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Q1 2020 OneSpan Inc Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the OneSpan First Quarter 2020 Earnings Conference Call. (Operator Instructions)

I would now like to introduce your speaker today, Mr. Joe Maxa, Director of Investor Relations. Sir, please go ahead.

Joe Maxa *OneSpan Inc. - Director of IR*

Thank you, Michelle. Hello, everyone, and thank you for joining the OneSpan First Quarter 2020 Earnings Conference Call. This call is being webcast and can be accessed on the Investor Relations section of OneSpan's website at investors.onespan.com.

Joining me on the call today is Scott Clements, OneSpan's Chief Executive Officer; and Mark Hoyt, our Chief Financial Officer. This afternoon, after market close, OneSpan issued a press release announcing results for our first quarter 2020. To access a copy of the press release and other information, please visit our website.

Following our prepared comments today, we will open the call for questions. Please note that statements made during this conference call that relate to future plans, events, or performance, including the guidance for full year 2020, are forward-looking statements. We have tried to identify these statements by using words such as believes, anticipates, plans, expects, projects and similar words, and these statements involve risks and uncertainties and are based on current expectations.

Consequently, actual results could differ materially from the expectations expressed in these forward-looking statements. I direct your attention to today's press release and the company's filings with the U.S. Securities and Exchange Commission for a discussion of such risks and uncertainties.

Please note that certain financial measures that may be discussed on this call are expressed on a non-GAAP basis and have been adjusted from a related GAAP financial measure. We have provided an explanation and reconciliations of these non-GAAP financial measures to the most directly comparable GAAP financial measures in the earnings press release.

In addition, please note that the date of this conference call is May 5, 2020. Any forward-looking statements and related assumptions are made as of this date. Except as expressly required by the Federal Securities laws, we undertake no obligation to update these statements as a result of new information or future events, or for any other reason.

At this time, I will turn the call over to Scott.

Scott M. Clements *OneSpan Inc. - CEO, President & Director*

Joe, thanks very much. Good afternoon, everyone, and thank you for joining us here today from wherever you are. OneSpan reported an outstanding first quarter of 2020, with 19% year-over-year revenue growth and a significant increase in profitability. Q1 continued the strong momentum in software and services that began in the middle of 2019, and we saw favorable impact late in the quarter, related to the global pandemic, with some orders accelerated from Q2.



Our total software and services revenue grew 58%, to \$37 million, and accounted for a record 65% of total revenue in the quarter. As you know, our strategy is to transition toward a majority recurring revenue during the 2020 to 2022 period. Recurring revenue grew 62% in the first quarter, to a record \$26 million.

Looking at profitability, adjusted EBITDA improved by \$8 million year over year to \$5 million, on higher revenue and gross margin, partially offset by higher operating expenses. Mark will give you additional detail on both the top- and bottom-line drivers in just a moment.

I'd like to spend a few minutes on how the pandemic is affecting our core customers. Banks are seeing sharp increases in digital channel banking activities and hacking attacks. They're telling us this, and it is evident in various studies as well. JD Power found online banking logins grew 40% month over month in the first three weeks of April, and that among the four largest banks in the U.S., the use of mobile banking increased from 63% of their customers in 2019 to 72% of their customers so far in 2020. The study also found that many people surveyed began using mobile banking for the first time since the coronavirus pandemic started. We believe these trends are an acceleration of longer-term financial services industry trends and bode well for the future of digital banking and OneSpan.

In another recent study, Aite Group interviewed fraud executives at North American financial institutions and found that most expect to see increases in online and mobile fraud losses this year. One large financial institution revised its fraud loss prevent -- projection, sorry -- from a decrease of 8% before the pandemic to an increase of 10% to 15% now. Our digital banking, fraud prevention, and secure account opening technologies enable the proper functioning of the financial system around the world and have never been more important than they are right now.

We're also benefitting from increasing demand for electronic signatures and saw a spike in transaction volume and order activity late in quarter and into Q2. Notable sales activity included a large mid-six-figure annual contract win over an e-signature competitor and a dramatic increase in usage from the U.S. Small Business Administration Office of Disaster Assistance. As an example of our ability to quickly respond and to deliver value to our customers, the CEO of a community bank said, quote; I'm very pleased with OneSpan's e-signing process for the Paycheck Protection Program loans. They set us up in less than 24 hours, and it has been a game changer for us. I would highly recommend them, end quote; The bank was able to process more than 225 loans totaling nearly \$50 million the very next day, meeting their deadline to fund these loans.

