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Gen Digital Inc. (GEN)

Q3 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, everyone. Thank you for standing by. My name is Frances and I'll be your conference operator today. I would like to welcome everyone to Gen's Third Quarter Fiscal Year 2023 Earnings Call. Today's call is being recorded and all lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session.

At this time for opening remarks, I would like to pass the call over to Ms. Mary Lai, Head of Investor Relations. Miss, you may begin.

Mary Lai

Vice President-Investor Relations, Gen Digital Inc.

Thank you, Frances. And good afternoon, everyone. Welcome to Gen's fiscal 2023 third quarter earnings call. Joining me today to review our Q3 results are Vincent Pilette, CEO; and Natalie Derse, CFO. As a reminder, there will be a replay of this call posted on the IR website along with our slides and press release.

I'd like to remind everyone that during this call, all references to the financial measures are non-GAAP and all growth rates are year-over-year unless otherwise stated. A reconciliation of non-GAAP to GAAP measures is included in our press release, which is available on our IR website at investor.GenDigital.com.

Today's call contains statements regarding our business, financial performance and operations, including the impact on our business and industry that may be considered forward-looking statements, and such statements involve risks and uncertainties that may cause actual results to differ materially from our current expectations. Those statements are based on current beliefs, assumptions and expectations, and speak only as of the current date.

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For more information, please refer to the cautionary statement in our press release and the risk factors in our filings with the SEC, and in particular, our most recent report on Form 10-K and 10-Q.

And now, I will turn the call over to our CEO, Vincent.

Vincent Pilette

Chief Executive Officer & Director, Gen Digital Inc.

Thank you, Mary. Good afternoon, everyone, and welcome to our Q3 earnings call. To start, I want to first thank each Gen employee for their contributions in 2022. Merging two companies is never easy, and I'm proud of their dedication and the tremendous progress we have made.

Quickly getting the integration done right creates the foundation for Gen to keep empowering millions to live their digital lives safely. We are at the intersection of a digital transformation that touches all aspects of our lives and an ever-evolving threat landscape that threatens our digital security, identity and privacy.

Although malware is still one of the biggest threat vectors, hackers and scammers continue to shift to attacking individuals and their data, not just the device anymore. The shift to the individual means that your information needs to be protected in all the digital places where it leads.

In today's world, protecting the device from malware is often not enough. Information, [ph] product usage (03:06), discovery or [indiscernible] (03:08) is more damaging financially and [indiscernible] (03:11) malware has ever been. The threat volume landscape and sophistication have grown, not reduced, whether it is theft identity, fraud, privacy or fake news, people's financials, their reputation and overall digital safety are under threat.

We are committed to fulfilling consumers' immediate needs and giving every person connected to the digital world, a path towards total cyber safety. Gen brings together trusted brands such as Norton, Avast and LifeLock, and combines many capabilities. Our combination of technology, products, marketing and sales channels, creates a strong foundation for Gen's long-term growth plan. It strengthens our product innovation efforts, diversify our business, increases global scale, and opens new go-to-market opportunities. We set a strategy to be the best cyber safety platform for consumers and we have the growth levers to get us there.

As we shared on the last call, the growth levers are extending global reach by leveraging our omnichannel strategy, increasing value for customers expanding to identity and privacy solutions, and growing loyalty from customers by improving user experience and retention.

Before I highlight our Q3 results and pass it to Natalie, let me share the progress made on the integration. As you would expect, we've hit the ground running fast. In the first three months, we've integrated our back-end systems and processes and deployed a unified go-to-market structure, enabling us to optimize our investments across all brands.

We identified and eliminated about 700 duplicative jobs or activities. We are in the process of deploying our new location strategy, leading to facility reductions. And this week, we're integrating our quote-to-cash processes.

Product integration will be the long pole where we are striving to not only maintain but accelerate our pace of innovation, which supports our revenue synergies and broader growth objectives. In this case, we are strategically driving the integration of our technology and engineering teams to ensure that we continue delivering innovative products that address the dynamic threats people face every day.

