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OneSpan

Second Quarter 2022 Earnings Conference Call

August 2, 2022

CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

Chad Bennett, *Craig-Hallum*

Gray Powell, *BTIG*

Rudy Kessinger, *D.A. Davidson*

PRESENTATION

Operator

Good afternoon, ladies and gentlemen. Thank you for attending today's OneSpan Second Quarter 2022 (audio interference). My name is Tia, and I will be your moderator for today's call.

All lines will be muted during the presentation portion of the call. You will have an opportunity for questions and answers at the end.

I would now like to pass the conference over to your host, Joe Maxa, Vice President of Investor Relations with OneSpan. You may proceed.

Joe Maxa

Thank you, Operator. Hello, everyone and thank you for joining the OneSpan Second Quarter 2022 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 Matt Moynahan, OneSpan's chief executive officer and Jan Kees van Gaalen, our interim chief financial officer. This afternoon, after market close, OneSpan issued a press release announcing the results for our second quarter 2022. 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 2022, are forward-looking statements. These statements use words such as believe, anticipates, plans, expects, projects, and similar words, and 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 Form 10-K and Form 10-Q 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 provide an explanation for 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 August 2, 2022. 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 turn the call over to Matt.

Matt Moynahan

Thank you, Joe and good afternoon, everyone. Thank you for joining us today.

We delivered a solid quarter with 21% ARR growth and 26% subscription revenue growth. We exceeded our internal revenue ARR and Adjusted EBITDA expectations despite foreign currency exchange headwinds, which Jan Kees will discuss with you during his financial review. Strength in the quarter was primarily driven by expansion contracts with existing customers, including several seven figure contracts for e-signature and security solutions.

Some of our important wins include the following. A multiyear seven figure TCD contract with a European customer, utilizing several of our security solutions. A six figure ACD expansion of an existing multiyear, seven figure TCD contract with a top global bank in Europe that had been experiencing higher than expected demand for mobile banking across all lines of business. A $300,000 ACD contract with one of the largest private banks in India. This bank is a long-term Digipass customer that began buying our mobile security solutions.

Several e-signature customers in North America, including a seven figure, multiyear new logo win and several expansion contracts with existing customers that added new lines of business and increased volume commitments. A customer of ours in the Asia Pacific region acquired three companies which were all running a competitor's e-signature platform. This customer standardized on OneSpan sign e-signature as their solution of choice. Our enterprise class feature set, ease of integration, and ability and willingness to white label our solutions were key factors in many of our wins.

Now, let me update you on our strategic transformation plan. We are hard at work building a digital agreement security company that matters to the world. Our objective is clear. It matters to protect to enterprises as they engage and transact with their customers throughout the transaction lifecycle, from identity verification to authentication, virtual interactions, the signing of digital transactions and documents, and eventually secure storage and we are just getting started. We announced our strategic plan in May at our investor day, along with the second phase of our restructuring plan, designed to enable us to move forward with a more effective and efficient operating model.

We are beginning to implement the plan, which we expect will take several months to gain traction as we prepare for its first year, Fiscal Year 2023. Q2 marked the beginning of the new OneSpan from a financial reporting perspective. For the first time, we reported operating results from our two new segments: digital agreements and security solutions. We plan to manage the digital agreements business for accelerated growth and market share gains and security solutions for cash flow, given its more modest growth profile.

It is important to note that digital agreement solutions are largely cloud based and consist of solutions that enable our clients to secure and automate business processes associated with the mission critical digital agreement and customer transaction life cycles. Today, they include our e-signature and virtual room solutions. As our transformation plan progresses, we expect to include additional cloud-based security solutions, such as identity verification, authentication, virtual interaction, e-signing, and e-vaulting, leveraging the considerable security talent in our Company. Security solutions consists largely of our historical on-premise software security product portfolio, including identity verification, multifactor authentication, and transaction signing, such as mobile application security and mobile software tokens, along with Digipass tokens that are not cloud connected.

A key part of this transformation has been the continual strengthening of our executive leadership team to bring scale experience to the Company. I am pleased to share we have successfully added our new chief information officer, general counsel, and chief product officer. Most of the team is in place and are all highly talented and experienced leaders with proven abilities to drive companies forward. We hope to have the remainder of our key executive positions filled within the next few months.

