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ServiceNow, Inc. (NOW) CEO John Donahoe on Q3 2019 Results -**Earnings Call Transcript**

Oct. 23, 2019 10:19 PM ET

by: SA Transcripts

Q3: 10-23-19 Earnings Summary



Press Release



SEC 10-Q



Slides

EPS of \$0.99 beats by \$0.10 | Revenue of \$885.83M (31.61% Y/Y) beats by \$2.11M

Earning Call Audio



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ServiceNow, Inc. (NYSE:NOW) Q3 2019 Earnings Conference Call October 23, 2019 5:00 PM ET

Company Participants

Lisa Banks - VP IR

John Donahoe - President & CEO

Bill McDermott - President & CEO

Conference Call Participants

Sarah Hindlian - Macquarie Group

Alex Zukin - RBC Capital

Brad Zelnick - Crédit Suisse

Kirk Materne - Evercore ISI

Jennifer Lowe - UBS

Walter Pritchard - Citigroup Inc.

Christopher Merwin - Goldman Sachs

Derrick Wood - Cowen & Company

Thomas Roderick - Stifel, Nicolaus & Company

Operator

Ladies and gentlemen, thank you for standing by and welcome to the ServiceNow Q3 2019 Earnings Conference Call. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions] I would now like to hand the conference over to your speaker today, Lisa Banks, Vice President of Investor Relations. Thank you. Please go ahead, madam.

Lisa Banks

Thank you. Good afternoon and thank you for joining us for ServiceNow's Third Quarter 2019 Earnings Conference Call. On the call with me today are: John Donahoe, our President and Chief Executive Officer and Bill McDermott, our incoming, President and Chief Executive Officer.

During today's call, we will review our third quarter financial results and discuss our financial guidance for the full year 2019. We'd like to point out that the company reports non-GAAP results in addition to and not as a substitute for or superior to financial measures calculated in accordance with GAAP. All financial figures we will discuss today are non-GAAP, except for revenues and remaining performance obligation. To see the reconciliation between these non-GAAP and GAAP results, please refer to our press release filed earlier today, our investor presentation and for future — and for prior quarters previously filed press releases, all of which including a replay of today's call are posted at investors.servicenow.com.

We may make forward-looking statements on this conference call, which are subject to risks, uncertainties and assumptions. Please refer to the press release and risk factors in our SEC filings, including our most recent Annual Report on Form 10-K and quarterly report on Form 10-Q for information on risks and uncertainties that may cause actual results to differ materially from those set forth in such forward-looking statements.

I would now like to turn the call over to John.

John Donahoe

Thanks, Lisa. Good afternoon everyone and thank you for joining us in today's call. Given our announcement yesterday, here's how we're approaching our call today. First, I'll give a brief overview of Q3 results in our 2019 annual guidance. Second, I'll provide a little more insight of my decision to leave ServiceNow and accept an opportunity to lead a company that I have been associated with and admired for a very long time.

And finally before taking questions. You'll hear from Bill who will provide a little more context and why he chose ServiceNow and the opportunities he sees ahead. So let's start first with our third quarter results, we delivered another strong quarter, continuing our focus on driving customer success. Subscription revenues were \$835 million, representing 35% year-over-year adjusted growth. This exceeded the midpoint of our previous guidance by \$9 million including the impact of FX.

Subscription billings were 864 million representing 29% year-over-year adjusted growth, this exceeded the midpoint of our previous guidance by 10 million excluding the impacts of FX and duration. Our remaining performance obligations ended the third quarter at approximately \$5.6 billion, representing 36% year-over-year adjusted growth. Current RPO was approximately \$2.8 billion once again, representing 36% year-over-year adjusted growth. Our operating margin in Q3 was 26% driven by hiring linearity and a shift in expenses that will be realized in Q4 and our free cash flow margin was 14%.

Now for a peek under the hood, we closed 46 deals in the third quarter with ACV greater than \$1 million representing 84% year-over-year growth, and we know of more than 800 customers, doing more than \$1 million in business with us annually, which represents 32% growth year-over-year, and our renewal rate for the quarter remained strong at 99%.

Our IT portfolio continues to have strong momentum. This quarter we again saw 18 of our top 20 deals include three or more products. As you recall, we launched ITSM Pro late last fall and we're seeing strong traction. Customers are upgrading from ITSM to ITSM Pro, and we're landing new customers, who see the value and starting with ITSM Pro. Simply what's happening is customers who are pursuing digital transformation are investing in ServiceNow's full suite of IT products. They see the value of better together and have leveraging our entire product suite and unique platform. This is a clear trend.

A leading company in financial services is one example, they enabled world-class IT, security and risk via automated workflows, natively on our single strategic platform that now platform. For HR business also had a strong quarter, and we closed one of our largest employee experience deals ever with a global distribution company.

ServiceNow employee service delivery solutions hide the complexity across functional work, making it easy for employees to get the services they need. This is making work, work better for people. In Q3, our New York release became generally available, New York extends new desktop, and native mobile capabilities across the workplace at scale. This enables companies to make their employees lives at work as simple, easy and mobile friendly as their lives at home.

