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OneSpan Inc.

First Quarter 2023 Earnings

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PRESENTATION:

Operator^ Good afternoon. Thank you for attending the first quarter 2023 OneSpan Earnings Conference Call. (Operator Instructions)

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

Joe, you may proceed.

Joseph Maxa^ Thank you, operator. Hello, everyone, and thank you for joining the OneSpan first quarter 2023 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, our Chief Executive Officer; and Jorge Martell, our Chief Financial Officer.

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This afternoon, after market close, OneSpan issued a press release announcing results for our first quarter 2023. 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 2023 and our 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.

In addition, please note that the date of this conference call is May 4, 2023, and 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.

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Matthew Moynahan^ Thank you, Joe. Hello, everyone. And thank you for joining us on the call today.

I'm pleased by the 10% revenue growth we reported in the first quarter of our 3-year transformation plan. ARR grew 10% and adjusted EBITDA was negative $1.6 million, consistent with our plan to front load investments in 2023 to drive ARR growth in the second half of the year and through 2024.

Topline growth was primarily driven by our Security segment as several customers increased their number of licenses and extended their contract lengths, resulting in strong subscription renewals. We also saw growth to a lesser extent and new customer logos.

Our marquee security client base continues to leverage our enterprise class security solutions to mitigate fraud and hacking attacks, protect their infrastructure, safeguard their reputation and optimize costs by consolidating vendors to achieve the best return on their investment during this uncertain macroeconomic time.

We experienced 25% growth in digital agreement SaaS revenue, driven by customer expansion.

Consistent with our decision to sunset our on-premise e-signature offering last year and moved to a cloud-first model, we experienced a decline in total digital agreements revenue in the quarter as a result of certain on-premise deals that had upfront revenue recognition in the first quarter of 2022, not repeating in this quarter this year. This model change is consistent with our plan to increase R&D efficiencies and grow revenue more predictably over time.

As we initially communicated in May of last year, investing in digital agreements is a key component of our growth plan.

I'm happy to share that we reached our goal of doubling our quota-carrying sales force ahead of our 2023 year-end target. I am pleased by the level of experience, talent and professionalism of the people we've been able to hire, all of whom are universally excited about our market positioning and growth strategy.

I also feel good about the progress we've made to enable our sales force and onboard new talent to execute our unified go-to-market strategy.

It is important to note that we are still in the initial phase of our 3-year plan. We continue to work hard to align our increased sales capacity with a maturing demand generation engine to execute against our new logo strategy in the second half of the year. Equally important to our new logo strategy is driving upsell and cross-sell opportunities within our existing customer base.

To this end, we are committed to getting new products into the hands of our sales team to help deliver against our goals. In Q1, we launched the first version of OneSpan Notary to test the market.

And later this quarter, we'll be launching OneSpan Notary more broadly to sell into additional states where we've been certified.

We also plan to launch DIGIPASS CX, our cloud connected device later this quarter, initially targeting certain use cases in the banking and health care sectors, and we are also working to bring secure e-vaulting for documents and artifacts to markets this year based on blockchain technology, which was acquired in the first quarter of this year with proven DB acquisition.

Lastly, we are pleased with the positive customer feedback we have received regarding our new pricing model, which allows us to offer advanced technology and services at the most favorable price per value in the market.

We believe this pricing model will be a key differentiator in generating new logo opportunities over the balance of the year.

Next, I'd like to highlight a few customer wins during the quarter. A long-term on-premise e-signature customer in North America significantly expanded its business with us by signing an upper 6-figure annual SaaS contract whose customer evaluated competing solutions and found OneSpan sign to be the most secure and flexible option for its needs.

The largest private bank in India, a current corporate banking customer purchased authentication and mobile security solutions for their retail banking unit in the mid-6-figure ACV range. It was a competitive win against multiple firms and highlighted the flexibility of our mobile security solution.

This bank has potential to become a much larger customer in the coming years. And an auto finance customer in Europe expanded their 6-figure ACV contract and migrated to our identity verification and OneSpan Sign solution from the legacy deal flow platform sunsetted last year. In a competitive bidding situation, the customer valued our expertise in helping them execute their complex workflows in their out-of-the-box identity verification service.

