Qualys Q3 FY2017 Earnings Prepared Remarks

REDWOOD CITY, Calif., – Oct. 31, 2017 – Qualys, Inc. (NASDAQ: QLYS), a pioneer and leading provider of cloud-based security and compliance solutions, today announced financial results for the third quarter ended September 30, 2017.

Joo Mi Kim, VP of FP&A and Investor Relations

Good afternoon and welcome to Qualys' third quarter 2017 earnings call.

Joining me today to discuss our results are Philippe Courtot, our chairman and CEO, and Melissa Fisher, our CFO. Before we get started, I would like to remind you that our remarks today will include forward-looking statements that generally relate to future events or our future financial or operating performance. Actual results may differ materially from these statements. Factors that could cause results to differ materially are set forth in today's press release and in our filings with the SEC, including our latest Form 10-Q and 10-K. Any forward-looking statements that we make on this call are based on assumptions as of today, and we undertake no obligation to update these statements as a result of new information or future events.

During this call we will present both GAAP and non-GAAP financial measures. A reconciliation of GAAP to non-GAAP measures is included in today's earnings press release. As a reminder, the press release, prepared remarks, and an accompanying investor presentation with supplemental information are available on our website. With that, I'd like to turn the call over to Philippe.

Philippe Courtot, Chairman and CEO

Thank you Joo Mi and welcome everyone to our Q3 earnings call.

Melissa and I are very pleased to report another quarter with strong performance on both revenues and profits driven by the continued adoption of our Qualys Cloud Platform and its integrated suite of security and compliance applications we call Cloud Apps.

We are very pleased to raise again the bottom and top end of both our revenue and non-GAAP EPS guidance for the full year 2017 and Melissa will provide you with more color on it.

These impressive results clearly underscore the competitive advantage we have created by taking the long view to build a highly scalable cloud platform that can be delivered both as a shared platform or on premise. This dual approach gives us an additional and unique advantage given the accelerated migration to cloud solutions in an increasingly vulnerable and regulated environment.

As we all know, traditional enterprise point solutions, which are inherently difficult to deploy, maintain and integrate, are not effective anymore in protecting against crippling attacks such as WannaCry and in coping with new regulations such as GDPR.

As a result, companies are now looking for true platform solutions to consolidate the security and compliance stack in order to reduce cost and complexity while improving their security and compliance posture.

Furthermore, businesses of all sizes have a critical need to accelerate their digital transformation. This transformation requires a new approach to security where security must be built in and not bolted on. These requirements make our platform approach strategic to our customers and bolster the expansion of our Vulnerability Management solution as well as the adoption of additional solutions.

This is underscored by the fact that 30% of our Enterprise customers have now deployed 3 or more solutions compared to 23% a year ago. We also saw this manifest itself this quarter through the continued adoption of our Cloud Agents with almost 5 million purchased over the last twelve months. This represents a 37% increase over last quarter and contributed to the increase in the number of large deals with both existing and new customers.

As an example, we signed a multi-million dollar expansion with a leading cloud provider who not only expanded the scope of their Vulnerability Management service but added Cloud Agent and AssetView. Additionally, this quarter we signed a multi-million dollar annual deal with a large healthcare company encompassing both Vulnerability Management and Threat Protection; this was an existing customer who had previously only used our Web Application Solutions and PCI service on a limited basis.

As WannaCry and GDPR are impacting enterprises worldwide, we saw new customer deal sizes in Europe increase this quarter as well. We signed a 6-figure deal with a new European customer to fully deploy Vulnerability Management in their environment; in the past, many customers had begun with partial deployment. As we've discussed before, larger deal sizes benefit both our stickiness with our customers as well as our profitability.

A few weeks ago, we hosted our 17th annual Qualys Security Conference in Las Vegas at which we had record attendance by our customers and prospects. The theme of the conference was "From Securing our Networks to Enabling the Digital Transformation". We demonstrated a significant expansion of our platform as evidenced by elasticsearch, where we now index over 250 billion data points and the addition of Cassandra, Kafka, and other open source analytics and reporting engines. We also showcased an impressive suite of additional solutions we will be delivering during 2018, underscoring the power of our true platform approach.

Enterprises worldwide are accelerating the adoption of cloud technologies to retool their businesses. This adoption requires unprecedented scalability, accuracy and speed in order to identify all global IT assets, which could be vulnerable, whether on premise, in the cloud or on endpoints. Enterprises also need to ensure that vulnerabilities are rapidly and properly remediated, which is something traditional enterprise IT security solutions cannot deliver effectively and at which Qualys excels.

Our Qualys Cloud Platform enables enterprises to build security into their digital transformation initiatives for global visibility and better business outcomes. Earlier in the month in Monaco, I introduced at Les Assises, the leading security conference in France, Khaled Soudani, Societe Generale's IT Infrastructure COO, as part of my keynote. He spoke about the vital need they had to accelerate their digital transformation, how security needs to be built into this new cloud-based infrastructure, rather than bolted on and how security needs to become an enabler rather than an impediment. He also added that the world is moving toward hybrid clouds, that is a combination of public and private clouds.