The New York release Now Platform and gets more than 650 innovations across IT employee and customer workflows. As you know, I am personally very excited about the native out-of-the-box mobile capabilities. For the first time, we have created consumer grade mobile experiences for the enterprise. Removing friction in everyday work; employees can now easily financers and seamlessly get stuff done across IT, HR, facilities legal and other departments and they can do so from a modern mobile app powered by the Now Platform.

As a reminder, you can download a demo of this great mobile app from the App Store. Mobile technology was at the epicenter of digital transformation and lives at home and we believe mobile technology be the very center of great experiences at work.

Now, let me turn to full year 2019 guidance. As a reminder, for several years we've used a very consistent methodology to manage FX. We simply take FX rates on the last day of the quarter and use those rates for the subsequent quarter. So for example, the guidance

we provided in our Q2 earnings call were based on FX rates as of June 30, 2019.

Now during this quarter, those rates change, impacting our Q2 results and annual guidance, so the guidance on today's call is based on FX rates as of September 30, 2019. We provide complete transparency and the impact of FX in our Q3 results at 2019 annual guidance in the Investor Relations presentation.

So for the full year 2019, we're carrying forward the \$9 million in subscription revenue and a \$10 million in subscription billings that exceed our previous midpoint guidance for the third quarter. So for the full year 2019, we expect subscription revenues between \$3.240 billion and \$3.245 billion representing 36% to 37% year-over-year adjusted growth. We expect subscription billings between \$3.740 billion and \$3.745 billion, representing 32% to 33% year-over-year adjusted growth. We're maintaining our full year 2019 margin guidance as follows. Subscription gross margins of 86%, operating margin of 21% and free cash flow margin of 28%.

Now, before closing out our review of the quarter, let me just take a moment to update you on our CFO search. As you know, over the past several months, we've done a global search for a world-class CFO and I'm delighted to say we've narrowed that search to a small group of exceptional finalist candidates. Now obviously, because of our CEO succession, I slowed the final interviewing process to enable Bill to be able to pick his preferred candidate. And the good news is what Bill's doing now is meeting those candidates and he expects to name our next CFO shortly.

Now I'd like to just take a couple of minutes to explain my decision. Let me just say upfront that I believe deeply in ServiceNow and I believe deeply in ServiceNow's opportunity. As I've said before, there is a clear cloud tailwind. This is a beautiful as Bill calls it clean strategic technology platform, customers are leaning in and want to partner with our platform and we have the ability to extend and expand across the enterprise.

And I believe as much today as any time I've been here, we're very well positioned to get to \$10 billion and move on our way to becoming a great enduring company. And to be honest, I fully intend to be part of that journey. However, our unique situation with what is a unique company for me has emerged. Some of you may know that I have a 20-year history with Nike. I met Phil Knight and Mark Parker 20 years ago. And over the last five

years, I've had the privilege of serving on their Board. I deeply resonate with Nike's purpose. And as everyone at ServiceNow knows I regularly use them as the gold standard of what a great company looks like and I love sports.

So when the Nike Board reach out to me to ask me to come to our next CEO I was a calling, I felt I had to pursue. But I will say it again, it is not in any way change my belief in ServiceNow and the opportunity ahead. And so the Board and I have spent the last couple of months trying to identify the best successor in the world for ServiceNow.

And let me just review the criteria we use and think about it these are criteria that will enable us to get to \$10 billion and beyond. We need to continue to elevate our relationships into the C-suite. We need to expand from IT across the enterprise. As a company, we need to continue to expand globally and build more industry relevance, as we expand the number of industries we serve. We need to expand our go-to-market function and scale our entire organization. And most importantly, ServiceNow needs an authentic leader who is purpose based, values driven and experienced.

And I think you would share my enthusiasm and excitement that the Board and I have that Bill McDermott has agreed to join as our next CEO. I would tell you I have gotten to know Bill personally over the last three years. I consider him most excellent CEO that I've learned from and a good friend.

So, with no further ado, Bill, let me turn it over to you to talk a little bit about your decision to join ServiceNow.

Bill McDermott

Well, thank you very much John and hello everyone. First and foremost, allow me to congratulate John Donahoe, a great friend and enormously successful CEO on his personal accomplishment to become the CEO of Nike, an iconic brand. No one is more deserving than you John. And it's an honor to follow in your footsteps.

I made my decision to open the next chapter of my career with ServiceNow. Way of background, I was with SAP for 17 years. I was CEO for 10 years. In that 10-year time horizon, we moved the market cap from \$39 billion to \$163 billion. We either doubled or

tripled or quadrupled revenue profits, the number of customers that we serve around the world. Our last count was in the order of 450,000 customers around 193 countries. I believe strongly that at this particular time rather than renew for another five years, it was proper to say 10 years is good principal and I passed at the time to two excellent leaders that are now co-CEOs of SAP and I'm very proud of them and I'm looking forward to their continued success of SAP, a really wonderful company, a great experience, and to my friends at SAP, thanks so much and we'll continue to do great job in the next couple of months.

As it relates to ServiceNow, why ServiceNow? First and foremost, the culture of ServiceNow is truly special. As I think about John Donahoe and what he's been able to accomplish and the amazing legacy of Fred Luddy and how he has set the tempo for really humble and hungry employees serving customers in the absolute best way possible and this idea of making work, work better for people is so human and so necessary in today's enterprise where customers more and more are looking for a true partner that really deeply cares.