Now turning to the macroeconomic environment. We are seeing longer sales cycles and more scrutiny over our investments by our clients in certain regions, similar to prior quarters. Specifically, we are seeing more caution around budget spend, which may put pressure on our expansion and new logo activities, particularly in the digital agreement market.

That said, we're also seeing an increase in our sales pipeline, and we are monitoring on a regular basis, our lead generation activities, conversion rates and sales force productivity.

We are still early in our 2023 investment cycle and continue to make adjustments as necessary to drive sales performance while also meeting our 2023 profitability targets.

Regarding our exposure to recent bank failures, I want to point out that we have minimal exposure to the banks impacted thus far, and we will continue to closely monitor developments across the entire banker sector over months to come.

Now I'd like to provide a few comments on generative AI and deep fake technology. I'm sure you've all seen or heard about several recent deep fakes. For example, Pope Francis is wearing a white puffer jacket, a German newspaper using AI to generate an interview with former Formula 1 driver Michael Schumacher and various other documents or content being created by AI algorithms.

The technology has progressed to a point despite its early days, where you literally cannot tell whether what you're seeing or reading is real or fake. If I'm in a virtual meeting with someone, I haven't met before, how do I know it is them? If I'm signing a digital document, can I trust its authenticity.

This is where we come in. The industry is coming in our direction. Our 5-pillar solution strategy was designed to enable us to secure an entire digital transaction life cycle by seamlessly weaving together identity verification, authentication, high assurance virtual collaboration, e-signature and secure transaction e-vaulting for our customers.

I believe in this world of generative AI and deep fakes, solutions like ours will increasingly be needed to deliver secure virtual user interactions, digital transaction integrity and secure and trusted digital documents, such as videos and other artifacts embedded in blockchain technology.

With that, I'll turn the call over to Jorge to review our financials. Jorge?

Jorge Martell^ Thank you, Matt. And good afternoon, everybody. I am pleased that we reported another good quarter. ARR grew 10% year-over-year to $141 million. ARR specific to subscription contracts grew 19% to $109 million and accounted for approximately 77% of total ARR. Net retention rate, or NRR, was 108%. ARR and NRR were impacted by longer sales cycles, timing related to contract renewals, a few lost contracts last year and our decision to sunset certain portfolio offerings. First quarter revenue increased 10% to $57.6 million. Subscription revenue grew 29% to $30 million and accounted for more than 50% of total revenue. Strong growth in security software and SaaS e-signature will more than offset a decline in term e-signature, which we began sunsetting last year.

First quarter gross margin was 68% compared to 70% in the prior year quarter and was impacted by an increase in third-party costs and lower DIGIPASS margins.

Operating loss was $8.1 million compared to $9.2 million in the first quarter of last year.

Higher gross profit dollars were largely offset by an increase in operating expenses resulting from increasing investments in sales hires, T&E, contract workers and third-party marketing fees among other costs. These costs were partially offset by an increase in R&D software capitalization costs and a reduction in nonrecurring expenses related to our restructuring plan as compared to the same period last year.

Regarding our cost reduction plan, total annualized savings from Phase 2 were $10.7 million as of March 31, 2023.

As a reminder, Phase 2 began May of last year and will continue through 2025. The total annualized savings expected to be in the range of $20 million to $25 million. Most of these savings are expected to be reinvested as part of our 3-year growth plan. GAAP net loss per share was $0.21 in the first quarter of 2023 compared to net income per share of $0.13 in the first quarter of last year.

Non-GAAP loss per share, which excludes long-term incentive compensation, amortization, nonrecurring items included the impairment of intangible assets, restructuring charges and the impact of tax adjustments was $0.09 in the first quarter. This compares to non-GAAP loss per share of $0.01 in Q1 of last year. First quarter adjusted EBITDA and adjusted EBITDA margin was negative $1.6 million and negative 3% as compared to positive $0.2 million and positive 0.5% in the same period of last year.