Let me turn briefly to our cloud-first Trusted Identity solution portfolio. The value of our opportunity -- pipeline of opportunities increased nearly 60% from last year at this time with a growing contribution from our Secure Agreement Automation offering over the last two quarters. Secure Agreement Automation helps institutions open new customer accounts online by integrating identity verification with e-signature, on top of the TID workflow engine.

I'll now turn the call over to Mark. He'll provide some further financial information about the quarter, and then I'll come back to provide some closing comments, along with our 2020 outlook, before opening the call to questions. Mark?

Mark Stephen Hoyt *OneSpan Inc. - CFO, Executive VP & Treasurer*

Thank you, Scott. It really was an outstanding quarter, and I want to join you in thanking all of our OneSpan associates around the world for powering through the adversity of this pandemic to service our customers.

Total revenue for the first quarter of 2020 grew 19% to \$56 million. Product and license revenue grew 20% to \$38 million. And services and other revenue grew 16% to \$18 million. Revenue by major products and services were as follows: software license revenue grew 145% to \$19 million, with both mobile security and server software contributing to the rapid growth. Subscription revenue grew 11% to \$6 million. Total software revenue, including software licenses and subscriptions, grew 90% to \$24 million. Maintenance, support, and other revenue increased 13%, and hardware revenue declined 19% to \$20 million this quarter, in line with our expectations.

This quarter, we disclosed our term-based software license revenue in order to provide you with a more detailed look at our rapidly growing recurring revenue, which includes subscription, term-based licenses, and maintenance revenue. Term licenses grew 750% to \$9



million from the same period last year, and as Scott mentioned, our recurring revenue grew 62% to a record \$26 million in the quarter.

Gross margin for the first quarter of 2020 was 72%, compared to 70% in the prior quarter and 66% in the first quarter of 2019. The increase in gross margin is primarily attributed to product mix, with software and services contributing 65% of revenue in the first quarter, versus 55% in the fourth quarter of 2019 and 49% in the quarter -- first quarter of last year.

Operating expenses for the first quarter of 2020 were \$39 million, an increase of 6% from \$37 million reported in Q1 last year. The increase was primarily driven by G&A, with investments in areas like IT, financial, and HR processes, along with bolstering our information security. This was partially offset by a decrease in travel expenses across the company. We expect operating expenses for the full year to normalize over the remaining three quarters, with higher growth in sales and marketing and R&D, and lower growth in G&A.

Adjusted EBITDA, or adjusted earnings before interest, taxes, depreciation, amortization, long-term incentive compensation, and nonrecurring items, was \$5 million, or \$8 million higher than in the first quarter of 2019. Adjusted EBITDA margin was 9%, compared to a negative 5% in the first quarter of last year.

GAAP earnings per share were \$0 in the first quarter of 2020, compared to a loss of \$0.14 in the first quarter of 2019. Non-GAAP earnings per share, which excludes long-term incentive compensation, amortization, nonrecurring items, and the impact of tax adjustments, was \$0.08 in the first quarter of 2020, compared to a loss of \$0.07 in the first quarter of last year.

We ended the first quarter with \$105 million in cash, cash equivalents, and short-term investments, compared to \$110 million at the end of last year. Cash utilized in operations was \$2 million in the quarter.

Geographically, our revenue mix for the first quarter included 60% from EMEA, 22% from the Americas, and 18% from the Asia-Pac region. This compares to 54%, 27%, and 19% in the same regions in Q1 2019 respectively.

I now turn the meeting back to you, Scott.

Scott M. Clements *OneSpan Inc. - CEO, President & Director*

Thanks a lot, Mark. The financial services industry's response to the pandemic is accelerating the adoption of mobile and cloud technologies, and of the antifraud technologies that are needed to protect those channels. By market-leading position, range of identify security, fraud prevention, and e-signature solutions, and our ability to deliver on a global basis, are powering our software and services growth as we transition to a recurring revenue model. And our strong balance sheet allows us to continue investing in the future of our business through the current period.