With that to ServiceNow, John continued that proud tradition and it's an honor for me to be humble and hungry and truly honored by this opportunity. I will give it everything I have. I'd also like to thank Jeff Miller, the lead Director and the Board of Directors for their support. What a Board of Directors ServiceNow has as well.

I met the management team, John was kind enough to have us over is home. I met each one of them. Also the VPs across the company and as John said, we're well on our way to closing the CFO search and I think you'll be very pleased with the outcome -- outstanding candidates indeed.

Now, if I was in your shoes, what would I want to hear from Bill McDermott? I would want to hear Bill, what about this \$10 billion path that John Donahoe and the ServiceNow management team have been discussing? Well, let me answer that very simply. I completely buy in, stand by it, and I'm looking forward to achieving it.

What about all the commitments including the financial commitments of the company on the revenue as well as the margin expansion story? Are you in on that too? 100%. That the customer commitments and the bright future of ServiceNow could not possibly be more in focus for me. I have already sold houses, bought houses, enough land move from my family and I am and I am a 100% in, and I'm looking forward to doing things that have never been accomplished before, because I am doing it off of a base that is just truly incredible. So, we are going to set the standard and be the most admired business-software company in the world. And I am fired-up and I can't wait to get started. Thank you, John.

John Donahoe

Great, Bill. Thank you. So let's just I need to say one more thing before we turn it over to questions. Bill and I want to be crystal clear. We get, it's Q4. We get, we want a strong end of the year. We are both fully committed to ensuring a high quality and smooth transition. I don't start my new role to mid-January, so I am committed to be fully accountable in this role at ServiceNow until Bill completes his transition at SAP and is fully in the job. So in the meantime, you can assure that both of us have a deeper sense of responsibility and accountability on behalf of our customers, partners and employees to ensure a smooth hand-off in a strong Q4.

So with that, operator you can now open the line for questions.

Question-and-Answer Session

Operator

Certainly. [Operator Instructions] Your first question comes from the line of Sarah Hindlian with Macquarie. Your line is open.

Sarah Hindlian

Okay. Great, thank you for taking my question. And John, thank you for all of your time and serviced. And Bill, I'm really looking forward to working with you. And by the way, I think we all really appreciate the depth of color you gave us around your decisions and your views on how important making in Q4 is. So thank you for that as well. One thing, I think would be really great to hear from you guys about is how you're feeling and thinking about the general global macro environment especially in light of some of the issues that

are going on in Europe and I think it would be helpful for us to just hear how you feel about your positioning in the global economy overall and any color you can give us around what you're seeing out there outside of the really strong large deal activity?

John Donahoe

Yes. Sarah. Thank you, and maybe what we'll do, Bill I'll get from this is kind of interesting your. I'll give him from ServiceNow perspective you've been out in the same markets from an SAP's perspective or maybe even broader. So Sarah, let me just tell you what I see. I was actually in Europe all last week, we had our Now it worked forum in the Amsterdam or we had 1,500 customers, we had two days later network forum in London, where we had I think it was close to 3,000 customers, highly engaged at several customer meeting several partner meetings. And I will tell you on the front lines, with customers and partners.

I hear no conversation around macroeconomic. Frankly, I didn't even care about Brexit last week. What they want to talk about is digital transformation and how do they use technology to drive productivity and better user experience. And so I hear them leading in. So we can't predict, at least I can't predict, what macroeconomic outlook is, but we are very focused on ensuring that under any macroeconomic scenario. Number one in that investment queue is an investment in the ServiceNow platform, because it drives productivity, to drive user experience and it drives digital transformation. Bill, what are you seeing from an SAP standpoint?

Bill McDermott

John, I see exactly the same thing as you're seeing and you're absolutely right. The tailwind behind digital transformation and the cloud in in particular is evident in strong companies. So if there was going to be any step back anywhere, it will be in commodity hardware players or commodity players in tech. The high value digital transformation companies they're adding real business value, will continue to prosper because without the digital transformation card, it's a little hard to compete and win in this digital economy. So if I look at the pipelines, they look strong and they look ever consistent which is why we strongly reiterated guidance today.

Sarah Hindlian

Thank you both very much and -- so much, congratulations to you both on your moves.

John Donahoe

Thank you very much. Thank you, Sarah.

Operator

Your next question comes from the line of Alex Zukin with RBC Capital. Your line is open.

Alex Zukin

Hey guys, thanks for taking my questions. And I have to add Sarahs congratulations wholeheartedly and looking forward to -- going to miss you, John. Looking forward to working with you, Bill. My question, may be is just around the strategic direction to the \$10 billion target. Clearly you have an organic framework and an inorganic opportunity to accelerate that track. I'm curious if -- when you think about the inorganic component, as you think about broadening the buying centers within your -- and broadening the strategic proposition of ServiceNow continually. What's the right way for us to think about the direction, whether it's within IT or outside of IT? And then just as a follow-up. I wanted to ask around just sales execution in the EMEA region, there were -- we talked about some issues last quarter. I'm just wondering if there were any kind of follow-ups on that?

John Donahoe

Bill -- I think it's appropriate for you to comment on the first.