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Overall, you can see our progress in the expanding operating margin. We are on track to achieve the $300 million-plus annual cost savings exiting fiscal year 2024. Our integrated teams are now coming together across continents, sharing knowledge and adopting best practices and technological know-how with a focus on driving customer loyalty, platform adoption, cross-selling activities, which are at the core of our revenue synergy plans for the next two years.

Let's turn to Q3 results. The market trends we saw in Q3 were consistent with what we have been seeing in the last few quarters, persistent pressure on global e-commerce traffic, and lackluster overall consumer demand and inflationary pressures.

We believe that consumers have taken a more cautious approach to their spending in this challenging environment. Despite the macro factors, we delivered our 14th consecutive quarter of growth and when we look at our direct and partner business combined, which we call now Cyber Safety, our Q3 bookings and revenue were both up 4% in constant currency when including Avast historical results in the base.

Growth was spread across regions, brands, and product lines. We expanded our operating margin by 3 points year-over-year and 4 points sequentially. EPS grew 2% with a negative impact of currency and interest expense, masking the strong execution and operational strength of our business.

Our direct business grew 3%, similar to last quarter's growth rate. In this soft environment, we continue to strategically deploy our marketing spend to achieve the highest returns and efficiency, prioritizing higher ARPU and customer retention but not taking our eyes off the ball on the top of the funnel.

Growth was supported by strong cross-sell, especially with double-digit growth in our privacy offerings and slight sequential improvement in Avast retention, while our direct Cyber Safety customers' count declined by slightly over 200,000 quarter-over-quarter. On the partner business side, we continue to make strong traction with our diversified and omnichannel approach, delivering another double-digit growth quarter. Growth this quarter was primarily driven by wallet share gains from existing partners as we continue to demonstrate our value proposition.

As you've heard me say many times, the core of Gen's success is product innovation. And the integration of the two companies will only accelerate our combined capabilities. In Q3, we introduced several new products. We launched Norton Executive Benefits (sic) [Benefit] Program, which is a product that includes both LifeLock and ReputationDefender solutions and is designed for employers that want personalized concierge support for their C-suite executives and other high-profile individuals. We continued to expand our identity business internationally with the launch of credit monitoring features in the UK market.

In the US, we launched two new products. First, Avast Identity Secure (sic) [Avast Secure Identity] was launched in December, which includes identity theft protection, alerts assistance and loss reimbursement. Additionally, LifeLock added an industry-first feature called Utility Alerts, which monitors new utility or telco accounts that are opened in customers' names.

In privacy, we have launched a mobile app for our Norton AntiTrack product to extend our reach. And we've also expanded our global reach with the launch of Norton Privacy Monitor Assistant to Canada for the very first time. Our strategy in the short and mid-term is to expand the value offered to our current customers through new product launches and an improved user experience that comes within our platform that we've developed. We believe these focuses will grow loyalty and retention. Innovation is a top priority, and we will continue to invest to have the strongest portfolio that keeps our customer cyber safe.

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Let me wrap up my comments here by saying that our growth strategy remains intact. We will continue to execute to drive profitable growth in this challenging environment and create long-term value for all stakeholders.

And now, let me turn the call over to Natalie to cover our results in detail. Natalie?

Natalie M. Derse

Chief Financial Officer, Gen Digital Inc.

Thank you, Vincent, and hello, everyone. For today's call, I will walk through our Q3 results, give an update on synergies, and wrap up with our outlook for Q4. We will focus on non-GAAP financials and year-over-year growth rates unless otherwise stated. Our Q3 results reflect another solid quarter of performance and consistent execution. We came in above the midpoint of our revenue guidance and at the high end of our EPS guidance.

We drove our 14th consecutive quarter of bookings growth, supported by a resilient customer base and expanding product portfolio and our channel and geographic diversification efforts. We grew Q3 bookings 29% in USD and 35% growth in constant currency. When including Avast historical financials, Cyber Safety bookings grew 4% year-over-year in constant currency.

Our major contributors to growth in Q3 included ARPU expansion as we scale our cross-selling efforts, stable retention with our existing customer cohorts, growing double-digits with our partners for the ninth consecutive quarter and driving our direct business to mid-single-digit growth supported by several new product launches.

