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Gray Powell, *BTIG Research*

Andrew King, *Colliers International*

Anja Soderstrom, *Sidoti & Company*

PRESENTATION

Operator

Good day, and welcome to the OneSpan Third Quarter 2020 Earnings Conference Call.

All participants will be in a listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key, followed by zero.

After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star, then one on your touchtone phone. To withdraw your question, please press star, then two. Please note that this event is being recorded.

I would now like to turn the conference over to Joe Maxa. Please go ahead, sir.

Joseph Maxa

Thank you, Operator. Hello, everyone, and thank you for joining the OneSpan Third Quarter 2020 Earnings Conference Call.

My name is Joe Maxa, and I am the Vice President of Investor Relations. 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 our CEO, Scott Clements, and our CFO, Mark Hoyt.

This afternoon after market close, OneSpan issued a press release announcing results for our third quarter 2020. To access a copy of the press release, and other investor 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 outlook for full-year 2020, are forward-looking statements. We have tried to identify these statements by using words such as “believe”, “anticipate”, “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 November 2, 2020. Any forward-looking statements and related assumptions are made as of this date. Except as required by law, we undertake no obligation to update these statements as a result of new information or future events, or for any other reason.

With that, I will turn the call over to Scott.

Scott Clements

Joe, thanks very much. Good afternoon everyone, and thanks for joining us here today.

Our results for the quarter reflect the near-term impact of the pandemic as our banking customers temporarily shifted their attention, and their expenditures, away from some security and authentication projects. Despite this shift, we continue to make progress on the execution of our strategy to transition to a recurring software and services dominant revenue model. We remain optimistic about the future and we continue to believe that the core drivers of demand for our solutions remain intact.

Let me start by providing some insight into what we saw in the third quarter. We entered the quarter with elevated uncertainty about our near-term business outlook, as our global financial services customers reacted to the increased severity of the pandemic by adding $70 billion to their loan loss reserve levels. In addition to this financial pressure, banks reallocated IT resources to support work-from-home implementation, other critical digitization projects and business continuity needs. This resulted in delays and uncertain timing for many other types of projects, including security and authentication improvement. These factors impacted OneSpan and other providers of software technology to banks.

Most banks also closed or restricted branch operations around the world, limiting new account openings and reducing customer churn, both of which are key drivers of demand for our hardware and mobile security software offerings. Branches remain the most used channel for opening accounts around the world, and are often the distribution point for authentication tokens. The biggest impact of the pandemic on our business has been a sharp drop in demand for hardware authentication products. This is a significant change compared with the third quarter of 2019, which saw record hardware token revenue, driven by the implementation of payment services directive to a strong customer authentication regulation in Europe.

This one-time surge in demand in Q3 ’19 makes for a difficult comparison. The impact of the pandemic has made this comparison even more challenging. A typical example is a major South American customer that temporarily closed most of its branches, resulting in a dramatic drop in new account opening and reducing by two-thirds the number of authentication tokens it will purchase in 2020.

It's also important to note that in most cases, the sale of an authentication endpoint also carries a user license for server or cloud-based authentication software.

Sellant (phon), a respected financial services advisory firm, published its COVID-19 banking insights study, confirming that the two most immediate priorities for financial institutions during the thick of the pandemic have been to support customers in financial distress and to enable remote work for their employees. The study also found that most banks do plan to increase their IT budgets in 2021, with customer on-boarding and mobile and online banking expected to see the largest increases, which we believe will benefit OneSpan. We've already seen these trends in our OneSpan Sign eSignature business and in the growth of our opportunity pipeline for mobile security and identity verification.

While uncertainties remain, our customers have moved past their immediate financial and business continuity responses to the pandemic. They are looking ahead to 2021, and we're gaining better visibility into their security and digitization investment plans. As a result, we are today providing updated guidance for 2020, and some comments around our expectations for 2021.

Now I'd like to look ahead and tell you why I'm optimistic about the outlook for OneSpan. As I've already noted, customers are reengaging, and there are several other positive developments. First, our sales opportunity pipeline is rapidly growing; second, we're seeing sequential improvements in top line metrics; and third, our strategies are working. I'll touch on each of these for a moment.

First, our software and services sales opportunity pipeline grew in excess of 40% year-over-year, with strength in eSignature, identity verification and mobile security. Our authentication token sales pipeline is presently at its highest level since Q4 of 2019.