Securing such hybrid cloud IT architectures requires that security and compliance vendors retool their solutions to adopt a cloud-based architecture. Because we started our journey with such a cloud-based architecture in mind, we believe that it gives us a significant head start. This is evidenced by the fact that 70% of the Fortune 50 have adopted our Cloud Platform including technology leaders such as Amazon, Microsoft, Apple, and Oracle.

We continue to expand our global partnerships and are pleased to announce that we have been selected by Ernst & Young to be a key component of their new next generation Cyber Security Center in Texas, from where they can monitor client environments, armed with the latest and most advanced tools to streamline detection and prevention of threats.

We are also starting to make inroads in the Federal market due to our FedRamp certification and the market being more receptive to cloud based solutions. Following the selection of our FedRamp certified private cloud platform by Lockheed Martin, we are pleased to announce that both the Secret Service and the Capitol Police became Qualys customers in Q3.

This quarter, we continued to expand our offerings, with the general availability release of File Integrity Monitoring (FIM) and the detection of Indication of Compromise (IOC).

Qualys FIM logs and centrally tracks file change events across global IT systems and a variety of enterprise operating systems to provide customers a simple way to achieve centralized cloud-based visibility of activity resulting from normal patching and administrative tasks, change control exceptions or violations, or malicious activity — then report on that system activity as part of compliance mandates. This highly scalable and centralized solution reduces the cost and complexity of detecting policy and compliance-related changes mandated by increasingly prescriptive regulations.

Qualys IOC detects activity and behavioral changes on the endpoint and delivers a continuous view of suspicious activity to customers that may indicate the presence of known malware, unknown variants, or threat actor activity on devices both on and off the network.

By expanding the number of applications we offer, we enable our customers to consolidate an increasing number of security and compliance solutions, eliminating the daunting challenges they have with point solutions that all require their own infrastructure, are difficult and costly to deploy and manage and extremely costly to integrate. Our platform allows our customers to drastically reduce their spend and for Qualys, we benefit from a more strategic relationship and increased stickiness with our customers.

In Q3, we closed the acquisition of Nevis Networks and integrated the team with our existing Pune, India operation. The acquisition of Nevis Networks enables us to enter the market that is currently served by solutions such as ForeScout. The acquisition of Nevis provides us with significant domain expertise in deep packet inspection, also known as passive scanning, and gives us the opportunity to accelerate our move into the adjacent markets of mitigation and response.

Once this technology is fully integrated into our platform, we will provide additional visibility and response capabilities to protect against threats from IoT devices. This will provide a holistic view of vulnerabilities within our platform across devices and web applications whether on premise, in the cloud or on endpoints. We also expect the Nevis acquisition to strengthen our commercial presence in India, which we see as a significant opportunity for our company.

Speaking of Pune, our operations there now encompass 350 employees across all departments, including Ops, DevOps, Engineering, QA, Customer Support and Product Management. This is a major strategic advantage for our company as it continues to be both a competitive and a cost advantage for us. We will continue to invest heavily in Pune.

In summary, we continue to strongly believe that we are best positioned to secure the vital digital transformation facing our customers while helping them secure their current on premise and endpoint environments.

We believe our customers increasingly see us as a strategic vendor which has earned their trust by delivering a true platform that offers them greater visibility, accuracy and scalability and helps them consolidate their stacks.

It is this platform approach, built over many years, that has allowed us to build a strong foundation of recurring revenues, while achieving industry-leading profitability. We believe we are positioned better than ever to help our customers improve their security and compliance posture and forge ahead with their digital transformation.

With that, I'll turn the call over to Melissa to discuss our financial results in detail.

Melissa Fisher, Chief Financial Officer

Thanks, Philippe and good afternoon. We had a terrific third quarter with both revenues and profits exceeding our expectations. We continue to see healthy demand driven by our strategic positioning as the leading cloud platform in our markets coupled with strong market conditions. The upside in revenue drove record margins for Qualys.

We saw strong demand this quarter from both new and existing customers, the latter with both renewals and upsells. Deal sizes continued to increase in Q3 growing 17% year over year and new customer deal sizes grew 62% year over year. From a geographic perspective, we saw very good year over year growth in all geographies. In fact, we had record new customer bookings in EMEA in Q3, driven by deal sizes for new customers growing year over year more than 100%.

Consistent with last quarter, we saw strong performance in the Vulnerability Management category; bookings for both Cloud Agent for VM as well as Threat Protection more than doubled year over year. This drove meaningful acceleration in new product bookings; new products released since 2015 contributed approximately 14% of total bookings in the quarter, up from 9% last quarter. These new product bookings are mostly due to Cloud Agent, which includes the associated subscription to either Vulnerability Management or Policy Compliance, and include renewals that convert to Cloud Agent. Including Cloud Agent for Policy Compliance, we sold 4.7 million Cloud Agents in the last twelve months, an acceleration from 3.4 million as of last quarter. Our Cloud Agent Platform, as you may recall, is the underpinning technology of many of our new solutions including FIM and IOC and therefore, should help adoption of these newly-released solutions.

