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Catharine Trebnick, *Colliers Securities*

Gray Powell, *BTIG Research*

Anja Soderstrom, *Sidoti & Company*

PRESENTATION

Operator

Good afternoon, and welcome to the OneSpan Fourth Quarter 2020 Earnings Conference Call.

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

Joseph Maxa

Thank you, Operator. Hello, everyone, and thank you for joining the OneSpan Fourth Quarter and Full Year 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 are 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 fourth quarter and full year 2020. To access a copy of the press release, and other investor information, including an updated presentation reflecting our fourth quarter and full year financial results, 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 2021, are forward-looking statements. These statements used words such as "believes", "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 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 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 February 23, 2021. 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?

Scott Clements

Thanks very much, Joe. Good afternoon everybody. Thanks for joining us on the call here today.

Improving demand for mobile security and continued strong growth in e-signature solutions resulted in record bookings of recurring revenue contracts and stronger than forecast revenue in the fourth quarter. The FY20 guidance we provided last quarter reflected uncertainty given the material slowdown in business in Q3 and early Q4 as our banking customers addressed urgent issues related to the pandemic. As the quarter progressed, we saw customer engagement return to more normal levels with improved sales closure rates and sales pipeline flow.

Now I'll turn to the outlook for 2021 and reasons why I expect it to be a year of further progress toward our goal of becoming a profitable and fast-growing recurring revenue-centric company.

First, our 2020 year-over-year ARR growth of 29% demonstrates that our growth strategies are working. To give you additional insight into our ARR performance, ARR specific to subscription and term-based contracts grew in excess of 50%.

Second, fourth quarter total bookings were strong, on par with the PSD2-driven booking levels of Q3 and Q4 last year. Bookings on recurring revenue contracts increased more than 60% sequentially and for the year grew by more than 40%.

Third, our transition to recurring revenue streams and high-margin solutions and services is progressing faster than planned. Software and services accounted for a record 69% of total revenues in the quarter and 62% for the year. Recurring revenue accounted for a record 83% of total software and services revenue in the quarter and 76% for the year.

Fourth, as the global economy recovers, we expect new account openings to trend towards more normal levels compared to last summer and early fall.

As a reminder, because of the pandemic, many banks or most banks closed or restricted branch operations around the world, which substantially reduced new account openings and consumer churn, key drivers of demand for our hardware and mobile security software offerings. Though branches in many parts of the world remain closed, we have seen that banks have made significant progress in adjusting their operations for the present circumstances.

Bookings for both our hardware and mobile security software had their strongest quarter of the year in Q4.

Finally, the value of our software and services sales pipeline, our opportunity pipeline, increased by 40% through the end of 2020.

Now let me discuss the specific cybersecurity threat that occurred during the fourth quarter, which highlights the importance of our mobile security solutions.

In December, there was a criminal attack that targeted online bank accounts in the U.S. and Europe using a network of mobile device emulators to steal millions of dollars. This emulator attack enabled hackers to spoof thousands of mobile devices, automate the process of accessing accounts, initiate transactions, and intercept second factors of authentication to successfully steal money.

This underscores that mobile banking attacks are becoming automated and can now increasingly be executed at scale. OneSpan solutions are designed to prevent such attacks. By using a layered approach to mobile banking security, including multi-factor authentication methodologies, strong device identifiers, application shielding and malware detection, risks from attacks like this can be mitigated.

Before I turn the call over to Mark, I want to provide an update on our hardware product line.

Last quarter, I noted that we were assessing the benefits of realigning our authentication token product line and assign an executive to lead the effort while streamlining operations to match forward revenue expectations. We're making good progress in this area with initial focus on areas, including product line rationalization, operational streamlining, and targeted innovation designed to maintain market position and sustain profitability at lower revenue levels.

We're also in the early stages of relocating some of our manufacturing from Southern China to Europe to reduce risk and time to market. An increase in Q4 bookings, combined with a sequential pipeline increase of 10%, gives us confidence that hardware's rate of revenue decline will moderate to somewhere in the single digits in 2021. We'll continue to update you on this as plans for the hardware business develop.

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

Mark Hoyt

Thanks, Scott.