Second, bookings in all major product categories increased sequentially during the third quarter. Subscriptions increased 14% quarter-over-quarter and more than 100% year-over-year, driven by an urge in demand for process digitization solutions such as eSignature and digital identity verification. Other categories improved more modestly.

Third, our strategy to transform the business, to focus on strong recurring revenue streams and high margin solutions and services, continues to progress. Software and services will likely exceed 60% of total revenues this year and forward. Recurring revenue accounted for 74% of total software and services revenue in the quarter, and annual recurring revenue, ARR, grew at 27% year-on-year. Also, our dollar-based net expansion rate on recurring contracts was a solid 120%. Year-to-date, our bookings on recurring revenue contracts are up 50%.

We're also working to expand our growth opportunities by improving and extending our solution portfolio, developing a partner ecosystem to access new customers, and increasing our focus on vertical markets beyond financial services.

We had several significant wins during the quarter that illustrate these trends. We continue to see progress in the government space, with a large six-figure win at the U.S. Department of Agriculture, as they continue to digitize their services for farm assistance programs. We also booked a seven-figure opportunity in the digital healthcare space, working with a top three U.S. telecommunications provider.

OneSpan also closed an opportunity in Latin America where the customer acquired multiple cloud-based solutions simultaneously, including identity verification for digital customer on-boarding, eSignature for new contract signing, and cloud authentication for prepaid card transactions.

Meanwhile, our partner ecosystem continues to expand. We announced a technology and go-to-market partnership with ForgeRock, with whom we are already pursuing several sales opportunities. We've also added Sopra Banking and OneLogin as partners, and continue expanding our global network of ID verification and trusted service partners for our eSignature, identity verification and new account opening services.

Lastly, before I turn the call over to Mark, I want to note that we continue to see evidence that financial institutions are accelerating their move to the cloud. The pandemic has made clear the value of the scalability, agility and resilience of cloud infrastructure and services as we envisioned in our Trusted Identity Strategy back in 2018. During the third quarter, we completed the deployment of our largest cloud project to date, at a U.S.-based financial institution. While there are still regulatory and other challenges, banks adoption of cloud-based services is gaining momentum, to OneSpan's benefit.

After Mark updates you on our financials, I'll come back to provide some additional comments, along with an update on our outlook, before opening the call to questions. Mark?

Mark Hoyt

Thank you, Scott.

As Scott mentioned, we entered the third quarter of 2020 with uncertainty around the near-term business outlook for our customers. This played out as we experienced reduced demand for our hardware and term license products. However, there are some bright spots I do want to share.

OneSpan had a strong quarter of annual recurring revenue growth. We define ARR as the annualized value of all active recurring product contracts greater than or equal to one year in length. As compared with the end of Q3 2019, ARR grew 27% to $96 million.

Recurring revenue declined 5% year-over-year to $22 million, due to diminished Q3 revenue from term licenses. However, when looking at our total software and services revenue, recurring revenue accounted for 74% of the total, up from 62% last year. We remain on track to exceed our initial goal for recurring revenue to be 75% of total software and services revenue by 2022. In fact, we may reach that goal this year.

Our dollar-based net expansion rate, which we define as the year-over-year growth in ARR from existing customers, was 120% in the third quarter. We believe that these operational metrics, like ARR and DBNER, and our non-GAAP financial results, provide additional insight into our transition to becoming a majority recurring revenue Company.

Total revenue for the third quarter of 2020 declined 35% to $51 million. Product and license revenue decreased 51% to $30 million, while services and other revenue increased 15% to $21 million.

Let me talk a little bit about our three recurring revenue components, that's subscriptions, term licenses and maintenance, in a bit more detail here. Subscription revenue grew 34% to $7 million. This included strong growth in eSignature, improved growth in identity verification, and a modest contribution from cloud authentication. Term-based software license revenue declined 68% to $2 million, on pandemic-driven delays in security-related projects, as Scott mentioned. Maintenance revenue grew 17% year-over-year to $12 million.

Total software and services revenue declined 21% to $30 million, and hardware revenue declined 48% to $22 million. Again, the steep decline in year-over-year total revenue reflects large orders a year ago, driven by the PSD2 regulation deadline.

Note that while Q3 revenue declined from Q2, bookings in all major product categories grew in Q3 from Q2. Of note, subscription bookings grew 14% and total software and services bookings grew 3%.

Gross margin in the third quarter of 2020 was 70%, compared to 67% in the prior quarter and the third quarter of 2019. The increase in gross margin is primarily attributed to our product mix, tilting towards software.