Q3 non-GAAP revenue was $936 million, up 33% in USD and 38% in constant currency, which includes a full quarter of Avast contribution. This also includes an unfavorable FX headwind of $34 million year-over-year or 5 points of growth, the highest it's been all fiscal year. When including Avast historical revenue, Cyber Safety revenue grew 4% year-over-year in constant currency.

Now, let me walk through our Cyber Safety key operating metrics for the quarter. Direct revenue of $818 million grew 31% in USD and grew 3% when including Avast historical financials. Considering the continued macroeconomic pressures persisting in the market, we are proud of our performance in driving higher value and loyalty with our existing customers as measured by ARPU expansion and retention improvement this quarter.

Direct monthly average revenue per user or ARPU was $7.09, an expansion of $0.11 quarter-over-quarter. We drove growth through our expanded cross-sell and upsell efforts, just like we said we would do back in November.

Our scaling privacy offerings have strong traction with our existing customers who choose to attach these incremental services to their existing subscriptions, driving high double-digit growth in the quarter.

Cyber Safety membership adoption has increased again this quarter as customers choose the incremental value and services we offer through our integrated platform versus stand-alone offerings.

Direct customer count ended at 38.4 million, a decline of 219,000 quarter-over-quarter as we continue to face into a challenged macroeconomic environment. Traffic to our e-commerce sites is lower than last year and is impacting our new customer acquisition funnel. We continue to invest in a diverse mix of marketing spend to help drive more traffic to our site, while optimizing the channel mix and dynamically adapting to market shifts in efforts to drive higher customer acquisition. We strive to delight and retain our existing customer base, and it's working with direct retention sequentially up and landing above 75%, with pockets of improvement in different cohorts.

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One of the primary synergy opportunities we shared in November was the Avast retention improvement. In a short period of time, we made early inroads with the Avast retention rate sequentially. And while the improvement was nominal, we are encouraged by the early progress. Looking ahead, we expect traction with revenue synergies to be measured directly through ARPU and retention improvements over the coming quarters.

Moving on to partners. We drove partner revenue to $95 million, 40% growth year-over-year as reported in USD and 11% growth when including Avast historical financials. This was our ninth consecutive quarter of double-digit revenue growth across our partner channels, a result of our growing international product portfolio, enabling us to sign new partnerships and capture more new business with existing partners.

We continue to leverage existing telco and retail partnerships to drive the distribution of our expanded product offerings. Our employee benefits channel is a differentiator in the market with a strong growing pipeline, spanning across small, mid-sized, and large employers. With our broad reach and distribution, we will continue to invest and are well-positioned for growth in this channel.

Turning to profitability, Q3 operating income was $526 million, up 41% year-over-year. We expanded operating margin to over 56% as a result of our continued cost discipline, our accelerated integration efforts, and our strong execution of cost synergies.

Through Q3, we have reduced our overall operating expense profile from 35% to 31% of revenue. Synergistic workforce reductions from approximately 4,500 employees to roughly 3,850, facilities rationalization from a hybrid workforce strategy and early consolidation of duplicative enterprise IT contracts are structural contributors to our lower operating costs. We are making inroads to the 60%-plus margin framework we've outlined last quarter.

At the end of Q3, we achieved approximately one-third of the annual cost synergy target from an exit rate perspective, and we remain on track to achieve cost synergies of over $300 million as we exit fiscal year 2024. As planned, this creates more operating leverage to reinvest in product innovation and sales expansion as we move forward in our growth efforts.

Q3 net income was $291 million, up 12% compared to last year. Diluted EPS was $0.46 (sic) [$0.45] for the quarter, up 2% year-over-year or 9% in constant currency, including $0.03 of currency headwind. Interest expense related to our debt was $148 million in Q3 with a negative EPS impact of $0.17 from total cost of debt in the quarter, $0.14 worse than last year. We anticipate the currency headwinds to continue and the interest rate conditions to remain volatile with a projected rise in SOFR in the near future.

Turning to our cash flow and balance sheet. Q3 operating cash flow was $306 million and free cash flow was $305 million, which includes approximately $150 million of interest expense payments for this quarter. This brings our fiscal year-to-date free cash flow to a total of $428 million. Our ending cash balance was over $800 million.