As Scott mentioned, the fourth quarter of 2020 came in stronger than expected in Q3 driven by increased demand across our security and e-signature solution portfolio. And for the full year 2020, we exceeded the high end of our revenue guidance ranges that we provided in early November. Annual recurring revenue or ARR at the end of Q4 was $104 million, representing a growth rate of 29%, in line with our 25% to 30% target growth rate for 2020. We define ARR as the annualized value of all active recurring product contracts greater than or equal to one year in length. Our dollar-based net expansion rate, which we define as the year-over-year growth in ARR from existing customers, was 120% in the fourth quarter.

Now turning to recurring revenue. For the fourth quarter, subscription revenue grew 39% to $9 million. This included strong growth of e-signature, modest growth in identity verification and an increased contribution from cloud authentication. Term-based software license revenue grew 27% to $8 million, driven by strong sequential increase in demand for mobile security solutions. And maintenance revenue grew 14% year-over-year to $14 million. We expect maintenance growth to moderate in 2021, as we continue transitioning our business model toward subscription and term-based licenses.

In total, recurring revenue increased 24% to a record $30 million in the fourth quarter and 26% to $102 million for the full year 2020. Recurring revenue accounted for a record 83% of software and services revenue in Q4 and 76% for the full year 2020. This compares to 63% in Q4 2019 and 64% for the full year 2019, respectively.

As you may recall, we recently increased our 2022 recurring revenue target from 75% to 85% of our software and services revenue. With the continued acceleration in our transition to recurring revenue, we now believe we can achieve that 85% target this year.

In the fourth quarter, total software and services revenue declined 6% to $37 million. Hardware revenue declined to 49% to $16 million, and total revenue declined 25% to $53 million. As discussed previously, we expected a sharp decline in our non-recurring perpetual software licenses and in our hardware driven by our increased focus on recurring revenues, a difficult compare to the year ago quarter that was driven by large orders to satisfy PSD2 regulations in 2019 and the impact of the pandemic on our results.

Gross margin in the fourth quarter of 2020 was 74% compared to 70% in the prior quarter and in the fourth quarter of 2019. The increase in gross margin is primarily attributed to product mix with software and services contributing a record 69% of total revenue.

Operating expenses for the fourth quarter of 2020 were $41 million, 8% higher than the prior quarter and 6% lower than the fourth quarter of last year, reflecting lower travel and other operating costs.

Adjusted EBITDA or adjusted earnings before interest, taxes, depreciation, amortization, long-term incentive compensation, and non-recurring items, was $3 million for the fourth quarter of 2020. This compares to $3 million last quarter and $13 million in the fourth quarter of 2019. Adjusted EBITDA margin was 6% in the fourth quarter versus 5% last quarter and 18% in the year ago quarter. For the full 2020 year, Adjusted EBITDA was $14 million and Adjusted EBITDA margin was 7%. GAAP loss per share was $0.04 in the fourth quarter 2020 compared to GAAP earnings per share of $0.11 in the fourth quarter of 2019.

Non-GAAP earnings per share, which excludes long-term incentive comp, amortization, non-recurring items and the impact of tax adjustments was $0.03 in the fourth quarter of 2020 compared to $0.23 in the fourth quarter of last year. We ended the fourth quarter with $115 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 and the year was $7 million and $15 million, respectively. During the fourth quarter, we repurchased $5 million or 250,000 shares of common stock at an average price of $20 per share. Geographically, our revenue mix for the fourth quarter included 54% from EMEA, 27% from the Americas and 19% from the Asia-Pac region, approximately the same geographic mix as the year ago quarter.

I will now turn the meeting back to you, Scott.

Scott Clements

Thanks, Mark. Appreciate it.

We made that faster than planned progress in our transition to recurring revenue in 2020. And we plan to continue this transition in 2021 with a goal of essentially completing that shift by the end of this year.

Now let me focus on our 2021 growth investments.

The decline in our hardware revenues and our recurring revenue transition reduced our overall profitability in 2020, and it will continue to do so this year. Nevertheless, our goal is to sustain high rates of subscription in term license growth greater than 40% in 2021, which is key to higher levels of profitability going forward. As we exit the pandemic period, we believe it's an opportune time to invest for growth. After declines in sales and marketing and R&D expenses in 2020 as compared to 2019, and given the strong growth we've seen in recurring revenue, we're increasing our investments in these areas to enable continued strong growth in 2022 and after.