OpEx in the third quarter of 2020 was $38 million, flat with the prior quarter and 7% higher than the third quarter of 2019.

Adjusted EBITDA, or adjusted earnings before interest, taxes, depreciation, amortization, long-term incentive compensation and non-recurring items, was $3 million. This compares with $3 million last quarter and $19 million in the third quarter of 2019. Adjusted EBITDA margin was 5% in the third quarter versus 24% in the same quarter last year.

GAAP loss per share was $0.04 in the third quarter of 2020 compared with GAAP earnings per share of $0.30 in the third quarter of 2019. Non-GAAP earnings per share, which excludes long-term incentive compensation, amortization, non-recurring items and the impact of tax adjustments, was $0.03 in the third quarter of 2020 compared to $0.36 in the third quarter of last year.

OneSpan ended the third quarter with $113 million in cash, cash equivalents and short-term investments, compared to $110 million at the end of last year. Cash generated from operations during the quarter was $3 million.

Geographically, our revenue mix for the third quarter included 52% from EMEA, 24% from the Americas and 24% from the Asia-Pac region. This compares to 61%, 20% and 19% in the same regions in Q3 2019 respectively.

Scott, I turn the meeting back over to you.

Scott Clements

Thanks very much, Mark.

As I noted earlier, we have improving visibility to customer demand compared to the end of the second quarter, so we'd like to give you some updated views on 2020 and 2021.

In the fourth quarter, we expect sequential and year-over-year growth in recurring revenue to be partially offset by a sharp decline in hardware authentication, as Mark described, and a continued shift away from perpetual license revenue. We expect ARR to be at or near our 25% to 30% goal for 2020. More specifically, for the full-year 2020, we expect software and services revenue of $126 million to $128 million, hardware revenue of $77 million to $79 million, and total revenue of $203 million to $207 million.

Looking into 2021, our software and services sales opportunity pipeline is strong, indicating that our product strategy is working and that our core value propositions in security, productivity, positive digital user experience and regulatory compliance are intact. Banks are overall financially strong, and while exact timing is difficult to assess, we believe that delayed projects will proceed in 2021 and that the demand for endpoint products, especially mobile security, will improve as banks refocus on consumer account growth. This will be to some degree influenced by the course of the pandemic, but like other businesses, banks are learning how to operate in this environment.

In 2021, we also expect a revenue headwind from the transition to recurring revenue to diminish, with continued strong ARR growth consistent with our long-term target of about 25% to 30%. We now expect at least 85% of software and services revenue will be recurring by the end of 2022, compared to the prior outlook of 75%. We also expect that hardware revenues will stabilize in 2021, though it's not yet clear whether we'll see some further decline or growth in that area. The revenue mix shift to software and services will be accretive to gross margins.

We're still evaluating our operating expense investment for next year. Given the uncertain path of the pandemic, the quarterly P&L spread is difficult to call at this point, but certainly, we would expect progressive improvements and growth across the year.

I also want to note that we're assessing the benefits of realigning our authentication token hardware product line. We have assigned an executive to lead this effort while also streamlining the operation to match revenue expectations and reviewing its organizational structure. We'll update you on this as our plans develop.

In the meantime, we're focused on four areas to strengthen our Company for the future. Number one, we continue to use our digital infrastructure to engage with our customers to address their immediate and evolving needs. We'll increase our focus on eSignature, identity verification and agreement automation solutions, which are in high demand and continue to build our overall sales pipeline. We'll continue to invest in our solution portfolio, increasing our capacity for innovation and differentiation, security, broad management, customer on-boarding and process digitization. Number three, we'll expand our partner ecosystem, focusing on accessing complementary technologies and expanding market access. Number four, we will develop target adjacent markets to increase our opportunity set and lessen our concentration in financial services.

Finally, I do want to remind you that we have prepared a Third Quarter Update presentation, and that is available on our Investor website right now.

With that, Mark and I would be happy to take your questions. Operator?

Operator

Thank you. We will now begin the question-and-answer session. To ask a question, you may press star, then one on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing any keys. To withdraw your question, please press star, then two. At this time, we'll pause momentarily to assemble our roster.

Our first question will come from Gray Powell with BTIG. Please go ahead.

Gray Powell

Okay, great. Thanks for taking the questions here.

