened at the beginning of this year, with SAP moving much closer to Red Hat, will be for SUSE over the medium to longer term?

Dirk-Peter van Leeuwen

Sure, Will. I think I’ll pass it first to Jonathan for the first part of your question in terms of the Q3, and I think, Jonathan, you will explain how ACV leads to revenue, right?

Jonathan Atack

Absolutely. Thanks, DP, and Will, thank you very much indeed for your question. Yes, look, for the rest of the year, and looking at the phasing between Q3 and Q4, obviously, we’ve got a fair amount of the revenue for the year already booked, so in excess of 85% is already booked revenue. And that includes some revenue that’s booked from the deals that have been done in Q3.

So the ACV expectations for Q3, again, at this stage in the quarter, we have got obviously much better visibility. ACV delivery tends to be back-end loaded, so there is still some uncertainty perhaps there. But we’ve got good visibility of what has been booked, what is committed and what is deemed highly likely, and we’ve got some good coverage there. So the ACV for Q3 that will contribute a bit to revenue in Q4 is also there.

And then, when we look at the rest of what we need to do to deliver and where there is some element, potentially, of uncertainty or risk, upside or downside, going forwards, cloud revenue is booked and recognised in the shorter term, so we still need to see delivery in Q3 and Q4 there. It’s an environment where we’ve seen some slowdown, but I think we’ve taken some reasonably conservative estimates, moving forwards.

And the retrospective consumption contracts, of course, are another area where there is some volatility, and again, we’ve taken a view there that does see some increase in the second half. And that obviously is an area that can be pretty binary in terms of some pluses and minuses. So those are the assumptions that underpin it and underpin the split and the phasing. So we have a fair degree of confidence, but it
will still need some good performance in Q4.

Will Wallis

Thank you.

Dirk-Peter van Leeuwen

Thanks, Jonathan. And I’ll address the question about SAP. I think it’s safe to say that the SAP relationship with SUSE is one of the strongest and warmest in partnership with the two organisations. It’s, yes, really a longstanding, over-20-years partnership.

We see that SUSE Linux Enterprise Server for SAP Applications was and remains an integral part of the rights with SAP Reference Architecture. Linux Enterprise is the leading Linux for SAP HANA, with 85% of the market and 100% of the SAP Business One version of SAP HANA. 70% of all SAP applications are running on SUSE Linux Enterprise Server for SAP.

So it’s actually a very strong relationship that continues to be strong. The fact that there is choice is something that the markets, yes, accept, and we are therefore equally a choice for any other vendor, because we also have a very strong portfolio in other parts in the market.

Will Wallis

Okay, thank you.

Operator

The last question comes from Deepshikha Agarwal from Goldman Sachs. Please go ahead.

Deepshikha Agarwal

Hi. Thanks for taking my question. I just have one, and I think this is more to DP. I think you talked about, currently, from where you see the one area is basically thinking about customer intimacy and looking at the product portfolio. And I think even Jonathan talked about that there would be further considerations, depending on how the strategy develops. So what are the other areas potentially that you see that need to be looked deeper into and there is scope of opportunity from the current vantage point?

Dirk-Peter van Leeuwen

Yes, that’s a great question, and some of that is still in development. As you will appreciate, being 60 days in, I’ve really been doing a lot of activities in terms of getting to know the company, getting to know the people, the customers, the partners and even the journalists, etc. So the immediate challenges were pretty clear to me, and as I mentioned, we addressed them.

The intermediate challenges that will set us up for the next fiscal year are still very much in progress, and so I would like to get back to all of you in the next session to give more colour on other opportunities that we’ve identified and that we will be working on. So I believe there are no more questions, right?
Operator
There are no further questions at this time, yes.

Dirk-Peter van Leeuwen
All right. Well, then, I’d like to thank everybody for joining this call, and we hope to stay in touch and to talk to you next time.

Jonathan Atack
Thank you.