After a great start to the year, we expect continued strong growth in software and services in Q2, though not necessarily at the same elevated growth rate as Q1, and this growth will be partially offset by the expected decline in hardware, as projected in our 2020 financial plan and guidance. We remain optimistic about our growth opportunities, but like most companies, we see a dynamic global environment with substantial economic uncertainty in the second half of 2020. We will further or continue to evaluate our outlook for the second half of 2020 as Q2 develops and will provide an update on our next earnings call. So, for now, we're comfortable reiterating our guidance for the year, revenue in the range of \$255 to \$265 million and adjusted EBITDA in the range of \$24 to \$28 million.

Finally, the health and safety of our OneSpan colleagues is a top priority for us, and I really want to thank them for transitioning quickly and efficiently to the remote work environment, while continuing to support our valued customers and delivering strong revenue growth. The IT investments we've made over the last year are really paying off for us right now.

So, with that, Mark and I will be happy to take your questions.

QUESTIONS AND ANSWERS



Operator

(Operator Instructions) Our first question comes from the line of Catharine Trebnick with Dougherty.

Catharine Anne Trebnick Dougherty & Company LLC, Research Division - VP and Senior Research Analyst of Data & Internet Protocol Networking

Great quarter, thank you for taking my question. Yes, really nice licensing beat, 100% growth here. What I wanted to dig into a little bit is, can you provide more color around the four revenue segments, the fast growth versus the perpetual? Thanks.

Scott M. Clements OneSpan Inc. - CEO, President & Director

Mark, go ahead. You want to take that? We're obviously not all in the same place, so we're coordinating over the Zoom here.

Catharine Anne Trebnick Dougherty & Company LLC, Research Division - VP and Senior Research Analyst of Data & Internet Protocol Networking

Yes, I understand.

Mark Stephen Hoyt OneSpan Inc. - CFO, Executive VP & Treasurer

You know, we can go into a little bit more detail this quarter for the first time, because I'm super excited with the extra disclosures that we're putting in our earnings press release. On Page 7, Catharine, you can see that we've called out our term-based software licenses. And that means that you can -- if you look at our license -- total license revenue, you can also see what our perpetual licenses are. So, you can see the growth we've had in subscription and in term license and in perpetual. And as we mentioned during the call, we saw tremendous growth in term licenses year over year, with growing from \$9.2 million -- growing to \$9.2 million from \$1 million last year.

Catharine Anne Trebnick Dougherty & Company LLC, Research Division - VP and Senior Research Analyst of Data & Internet Protocol Networking

Okay, got it. I didn't get to that part of it.

Mark Stephen Hoyt OneSpan Inc. - CFO, Executive VP & Treasurer

No, that's quite all right.

Catharine Anne Trebnick Dougherty & Company LLC, Research Division - VP and Senior Research Analyst of Data & Internet Protocol Networking

The other question was, any gross margin color you can give us on the different revenue streams that you have?

Mark Stephen Hoyt OneSpan Inc. - CFO, Executive VP & Treasurer

Yes, the gross margins we saw in our software and services lines were in the low 80s again this quarter, and the margins that we saw in our hardware business lines were in the low 50s, which is also similar with previous quarters. The growth we saw in our total gross margin, up to 72% over last year, is really attributed to the mix shifting towards software and services.

Catharine Anne Trebnick Dougherty & Company LLC, Research Division - VP and Senior Research Analyst of Data & Internet Protocol Networking

Okay, excellent. And then, going into the rest of the year, is there any way you can give us color? I think it's great that you're maintaining your revenue in this (sic) [these] uncertain times, but can you give us some color on how you look at hardware versus the recurring revenue growth and what to expect there? Because last year, you had some upside down (inaudible). You had everything coming in in September because of the PSD2 regulatory issues that came through in EMEA, so I'm wondering if you're seeing any changes in how you're looking at revenue contribution in 2020.

Scott M. Clements OneSpan Inc. - CEO, President & Director

Hey, Catharine, this is Scott. I'll maybe give you a couple of comments on that. I think first of all, I would note that this quarterly spread of revenue over the course of the year will be, I would say, much more normal than it was last year. So, you rightly called out the PSD2 deadline impact in September last year that had definitely elevated the contribution, revenue contribution in the third quarter last year. I

think we'll see a much more normal pattern this year, with the second half delivering, you know, some meaningfully more than the first half, but certainly more balanced than what we saw in 2019, and also more balanced, typically balanced, between Q3 and Q4. Q4 is usually our largest order, and I would expect that to be the case again this year, based on what we know right now.

