Qualys Q4 FY2017 Earnings Prepared Remarks

Foster City, Calif., – Feb. 12, 2018 – Qualys, Inc. (NASDAQ: QLYS), a pioneer and leading provider of cloud-based security and compliance solutions, today announced financial results for the fourth quarter ended December 31, 2017.

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

Good afternoon and welcome to Qualys' fourth quarter and full year 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 and welcome everyone to our Q4 earnings call.

Melissa and I are pleased to report another great quarter that included both strong revenues and continued profitability. We closed 2017 with 19% annual revenue growth normalized for MSSP and FX and record full year EBITDA margin of 37% while at the same time growing our headcount almost 30% to 869 full-time employees.

We are happy to report that we see continued momentum with our Cloud Agents; in fact, we had a record number of Cloud Agent subscriptions in Q4 and we ended 2017 with almost 6 million Cloud Agents purchased over the last twelve months, 3 times the amount we had at the end of 2016 and a 27% increase over the last quarter. These results reflect our position as the leading security and compliance cloud-based platform that is centrally managed and self-updating, allowing our customers to consolidate their stack while helping them build security and compliance into their digital transformation initiatives.

This is evidenced by the fact that our penetration of leading enterprises worldwide has increased, from 68% of the Fortune 50 in 2016 to 74% at the end of 2017 and from 60% of the Fortune 100 to 70%. These market share gains have been driven by our unique ability, as mentioned previously, to help our customers drastically reduce the cost and complexity of deploying and maintaining a plethora of security and compliance solution across on-premises, end-points and cloud environments.

This in turn enables us to expand our share of wallet in our over 10,000 customers and attract new customers as well. In fact, 32% of our enterprise customers have now deployed 3 or more solutions compared to 25% a year ago. Our competitive position has been further validated by our announcement today that Qualys is in the No. 5 position in the Worldwide Security and Vulnerability Management Market and No. 1 position in the Worldwide Vulnerability Assessment Segment for the second year in a row. According to IDC, Qualys has approximately 3% of the Worldwide Security and Vulnerability Management Market. As you know, competing vendors' revenues are mostly perpetual software and contain services revenues; as a subscription model, Qualys' market share is in fact understated as revenue is recognized ratably.

We continue to progress on expanding our solution set for our customers, both organically as well as through acquisition. This quarter, we signed a term sheet to acquire another company in India, which has developed a well architected and comprehensive agent technology for mobile platforms and which we plan to integrate into our platform. Their solution enables enterprises to prevent, detect and respond to potential malware in both corporate-owned as well as bring your own iOS, Android and Windows mobile devices. After we integrate this technology into our platform, we will be able to uniquely provide enterprises discovery, inventory, security, compliance and response on both enterprise-owned as well as employee-owned endpoints, expanding our footprint within our customer base. Our ability to then provide global asset IT inventory, as well as cloud inventory, in 2 seconds will be unmatched by competitive offerings.

Furthermore, our ability to deliver our solutions on-premises in a private cloud platform is unmatched by our competitors. This has allowed us to expand in territories or within companies subject to strict data residency regulations or policies. This is why cloud technology leaders choose our solutions to secure their global IT environments and, thanks to our private cloud architecture, we uniquely provide scale, accuracy and immediacy. We also now have partnerships with all of the major global MSSPs as we added additional partnerships in 2017, which enable us to expand our capabilities for our customers in a cost-effective manner.

2017 was an important year for Qualys during which we released new groundbreaking applications to our cloud platform and completed our first 2 acquisitions. In 2017, we launched several new solutions into General Availability including File Integrity Monitoring (FIM), the detection of Indication of Compromise (IOC) and Security Configuration Assessment (SCA).

In August, we acquired Nevis Networks, which provides us with significant domain expertise in deep packet inspection, also known as passive scanning, enabling us to expand our addressable market, currently served by point solutions such as ForeScout. More recently, in Q4 we acquired NetWatcher to expand our reach into the real-time threat intelligence market.

The co-founders of NetWatcher, Scott Suhy and Kenneth Shelton, have joined us as VP of Strategic Alliances and Business Development and VP of Engineering, Real-time Threat Correlation Platform, respectively, adding management talent to help us scale. These additional applications expand our addressable market and enable us to provide more value to our customers.