In sales and marketing, in preparation for 2021, we expanded our sales team in the second half of 2020 with the focus on new customer acquisition and we're pairing this with higher lead generation investment this year.

In R&D, we'll be investing in the core TID platform to shorten customer time to value, increase solution flexibility, and simplify integration to third-party technologies. We also plan to enhance our mobile security solutions with improved usability and increased data collection capabilities to deliver next generation, authentication and fraud prevention capabilities.

And finally, we'll be adding high value extensions to our rapidly growing e-signature product line that we expect to increase the average transaction value in that business. As I've noted previously, the profit generating capacity of our business model is fundamentally strong as indicated by our solid gross margins. As we complete our business model transformation and the rebuild of our internal business systems, we're increasing our focus on operational productivity and structure cost reduction. In the coming months, we'll be identifying opportunities for significant cost savings plans to improve profitability without impairing our growth outlook. We'll refresh our multi-year financial goals and update you further on that later this year.

Now I will summarize guidance for our fiscal year 2021, along with some comments around our expectations for the first quarter and the full year.

For the full year of 2021, we're providing the following guidance: ARR growth of 22% to 26%; recurring revenue to be in the range of $120 million to $125 million; total revenue of $215 million to $225 million; and Adjusted EBITDA to be approximately breakeven.

This includes approximately $15 million to $20 million of revenue headwind related to the recurring revenue transition in 2021. We then expect to see acceleration in total software and services revenue growth in 2022 with increasing profitability as we enter the post-transition period. We currently expect the second half of 2021 revenue to exceed first half revenue similar to our longer term historical quarterly distribution of revenue. And we expect decline in hardware revenues to moderate into the mid-single-digit range this year.

Gross margins should be approximately flat as higher overall software and services revenue mix is offset by the impact of our transition to recurring revenue.

In the first quarter, we expect ARR growth to be within our long-term target range of 25% to 30%. Q1 recurring revenue is expected to be higher than a strong Q1 of 2020, but year-over-year growth rate will be somewhat below our full year guidance range. We also expect perpetual license and hardware revenue to decline as we continue to shift to recurring revenue model.

So, to conclude, our core value propositions in security, productivity, positive digital user experience and regulatory compliance remains solid. We believe that we will over time, that the pandemic will amplify the value of what we do as more economic activity shifts into the digital sphere, driving long-term demand for our security and e-signature solutions. Overall, banks are financially strong and have effectively managed the adverse impacts from the pandemic. And so we expect demand will improve as banks return their focus to new account growth and respond to emerging cyber threats. Recent major cyber events like Solar Winds and the mobile emulator attack show that identity-centric security is more important than ever.

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

Operator

Thank you. The first question will come from Catharine Trebnick with Colliers. Please go ahead.

Catharine Trebnick

Hi, thanks for taking my questions, very impressive quarter. Can we talk a little bit about going forward? You had record bookings this quarter, but could you maybe parse a little bit more on the 22% to 26% ARR growth, I expect that maybe with the record bookings, it might be a little bit stronger.

Scott Clements

Hi Catharine, good afternoon. I'll take a crack at that. And Mark, you can you can add too. Catharine, I think it really comes down to a couple of things. There is still some uncertainty that remains about the pace of the recovery and the economic recovery global and the impact that that has on banks. I think we all feel optimistic that it's moving in the right direction. Certainly, seems to be good news, some more good news each day in that area. But how our ARR number turns out for the year will depend to some degree on how that proceeds and the pace with which that recovery happens. Also as you go into the back of the year, obviously, the compares get tougher. And so we want to be aware of that.

So I don't think it's anything more than we want to be sure that we have a good handle on the progression of bank spending on security and technology as the overall economy recovers and as the pandemic impact start to lessen.

Catharine Trebnick

All right, thank you.

Mark Hoyt

I'll just add on there, Catharine, this is Mark. Reminder that recurring revenue can be driven in lumpy—if we get multi-year contracts to come in and we did get one of those that came in Q4 that did drive up recurring revenue that we won't see necessarily drive up ARR as much. But overall, as Scott said, we want to make sure that we can hit these numbers.

