OneSpan Inc(Q3 2024 Earnings)

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Corporate Speakers:

- Joe Maxa; OneSpan Inc; Vice President of Investor Relations
- Victor Limongelli; OneSpan Inc; Chief Executive Officer
- Jorge Martell; OneSpan Inc; Chief Financial Officer

Participants:

- Catharine Trebnick; Rosenblatt Securities; Analyst
- Trevor Rambo; BTIG; Analyst
- Anja Soderstrom; Sidoti; Analyst

PRESENTATION

Operator^ Good day. And thank you for standing by. Welcome to the OneSpan Q3 2024 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. I would now like to hand the conference over to your first speaker today, Joe Maxa, Vice President of Investor Relations. Please go ahead.

Joe Maxa^ Thank you, Operator. Good afternoon, everyone. And welcome to the OneSpan third quarter 2024 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 Victor Limongelli, our Chief Executive Officer; and Jorge Martell our Chief Financial Officer. This afternoon after market close, OneSpan issued a press release announcing results for our third quarter 2024.

To access a copy of the press release and other investor information, please visit our website. Following our prepared comments, 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 2024 and other long-term financial targets are forward-looking statements.

These statements involve risks and uncertainties and are based on current assumptions. 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. Also 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 for and reconciliations of these non-GAAP financial measures to the most directly comparable GAAP financial measures in the earnings press release and in the earnings presentation available on our website.

In addition, please note that all growth rates discussed on this call refer to a year-over-year basis unless otherwise indicated. The date of this conference call is October 30, 2024. 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. I will now hand the call over to Victor.

Victor Limongelli^ Thank you, Joe. Hello, everyone. Thank you for joining us on the call today. I'm thrilled we reported another solid profitable quarter, driven by the team's hard work and focus on operational excellence. Adjusted EBITDA was $17 million or 30% of revenue, and both business units were profitable.

I am particularly pleased that our Digital Agreements segment for the first time was profitable on a fully burdened basis, that is including corporate allocations, and that our Security segment continued to be highly profitable.

We had strong double-digit subscription revenue growth in the third quarter. Subscription revenue grew 29% and accounted for 60% of total revenue. Total software and services revenue grew 10% and accounted for 78% of revenue.

Overall, revenue declined 4%, primarily due to the anticipated decline in hardware that we discussed on last quarter's call. ARR grew 9%, in line with the approximate 7% to 10% guidance range implied by our full year ARR guidance of $166 million to $170 million.

As a reminder, we saw ARR growth of 15% last quarter, driven in part by a few large deals that closed earlier than expected. Q3 ARR was impacted sequentially by approximately $2 million from products we previously sunsetted. We believe we are on track to achieve our full year 2024 ARR guidance range.

I want to remind everyone that the products we sunsetted, though they contributed some revenue and ARR, and therefore, have some associated top line and ARR headwinds, were low growth and low return on investment products.

We are already benefiting from increased operating efficiencies and profitability from the sunsetting of these products and believe we are better positioned from a product portfolio perspective to drive increased profitable growth in the coming years.

We continue to generate strong cash. We generated $14 million in cash from operations in the third quarter and $43 million year-to-date, which is a significant improvement from the prior year. Last year, we used $7 million in cash during the third quarter and $14 million in cash through the first nine months.

As of September 30, we had $77 million in cash on hand. And we continue to focus on operational excellence and accountability throughout the company.

For example, our sales team continues to focus on transitioning the company to more higher-margin software revenue, and they've been working hard to stay close to customers so that we can continue to improve our performance in response to customer feedback.

Our renewals team continues to make strides in closing maintenance renewals in a timely fashion. Year-to-date, our on-time renewal rate improved several percentage points compared to 2023. And our R&D team is continuing to make improvements to our SaaS offerings, which we are starting to see through increased operational efficiencies reflected in higher gross margins.