In addition to innovative product releases, we invested significantly in our cloud platform this year. We added new technology components to enable us to ingest, process, analyze, and store a high volume of sensor data coming from our agents, scanners, and passive analyzers and correlate information at near light speeds in a distributed manner for millions of devices. We have over 250 billion security data points indexed in our elastic search clusters providing almost instant query results. This gives our customers 2-second visibility without them having to index large amounts of data.

As we continue to broaden our platform and grow our business, we continue to attract talented people to Qualys. We recently hired Bill Solms, who was CEO of Wildrock Security Group and formerly the CEO of Wave Systems, as our VP and GM of Federal; we see significant growth opportunity in the Federal segment for Qualys. We also hired Neeraj Sharma, who came from Getronics, as our VP Ops for India. Additionally, Amit Godbole, who previously managed large finance functions in India for Symantec and BMC, joined us as VP Finance India. We are continuing to expand our presence in India and we now have 58% of our R&D, operations and customer support employees in Pune. This represents an important strategic advantage as we can add world-class talent at rates favorable to our cost structure.

As we look into 2018, we are expecting further growth and customer adoption of our solutions, expansion of our customer base and the release of many new features and offerings. Our current plans include the release of Container Security, Cloud Inventory and Security Assessment, Certificate Inventory and Assessment, Passive Network Discovery, Patch Management, Secure Access Control as well as Certificate Management and Cloud Security Management.

Acquisitions will continue to be a part of our strategy as we seek to accelerate our product development and expand into adjacent markets. As such, we announced today a designation of $25 million for venture investing, from which we will invest in early-stage opportunities in related security and compliance technologies, in a similar manner to our approach to acquisitions. Additionally, as we continue to generate cash in excess of our current use for M&A, we announced today a $100 million share repurchase program, which will enable us to reduce dilution from employee grants and acquisitions.

In closing, we are very pleased for our shareholders that Qualys was the best performing security stock in 2017, as one of our analysts noted. We are very excited about our opportunity in 2018 as we see our momentum picking up as evidenced by our:

1) Strong business performance as reflected in our new business, renewal and upsell trends
2) A winning product and partnership strategy with an expanding and fully integrated product portfolio and new, key partnerships
3) Balanced financial strategy as we continue to grow the top line of the business, building a strong foundation of recurring revenues, while maintaining industry-leading profitability.

With that, I'll turn the call over to Melissa to discuss our financial results and guidance for 2018.

Melissa Fisher, Chief Financial Officer

Thanks, Philippe and good afternoon. Before I start, I'd like to note that except for revenue and billings figures, all financial figures are non-GAAP, unless stated otherwise. 2017 was another great year for Qualys as we successfully released several new products, features and enhancements while growing revenues by 19% and achieving record EBITDA margins of 37%, despite our continued investment in the business, including 27% year over year growth in headcount in 2017. As Philippe mentioned, we sold 6 million Cloud Agents in 2017, 3 times the amount we had sold at the end of 2016. Our Cloud Agent Platform, as you may recall, is the underpinning technology of many of our new solutions including FIM and IOC and these results provide a solid foundation for adoption of these newly-released solutions. In 2017, we also saw very good growth both from existing customers and new customers. Vulnerability Management continues to be a strategic solution for our customers as we experienced a re-acceleration in bookings for our Vulnerability Management category, partly influenced by customer adoption of newer VM-related solutions like Cloud Agent and Threat Protection. In fact, the percent of bookings contribution from new products released since 2015 more than doubled to 12% in 2017 from the previous year. Continued adoption of our platform is a contributor to larger deal sizes, and we saw a meaningful expansion in average revenues for enterprise customers with multiple Qualys cloud apps in 2017. As an example, at the end of 2016, enterprise customers purchasing 4 or more solutions generated on average approximately $180,000 in annual revenue; at the end of 2017, we saw that level of revenue generated with enterprise customers purchasing only 3 or more solutions.

Turning now to the fourth quarter results, we are delighted that both revenues and profits exceeded our expectations. Revenues in the fourth quarter were $62.9 million, which represents 22% normalized growth over the fourth quarter of 2016. There was a negative impact on our Q4 2017 revenue growth rate of approximately 60 basis points from the MSSP contract as well as approximately 70 basis points from FX.

We continue to see healthy demand driven by our strategic positioning as the leading cloud platform in our markets. The percent of enterprise customers with three or more Qualys solutions rose to 32% this quarter, up from 25% a year ago, and their average revenue in the quarter increased 20% year over year.