Catharine Trebnick

All right. Thanks gentlemen.

Operator

The next question will come from Gray Powell with BTIG. Please go ahead.

Gray Powell

Great. Thanks for taking the questions and congratulations on the good numbers.

Scott Clements

Thanks Gray.

Scott Clements

I guess, maybe just sort of a follow-up question. So in recent conferences, you've been talking about how large banking customers pushed out deals in mid 2020, and now you're starting to see that trend reverse. So I guess just how quickly does that play out? And then do you see the recovery maybe shifting from the hardware side more into the software and the recurring side of the business? And then I guess the other part of the question would be—I just want to make sure I understand your guidance. Did you say hardware is going to be down mid-single digits for the full year or would it trend to down mid-single digits at some point in the year? I just want make sure I understand that component correctly.

Scott Clements

Sure. All right. There's a lot there. So I'll try to...

Gray Powell

Yes. Sorry about that. I get very excited.

Scott Clements

Sorry, if I miss one, just ask it again. So I'll try to go in reverse order here. The guidance or the commentary that we gave on hardware was really for the full year. We expect sort of a single-digit decline in hardware in 2021. So that's a significantly better outcome, obviously, from a growth point of view than we—or declined point of view than we saw in 2020. We have seen some improvement in the hardware space. I think the bookings were—we had our strongest booking quarter of the year in the fourth quarter for hardware, and the opportunity pipeline is actually higher than it was at this time last year.

So we'll see how that plays out over the coming days. We spent—we put a great deal of effort into really doing a very detailed bottoms-up forecast on hardware. And we just want to set the reasonable level of expectation for that. We'll do everything we can to do better than that number, but I think that's a reasonable expectation for right now.

With respect to the pacing of the recovery, I guess, in banking and financial services, generally, what I think our sales team's perspective is, is that we'll see increasing or a better environment as we go through the first half and then as we kind of get to the middle of the year, we would hopefully be in a position where we'd be seeing a full recovery to the more normal tenor of business and approach to business that we have seen in the past. I think that recovery will affect—actually software and services will be the bigger beneficiary of that than hardware. So we do come into the year, I think with a substantially higher sales pipeline by 40% higher, exiting last year and coming into this year. We have very high expectations for growth of term license and subscription revenue in 2020, which will be the main drivers of ARR growth. But we'll see how that improves as we go through Q1 and Q2 and into the middle of the year. But I think our view right now is by the time we get to the middle of the year, hopefully we'll be back to a substantially normal environment with respect to banks or acquisition of security technology.

Gray Powell

Understood. Okay. Thank you very much.

Scott Clements

Sure thing. Thanks, Gray.

Operator

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

Anja Soderstrom

Yes, hi everyone. Thank you for taking my question and congratulations on the good numbers. So first of all, if you can just elaborate on the investment growth you need to do there that's going to keep the gross margins flat. It's mainly, you said more investment in the sales (audio interference) or is it also that you need to invest infrastructure more than you did in 2019, 2020?

Scott Clements

Hi Anja. Thanks for your question. Good afternoon. The incremental investment that we're making is really in two areas and it's a little bit different in sales and marketing versus R&D, those two areas. In sales and marketing, we come into the year essentially fully staffed for what we think we need in sales for 2021. That's good. I think when we came into 2020, we still had some holes in the sales team that we needed to fill as we went through the year, but we really took the effort to fill all of the positions that we think we needed in sales in the second half of 2020 so that we would enter 2021 fully staffed and ready for 2021. And so the biggest piece of the increase in selling expense, sales and marketing expense in 2021 is related to those people that we have already brought on in the second half of 2020, a full year of their costs.

The second piece is that we want to make sure that as we put those people in the field we're driving increased amount of lead activity to those sales, through the sales organization, those people in the field. So we have been spending a great deal of effort, I think, to really build a very, very capable lead-generation process over the last couple of years. We did see some good results from that in 2020, and that's part of what helped to drive our recurring revenue growth in 2020. And so, as we gain confidence in that lead-generation activity, we want to put more against that in 2021 to drive growth, not only in '21, but also in 2022 and forward.