Bill McDermott

Sure. I mean I think first and foremost, Alex, you have a great organic growth storage here. The pristine nature of this platform and the revenue that this platform alone can begin to drive is a real growth story in and of itself. And then when you think about the solution set that ServiceNow has, there's plenty of room within the context of these solutions to grow them in different geographies; obviously, same account revenue growth as you get more and more customers to buy the complete solution set. And of course,

putting an industry flavor to things will also be quite helpful. And that flavor can then be personalized to different buying centers and you can use different channels to get at that in the marketplace. So lots of room to grow organically.

I really believe that I said this to John many times. I believe ServiceNow is in the privileged position of being a platform --of the platforms, because when you look at the business process and the workflow that goes on and enterprises today. Everybody has this deep need to get the data aggregated in a workflow that creates simplicity for the users. And the more we can reinvent business processes in the image of the actual users themselves, the more we can become the defining platform of the platform for the modern enterprise. So I think the organic growth story here is just amazing and it's only just begun.

I would also say, I've learned a lot and I've seen a lot of different business models, and the company, I work for very hard, had a very different business model at ServiceNow. Now this is a pure play cloud and when you do a tuck-in, if that's necessary because it has extreme value to the customer. Then you would certainly make sure that its integrated beautifully into the Now Platform. So you make sure this stays very simple and extremely easy to use, so more and extensibility can be realized by the developer community, the customers themselves and our great engineers. One of the things that, I've been blown away by is just how strong the engineering talent and leadership business at ServiceNow. So when I see that kind of talent. I start to feel really strong about organic growth. And I do want to underscore the go-to-market machine is equally up to the task. This is an outstanding leadership team here. I'm really impressed.

John Donahoe

And now I'll try just to add to that you asked about European specific. It's so funny because we have to remind ourselves every now and then. We have the challenge everyone else wants to have. Scaling 30% a year, while growing so you've got to scale and grow a go-to-market team that has a growing number of account reps, product line specialists, solution architects and consultants. But it's some industry overlay. And then you do it across multiple countries in Europe, and as I said, I was in Europe last week and that team is really, really coming together and humming. We have a new leader in the U.K. who quite strong, from the VMWare all across Europe. I think our team is really coming

together. So we had a lot of changes in the first half of the year, just as we layered in, a lot of new people. But those teams are coming together and on several customer calls, those the teammates are working seamlessly on behalf of our customers.

Alex Zukin

Thanks guys, that's awesome. Good luck in Q4 and looking forward to seeing you again soon.

John Donahoe

Thank you.

Operator

Your next question comes from the line of Brad Zelnick with Credit. Your line is open.

Brad Zelnick

Excellent, thanks so much. John congrats to you. It sounds like your next chapter aligns perfectly with your destiny. Many people work their entire lives and never get a chance for something like that. So I truly wish you the best. But as it relates to ServiceNow --

John Donahoe

Thanks, Brad.

Brad Zelnick

You're quite welcome. As it relates to ServiceNow and you may see my question is a bit shortsighted, but it's a conversation I've been having with several investors. Just trying to get comparable with what's ahead of us. And we're now seeing significant changes with some strong leaders exiting, some really strong executives entering and what sounds like at least some mid-level folks being hired away or at a minimum distracted by all the excitement.

And Bill, I appreciate your commentary earlier today and the kind of following that you have, but is there anything Bill perhaps that you've experienced in the past that can service a guide for the potential disruption that we might be disruption that we might be in for during this transition? And perhaps even and I know its early days you're not really even in the seat just yet, but how you're thinking about it relative to the company's own internal model as you look out to next year?

John Donahoe

So Bill, why don't I, maybe just give a quick context because Brad, I think I think there have been a couple of things written recently. There are a little bit misleading. So it is actually true that Mike start probably delays. The only member of our senior leadership team, our overall attrition rate as a company is I think in all is an industry low and it is the same this year as it was last year. On sales leadership, we have had of our top 100 sales leaders, three have left. So yes, three sales leaders have left to go Snowflake. 97 have not and we have a strong deep sales bench and it was not the Head of North America. It was some are working, running our commercial business and another North American role. And so we have a strong team. There's not a lot of departures. By the way some are saying, all the others that joined Salt Lake, they all left ServiceNow well before 18 months ago. And so we are very focused as a lot of people are very excited here about the momentum, about the prospects and the opportunity. And so I think that's the starting point, and then Bill you can talk about scaling and adding to that.

Bill McDermott

Sure, John. So I think the disruption is, obviously, very well in hand. Thank you, John. And regarding the internal models and the things that have been built here, they're doing things very well. I mean, when I look at the org chart or I look at the way the sales force is set up, or the way the channel management's strategy is done it's very good. The question becomes can we do more and can we make it even better? And the answer is of course. That's why I'm here, because I see a great opportunity. But I see innovation without disruption. I see a way that we can layer in some added focus to give the solutions a richer context around the buying centers or around the scientific methodology to deliver

the value. So we can have even new hires, look like they've been on the job for a long time. But this is systemic. It's something that's been done before and we'll do it the ServiceNow way.

But all-in-all, I am very, very pleased with everything I have seen from the management team and it's just about a continuous evolution. We do not need to disrupt this place. We do not need to revamp territory coverage. We do not need to break customer relationships. This is going to be very smooth transition. And John and I are very similar in terms of how we look at the world, the value set that we have, the way we treat people, the way we value customers, the way we think about running companies. So you're not going to see a big change here. You're going to see a continuous evolution of a great thing.