We saw strong demand this quarter from existing customers in terms of renewals and upsells and deal sizes continued to increase in Q4 growing 15% year over year. EMEA continued to perform very well, both from existing and new customers. From a product perspective, we saw strong performance in the Vulnerability Management and Policy Compliance categories. We continued to see very good growth from both Cloud Agent and Threat Protection; new products released since 2015 contributed approximately 15% of total bookings in the 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.

Turning to our deferred revenue balance, the current deferred revenue balance was $143 million as of December 31, 2017, 25% greater than our balance at December 31, 2016. Normalized for the impact from FX, our current deferred revenue balance would have grown approximately 24% year over year. Calculated current billings, which is revenue plus the change in current deferred revenue, was $74 million for the fourth quarter of 2017, up 27% from the same quarter last year.

Adjusted EBITDA for the fourth quarter of 2017 was $23.8 million, representing a 38% margin as compared to 35% in the fourth quarter of 2016. In Q4, our outperformance on revenues drove an increase in gross margin to 79% from 78% in the fourth quarter of 2016. Gross profit increased by 21% year over year to $49.5 million in the fourth quarter of 2017.

Operating expenses in Q4 increased by 14% year over year to $30.8 million. Q4 expense includes 1 month of the Netwatcher team. We’re excited that Scott, Kenneth and Lauren have joined us; like Nevis, Netwatcher not only provided us with technology but significant talent as well. Research & Development expense increased to $9.8 million, or 24% year over year, primarily due to higher headcount. Sales & Marketing expense increased to $15.6 million, or 10% year over year, primarily due to higher headcount and related costs as well as greater spend on trade shows. G&A expense increased to $5.4 million, or 9% year over year, driven in part by higher headcount and higher payroll taxes.

Net cash from operations in the fourth quarter of 2017 increased by 93%, to $25.9 million, compared to $13.4 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. Our Q4 operating cash flow also benefited from the reimbursement of $5.4 million in leasehold improvements for our new headquarters; excluding this payment, operating cash flow would have grown 53% year over year in Q4.

Capital expenditures were $11.2 million in the fourth quarter of 2017, compared to $4.4 million in the fourth quarter of 2016. Out of the $11.2 million, $7.4 million was for our business operations and $3.8 million was for our new headquarters buildout.

Now, I’d like to talk to you about 2018 guidance. Starting with revenues: For the full year 2018, our revenue guidance is from $275.5 million to $278.5 million, which represents a growth rate of 19 to 21%. For the first quarter of 2018, we expect revenues to be in the range of $63.4 million to $64.1 million, representing a year over year growth rate of 19% to 21%.

Given the growth opportunities ahead of us, we will continue to invest in operations, people and systems and so we expect full year 2018 operating margin to be roughly flat. We expect capital expenditures in 2018 to be in the range of $23 to $28 million and in Q1 of 2018 to be in the range of $6 to $7 million. Our 2018 income statement will be positively impacted by the adoption of 606, which requires the capitalization of commissions from our new and upsell bookings, which were previously expensed. We expect to capitalize these commissions over 5 years and estimate this to impact our operating margins by approximately 150 basis points. Additionally, tax reform has driven a meaningful decline in our effective tax rate and this provides another driver of earnings and cash flow growth for Qualys. That is illustrated in our non-GAAP EPS guidance, which calls for 28-32% growth in 2018 earnings per share.

As we enter into 2018, we expect to share new metrics as our business continues to evolve. Additionally, as we consistently grow and generate cash due to our highly profitable operational model, we have continually reviewed our capital allocation. We finished 2017 with $356 million in cash and investments and because we expect to generate meaningful cash in 2018 as well, we've announced today 2 important initiatives as part of our continual efforts to increase shareholder value. First, as part of our initiatives to accelerate growth through M&A, we've announced the designation of $25 million for venture investing. Additionally, we're delighted to announce a $100 million share repurchase program focused on offsetting dilution from employee grants and M&A. We plan to execute this program through open market share repurchases, which is baked into our EPS guidance.

In conclusion, for both the quarter and the year, we delivered strong top line growth and industry-leading profitability. We delivered an impressive suite of new technology and application components for our cloud platform and completed our first 2 acquisitions. These achievements position us well to continue expanding our solution set, helping our customers secure their digital transformation and consolidate stacks for better visibility and security. Our platform and unique operational model enable sustainable growth and economic leverage for Qualys, both now and in the future.

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