Maybe just a couple; so, high level, and I think you did a good job addressing this, but how do you feel about the visibility you have on the business today versus three to six months ago?

Scott Clements

Yes, hi, Gray. It's Scott. I would say it's much better than it was at the beginning of the third quarter. I say that in the sense that, at that point in time, you'll recall we went through our guidance. The reason that we did that was because we were having trouble working with our customers in understanding what their plans were going to be. They couldn't tell us what, in many cases, their plans were going to be for projects that we knew about and been working with them, some new projects. They really had a lot of uncertainty about when, or what the timing would be on when those projects would go forward. Those organizations were just very focused in these other areas of business continuity and work-from-home and so on that I mentioned to you before.

If I go back to, certainly the beginning of the year, I would say visibility right now, not yet as good as it was in a normal circumstance or at the beginning of the year, but certainly, I think, significantly improved from what we saw three months ago. We have, I think, spent a great deal of time and effort really engaging with our customers very deeply, spending the time with all of our sales organizations around the world to do our very best to understand what's likely for the fourth quarter and, to some degree, for next year.

I think visibility, in short, significantly improved from the end of Q2. In some areas of the world, not yet where we would like it to be normally.

Gray Powell

Got it, okay, that's very helpful. Then on the hardware business—so I mean, obviously you understand the headwinds there. I think, just correct me if I'm wrong, but I think you said the pipeline on the hardware business is the best it's been since Q4 '19, is that correct?

Then, how should we think about the potential for that to recover as the economy gets better at some point? Is that something that will just naturally happen, or will you try to push more of that business into software form factors?

Scott Clements

Yes. I think when we look at the sales pipeline, we look at that every month and every quarter, that pipeline really bottomed out in the early part of last year; a lot of orders coming in at that point of time. We're sort of whittling down the forward opportunity pipeline.

The value of the pipeline, as we see it today, is slightly above where it was, really, all of this year and even through the fourth quarter of last year. I read that as, I think, some stabilization of demand going forward. It will take, to some degree, new account opening trends to improve, for banks to be bringing in new customers into their branches and so on, and that will start to pull through hardware, as well as increased demand for mobile security as we go forward. We're already seeing some significant improvements in the opportunity pipeline around mobile security.

I think we continue to be focused on driving our growth in software and services in the endpoint space for mobile security. Nevertheless, if you look at the data, about 82% or so, roughly, of our customers today still use our hardware token devices. That's a meaningful part of our business; it's important to a lot of our customers. We understand, and really have understood, I think, for quite some time now, that that's not going to be the growth engine of the Company going forward, and that will really come from mobile security and from the other solutions that we have to offer.

I hope that answered your question, Gray.

Gray Powell

Yes, it was perfect. Thank you very much.

Operator

Our next question will come from Andrew King with Colliers Securities. Please go ahead.

Andrew King

Hey there, thanks for taking my question.

Obviously as you mentioned, it sounds like the hardware piece is still very important to some of your customers, though it doesn't sound like you would consider the sale of it. But given the unpredictability and the volatility of it, will you consider breaking out the hardware and software gross margins and operating margins to give a little bit more visibility into, really, what seems to be the real strength of the business behind the software?

Scott Clements

Yes, I'll make a couple of comments there, Andrew. Good evening, by the way. Mark, you may have some additional things you want to add here.

Look, I think that, as I always say, that we, as a Management team and as a Board, look at our portfolio of solutions constantly, trying to really assess, what's the right way for us to maximize value in terms of the assets we own and the assets that we don't? I think it's not appropriate for me to talk, really, about private M&A activity or things like that if and until they become public.

I would just, I guess, reiterate what I said in the conference script, that we put somebody, a very experienced executive, in charge of that business. He's taking a look at the operation itself, how to streamline the operation, how to focus that on the right product set and how to size it, really, I think, for the level of business that we see going forward. I think regardless of what we ultimately do, these are all positive steps as we think about how to construct that business going forward.

Mark, I don't know if you have anything you want to add to that?

Mark Hoyt

Sure. I mean, I think, as Scott mentioned, we are starting to focus more on looking at that business. One of the challenges we have is the shared back office functions we have that support all of our business lines. I think that's one of the things that we're going to be taking a look at to see what is necessary to support the hardware and support software and services, and that's kind of the path that we're headed down, headed towards.

We expect to (inaudible).

Andrew King

Got it, thank you.

Then just briefly looking at the go-to-market strategy, specifically as outside of the banking vertical; how have you sort of adjusted that strategy to adapt to the COVID world, and how do you see that going forward?