The year-over-year change is primarily related to the investments we made in the quarter, particularly in our sales and marketing functions, including the increased hiring of quota-bearing sellers. I'll now discuss our first quarter digital agreement segment results. ARR grew 14% year-over-year to $48 million, led by subscription ARR growth of 17% to $43 million.

As Matt noted earlier, a strategic decision to sunset our on-premise e-signature product and go to a cloud-first model impacted our segment revenue in the quarter. Digital agreements revenue decreased 13% to $11.6 million.

This decrease was associated with the upfront recognition of 2 multiyear e-signature term contracts totaling more than $3 million in the first quarter of 2022. That didn't repeat this year. We are no longer sending new term e-signature contracts.

We believe this will enable us to be more efficient with our R&D resources and result in more predictable and stellar revenue growth in the coming years. It will take a few quarters for this to work through the system. We expect the related revenue variability to be smaller going forward and to be behind us beginning of next year.

SaaS subscription revenue grew 25% year-over-year and accounted for nearly 100% of subscription revenue in the quarter. We are investing for growth in this part of our portfolio as a key tenet of our strategic growth plan.

First quarter gross margin was 73% compared to 77% in the prior year quarter.

The decline in gross margin percentage was largely a result of lower term revenue.

Operating loss was $6 million as compared to operating income of $1.1 million last year. The change in profitability is primarily attributed to the reduction in high-margin on-premise subscription revenue I just discussed, reallocation of expenses from our Security Solutions operating segment, the increased investment in core bearing sales people and increases in sales and marketing T&E. These factors were partially offset by an increase in software capitalization costs.

The investments and changes we made this quarter are consistent with our transformation plan to drive top line growth. We anticipate operating leverage improvements as we make progress in the coming quarters.

Turning to our Security Solutions segment results. ARR grew 7% year-over-year in the first quarter to $93 million. Subscription ARR grew 20% to $66 million and was partially offset by a decline in perpetual maintenance ARR, which we expect this trend to continue.

Revenue increased 18% to $46.1 million. Subscription revenue grew 69% to $19.6 million, primarily driven by strong term renewals from existing clients for authentication, transaction signing and app shielding solutions.

The growth in subscription revenue in this segment was partially offset by expected declines in perpetual maintenance and support, professional services and other, DIGIPASS token revenue and legacy software products that we sunset in 2022.

We believe the electronic component shortages that impacted our DIGIPASS token shipments last year are largely behind us and expect to return to normalized delivery levels beginning later this quarter or early next quarter.

We have increased inventory levels and partnered with our customers to optimize delivery schedules. This should enable us to ship the majority of DIGIPASS units that were delayed this year by the end of the third quarter.

Q1 gross margin was 67%, consistent with the same period last year. Product mix favor in subscription revenue was offset by an increase in third-party costs and lower-than-average DIGIPASS margins, which were impacted by electronic component prices, increased freight costs and product mix. We expect DIGIPASS margins to return to normalized levels for the balance of the year.

Operating income was $15.6 million and operating margin was 34% compared to $7.8 million and 20% in last year's first quarter. The increase in profitability is primarily attributed to higher revenue and lower operating expenses, including the reallocation of certain expenses to digital agreements and lower amortization as a result of the prior year deal flow intangible asset impairment.

Turning to our balance sheet. We ended the first quarter of 2023 with $107 million in cash, cash equivalents and short-term investments compared to $99 million at the end of 2022. We generated $13 million of cash flow from operations during the quarter, primarily related to improvements in net working capital, and we have no long-term debt. Geographically, our revenue mix by region in the first quarter of 2023 was 48% for EMEA, 36% from the Americas and 16% from Asia Pacific. This compares to 47%, 33% and 20% for the same regions in the first quarter of last year, respectively. Now turning to our outlook.

As mentioned last quarter, we plan for our sales and marketing investments to be more highly weighted in the first half of the year to drive ARR growth as the year progresses as we expect will result in increased revenue growth and profitability in the second half of 2023 as compared to the first half of the year.