Turning to our two business units. I'm, of course, thrilled with the profitability delivered by both BUs in the third quarter. In Digital Agreements, revenue and ARR growth was driven by expansion contracts and to a lesser extent new logos. In terms of the seasonality of bookings, we expect Q4 to be stronger than Q3, as it typically is. This will help our end of year ARR, but will have limited impact on Q4 revenue.

In our Security business unit, our Q3 subscription revenue and ARR growth was primarily driven by authentication solutions for existing customers. In Q4, we expect another quarter of double-digit subscription revenue growth.

However, like last quarter, given our visibility into our hardware pipeline and anticipated customer delivery schedules, we anticipate a decline in hardware and total security revenue as compared to the fourth quarter of last year.

Over time, a number of banks in EMEA and to a lesser extent in Asia Pacific have adopted mobile-first policies with respect to consumer banking.

Looking ahead, although we are not ready to provide fiscal year '25 guidance, our initial view for next year suggests hardware revenues will continue to decline modestly year-over-year.

Our goal is to have both business units deliver growth and strong profitability, and we are well on our way to achieving that goal.

Security growth may be more challenging in the near term given the context I just provided around hardware, but I believe we are in a strong position long-term to drive increased growth and profitability as we focus on driving higher-margin software revenues.

For the full year 2024, given the dramatic strides we have made in terms of profitability, we expect our adjusted EBITDA to be significantly higher than previously forecast.

In addition, we continue to expect strong double-digit growth in subscription revenue. However, given our increased visibility into hardware, we now expect our full year revenue to fall in the lower half of our prior revenue guidance range.

Finally, as I noted last quarter, the Board plans to undertake by year-end a review of our cash generation and capital needs, balancing those factors with a desire to return capital to shareholders. With that, I will turn the call over to Jorge. Jorge?

Jorge Martell^ Thank you, Victor. And good afternoon, everyone. Before reviewing our financial results, I want to highlight the substantial completion during the third quarter of our multiyear cost reduction initiatives.

I'm very pleased with the team's efforts as we worked to capture significant cost savings over the last couple of years, which has helped us meaningfully improve our operating profitability.

During the third quarter, we realized $3 million in annualized cost savings, bringing our cumulative annualized cost savings to $18 million year-to-date and to approximately $76.5 million dating back to May of 2022, exceeding our year-end 2024 cumulative annualized cost savings goal of $75 million.

Now turning to our third quarter results. ARR grew 9% to $164 million and our net retention rate was 106%.

As compared to last year, ARR and NRR primarily benefited from customer expansion contracts and ARR to a lesser extent also benefited from new customers. Growth in ARR and NRR was partially offset by an increase in typical churn and churn related to end-of-life products.

Third quarter 2024 revenue was $56.2 million, 4% lower than last year's Q3, primarily due to the expected decline in hardware revenue. Digital Agreements revenue grew 18% and was offset by a decline in Security revenue of 11%. Within our Security business unit, software and services grew 6%.

Subscription revenue grew 29% to $33.6 million including 29% growth in Security Solutions and 27% growth in Digital Agreements. Maintenance revenue declined by design as we continued to transition to a SaaS and subscription license model. Third quarter gross margin was 73.9% compared to 69.1% in the prior year quarter. The increase in gross margin was primarily driven by favorable product mix within our Security segment including an increase in software and a decrease in hardware, partially offset by an increase in depreciation of capitalized software costs in Digital Agreements.

Third quarter GAAP operating income was $11.3 million compared to an operating loss of $4.8 million in the third quarter of last year. The year-over-year improvement was primarily driven by an increase in gross profit dollars due to the favorable product mix just discussed, a decrease in operating expenses primarily from lower headcount and vendor-related costs, and lower restructuring costs.

GAAP net income per share was $0.21 in the third quarter of 2024 compared to a GAAP net loss per share of $0.10 in the same period last year. Non-GAAP earnings per share was $0.33 in the third quarter of 2024. This compares to a non-GAAP earnings per share of $0.09 in the third quarter of 2023.