Multi-product adoption continues to increase as well, with the percent of Enterprise customers with three or more Qualys solutions rising to 30% this quarter, up from 23% a year ago, and their average spend in the quarter increased 24% year over year.

Revenues in the third quarter were $59.5 million, which represents 19% normalized growth over the third quarter of 2016. There was a negative impact on our Q3 2017 revenue growth rate of approximately 150 basis points from the MSSP contract and approximately 110 basis points from FX. In Q3, we also saw more front-loading of deals, which benefited our revenues.

Turning to our deferred revenue balance, the current deferred revenue balance was $132 million as of September 30, 2017, 21% greater than our balance at September 30, 2016. Normalized for the impact from FX, our current deferred revenue balance would have grown approximately 22% year over year.

Before moving to our profitability and cash flow, I would like to remind everyone that unless otherwise specified, all of the expense and profitability metrics I will be discussing on this call are non-GAAP results. Our non-GAAP metrics exclude stock-based compensation and non-recurring items. A full reconciliation of all GAAP to non-GAAP measures is provided in the financial tables of the press release issued earlier today and is available on the investor section of our web site. Also note that certain amounts in prior periods have been reclassified to conform to the current period's presentation.

Adjusted EBITDA for the third quarter of 2017 was $23.9 million, representing a 40% margin as compared to 35% in the third quarter of 2016. This contributed to a 63% year over year increase in GAAP EPS and a 40% year over year increase in non-GAAP EPS this quarter. Because of our expansion in India, we achieved this earnings growth despite a 26% year over year increase in headcount. In Q3, we also benefited from greater efficiencies in operations, which contributed to an increase in our gross margin to 80% from 79% in Q2 and from 79% in the third quarter of 2016. Gross profit increased by 18% year over year to $47 million in the third quarter of 2017.

Operating expenses in Q3 increased by 7% year over year to $28.7 million. Research & Development expense increased to $9.4 million, or 15% year over year, primarily due to higher headcount. Q3 R&D expense also includes 1 month of the Nevis team; we're excited to have added the team from Nevis. Sales & Marketing expense increased to $14.2 million, or 4% year over year, primarily due to higher headcount and related costs. G&A was flat year over year at $5.1 million as higher headcount count was offset by lower third-party spend.

Net cash from operations in the third quarter of 2017 increased by 62%, to $32.8 million, compared to $20.2 million in the same period in 2016. The year over year increase in operating cash flow was driven largely by the growth in our billings and profits.

Capital expenditures were $13.4 million in the third quarter of 2017, compared to $9.8 million in the third quarter of 2016. Out of the $13.4 million, $5.1 million was for our business operations and $8.3 million was for our new headquarters buildout. We expect capex related to our operations in the fourth quarter of 2017 to be between $6 and $7 million and capex related to the new office to be another $4 to $5 million, for a total Q4 capex spend of between $10 and $12 million. Total 2017 capex related to the new headquarters buildout is now expected to be between $16 and $17 million, up from our prior expectation of $13 to $15 million. We also spent $5.8 million on the acquisition of Nevis Networks in Q3.

In terms of guidance, for the fourth quarter of 2017, we expect revenues to be in the range of $61.7 million to $62.2 million, representing an estimated normalized year over year growth rate of 19% to 20% based on our current FX forecasts as well as the previously mentioned impact from the MSSP contract.

We will continue to invest in Q4 and look for high quality talent in a number of areas, however given our highly scalable operational model, we now expect full year 2017 operating margin expansion. We expect GAAP EPS for the fourth quarter of 2017 to be in the range of $0.15 to $0.17 per diluted share, while non-GAAP EPS is expected to be in the range of $0.27 to $0.29 per diluted share.

We are delighted to be raising our full year 2017 guidance for both revenues and earnings. We are raising the bottom and top end of our revenue guidance for full year 2017 again to now be in the range of $229.6 million to $230.1 million from the prior range of $226.8 million to $228.3 million. We are raising our GAAP EPS guidance range to $1.09 to $1.11 from $1.02 to $1.06 and non-GAAP EPS guidance range to $1.04 to $1.06 from $0.87 to $0.91.

We believe our strong financial results reflect the enthusiasm our customers have for a cloud-based security and compliance platform that can secure their digital transformation and enable them to consolidate stacks for better visibility and security. At our user conference a few weeks ago, I personally saw how strategic our platform and applications are to our customers and how appreciative they are of our solution that is integrated and at a lower total cost of ownership than competitive on-premise solutions. We continue to believe that our unique competitive positioning coupled with our scalable model will enable us to continue to grow our revenues and boast top-tier margins.

With that, Philippe and I would be happy to answer any of your questions.