Brad Zelnick

Thank you very much. And I am glad I ask the question very directly John. So, we can get the fact straight and Bill I have to imagine you've had your pick of the litter of just about any software company that you'd want to run and we see a phenomenal opportunity as well here at ServiceNow. So, thank you so much for the comments.

John Donahoe

Brad, I just want to underscore how smart you are to say that. I look at quite a few different things in quite different sectors. This was by far the most interesting sighting opportunity of a lifetime. And so I'm glad to see we're on the same sheet of music and I look forward to being great friends going forward.

Brad Zelnick

Great. Thank you, again.

Operator

Your next question comes from the line of Kirk Materne with Evercore ISI. Your line is open.

Kirk Materne

Thanks very much and I'll add my congrats to you both, pretty phenomenal opportunities for both of you. So best wishes John and Bill. Nice to see you. Again, I guess just first John, big quarter for your government business. I wonder if you could just give us an update on that. And then Bill, one of the things I think John has done really well over the last couple of years has been lifting ServiceNow's profile with CEOs not just CIOs and I was wondering if you can have some thoughts on how you'd continue to make ServiceNow your brand that's not only trusted and well-respected by the CIO sweep, but really take it up to be a key and critical platform for CEOs as they go through their digital transformations? Thanks.

John Donahoe

I'm going to answer your first question -- in fact I have to say, I will let go on second, but I have said repeatedly, internally in the last few days. Bill McDermott makes my role of desk look poultry in terms of his relationship with CEOs all over the world. But I'll let him comment to that in a minute. On federal, look federal, very strong business for us, very strong third quarter. Again what's driving it? Governments are embracing cloud, because they're under pressure to deliver better experiences for their citizens and employees and drive productivity. So we're seeing that in the U.S. federal business and we're seeing that in other public sector markets around the world. But in Q3, we had 13 deals in U. S. federal over \$1 million compared with five in Q3 of last year. We had a nice mix of federal and civilian agencies. And we have a nice milestone in Q3 that will get good prospects going forward and that we received our FedRAMP High and IL4 certifications.

What's interesting Kirk is that federal is starting to behave as federal has embraced cloud, its beginning here a little bit more like enterprise and it's less a only Q3 scenario and it's more continuous scenario. So year-to-date we've got 22 deals greater than \$1 million compared to 14 in all of 2018. So we had good federal first quarter, second quarter and third quarter. And our pipeline looks strong in Q4 as well. So Bill very good of a U.S. federal. I'll also note, as I mentioned we're seeing nice demand for public sector globally. So we saw large deals and public sector customers in the U.K. In that case it would be U.K. equivalent of the IRS, the HM revenue and customs agency. And big public sector

new customers in Germany and Australia as well. So strong business, I think that's going to continue to be a strong business. Again an area that Bill brings a lot of experience in. So you want to talk about CEO stuff?

Bill McDermott

Sure, John. As John said, I am like-minded with John. We're very similar executives in the sense that we recognize the power of power. And last year I think we had something like 34 heads of state types of meetings around the world. And on the CEO front, one of the things that brought John and I together over the years is the CEO meetings that I host and I was very fortunate to have John join me.

And as an example, we have one coming up in November, where there'll be 100 CEOs from around the world and some and of the biggest business cards in the world. And we do this on SAP does SAP does this not only in United States but also in Europe and Asia. So the rolodex is really strong and I believe that John and I had kind of executives that work our heart out to help hard-working CEOs solve mission-critical business problems so they can help their customers be successful. And that's the attitude we kind of bring to those relationships.

When we make promises we keep promises. So it's really been an honor to operate at that level. And the altitude of there is nice and clear and it helps the conversations down below to take place faster, better and bigger. So that kind of where we run it.

Kirk Materne

Thanks a lot.

Operator

Your next question comes from the line of Sterling Auty with JPMorgan. Your line is open.

Unidentified Analyst

This is Matt on for Sterling. Thanks for taking my question. I know you guys talked about on the macro side, but specifically have you seen any impacts on Brexit or any impact on demand from the FX changes that you guys were talking about previously?

John Donahoe

Yes. Short answer is no.

Unidentified Analyst

Okay, thanks.

Operator

Your next question comes from the line of Karl [ph] with Deutsche Bank. Your line is open.

Unidentified Analyst

Thank you. And congrats to you both. Maybe my question to you John. You mentioned that you want a strong fourth strong. We all do too. So, maybe I'll press you a little bit there because as you're well aware the implied growth rate for your subscription billings is much stronger in 4Q than the quarter that you just put up. So, I'm just wondering if you could help us get comfortable with that expected fourth quarter acceleration, what gives you that confidence. That would be helpful. Thanks a lot.

John Donahoe

Yes, Karl. So, we've been saying all year long that we continue to see great seasonality in the business and so Q4 is increasingly important. Frankly, we've had visibility into this all year long that the Q4 pipeline looks strong. And part of that I think frankly is as we become more strategic and have larger deals, I think customers have a little bit of an inclination that the larger deals tend to get down more in their last quarter of their year because they're confident they can fund it.