Third quarter adjusted EBITDA and adjusted EBITDA margin was $16.7 million and 29.7% compared to $6.3 million and 10.7% in the same period of last year, respectively. Turning to our Security Solutions business unit. ARR grew 6% in the third quarter to $104 million. ARR growth was negatively impacted by approximately 1.5 percentage points through the relocation of identity verification products to our Digital Agreements business unit at the beginning of the year.

In addition, ARR headwind related to end-of-life products was approximately $1.6 million in the quarter and $2 million year-to-date.

Third quarter Security revenue declined 11% to $40.8 million, primarily due to the expected decrease in hardware revenues we discussed previously. Hardware revenues declined 36% year-over-year to $12.1 million.

Security subscription revenue increased 29% to $18.6 million, primarily driven by expansion of licenses from existing customers for software-based authentication solutions.

Maintenance and support revenue declined by design and was in line with our expectations as we continued to transition legacy perpetual maintenance contracts to term licenses. Q3 2024 gross profit margin in our Security segment was 75% as compared to 67% in the third quarter of 2023. The increase in margin is primarily attributable to favorable product and customer mix.

Operating income was $20.2 million and operating margin was 49% compared to $15.7 million and 34% in last year's third quarter. The enhancement in gross profit margin combined with reduced operating expenses primarily attributed to restructuring and other cost reduction activities drove the majority of the improved performance. Turning to our Digital Agreements business unit. ARR grew 16% in the third quarter to $60 million.

ARR growth benefited by approximately 3 percentage points due to the relocation of identity verification products to digital agreements at the beginning of the year. ARR headwind related to end-of-life products was less than $0.5 million in the quarter and approximately $3 million year-to-date. Third quarter revenue grew 18% to $15.4 million, primarily driven by new contracts and expansion of renewal contracts and to a lesser extent, the relocation of identity verification products.

Subscription revenue consisting of 100% SaaS revenue grew 27% to $15 million. Third quarter gross profit margin was 72% as compared to 75% in the prior year quarter. The year-over-year change was primarily driven by an increase in depreciation of capitalized software costs.

Operating income was $3.4 million or 22% of revenue as compared to an operating loss of $4.7 million or 36% of revenue in Q3 last year. The significant improvement in performance was driven by an increase in revenue and gross profit dollars, along with a decrease in operating expenses, primarily attributed to restructuring and other cost reduction activities.

Now turning to our balance sheet. We ended the third quarter of 2024 with $77.5 million in cash and cash equivalents compared to $42.5 million at the end of 2023.

We generated $14 million in cash from operations during the quarter and used $2 million in capital expenditures, primarily capitalized software costs.

We have no long-term debt. Geographically, our revenue mix by region in the third quarter of 2024 was 40% from EMEA, 39% from the Americas and 21% from Asia Pacific. This compares to 45%, 34% and 21% from the same regions in the third quarter of last year, respectively.

I will now provide our financial outlook. For the full year 2024, we are narrowing the range of our previously issued revenue guidance to reflect a reduction in anticipated hardware token shipments, partially offset by stronger than previously expected subscription revenues.

We are affirming our ARR guidance and we are significantly increasing our adjusted EBITDA guidance to reflect stronger than originally anticipated operating leverage driven by improved execution of our cost savings initiatives.

More specifically, we expect revenue to be in the range of $238 million to $242 million as compared to our previous guidance range of $238 million to $246 million. ARR to end the year in the range of $166 million to $170 million and adjusted EBITDA to be in the range of $65 million to $67 million as compared to our previous guidance range of $55 million to $59 million. That concludes my remarks. Victor?

Victor Limongelli^ Thank you, Jorge. I am very proud of the entire OneSpan team. Their hard work and focus on operational rigor over the last several quarters has resulted in a much stronger company. Our ability to generate cash has significantly improved and we are much more profitable as compared to recent years.

Looking ahead, we are committed to delivering value to our customers and to returning value to our shareholders by growing revenue efficiently and profitably. Jorge and I will now be happy to take your questions.