We maintain a balanced approach in our capital deployment. In January, we made a $250 million prepayment of our TLB. In Q3, we deployed $500 million of opportunistic share repurchases, the equivalent of 23 million shares, and we have approximately $870 million remaining in our current buyback program.

We also paid $80 million to shareholders in the form of a regular quarterly dividend of $0.125 per common share. For Q3, the board of directors approved a regular quarterly cash dividend of $0.125 per common share to be paid on March 15, 2023, for all shareholders of record as of the close of business on February 20, 2023.

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We are well-positioned with over $2 billion in total liquidity and we have no near-term maturities due until April 2025. With our strong cash flow generation and disciplined capital deployment, we will continue to utilize our capital to deliver EPS expansion and target net leverage of approximately 3 times with a balanced approach to pay down debt and deploy opportunistic share buyback.

Now turning to our Q4 outlook. For Q4, we expect non-GAAP revenue in the range of $935 million to $945 million, translating to low to mid-single-digit growth in Cyber Safety expressed in constant currency. We expect Q4 non-GAAP EPS to be in the range of $0.44 to $0.46 per share as cost synergies are partially offset by increased interest expense based on current SOFR forward curves.

Beyond Q4, we remain focused on our long-term objectives and are still targeting to achieve $3 annualized EPS exiting fiscal year 2025 with the following underlying key assumptions. Our Cyber Safety business continues to grow mid-single digits, post synergy structure of 60%-plus operating margin, free cash flow deployed towards debt paydown and share buyback. The SOFR curve trends indicate rates below 3% exiting fiscal year 2025, and our diluted share count expected to be around pre-Avast merger levels.

In summary, this was a solid quarter and in line with our long-term plan. We are proud of our continued growth, the level of execution across our teams, and the accelerated achievement of synergies.

Amidst the headwinds we face, we remain focused on delivering the best products and services to our customers, both current and future, and we remain committed to driving incremental shareholder value with our robust business model, high ratable revenue streams, healthy customer base, and strong cash flow generation as we take advantage of the huge secular growth opportunity in front of us.

As always, thank you for your time today. And I will now turn the call back to the operator to take your questions. Operator?

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QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question from Saket Kalia. Please go ahead.

Vincent Pilette
Chief Executive Officer & Director, Gen Digital Inc.
A

Hi, Saket.

Saket Kalia
Analyst, Barclays Capital, Inc.
Q

Hey. Great. Hey, Vincent. Hey, Natalie. Hey, guys, how are you?

Natalie M. Derse
Chief Financial Officer, Gen Digital Inc.
A

Hi.

Vincent Pilette
Chief Executive Officer & Director, Gen Digital Inc.
A

Good. Good.

Saket Kalia
Analyst, Barclays Capital, Inc.
Q

Thanks for taking my questions here. Vincent, maybe just to start with you, kind of a longer-term questions – to start with the longer-term question. I know that revenue synergies are a little bit more of a multiyear process, but I guess with the first full quarter of Avast under your belt, how do you feel about what you've seen for synergy opportunities, right, whether that's processes around retention or cross-selling? Curious how you feel about those revenue synergies, again, kind of having more time as a combined entity?

Vincent Pilette
Chief Executive Officer & Director, Gen Digital Inc.
A

Yeah. And it's a very good question. We said on the last call, right, we will first really focus on fast integration of our operations than of our products to put in the best position to grow the value for our customers.

On the last call, for those who were not on the call, we identified about $200 million of revenue synergies to be realized over the next two years. Half of those revenue synergies were about improving retention. NortonLifeLock before the acquisition of Avast had retention of about 85% on the customer side. When we merged with Avast or brought Avast portfolio in, the aggregate portfolio dropped to 75%. And based on our initial assumptions, we felt we can improve that retention by about 5 good points on operational activities that we had identified at NortonLifeLock, including moving more customers to a membership level and making sure that they benefit and use all of the functionalities of the platform.

After 90 days in, I think, Natalie mentioned in her script that we improved Avast retention nominally, so not enough yet to make it a trend or mature, but it give us good confidence that we're on the right path having identified the right operational plan to improve over the next few quarters.