And I just remind you from a billings standpoint, 50% of Q4 billings is contracted backlog. The second next big piece is renewal, so we know we have great visibility into renewals coming into Q4 and given our very high renewal rate that gives us confidence. And frankly, the smallest portion of our Q4 pipeline -- or a small portion of our overall billings is net new ACV. Now, we've got a strong pipeline, we do bring up a strong net new ACV quarter, but

it's -- remember the foundation of the contracted backlog and the renewals, we have great visibility going into the quarter. So, that said, in every quarter heads down, focused, working with our customers.

Unidentified Analyst

Okay. Thank you, John. That's helpful.

Operator

Your next question comes from the line of Jennifer Lowe with UBS. Your line is open.

Jennifer Lowe

Hi, thanks for taking my question. This is Rakesh Kumar sitting in for Jen Lowe. My question is for Bill, SAP has very well served large enterprises as well as mid and small businesses whereas ServiceNow has largely focused in large enterprises so far. Do you see an opportunity to take the prior down market and what should we expect there?

John Donahoe

Yes. Well, I mean first of all, it's really a privilege position to be focused on large and still have so much room to grow. And there's nothing wrong with being very focused and segmented on large when you're putting up these kind of numbers. So let me first in high respect say good for to ServiceNow and good for the engineers making products that those big companies need to complete their digital transformation. I really mean that. It's a focused company. It's a really good thing.

Now, can you take this down market? Absolutely. And the question then becomes between spreading your wings in the large space and taking it down a little bit in the channel strategy that you approach that with and the cost of sales that you work that with, are all items that we'll be discussing in the coming weeks. And of course we'll talk about it at the annual guidance as we go into next year. But theoretically, it looks like another big opportunity for ServiceNow.

Jennifer Lowe

Thank you.

John Donahoe

You're welcome.

Operator

Your next question comes from the line of Walter Pritchard with Citi. Your line is open.

Walter Pritchard

Great, thanks. And, Bill, I didn't think I could talk to you so quickly, but good to have you back. I'm curious just on two markets in your adjacencies on the CSM side and the HCM side. I guess, it's probably a question for John. Are you starting to see we're starting to hear some of the competition, I guess, wake up a little bit, realize there's these opportunities you're pursuing. And I'm wondering, if you're seeing any change in the field in competitively and how you're responding and how you're taking the product direction, given what's going on in CSM and HCM?

John Donahoe

Yes. Well, Walter, I think you're right in that, what we're seeing is validation of the need and the demand. I was with one of our top five. In fact, I've been with three of our top five SIs partners in the last three weeks. And employee service delivery is on the lead of all three, because companies know they have to improve their employee experience and they need to drive healthy sources of automation and productivity. And an end-to-end cross-functional employee service delivery is part of that.

Customers or employees don't really care if the issue is HR or IT or finance or facilities. They just want to get it dealt with. And that's what we do. We are the only platform out there architected to do cross-functional workflow. And so, it's a very different thing when that's your starting point versus having a functional platform and hoping you can do a little process for workflow around it. And so, I just think our platform is architected from day one

to address that market. By the way, in partnership with a lot of other platforms, right? We are not a system of record in many of these functions. And so, what our sweet spot is, is that ability to integrate in with the other platforms.

And Bill talked about platform of platforms, the enterprise, or the employee service delivery, some people call it enterprise service delivery. Our role of integrating the multiple systems of record and the other systems, so that the complexity is hidden from the employee and they have a great experience. And by the way, we don't put our brand on it. We have a different point of view than others do on that. We think that employees want to have that brand of their company they're working for on their mobile app or on their desktop. Similarly, at CSM, I've said this before, so this is probably the last time I'll be able to say it, CSM is a \$20 billion market, big market.

There are different segments in that market; there are some segments that are more CRM-based where you want your customer service agent to be connected and tightly integrated in with the CRM system. There's another segment of the market which is our sweet spot, where you want the customer service representative have to be connected into the operating system of that business. So that when a customer calls or reaches in, you can't just say, oh!, you've been a customer for eight years. We'd like to be on the phone with you for a long time. You say, no, we understand what the root cause of issue have is, we're getting it addressed, we're getting regular real-time updates on how it's getting addressed.

And by the way, next time it happens, you're going to be able to do it in an automated fashion and there might not be a next time, because we understand the cross-functional workflow, the cross-functional root cause so that we can fix the problem and prevent it from happening again. That's our sweet spot. That's what our cross-functional platform does.

In essence it's the same concept of ITSM or other things we do. And so we're seeing very good success in that segment of the market. It tends to be B2B, services, technology, really high-value situations where the customer -- and I was in -- for instance, I was in Europe last week, two large telcos -- I met the President and CEOs of the business side of

two large telcos who are saying they are increasingly driving software-as-a-service to their customers. And when their customers contact them, they need to see inside their network, they need to be able to see -- have great transparency and not just ServiceNow does.

So, I think you will see multiple winners in the CSM space. It is not a zero-sum game. It's an opportunity to apply technology in ways that hasn't been done before, we think is a big opportunity for us, right Bill?

Bill McDermott

Absolutely, John. 100% with you.