And then I think in R&D, these are really investments to just, I would say in general, strengthen the software and services product lines. And I described those, some of those in a conference call. We have, I think, an opportunity and need to strengthen our mobile security offerings and modernize elements of that, and to really make it a strong element of data collection that can drive our analytics capabilities, our fraud and other analytics capabilities in the future. And then of course, we had a tremendous year in 2020 with e-signature. We expect to have another very good year with that product in 2021. And there's a real opportunity to extend that product into some areas of very high value around notarization and ID verification and things like that that can substantially raise the per transaction value of that product line.

So these are investments that we think will accelerate our time to market, increase our differentiation and allow us to access new opportunities beyond those, which we have focused on in the past.

Anja Soderstrom

Okay, thank you. And then you alluded to that you were going to revisit your longer term guidance later this year. It would be safe to assume that the sales that would have recurring revenue should accelerate (audio interference) in 2022 and we will have a lot of these investments behind you, so we would also see the margin fashion in 2022. Is that (audio interference) to think about it that way?

Scott Clements

Yes. You're breaking up a little bit, Anja, I don't know if it's on my end or your end. But I think I got the general gist of the question. Yes, we believe that for several reasons that as we go into '22, '23 and forward that we have the opportunity to drive higher levels of profitability in the business, as we grow. We continue to target 25% to 30% ARR growth over the period through 2022. I think we have a very good shot of achieving that or doing better than that. But as we sustain our margins, we see the benefits of the investments that we're making this year. We really put that recurring revenue headwind behind us.

All of those things should help to improve the profitability of the business as we look ahead in '22 and 2023. So we take that very seriously. We made a very conscious choice in '21 to make some of these incremental investments because we liked the momentum in the business. And we think that these are investments that can really continue to build the story and the differentiation of what we offer to our current customers and hopefully to a lot more new customers as we go forward.

Anja Soderstrom

Okay. Thank you. And then just one last question. In your investor deck, or the presentation for the fourth quarter on Slide 10, you are talking about adjacency expansion in 2021/22. Can you just expand on that a little bit? What do you mean by that?

Scott Clements

Sure. As you know, Anja, we have been really primarily a company that has been focused on banking, financial services for most of our history. I think we're roughly 75% of our revenue comes from banking and financial services still today. We believe there are good growth opportunities that remain and exist in banking and financial services, but we also know that there's a lot of work being done and progress being made in digitization in the areas of digital healthcare, telehealth and in government. And if you really look at the use cases there and the needs in those spaces, they look in many ways, very similar to what we do in banking and financial services.

And so we believe we have the opportunity to target some of these adjacencies with our existing technology, without having to make major changes to that technology and really expand our total available market. And then, hopefully, our growth rates as we go into '22, '23 and forward.

Anja Soderstrom

Okay. I know (audio interference) sort of repositioning some of your (audio interference) to go after that, or is that something you would have to do down the road?

Scott Clements

We do business in both of those areas already. And we're looking at the different ways to go to market there. So in the healthcare space, in the telehealth space, for example, we would probably do a lot of that through channel partners and OEM partnerships rather than trying to go direct—a direct sales model into that market. And then I think in government, it will vary a little bit, but the goal that we have for 2021 is to really do some of the work and the validation of those opportunities and determine the approaches that we will use to drive penetration growth in those markets in '22 and forward. As I said, we do have a significant amount of government business already. I do expect that to grow in 2021. And we are working with some partners in the healthcare and the telehealth space already as well, and trying to learn more about that so that we can structure the right approach.

Anja Soderstrom

Okay. All right. Great. Thank you. That was all for me.

Scott Clements

Sure. Thanks, Anja.

Operator

Ladies and gentlemen, this concludes our question-and-answer session. I would like to turn the conference back over to Scott Clements for any closing remarks.

Scott Clements

Thanks very much Operator. Again, I appreciate all of you joining the call today. We had, I think, a good finish to the year of 2020 after a tough spot in the middle of the year. We're really optimistic about 2021 and the continued shift of our business to recurring revenue. And we've learned a lot and I think we'll be largely done with that transition by the end of 2021 and that should really help both our growth and our profitability as we complete that transition. Thanks again, everyone. Have a good day.

Operator

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

Scott Clements

Thank you Operator.