Next, I'll provide color on our go-to-market strategy. We internally launched our OneSpan 1,000 program which prioritizes growth at our largest 1,000 enterprise and target accounts. We are hard at work to improve our new enterprise logo acquisition and are targeting increased share of wallet at existing customers through sales enablement training and an increased focus on cross selling and upselling. We plan to access new routes to market through an increase in alliances and partnerships and are targeting a doubling of our direct sales force by the end of Fiscal Year 2023.

These activities will take time to operationally implement, and the next two quarters will be important to put the building blocks in place to enter FY23 on solid ground and begin the execution of our strategic plan. I spent considerable time with our enterprise customers and prospects this quarter, both in person and virtually across the globe and I am pleased to tell you our go forward strategy is resonating. We have enterprise class solutions today and we're building the next generation solutions to enable an enterprise class go-to-market capability to take advantage of the opportunities we see ahead.

It's clear that digital agreements and cybersecurity are both important markets that will become even more important to enterprises in the years to come. A report from a prominent research firm highlighted this trend just a few weeks ago. At OneSpan, we see the world of agreement processes evolving to one that requires security not at the point of authentication but throughout the entire transaction life cycle. Our transaction cloud platform will enable the seamless inclusion of security capabilities and compelling user experience to help customers secure their entire digital agreement process.

With that, Jan Kees will now take you through our second quarter financials. Jan Kees?

Jan Kees van Gaalen

Thank you, Matt. Hello everyone. Good afternoon.

I am pleased that we reported a strong quarter, largely driven by improved operational rigor in the business. Additionally, I want to highlight the impact of foreign currency exposure on our revenue for the quarter. Excluding this impact, our Q2 revenue would have been $3.2 million higher than we reported, representing a year-over-year growth rate of 7%.

Now turning to our financial results. ARR grew 21% year-over-year to $134 million. ARR specific to subscription contracts grew 35% to $98 million and accounted for approximately 73% of total ARR. Dollar based net expansion, or DBNE, which we define as the year-over-year growth in ARR for our existing customers was 116%, up slightly but consistent with recent quarters.

Revenue grew 1% to $53 million, led by 26% growth in subscription revenue to $20 million, offset by the expected decreases in perpetual base software maintenance and non-recurring revenues.

Gross margin was 67%, consistent with the same quarter in 2021. An increase in the higher margin digital agreement revenue was offset somewhat by a product mix shift within the security solutions segment.

GAAP operating expenses included $1.5 million of outside services related to our strategic plan and $2.7 million of severance cost and other expenses related to our restructuring plan. GAAP OpEx benefitted by approximately $2 million from changes in foreign exchange.

As noted last quarter, we completed substantially all of the action items contained in phase one of our cost reduction plan announced in December 2021. As of June 30, we achieved annualized cost savings of $11.8 million, which is near the high end of the $10 million to $12 million of annualized savings called for in the plan.

We announced phase two of our cost reduction plan in May of this year, which calls for total cash charges related to severance and benefit cost associated with headcount reduction of approximately $10 million to $17 million during the period covering the last three quarters of 2022 through the year ending 2025. This phase of the plan is expected to result in approximately $20 million to $25 million in annualized savings. As of June 30, 2022, we achieved annualized savings of nearly $6 million.

GAAP operating loss improved 7% to $8.2 million.

Adjusted EBITDA was negative $1.5 million in the second quarter of 2022, as compared to negative $1 million in the same period of last year. Adjusted EBITDA margin was negative 3% in the quarter versus negative 2% last year. This year-over-year difference in Adjusted EBITDA can be largely explained by a foreign exchange movement of our international business.

The GAAP net loss per share was $0.23 in the second quarter of 2022 compared to $0.17 in the second quarter of 2021. Non-GAAP net loss per share, which excludes long-term incentive compensation, amortization, nonrecurring items and the impact of tax adjustments was $0.10 in the second quarter of 2022 compared to $0.04 in the second quarter of last year.

I'll now discuss our digital agreements segment results. Digital agreements ARR grew 27% to $45 million, led by 34% growth in subscription ARR to $40 million. Revenue grew 10% to $10.5 million, including 12% growth in subscription revenue to $8.7 million.