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The next big revenue synergies, it's all about cross-selling opportunities. Three quarters of our customers being more security focused, still device-centric and offering them the opportunity to grow in the identity and privacy space. In the quarter, the launch of new identity features or privacy products give us confidence that those would be well-received. And I think over the next few quarters, we're going to accelerate that cross-sell, upsell activities.

One of the conditions is to have the product strategy fully defined in the product integrated so we can do in-app identifications of the weaknesses for the customers and helping them being fully protected. And then, the remaining other activities is between e-commerce, optimization, marketing, recalibration across the business models. We diverted a little bit of our marketing spend on the free-to-pay conversion, so good result. So, I think, all in all, I would say today, I would reconfirm our $200 million estimate.

The timeline does not change, but our confidence in getting there is there. We know in the short-term, Natalie mentioned some macro level changes on global traffic and others, but when we based our – the next two-year model and come in to the $3 EPS, we're confident we can rely upon a mid-single-digit growth rate to get there. Half of that growth rate is coming from those revenue synergies.

Saket Kalia
Analyst, Barclays Capital, Inc.

Q

Got it. Got it. That's very helpful. Natalie, maybe for you. Great to see the $500 million in buyback in the quarter. I think you said it was $250 million of a little bit of delevering here early in Q4. Can you just talk to us a little more broadly about how you're factoring in capital return into maybe the Q4 guide? And maybe longer-term, and you mentioned some nuggets there just around the $3 in EPS. How should we sort of think about that kind of mix of share buyback and delevering?

Natalie M. Derse
Chief Financial Officer, Gen Digital Inc.

A

Yeah. Hi, Saket. Thank you for the question. To answer your question very specifically, for the Q4 guide, we have nothing factored in there in that model beyond the mandatory debt paydown. But as you know, we are very, very consistent with our capital allocation priorities. We'll continue to strike the right balance across accelerated debt paydown and opportunistic share buyback. As we all know, there's financial benefits to both of those as we maximize return back to our shareholders.

We've stated delevering as a priority. It is. And as the cost of debt, you've heard it now a couple of times in today's call, the cost of debt for us is a major, major hurdle, one that's going to get worse before it gets better. So you can count on us that as we continue to generate strong cash flow and we continue to repatriate our international cash, we will be very, very active in deploying capital allocation in the most advantageous way.

As we look into the long-term model, our capital allocation priorities stay very, very consistent. We have a large amount of outstanding debt, SOFR curve that anybody can see doesn't seem that it will get much better until fiscal year 2025. So as we navigate through not only Q4 but fiscal year 2024, you'll see us strike that right balance across opportunistic share buyback and accelerated debt paydown. We got to do both.

Saket Kalia
Analyst, Barclays Capital, Inc.

Q

Absolutely, absolutely. Vincent, maybe just one last one for you, a little bit more shorter term. So, obviously, a much more challenging macro backdrop. We saw that in the net add metric. I'm just kind of curious if you could

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parse that out a little bit. And maybe that's just a focus on kind of the [ph] N-Lock (27:31) piece. How did gross adds do? How did sort of churn do? How are you kind of thinking about that in coming quarters?

Vincent Pilette
Chief Executive Officer & Director, Gen Digital Inc.

A

Yes. So when you step back at a high level, three growth drivers. One is the revenue we get for users, which really is about adoption of some of the products or the full portfolio; the retention activities, so more customers being retained satisfied with our values; and then the total customer adds, not just the direct customer add that we report.

On ARPU slight growth sequential on retention, slight improvement driven by Avast mainly, and we continue to work on those behind that. Many investor ask me, okay, how do you do that? Obviously, we have a lot of operational know-how, but product innovation and membership adoption are the two very important driver there. And I think you've seen that we have a good cadence there.

Then comes total membership. We look at membership as a total, including from partners, even though they're not our direct customers, they benefit from our overall membership. And so, we'll continue to invest into that partnership, you've seen double-digit growth and we're pretty happy about the performance there. We continue to work on the funnel.