QUESTIONS AND ANSWERS

Operator^ (Operator Instructions) First question comes from the line of Catharine Trebnick of Rosenblatt Securities.

Catharine Trebnick^ So you've talked a lot about focus on execution. Can you give us an update on where you are with your ecosystem and building that out? Because I think that was one of the areas that I thought was interesting when I came back to covering the stock.

Victor Limongelli^ Yes, one of the ways we want to grow the business is to extend our reach by working through partners. And we have some progress on that front, but I would say the impact to date is not in the numbers that we reported. It's more in the future than in the past.

So we have a direct sales force that can -- when we talk about banks, as an example, we talk about having over 60 of the 100 biggest banks as customers. And other banks of that scale, we deal with our direct sales force.

But for us, it's way more efficient to work for -- to address the midmarket and lower banks through partners.

So we've started to sign up partners.

We have a new leader of the channel in Europe, and I expect to see that continue to develop as we move into 2025.

Catharine Trebnick^ All right.

So it's more of a three or four quarter out type of impact -- positive impact on revenue?

Victor Limongelli^ Certainly.

So what's going on now is signing up partners, getting them trained, and it takes some time before they're productive and probably even longer for them to materially impact revenue.

Operator^ Our next question comes from the line of Trevor Rambo of BTIG.

Trevor Rambo^ This is Trevor on for Gray Powell. Congrats on some solid results.

So to start, how would you guys say the overall macro environment is now compared to about earlier in the year? And I know you touched on it a little bit during the prepared remarks, but could you add some more color on what you're seeing in the hardware business going forward kind of now and into next year? And what you guys are seeing around some customer churn because I know you mentioned that as well in the prepared remarks.

That will be great.

Victor Limongelli^ Sure. With respect to hardware, so there's a couple of things going on.

In the retail consumer banking segment in Europe and to a lesser extent in Asia Pac, there's definitely more mobile authentication than there was some years ago, and that trend has been going on for a while. Less so in corporate banking. Corporate banking still tends to be done in front of a screen, in front of a computer.

So it's more amenable to hardware, I think, than consumer banking.

So that's been a long-term trend. And you can see that in -- if you look back over the last decade, you can see that in our hardware numbers. The advantage we have is that if a bank is going to use some hardware, we enable them -- our solution enables them to use the same authentication back-end for both hardware and software.

So if they go with OneSpan, they can have one back-end, easy to administer, handle their hardware needs for the customers who want that, handle their mobile authentication needs maybe for the majority of consumers versus going with a competitor and then having to have two different back-ends if they're going to have any hardware at all.

So I think there's still some long-term strength in having the hardware offering.

It actually helps our software offering, if that makes sense, Trevor.

Trevor Rambo^ Yes. That makes sense. Yes. That's some good color. And then maybe just one more. You guys did some nice jobs with the cost-cutting initiatives, both finishing that earlier than you initially expected. And you've been really ramping both operating margins and your adjusted EBITDA throughout the year.

So I guess moving forward, how are you guys thinking about your ability to both sustain those margins, but also reaccelerate the top line growth as we finish this year and head into next fiscal year?

Victor Limongelli^ Yes. Great question.

So of course, we want to get to the Rule of 40. And I think we're going to get there through a combination of operating income, operating leverage and some growth.

We don't think it makes sense -- we don't think we'll generate as much value by having it all be EBITDA.

So we are looking at ways to grow faster whether that's through a partner channel, whether it's through new offerings, expansion of our relationships with existing customers. And we haven't given guidance for 2025 and, in fact, haven't finished our budgeting for 2025 yet, but we are definitely looking to grow faster. With respect to the operating income, we certainly don't think we're at a peak there.

We think we can do better.

But it's fair to say that progress from here on out will be a little bit harder.

So it's one thing to go from negative to upper 20s adjusted EBITDA.

We're obviously not going to go from upper 20s to 50s. Like we're not going to make the same jump, but we do think we can make additional progress.

Trevor Rambo^ Congrats again on a nice quarter.