I think in terms of the drivers of that, we have talked about hardware over the longer term being down in, you know, kind of the mid-single, maybe higher-single digits, but it's certainly going to be more than that this year, coming off of the really robust year we had for hardware last year. So we -- I would expect hardware revenues to be similar in the -- kind of in the same ranges they were in 2018, in 2020, and then we will see, obviously, that offset or more than offset by software and services growth.

So that's -- I think that's the pattern that we would expect, and we don't see any reason to change that view right now. There are a lot of moving parts. I think as anybody who's trying to run a business right now knows, there are a lot of moving parts in the economy and, you know, differences between the different regions of the world and so on. We see, you know, a lot of strength right now in consumer banking, helping both our security software businesses as well as our e-signature business. When we -- as we look forward into the second half of the year, you know, businesses are not doing a lot of business right now, many of them, so that's probably a little bit of a negative that we might expect to come out in the second half of the year, but we'll have to see. That's a much smaller part of our revenue stream than consumer banking, but those are a couple of the things that we do need to keep an eye on, as well as the timing of when different regions start to recover from, you know, essentially the shutdown right now.

Operator

Our next question comes from the line of Gray Powell with BTIG.

Gray Wilson Powell BTIG, LLC, Research Division - Director & Security and Analytics Software Analyst

Maybe to start off, the term license contribution is just a lot higher than what we had expected. How sustainable is that performance, and was there anything unusual in the quarter, like any multiyear deals or emergency spending, or just anything like that that helps your performance there in Q1?

Scott M. Clements OneSpan Inc. - CEO, President & Director

Mark, you may want to add some details to this, but I think there was, as I mentioned I think in the comments, that there's probably just a little bit of pull-in from Q2 into Q1, and we did see a little bit of an uptick, I think, in terms of some demand that affected the first quarter. And I don't think those patterns are generally going to change a lot going into the second quarter, but I think the, you know, that really high level of growth that we saw year over year will not -- probably not be quite as strong as it was in the first quarter. We do expect to see another good quarter in Q2. And I think as I mentioned a little bit ago, I think, you know, it looks fairly similar to, as a percentage of total-year revenue, as we saw last year in the second quarter.

So, I don't think there's anything really unusual. There's always a little bit of revenue that moves back and forth across the end-of-quarter line that can move us a few percentage points one way or the other. But outside of that, I don't think there's anything that I would remark on. Mark, anything you have to add to that?

Mark Stephen Hoyt OneSpan Inc. - CFO, Executive VP & Treasurer

I'll add just a little bit more color, and Gray, you kind of alluded to it with, do we have multiyear deals that were included here? And the answer is, yes, we do. And I'll remind everybody that our [rev rec], it can be lumpy because of 606. So, we had a couple 3-year deals that did come in in Q1. They were not unexpected. They do -- that means 62% of those -- of that revenue was recognized in the first quarter, so that will lead to some higher numbers here in Q1, as Scott just mentioned. So, there is still some lumpiness in that recurring revenue line, in that term license line.

Gray Wilson Powell BTIG, LLC, Research Division - Director & Security and Analytics Software Analyst

Got it. Okay, that's really great color. And then, just one more, if I can. So, in terms of just the higher-growth software businesses, both on the license and subscription side, I'm not sure if you can give this color, but like, just what historically has been sort of the split in growth from new versus existing customers, and just how do you see that changing over the course of the year?



Scott M. Clements *OneSpan Inc. - CEO, President & Director*

Yes, our business is really driven a lot by existing customers and expanded use, or new purchases by existing customers. We have seen, over the last couple of years, increased contribution from new customers in terms of our growth. Frankly, it's an area where we can do better, and we have a lot of new things to sell, and we have a lot of reasons to talk to new customers, more than we've had, really, ever before. So, we are really driven today, mostly by existing customers, by selling new solutions to existing customers, or selling, you know, more of the solutions they already use and that they rely on.

So, I think we're seeing this, you know, frankly, without any outsized contribution from new customers, but it's an area where we have a lot of effort, and I think we'll see some real benefit from new customers as we go through the year.

Operator

Thank you. (Operator Instructions) Our next question comes from the line of Anja Soderstrom with Sidoti and company.

Anja Marie Theresa Soderstrom *Sidoti & Company, LLC - Senior Equity Research Analyst*

Congratulations on another great quarter. I hope you all are doing well. Can you hear me?