When it comes to direct customers with a stable retention across all lines and across regions and slightly growing ARPU, it's all about the net gross adds, so the new top of the funnel, if you want. A trend we have seen now for a couple of quarters, right, so it's no different this quarter than it was last quarter or in Q1. Slightly more robustness on the identity-privacy combined pillar, if you want, and a bit more weakness on the security when you may be closer to the device. Same dynamic, whether it's Europe or Americas. And I think for us, it's all working on that marketing spend optimization as we continue to innovate the portfolio.

Saket Kalia
Analyst, Barclays Capital, Inc.

Q

Very helpful. I'll get back in queue. Thanks, guys.

Vincent Pilette
Chief Executive Officer & Director, Gen Digital Inc.

A

Thank you.

Operator: Thank you for your questions. Our next question comes from the line of Hamza Fodderwala with Morgan Stanley.

Vincent Pilette
Chief Executive Officer & Director, Gen Digital Inc.

A

Hey, Hamza.

Hamza Fodderwala
Analyst, Morgan Stanley & Co. LLC

Q

Good evening. Thanks for taking my question.

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Vincent Pilette
Chief Executive Officer & Director, Gen Digital Inc.

A

Yeah, of course.

Hamza Fodderwala
Analyst, Morgan Stanley & Co. LLC

Q

So, I wanted just to follow-on the net add question because I think that's probably what folks might be picking on a little bit. But Vincent, it sounds like the overall environment was pretty consistent with your expectations for this past quarter. But I think last quarter, we saw that the net adds coming in a little bit more stable, at least on the NortonLifeLock side. So I'm curious, was there anything throughout the quarter, perhaps what you saw towards the end of December, where the consumer maybe got a little bit weaker as it relates to Gen Digital?

Vincent Pilette
Chief Executive Officer & Director, Gen Digital Inc.

A

Yeah, I understand the question. So, actually, Q1, Q2, Q3, the trends were somewhat [indiscernible] (30:52) dynamic, the same. And you're right, that last quarter, it was the Norton and LifeLock lines, if you want, that were sequentially slightly more under pressure – sorry, less under pressure versus Avast, and this quarter is actually the reverse. I would not indicate that as like one quarter change within the proportion of what we're looking at is not mature enough. And I think overall, you can say about the same dynamic, slightly worse in Europe than Americas, but same dynamic across the two continents, and slightly worse in security closer to the device than in identity and privacy.

And I think when we guided back in November, we had said, hey, we don't see a change in that trend. And I think for the next few quarters, [ph] it would close (31:41) the fiscal year, we see similar trend. And that's why we, right now, really focusing on integration, product integration, increasing ARPU and retention as we continue to optimize between the different brands and business models we have.

Hamza Fodderwala
Analyst, Morgan Stanley & Co. LLC

Q

Got it. And just maybe a quick one for Natalie. The dollar has gotten quite a bit weaker year-to-date. Just curious how you're thinking about FX headwinds in relation to the fiscal Q4 guidance, and perhaps any commentary you [ph] get through (32:15) beyond that?

Natalie M. Derse
Chief Financial Officer, Gen Digital Inc.

A

Yeah. Hey. Hi, Hamza. Yeah. From a guidance perspective, we just assume no change to currency rates. We don't guide based on projected impacts of currency fluctuations in the market.

Hamza Fodderwala
Analyst, Morgan Stanley & Co. LLC

Q

Yeah. [indiscernible] (32:36)...

Vincent Pilette
Chief Executive Officer & Director, Gen Digital Inc.

A

[indiscernible] (32:36) Hamza, it's only a few percentage points. So, it's – sorry, I just wanted to add Hamza that between a dollar versus euro at $1.06 versus $1.09, yes, it may change in big views, but it's not materially

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different for us to change how operationally we drive. And inside the company, we drive all of our teams in constant currency and each sales team and direct-to-consumer teams are managing their business on the bookings in constant currency. So...

Hamza Fodderwala
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Got it. Thank you.

Operator: Thank you for your questions. There are currently no questions registered. [Operator Instructions] At this time, there are no more questions remaining. This will conclude today's Gen Q3 Earnings Call. Thank you for joining, and have a great rest of your day.

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