Scott Clements

Yes, I wouldn't say we've really had to adjust that much for COVID at this point. These are things that we're in the early phases of, really trying to explore a couple markets, like healthcare, like government, and one or two others that we're thinking about, really trying to… We look at these verticals in the sense of, what are the use cases that are very similar to what we do in banking, financial services, where the technology in the products can deliver value to that customer set, outside of banking and financial services, without us having to go create a whole other set of products to do that.

When we look at these spaces in government, not only U.S. government but governments, really, around the world, there is a real increased focus on digital identity, digital citizen services and things like this. Those can, in their own way, be very high-value transactions. Maybe not in the same monetary sense as the bank, but certainly in many other ways. That's an area, for example, where we can take much of our core technology and really, I think, apply it to a vertical market like government. I think the same holds true with healthcare, particularly as it applies to digital healthcare, Telehealth, things like that.

We're in the very early phases of that. It's certainly gotten a boost because of the pandemic, so I think in that sense, I guess the pandemic is having an impact that is really driving interest and demand. It's almost always the case when sectors like this start to digitize and go mobile and all that, they do it in a big hurry and oftentimes their security is not as good as it should be in the early days. I think these are two areas we think there's a tremendous amount of opportunity. We don't have to really change our products or our business model all that much to address those markets, and they're ones that are quite large and growing, in terms of their demand.

Andrew King

Great, thank you.

Operator

Our next question will come from Anja Soderstrom with Sidoti. Please go ahead.

Anja Soderstrom

Hi, good evening, everyone, and thank you for taking my question.

I just wanted to follow-up on this going after adjacent markets. Are there any additional investments you're going to need to do in terms of the Sales team to do that? Or how do you see that playing out?

Scott Clements

Yes, hi, Anja. That's a good question. I think we're trying to—well, first of all, I think in the government market, we already do have some Sales coverage. I think, certainly in North America and in a few other parts of the world, the government sector's not completely new to us by any means, but we think there is really an expanding opportunity there. I think we'll take that bit by bit, in terms of scaling out any resources.

I think when we look at the healthcare space, that's one where we would really be using probably a partner strategy, a go-to-market approach that would really identify technology companies and players that exist, are operating in that market already. The reason for that is because it's a very fragmented market. It'd take a lot of effort to really build a direct sales model into that space.

We're very early on this one, but I think our present approach, and I think the likely approach going forward, will really be one of finding the right channel partners where we can add security and digitization tools and things like that to, maybe at the larger value proposition that that company may already have, into the digital health and the Telehealth space.

Anja Soderstrom

Okay, thank you.

That segues into my next question, about your partnership ecosystem. How is that working for you, to build that out, given the remote working and the pandemic? Has that affected that effort in any way?

Scott Clements

No, I don't think it has. It really hasn't. I think that we've added a number of new partners in the quarter, as I mentioned; there'll be more to come. There are a lot of different flavors of partners that we're engaging with. That really has not been a problem to any great degree that I've heard from the team.

I think the area where the pandemic and remote work and all that probably has the biggest effect is trying to land new customers and new accounts. I think, in most cases, we've got pretty long-standing relationships with our existing customers and we can do a lot to manage our relationship with those customers through our digital network. It's a little tougher when you're trying to access a new customer and build a new relationship. That's not a very big part of our business today; we want it to be a bigger part of our business going forward. It's something that's certainly not helpful right now, but not a significant problem for us, I don't think, at the moment.

Anja Soderstrom

Okay, thank you. That was all for me.

Scott Clements

All right, thank you, Anja.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Scott Clements for any closing remarks. Please go ahead, sir.

Scott Clements

Yes, thanks very much, Operator, and thanks, everybody, for joining the call today.

I think the pandemic has certainly created some challenges for our customers and in turn us, here in the third quarter. But we do see this opportunity pipeline really, really continuing to grow. I think we're making great progress on our transition to recurring revenue and thinking about these adjacent spaces.

As I look ahead, I think there's tremendous opportunity for our Company and we're going to continue to do our best to execute against that and not only deliver on the opportunities we have today, but to find new ones that will expand our opportunity set. I think as we go forward, end up with a Company that has very high recurring revenue that's stable and growing. That's our goal and I think we're making great progress towards that despite the current period of challenge.

Thanks, everybody. Appreciate it and look forward to talking to many of you in the days ahead.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.