We are making progress in our transformation and affirm our full year 2023 guidance as follows: revenue to be in the range of $232 million to $242 million, ARR to be in the range of $157 million to $164 million and adjusted EBITDA to be in the range of $3 million to $6 million. And with that, I'll turn the call back to Matt for some closing remarks.

Matthew Moynahan^ Thank you, Jorge.

New enterprise logo acquisition and expanding within our installed base by cross-selling our entire solution portfolio remain our top priorities for 2023. I'm very proud of our team. We've made a lot of progress in the transformation plan over the last several months, including bringing new products to market, doubling the size of our sales force and continuing to implement the marketing infrastructure required to execute our unified go-to-market strategy. We believe this will result in more predictable revenue growth and synergies over time.

I'm confident we are moving from a product company to a problem-solving company to become more strategic to our customers.

And I believe we are well positioned for future success, driven by our talented employees, world-class products and newly implemented operational rigor.

Jorge and I will now be happy to take your questions.

Operator^ (Operator Instructions) Our first question comes from the line of Rudy Kessinger with D.A. Davidson.

Rudy Kessinger^ Hi, guys. Thank you for taking my questions. Jorge, on the Security Solutions subscription, you mentioned there were some large renewal business in there. Can you quantify how much of large renewals, license renewals were in there in Q1 in that figure, the $19.6 million figure?

Jorge Martell^ Yes. Thanks for the question, Rudy. So that yes, we saw just to maybe take a step back. So we saw good demand for authentication, mobile security, app shielding solutions in the quarter, basically across the board. The increase in the quarter, the strength of the quarter was right to 3 things. One is the earlier renewals that we saw in Q4, we started in Q1. Second component was renewal on these products, as I mentioned. And then multiyear renewals to your renewals into 2020 -- in Q1 2023. And so you get the benefit of that acceleration. So from a quantification perspective, I think most of the increase that you see is related to these 3 things, the multi-renewals probably about 30% or 40% of that increased number. Now one thing to consider though is that when you look at seasonality in terms of our renewal seasonality, Q1 tends to be the highest highly weighted on that renewal. So just to keep that at the back of your head.

Rudy Kessinger^ Okay. Got it. Fair enough. On the sales force side, I certainly could see it hit the doubling of the quota carriers well ahead of schedule. What is the -- where is productivity at today versus where fully ramped is? How far do you have to go to get sales productivity up to where your guys' targets are?

Matthew Moynahan^ I think right now, we're consistent with the plan. We've had January 1st was the first year of the 3-year plan, we accelerated the hiring of our sales force. We brought it in by about 6 months. Our talent acquisition team did a great job front-loading that. And now we have to really digest that, Rudy. So I would say we're hard at work enabling the sales team, making sure that they're certified and with sales cycles somewhere between 5 to 9 months depending on the region based on the current macroeconomic, now you should see that kick in according to plan in Q3 and Q4. But we're monitoring it very closely, and that's probably our top priority is getting our sellers that we've now got on board enabled and productive.

Rudy Kessinger^ Okay. And then last one for me. I'm not going to pick exposure to any of these certain banks who have failed. But is there -- maybe 2 questions. One, just what percent of your total revenue comes from financial services. I imagine it's probably the bulk of it. But secondly, what percentage of your revenue comes from regional banks, credit unions, smaller type of banks who, in general, are being pressured right now.

Matthew Moynahan^ I'll speak to the materiality of it. Our exposure to the banks is as far as company-wide, our BFSI Banking Financial Services is over 50% of our revenue. Our exposure within that sector to the regional banks is really immaterial. I would say, across the board, we have less than 2% of ARR exposure to the company from banks that have been impacted. And that's just exposure not realized impact. So we're monitoring it closely, but I would say right now, we're fortunate to have immaterial impact from that. And on the flip side of this, we have seen a flight of capital to larger international banks. And so we do see an opportunity to benefit from that as some of our larger banking customers actually see increased volumes. So it's a little bit of a put and take right now. But I would say, overall, it's an immaterial impact to the business, certainly in Q1, and I would say, going forward as well.

Rudy Kessinger^ Got it. That is very helpful color. Thank you. I'll jump back in the queue.