Operator^ Our next question comes from the line of Anja Soderstrom of Sidoti.

Anja Soderstrom^ Congrats on the nice progress here.

So the cost cutting, is that coming through faster? Or is it more -- or are you seeing more savings than you initially thought?

Jorge Martell^ It is -- I can jump in here, Vic.

So it's a little of both, Anja.

So the team executed very well.

So we had a plan, particularly for the second and third quarter.

Some of those savings came in earlier than we expected.

And so you see that reflected in the numbers for sure. And then obviously the adjusted EBITDA guide that we changed favorably.

So some of -- and then some of it is also unplanned savings that we identified as you are always trying to identify how do we work smarter, how do we make sure that we can do things more efficiently.

So some of these either through vendors or just process improvements that led you to operational efficiencies come to light. And so some of that is on plan.

And to a certain extent, also, you may have an idea in terms of like real estate footprint, but some of that comes to fruition into accelerating some of those or increasing some of those savings.

So maybe not the nature of it may be new, but in terms of maybe the mix of different vendors that contribute to the savings may be a little bit different than originally planned.

So we'll take both of these.

Anja Soderstrom^ Okay. And as we think about that adjusted EBITDA increase and with the hardware becoming a smaller part now does the -- do you expect the gross margin to also be maybe higher and contribute to that EBITDA? Or is it mostly on the operating side?

Jorge Martell^ You're talking about for 2025?

Anja Soderstrom^ '24.

Jorge Martell^ For '24. So maybe to unpack that a little bit. So I think overall, we're going to -- we're increasing that a little bit in terms of our expectation to the low 70s, just like you saw the benefit in Q3. If you look at the two business units, DA -- I guess both DA and Security will be in the low 70s. We talked about hardware.

Hardware actually is increasing because of the mix of APAC clients that come with a better margin. So that's driving a little bit of an improvement there.

So I guess just to answer your question, from the earlier discussion that we had maybe a couple of quarters ago from the high 60s, I think we now can say it's likely going to be in the low 70s. So it's an increase overall.

Anja Soderstrom^ Okay. And then the jump in the Security Solutions in the subscription, there was a nice jump sequentially. What drove that? And how should we think about that going forward?

Jorge Martell^ Sorry, I missed the first part of the question, Anja, can you repeat that?

Anja Soderstrom^ The jump, sequentially jump in the subscription for the Security Solutions, what drove that? And how should we think about that going forward?

Jorge Martell^ Yes. No. We continue to see very good progress on the demand side for authentication products, Anja, also mobile application products that we cross-sell to our existing customer base. And so that is primarily what drove that on the subscription revenue.

So we're seeing a lot of good adoption, new licenses in particular. Some of those are obviously conversions on the perpetual to term. And so we tend to see price upside to those conversions. So that also benefited the quarter either year-over-year or sequentially.

Victor Limongelli^ Anja, let me add a comment to that. If you look at 2024, it's the first time that security subscription revenue will exceed hardware revenue. And on top of that, our security BU is just about two-thirds's software when you count maintenance and support and subscription. So that certainly has helped the operating leverage of that BU.

Anja Soderstrom^ Okay. And at what sort of revenue level do you expect to be profitable in the Security Solutions?

Jorge Martell^ Yes. So that was -- as you know Security Solutions is our highest -- of the two BUs, the one that generates the most profit. If you're looking for a revenue breakeven for that business unit, I mean you can probably look at mid -- low to mid-20s is probably a good number.

But just doing the math here in my head, Anja, if you just look at -- just try to look at the numbers. So -- on a quarterly basis, yes. Sorry. Just to clarify that.

Operator^ I am showing no further questions at this time. I would now like to turn it back to Joe Maxa for closing remarks.

Joe Maxa^ Thank you, everyone. Thank you for your time today.

We look forward to sharing our progress with you again next quarter. Thanks again and have a great day.

Operator^ All right. Thank you for your participation in today's conference. This does conclude the program and you may now disconnect.