John Donahoe

And Bill by the way brings a lot of experience in that space and will bring additional perspective and insight and frankly, both of those spaces can build almost unique -- anybody in the industry has played for years in almost all the major buying standards inside of the company. And I've been so struck in our conversation, he see scenes I didn't know exists. He know all the scenes in between the software is where this unmet need and opportunity because of his broad experience across all about buying centers in each of these areas. And so I think ServiceNow is going to -- he's going to bring even additional insight and energy to these new areas.

Bill McDermott

Thank you, John.

Walter Pritchard

Great. Thank you.

Operator

Your next question comes from the line of Chris Merwin with Goldman Sachs.

Christopher Merwin

Okay. Thanks very much and let me add my congrats to John and Bill on the incredible opportunities ahead. And Bill when you look at the opportunity for ServiceNow, there's obviously an enormous TAM here and it seems to be one that grows every year as the company keeps adding more and more new products. So, when you think about how to go after that opportunity, can you maybe just talk to us a bit about your philosophy on balancing investment and growth. And more recently for ServiceNow the commitments been 100 basis points of margin per year and I'm sure you'll hear more about this at Q4, but maybe you can just share your initial thoughts there. Thanks.

Bill McDermott

Yes, Chris, it's a great question, right? Because one of the power pieces of this whole equation is that this is a native born in the cloud company. And it's a company with a great platform and enormously successful products and very, very happy customers. The loyal employees are -- is also significant as John mentioned. If you put all that together, this is an organic growth story. And when you have an organic growth story and you can evolve that over time, there's plenty of growth from the core on an organic basis where you cannot only grow the revenue at a rate that's pleasing to the capital markets, but also you can expand the margins.

And we can be very discerning as to what tuck-in we may or may not choose to do on that basis because we want to do both. We want to both grow the topline and we want to evolve the margin expansion story of the company because we can.

So, you should expect me to stay very in concert with John's strategy. You should expect a tremendous amount of continuity between everything that John has told you. It's one of the reasons I'm here by the way because I believe in John and I believe in the management team on what they've been doing and we're going to evolve that. But I also learned a lot of lessons too because other companies who don't have such a pleasing business model, have to do perhaps more M&A that would be negative to the operating margin expansion, at least for some period of time. Here, I think we can balance this out pretty nicely.

Christopher Merwin

Okay, great. Thanks so much.

Operator

Your next question comes from the line of Rangan [ph] with Bank of America. Your line is open.

Unidentified Analyst

Thank you very much, John. You get to do it. So just do it, congratulation. And Bill congratulations, an exciting chaperone new journey. I'm curious to get your perspective from your SAP. As you had a tremendous playbook at SAP that drove significant organic growth rate coupled with innovation. What about that experience and what about that playbook, can you bring to the ServiceNow chapter field life and congrats again. And thank you so much. I'm really excited about this.

Bill McDermott

Well, thank you very much. I am really, really excited. Also I'm very excited for John, and I think it's so nice that you all recognize what a great man he is and deserving years of an iconic brand like Nike and vice versa. So it's really great. What have I seen that might be transferable here?

First of all, they are doing a lot of things extremely well. It's really more a matter of scale and some of the things that we had to do to scale there for example a value engineering methodology, where you could have a proven science around the value you create for an enterprise and the manner in which you personalize that to buying centers in a way that's compelling and highly repeatable and differentiated by industry. So that's one clear example. Another clear example is the way you broaden the perimeter. Right now, I believe that the TAM of ServiceNow is limitless, in the sense that, if you really think about how broken most enterprises are and how net up the workflow and business processes are in most companies and how unpleasant using these old systems are for the users.

We literally could create a revolution, where the business users in the enterprise demand ServiceNow get the story straight by aggregating the workflow of these various platforms. I'm not sure that any work has actually been done on identifying the size of that TAM, but I

believe it's only limited by one's imagination. We heard also, earlier today the idea of how we could expand in Europe and John talked about how many million dollar deals are now happening in the European theatre, perhaps there is a few place within Germany and France in certain areas of Europe where the relationship plans can be appreciated in a positive way for ServiceNow. But that certainly isn't limited there, you have Korea you have other parts of Asia, where we could be very interesting based on international business and global companies and prior history.

And then I think one of the colleagues also brought up, how you can move the company into different markets based on the dynamics of the size of the customer, the size we established. I think we're focused on 5,000 employees and better now, when you go to 4,000 to 3000 that creates yet another opportunity.

And finally, I think the team has done a great job here of expanding the ecosystem. but if you look at the ecosystem and the relationships that I have in the ecosystem there maybe a value play here or there with some of the partners not just the biggest ones, but also the mid-sized ones around the world. So all-in-all I mean, this is like one of those dream of a lifetime opportunities and my problem is that my feet just haven't touched the ground. I'm just walking on air.

Unidentified Analyst

Congratulations. Thank you very much.

Bill McDermott

Thank you.

Operator

Your next question comes from the line of Derrick Wood with Cowen and Company. Your line is open.

Derrick Wood

Great, thanks and congratulations. And Bill, look forward to working with you. First, I guess John your finance operations product one GA in Q3, could you just can you talk about the initial interest and what you're seeing in terms of pipeline build as you go into Q4 next year. And then Bill I mean you know the ERP space better than anyone and this product integrates directly with ERP spaces. And so it would be great to get your take on what you're hearing in terms of early interest and kind of how big of an opportunity you see this market being for ServiceNow over the next several years?