Scott M. Clements *OneSpan Inc. - CEO, President & Director*

We can.

Anja Marie Theresa Soderstrom *Sidoti & Company, LLC - Senior Equity Research Analyst*

So, I just want to follow up on that last comment there around the sales. So, you're ramping up the salesforce and added just software-based salespeople. How has that been sort of trending, and how has the working-from-home environment sort of impacted their productivity?

Scott M. Clements *OneSpan Inc. - CEO, President & Director*

Yes, so when we think about this year, you may recall, Anja, that we've described this previously, that we did intend to make some meaningful incremental investments in sales and marketing in 2020, after being a little cautious on that, I would say, in 2019, as we were rolling out some of these new solutions. We are on track with that. Our plan is roughly to add about 30% to our quota carrying salesforce. We got about half of that, I think, so far this year, and a little bit more to go -- some more to go here in the second quarter. I would expect that we'll be largely through that in the second quarter in terms of adding those resources.

So, I would say everything's pretty on track for that. We are continuing to be, I would say, active and aggressive in executing our business plan and bringing on the talent that we require to grow our business and satisfy, you know, an expanded set of customers. So, that's -- I think that's going along just fine. We've got a lot of great sales training materials and sales enablement from our marketing team, and we are making incremental investments, also, on the marketing side and lead generation this year.

We have shifted that investment a little bit because of the, you know, the present situation. Some of the live events that we would have hosted or attended obviously aren't happening, so we have shifted some of that investment away from those areas and more toward digital and online lead generation. And, you know, so far, that's been pretty productive, I would say. We're going to continue to watch that, and if we don't feel like we're getting a bang for the buck, then we won't spend that money. But, so far, it looks okay.

Anja Marie Theresa Soderstrom *Sidoti & Company, LLC - Senior Equity Research Analyst*

Okay, thank you. I appreciate the additional color. And I think you mentioned in terms of hardware. I know that's going to decline because you had an influx from the new regulation in Europe. But you mentioned that there might be a renewal cycle coming up. Are you seeing anything in terms of that that might not impose such a slowdown in the hardware sales that you had expected this year?

Scott M. Clements *OneSpan Inc. - CEO, President & Director*

We don't see anything at this point that would I think change the outlook in a positive or negative direction, you know, for that matter. I think we've got a reasonably good handle on it. These refresh cycles are always very, very difficult to time and know exactly how that's going to go. I wouldn't be surprised if, given the current situation, that in some cases might even get pushed out a little bit. But we also



have customers who really haven't used authentication before, who are -- you know, really, really need authentication, so we're seeing some of that happening. And then, I think when you sort of balance those things out, we're -- you know, I think we're on track with our expectation for this year.

We're going to obviously continue to look at that through the second quarter and see if there's any reason for us to change that view in the upward or downward direction. But, you know, so far, I think we're pretty much where we expected to be on hardware.

Anja Marie Theresa Soderstrom Sidoti & Company, LLC - Senior Equity Research Analyst

Okay, thank you. And then, the next one is sort of housekeeping. You mentioned the operating expenses. You expect the sales and marketing and research and development to tick up a bit, and the G&A to come down a bit. Was that correct, or?

Scott M. Clements OneSpan Inc. - CEO, President & Director

That's correct.

Mark Stephen Hoyt OneSpan Inc. - CFO, Executive VP & Treasurer

That's exactly right, Anja.

Operator

Thank you, and I'm showing no further questions at this time, and I would like to turn the call back to Mr. Scott Clements for any further remarks.

Scott M. Clements OneSpan Inc. - CEO, President & Director

Okay, well thank you very much. I know we had quite a few people on the line today. I really appreciate all of you dialing in and, you know, we'll have a chance to talk to many of you over the next few days, I'm sure. We're very pleased about the quarter that we just had, and I think the demand. You know, the things that this company has always done is to secure digital transactions for -- primarily for banking and financial services. I think in the world that we're in, obviously, that's a very valued set of capabilities, and it's not new, but it is an acceleration, I think. And we expect this to have, I think, long-lasting and positive impacts for our business. As more and more people experience and use digital channel banking, we think many of those people will continue to do so, and that ultimately will be good for OneSpan.

So, thanks everybody for calling in. Really appreciate it. Again, thanks to our OneSpan colleagues around the world for making it happen, despite the challenges. Thanks, everyone.

Operator

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

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