We won several large, multiyear ratable e-signature deals during the quarter. Large multiyear on-premise contracts, like the one we closed last quarter that resulted in significant upfront revenue can result in quarter-to-quarter revenue volatility inherent with the size of the business. Nearly all subscription revenue recognized this quarter was ratable.

Gross margin was 73% compared to 70% last year. The higher gross margin was largely a result of increased scale and efficiencies. Operating income was $0.1 million as compared to negative $0.8 million last year. Increased revenue and gross profit, along with lower operating expenses related to restructuring and foreign exchange, led to the improved performance. As a reminder, we are early in our transformation and plan to invest for growth in this segment, including the hiring of additional talent to drive topline growth through increased sales and product development.

Now, turning to our security solutions segment results. ARR grew 18% to $89 million, led by 35% growth in subscription ARR to $57 million. Subscription revenue grew 39% to $11 million, driven primarily by expansion contracts from existing customers for on-premises mobile security and service solutions. Total revenue decreased 1% to $42 million, largely driven by expected decreases in legacy deal flow, perpetual base software maintenance, and nonrecurring revenues, including Digipass tokens which account for the largest percentage of this segment's revenue. As we continue to focus on driving subscription revenue and as the Digipass hardware supply chain improves, we expect to see modest growth in the total security solutions revenue.

Demand for Digipass tokens is healthy. Last quarter, we noted risks associated with temporary COVID-driven closures at our contract manufacturing facilities in China, along with delays in deliveries of electronic components to these facilities. While we were able to manage through these risks effectively in Q2, supply chain challenges could impact quarterly Digipass revenues by up to $2 million in the second half of the year. We continue to monitor the situation closely and we'll work contingency plans to mitigate this potential risk as best as possible.

Security solutions gross margin was 66%, consistent with the year ago quarter. Operating income was $8.6 million and operating margin was 20% as compared to $10 million and 23% last year respectively. The primary difference was due to an increase in severance and related cost.

Turning to the balance sheet. We ended the second quarter of 2022 with $98 million in cash, cash equivalents and short-term investments compared to $98 million at the end of 2021 and $120 million at the end of last quarter. We used $15 million of cash in operations during the quarter, including more than $4 million in nonrecurring costs. We also used $5.7 million to repurchase approximately 446,000 shares of common stock.

I also want to remind you that we have no long-term debt. Geographically, our revenue mix by region in the second quarter of 2022 was 45% from EMEA, 37% from the Americas, and 19% from Asia Pacific. This compares to 47%, 33%, and 20% from the same regions in the second quarter of last year respectively.

That concludes my remarks. Matt?

Matt Moynahan

Thank you, Jan Kees. We estimate first half 2022 revenue would have been nearly $5 million higher had currency exchange rates been constant as compared to the year ago period. Based on current rates, we expect continued but somewhat less FX pressure in the second half of the year.

We are making initial progress in our transformation and are confident in our second half outlook. Therefore, we are affirming our Full Year 2022 guidance. For the Full Year 2022, notwithstanding FX headwinds, we expect the following. Total revenue to meet or exceed Full Year 2021 revenue. ARR growth to be in the range of 16% to 18% and Adjusted EBITDA to be in the range of negative $5 million to negative $7 million.

In closing, the future of OneSpan is bright. We are working hard to improve revenue predictability and to get more balanced contribution across product lines, business segments and geography that I'll likely see over time. I am pleased by the improved sales performance and operational rigor we saw in Q2 and I'm proud of the team for our progress to date. Moving forward, I am confident in our ability to unlock shareholder value as we increase our focus, leverage our competitive advantages, and enhance our operational performance.

With that, Jan Kees and I will be happy to take your questions. Operator?

Operator

The first question is from the line of Chad Bennett with Craig-Hallum. You may proceed.

Chad Bennett

Great. Thanks for taking my questions. Matt, you rattled off a lot of pretty significant six figure, seven figure multiyear wins, which are great. Just in terms of the new logo pickup, if you did see a new logo pickup in the quarter, what were the differentiators in you winning those e-sign deals, whether it was a consolidation deal or just a brand-new e-sign new logo?

Second added question to that is did the security side also from just a pure booking standpoint do better than expectations?

Matt Moynahan

Let me talk to the last first and then I'll get to the e-signature business. On the security side, we are seeing very healthy demand for our Digipass solution. Obviously, we don't, we haven't historically broken out product line detail at that. But Digipass bookings are doing well. We had a book to bill issue associated with the supply chain, but I can tell you that I'm very pleased with the performance of the token business. As the FX and supply chain issues level out, we do anticipate that business being one of growth.