Matthew Moynahan^ Thank you, Rudy.

Operator^ Thank you. Our next question comes from the line of Nick Mattiacci with Craig-Hallum. You may proceed.

Nicholas Mattiacci^ Hi. This is Nick on for Chad Bennett. Thanks for taking my questions. Matt, in the flip side of last question. Can you talk about your customer base outside of banking and financial services, maybe the other types of verticals and customer sizes you have exposure to? And also if the product mix looks any different outside of Finserve and banking and just how that kind of diversification has evolved since you joined the company?

Matthew Moynahan^ Yes. No. I appreciate that. So if there's one vertical, you want to be strong in, BFSI is the one, okay? And that the Legacy Vasco and now OneSpan really made the reputation partnering with these mission-critical banks and certainly prove that our products belong in those types of high-value mission-critical environments. The company really historically had not made much attempt to break into other verticals, but we certainly see opportunity there. Pharmaceuticals is one that we're doing well in. And any organization that has -- so it's a high assurance applications. We believe certainly our reputation, but also our products would support that environment.

And that's really on the security side of things. On the digital agreement side of things, the e-signature capability lives everywhere, right? So this is really around some one of my top priorities here, obviously, both in acquiring new logos and non-BFSI customers, but also cross-selling e-signature into our BFSI infrastructure, which we've been effective, but I think we have a lot of upside to go and do more on that, essentially acquiring a BFSI customer in our installed base is somewhat equivalent of a new logo acquisition, although obviously, converting an existing customer is far easier, more cost effective than a pure new logo, but that's where the enablement comes in for our sales force is really aligning the new sellers, our existing sellers and a singular account control model to go after both new logos in our installed base in a more aggressive fashion than we have in the past. So I would say we've made some improvement certainly in targeting non-BFSI customers, but much more we can do, and that's a core focus of mind going forward.

Nicholas Mattiacci^ Got it. And then maybe if you could expand on the opportunity for your new Notary offering, just how that fits into the digital agreements portfolio and how you're thinking about that cross-sell motion. And then also anything you can comment there on early indications from customer interest and if that can be a landing product for new logos?

Matthew Moynahan^ Yes. No. Sure. I'm very excited about this. So just to recap the bit here, at the end of Q1, we launched our initial foray in the into OneSpan Notary and had limited coverage for states that as many will know that you have to go state by state by state to get certification based on individual state regulations. We are launching a more generally available version this quarter, but we'll have coverage for approximately 30 out of the 50 states, and we'll continue to improve that over time. I'm very excited by this for 2 reasons. One is almost every single company out there has a notary in some shape or form. And then 2, in particular, in BFSI, given the nature of the applications, loans, regulated documentations, I would even say there's an overweighted concentration of notaries in the upper half of the pyramid and the enterprise BFSI segment where we live.

So early days, obviously, for the product in the market. We do believe we have a significant opportunity in this multibillion dollar TAM. I think it's also important to note that many of the notaries are doing notarization on high-value documentation, and we do plan on integrating our DIGIPASS CX product, cloud-based authentication capability to authenticate yourself into a virtual notary session to bring additional layers of security to that notary environment, particularly when remote notary is being done on unknown users. So I think it's a perfect example. It's really leveraging our virtual room infrastructure that we talked about in the past, and it's a perfect example of bringing together the security and the digital agreement workflows into a virtual environment. So I'm very bullish on it, but still early days for sure.

Nicholas Mattiacci^ Okay, thanks for taking the questions.

Matthew Moynahan^ Sure. Thank you, Nick.

Operator^ (Operator Instructions) There are no additional questions waiting at this time.

So I would like to pass the conference over to Matt Moynahan for closing remarks.

Matthew Moynahan^ Great. Thank you very much. Thank you, everyone, for joining our call today. I appreciate you taking time out of your day to speak with us. We look forward to sharing our progress with you next quarter and in the quarters to come.

Thank you for your time. And look forward to our follow-on conversations.

Operator^ That concludes today's call. Thank you for your participation. You may now disconnect.