John Donahoe

Yes, Derrick just a general availability. We are still working on the next-generation implementations of our existing customers. So those I think come along well. And here's what's interesting, the biggest initial interest is from some of our SI's. And so as I think you know we have an explicit partnership with the White, for instance, around -- because they see how many of their clients need this capability. In many ways it's one of those themes I was talking about earlier. There's great software in the finance world. Bill knows it. Bill forgot more about than I know. But from everything we hear, they'll be seeing that our weathers is on structured workflow by closing the books, and so our SI's have given us a very strong indication they want to be part of go-to market solution and that's great, because we don't have long, deep relationships to date in the finance department.

And so Bill you've got lots of experience in that world, so.

Bill McDermott

Yes, John. I think you said it beautifully. I mean, the idea is within the context of these systems, be it financial systems, capital management systems, even if you think about supply chain systems and manufacturing systems there are areas of the workflow that are not meeting the modern needs of the modern user. And we are in a hold position to architect that workflow in a way that's highly pleasing to lighthouse customer and then that is transferable from that lighthouse customer at the high end to many other customers around the world.

And you could certainly segment that by industry. And then you really start to think about that by buying center. And if I learn anything along the journey, it's the empathy that goes into the initial meeting because it's preprogrammed, it's outside and manufactured and it's choreographed in such a way where even people that might be fairly new at the company or people that are looking to up their game have the tools in their hands to do a great job for the customer. And the more we can do that in a way that doesn't require somebody of John's caliber, but somebody that's just carrying a bag to the extent they can do that, you start to get mass scale.

Furthermore, I just want to say, I have spoken with the co-CEOs of SAP, whom I'm working with in friendship by the way in achievement of their goal as well. It's really a beautiful situation, where everybody really does care genuinely about the other and we have an affinity for SAP from ServiceNow's perspective and ServiceNow has, I mean, SAP has a very strong relationship and affinity for ServiceNow. They told me that. So I spoke with Jennifer Morgan and Christian Klein. Christian Klein is you or may not know was the lead decision-maker and actually choosing ServiceNow to run the IT operations of SAP because there was huge value creation for SAP by doing that. And we talked about the importance of this partnership and what could be done in the open market. So I actually think that you should really takeaway from this. But again, it's a great foundation that's already in place that can be built upon.

Derrick Wood

Great. Thanks for the color.

John Donahoe

My pleasure.

Operator

Your next question comes from the line of Tom Roderick with Stifel. Your line is open.

Thomas Roderick

Thank you for taking my questions. And I'll echo the sentiments from others and saying congratulations to you both. My question here is for Bill. Bill you've got a couple of questions already just on the general sentiment of M&A. I'm not going to ask you to share your playbook before you get in the seat. But as you yourself has scaled, SAP over the past decade, would love to hear about your general philosophy towards M&A and particularly M&A at scale. Well, how do you think about the risks, the opportunities of doing M&A at scale and what is work for you and what hasn't as you look back at your past you apply it to the future with ServiceNow? Thank you.

Bill McDermott

Well, Tom, thank you very much for the question. And I'm really happy you asked that question, because you've given me an opportunity to kind of set the record straight. Because ServiceNow is not SAP and SAP is not ServiceNow. These are entirely different companies at entirely different stages of their evolution and they have very different business models. So what I believe is that SAP did a great job of taking the core and expanded the perimeter into the cloud through strategic M&A. That was done very effectively. But as you know, when you do M&A you also have to integrate M&A and you have to put all the pieces together over time, because you want to make sure that customer relationship is absolutely best-in-class. So you have to walk and shoot gun, right? You have to get revenue right, the margin profile right, but also the happy and loyal customers. And I think SAP has done a very good job with that.

On the ServiceNow side, with the way we're positioned and the literally immaculate nature of this amazing platform and these solutions that the whole world needs and it's a matter of expanding the solution set, it's a matter of getting to new customers, the new geography, expanding the industry, expanding maybe the market profiles, but it's all there. All the pieces are there and the TAM for being the platform of the platform and really working through that workflow scenario, where we can continue to build. We have developers that can build solutions. We have customers that can build their own solutions on the platform. We can literally take customers build solutions and make them commercially viable successes all over the world. So this is a juggernaut waiting to happen on its own organic means. Now to the extent we weren't to do strategic M&A and I'm just giving you my bias, again this is not a decision this is just what I honestly think

from the answer to question is that, I would be very careful with it. You should do tuck-ins where it's in the best interest of the customer and obviously the shareholder. But it should never affect the pristine nature of this platform, because I think our customers are really relying on ServiceNow for that simple, beautiful, gorgeous user experience and they really expect us to be so perfect with the workflow and so pleasing that they just walk away from the relationship after the transaction and say, I can't wait to do another one. Keep making me happy, keep me loyal. And that is the culture here that is super powerful and I would never want to do anything to jeopardize that.

Thomas Roderick

Outstanding.

John Donahoe

Okay.

Thomas Roderick

Those are great insights. Thank you.

John Donahoe

All right. Well, everyone, I hope you got a good flavor of why I'm personally, the Board and organization is so excited to have Bill onboard, rest assured, heads down focusing on Q4 and a lot of momentum into 2020. So thanks for joining us in today's call.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.