We still have lumpiness in the other parts of our business on the subscription side. We did see strength in mobile security and a number of the security products. Security overall had a good quarter from a bookings perspective.

On the e-signature side of things, let me address new logo and then I'll get to the competitive differentiators on why we won. First of all, historically, the Company really hasn't had an enterprise go-to-market. We've had enterprise products, but the go-to-market was fragmented across three different sales teams, and we are bringing that together. Over time, you should see an increase of new logos in the enterprise target segment. That is an incredibly important focus area for us.

When we have won in the enterprise segment, the relationships that acted like true enterprise customers where you get that land and expand capability. We did have a good quarter in new logos, but we need to rebalance the growth in new logos from the bottom half of the pyramid to the higher half of the pyramid by building out our unified go-to-market. That's an important focus here for us over the quarters to come.

As far as why we win, I would say there's three key areas. First and increasingly so, the price per value that we offer by having an enterprise class solution with essentially close to parity in functions with DocuSign, but the pricing flexibility and the modularization of our solutions really is the key driver for us in this market. Particularly with tightening economic, you know, tightening economic environment. Now, DocuSign largely has not had a number two competitor of enterprise class and we would like to fill that void. You are starting to see first year, first time and second time contracts for DocuSign come up for RFP and we need to effectively compete and get into the consideration phase more than historically the case. But certainly, price per value is I would say number one.

Number two is our flexibility of integration. We do white label our solution. DocuSign and other competitors of larger size are increasingly falling into top categories of phishing. When that does happen, transaction rates can go down and user experience can go down as phishing emails associated with platforms get caught in spam inboxes or what have you. White labeling is incredibly important. We are positioning ourselves as a digital security company and we believe that white labeling is a key part of that.

I think flexibility is also important. We have an ability to implement our solution in a much more flexible way than other competitors out there. Again, we're seeing good signs for why we're winning. Now we have to get more bats and get higher closure rates.

Chad Bennett

Got it. I appreciate the color. Then maybe one quick follow up. I heard the FX impact on revs, but I didn't hear an FX impact on ARR, subscription ARR. Do you have that?

Matt Moynahan

Jan Kees, do you want to take that, or would you like me to? It's largely very similar to what you would have had in the revenue. Go ahead, Jan Kees.

Jan Kees van Gaalen

Yes, it's basically similar to what we saw on the revenue line, so within a couple of hundred thousand is our estimate.

Chad Bennett

Okay. All right, thanks much. Nice job on the quarter.

Matt Moynahan

Thank you.

Operator

Thank you. The next question comes from the line of Gray Powell with BTIG. You may proceed.

Gray Powell

Can we focus in on what you're seeing in Europe? I think almost 50% of revenue comes from the EMEA region. Have you seen any changes in the customer behavior or sale cycles there the last few months?

Matt Moynahan

You know, not really. Again, when you look at the business, we have 55%, lion's share of revenue coming from EMEA and most of the EMEA business is security. The inverse is true of the Americas. Forty five percent and vast majority of that is digital agreements but the behavior is similar across both with large enterprise customers.

On the security side, again, with EMEA being highly concentrated in security, our security solutions thankfully are mission critical. They're used for online banking, which in environments like this is actually increasing and we have a very sticky solution, both with our back-office authentication capabilities and

Digipass tokens that are a part of the install base go-to-market for these banks. We haven't seen any material decline in demand. Actually, we've seen slight upticks in demand but our ability to fulfill that demand has been hampered by the supply chain. But it's a good thing for us given that the vast majority of historical OneSpan is associated with online banking and such.

Gray Powell

Understood. Okay, that's helpful. Then on the ARR side, I'm sorry. I missed the answer to the last question. Did you say the FX impacts on ARR was just a few hundred thousand dollars? Was that correct?

Jan Kees van Gaalen

No, it's the same. It's the same as what we've seen on revenue.

Gray Powell

It's $5 million on revenue. But FX is pretty big in absolute dollar terms. Okay. Then maybe on the cost side, so you called out $1.5 million in outside services and $2.7 million in severance for a total of $4.2 million in one-time costs. Is it safe to say that that entire $4.2 million hit the operating cash flow line? Then just how should we think about transition costs for the rest of the year as we try to think about operating cash flow?

Jan Kees van Gaalen

Yes, so the entire cost hit to the operating cash flow line, that is correct. It sat in the net income losses that we reported. It was rest of hit our still some amounts of severance to come but we currently cannot wait whether it will be in Q3 or Q4.

Gray Powell

Okay, that's helpful. Thank you very much.

Jan Kees van Gaalen

You're welcome.

Operator

Thank you. The next question comes from the line of Rudy Kessinger with D.A. Davidson. You may proceed.

Rudy Kessinger

Hi guys. Thanks for taking my questions. I'm curious on the EBITDA guide. You're negative $1.3 million in the first half. You're guiding to a $5 million to $7 million loss for the year, so guiding to a step down in the EBITDA loss in the second half, despite when you put it together you've got $17.8 million in annualized costs cut so far versus $10.8 million as of Q1. You've gotten more costs cut that should be flowing through here and obviously you're adjusting out the severance and whatnot in that Adjusted EBITDA figure. Why the step down in EBITDA in the second half?

Matt Moynahan

Jan Kees, do you want that?

Jan Kees van Gaalen

Yes, look, there are a certain number of costs which we don't adjust out, first of all, in terms of severance. Second of all, the severance, the savings in the second half of the year are accruing towards the end of the period and so that's basically the explanation.

Matt Moynahan

I'd say the other big two other elements that are at play there are the timing of the sales and marketing expenses with the buildup.

Jan Kees van Gaalen

Yes.

Matt Moynahan

Obviously, that's going to be subject to our ability to effectively hire the sales team, right. The other one is timing (multiple speakers).

Jan Kees van Gaalen

In terms of the investment and cost.

Rudy Kessinger

Okay.

Jan Kees van Gaalen

Then also there was some new product development, focusing on the DA area.

Rudy Kessinger

Okay. That's fair. Then Matt, on some of the six and seven figure wins in the quarter, it sounds like for the most part it was e-signature but of course as you've said pretty frankly, e-signature you view it more as a feature, not a product, so I'm curious. Were any of those deals lead or did they involve virtual room and what kind of interest are you seeing in that in the pipe and the conversations you're having?

Matt Moynahan

We're having—we're seeing significant interest in virtual room. Obviously, still early days in that. I would say the activity in our internal sandbox, which we had not gone to GA (phon) commercial had doubled over the previous quarter. Again, but still fairly small. We will plan on integrating virtual room into our unified go-to-market and we expect to start seeing business happen in that product SKU as we ramp the enterprise sales team.

I personally have seen significant interest in it. There are variations of this type of product in very basic form out there as people are looking to secure virtual interaction in business, particularly in the banks. I do have significant hope for this product line in the marketplace and the place it will hold relative to what largely is video collaboration as a very, very different category.

Rudy Kessinger

Got it, and then just one last one if I could. On the ARR growth, you're 21% in the quarter. You're guiding to 16%, 18% by year-end. Is your expectation at this point for ARR growth to bottom in Q4 and then start to reaccelerate in Q1 as some of the new sales initiatives and reps start to ramp up and contribute?

Matt Moynahan

Yes, that is the anticipation. Again, we have a couple of puts and takes across the portfolio. As I have cleaned up the product portfolio and some of the smaller products, we also have other products that we're end of life-ing. In general, the Company is largely through its conversion from perpetual to subscription. If you remember during the investor day, I used the term core ARR growth, so I absolutely think it's fair to say that the knee of the curve as you go through Q4 and then we are on almost fully the three-year strategic plan where what we'll be reporting is core ARR growth, business model conversion. We're largely through that.

Rudy Kessinger

Great. Thanks for taking my questions.

Matt Moynahan

Thank you.

Operator

Thank you. There are no additional questions at this time. I will pass it back to Matthew for any closing remarks.

Matt Moynahan

Thank you, everyone, for joining today. We very much appreciate it. We look forward to sharing with you our continued progress in the quarters to come.

I'm very proud of the work that the team is doing here, and you have our full commitment to continue to bring clarity and transparency to the way we're communicating and managing the business. Thank you much for your time today. We'll speak with you soon.

Operator

That concludes today's conference call. Thank you.