OneSpan Inc.

Second Quarter 2021 Earnings Conference Call

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C O R P O R A T E P A R T I C I P A N T S

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Steven Worth, *Interim Chief Executive Officer*

John Bosshart, *Interim Chief Financial Officer*

C O N F E R E N C E C A L L P A R T I C I P A N T S

Gray Powell, *BTIG Research*

Catherine Trebnick, *Colliers Securities*

Anja Soderstrom, *Sidoti and Company*

Rudy Kessinger, *D.A. Davidson*

P R E S E N T A T I O N

Operator

Hello, and welcome to the OneSpan Second Quarter 2021 Earnings Conference Call.

All participants will be in listen-only mode. After today's presentation, there will be an opportunity to ask questions. Please note, today's event is being recorded

I would now like to turn the conference over to Joe Maxa, Vice President of Investor Relations. Mr. Maxa, please go ahead.

Joseph Maxa

Thank you, Operator. Hello, everyone, and thank you for joining the OneSpan Second Quarter 2021 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.

This afternoon, after market close, OneSpan issued a press release announcing results for our second quarter 2021.

In a separate press release, also issued after market close today, the Company announced several leadership changes, including Steven Worth, who has been named Interim Chief Executive Officer, and John Bosshart, who has assumed the role of Interim Chief Financial Officer.

To access a copy of these press releases, and other investor information, including a presentation reflecting our second quarter financial results, please visit our website.

Steven Worth and John Bosshart will both participate in today's call. 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 2021, are forward-looking statements. These statements use 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 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 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 call is August 4, 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 Steven.

Steven Worth

Thanks very much, Joe, and good afternoon, everyone. Thanks for joining us on the call today.

Before we get into our second quarter results, I'd like to address the leadership changes we announced this afternoon.

I'm honored that the Board has appointed me Interim Chief Executive Officer. We've made progress on our transformational journey over the last several years, but we know the results have fallen short of the potential we see in the Company. Accountability is important to our Board and, together, we believe that progress requires proactive change, starting at the highest levels of our Leadership Team.

I've had the pleasure of working at OneSpan for five years across a number of functions within the Company, and I see the opportunity we have before us to optimize our strategic execution, focus on the products and markets where we are best positioned to succeed, and act with greater urgency as we look to accelerate revenue growth and drive value for shareholders, customers and employees.

I look forward to working closely with our Board and our Management Team as Interim CEO to drive our transformation forward and deliver results that reflect the strength of our solutions. That team includes our Chief Accounting Officer John Bosshart, who has assumed the role of Interim Chief Financial Officer. I've worked closely with John and can attest that his financial expertise, relevant experience and straightforward approach will be tremendous assets in that role.

As we look ahead, we have a good deal of work to do in the coming months, but we are approaching it with a sense of opportunity and an appropriate urgency to drive these results. We will take a fresh look at our overall product portfolio, the markets we serve, and other aspects of the Company, to explore ways to leverage our strengths and to enhance our growth profile. At the same time, we will evaluate areas where we can do better operationally and be more efficient across the organization. You can expect to hear more about these initiatives next quarter.

In addition to the executive changes, we also announced today that Al Nietzel has assumed the Board Chair role from John Fox, who has retired effective today. John was our first independent lead director and our first independent Board chair, and I want to thank John for his contributions to the Company over the years. I also want to welcome Al to his new role. Al has significant finance and cloud experience, and has made contributions to the Board since he joined last November. I look forward to working with him in his new role.

With that, I'll now turn to our second quarter results.

We continue to make progress in our transition to a recurring software revenue business. During the quarter, we had strong year-over-year revenue growth in two key recurring revenue solutions, with both e-signature and mobile security growing in excess of 50%. Annual recurring revenue, or ARR, increased 24% year-over-year, and ARR specific to subscription and term-based contracts increased 40%.

Some other highlights for the quarter include:

A seven-figure recurring booking contract with one of the largest banks in North America that combines multiple long-term solutions, including our mobile security solution, to solve that bank's unique use case.

We won our first OneSpan Sign Virtual Room customer. This new solution has built-in e-signature, web-enabled video conferencing and co-browsing features, that enable our customers and their users to securely collaborate, to review and e-sign documents. This was launched during the second quarter of 2021, and currently we have a growing number of customers doing trials.

We also completed integrating our newest identity verification capabilities into OneSpan Sign, which, combined with our Virtual Room technology, will help deliver remote online notarization capabilities in the future. We expect this solution to be available to customers next year and to strengthen our e-signature offering.

There are significant opportunities for our newest identity verification, Virtual Room and remote online notarization solutions. A recent study by Juniper Research found that spending on digital identity verification, driven by the need to digitally onboard users, will increase 77% from $9.4 billion this year to $16.7 billion in 2026. Furthermore, this study found that banking and financial services will account for almost 62% of digital identity verification spend by businesses by 2026.

John will now take you through our financial statements, and then I'll come back to provide additional comments, along with an update on our outlook, before opening the call to questions. John?

John Bosshart

Thank you, Steven.

I appreciate the Company's trust in me to take on this role.

Jumping into the quarterly results, annual recurring revenue at the end of Q2 was $112 million, representing a growth rate of 24%, compared to the prior year period. Our dollar-based net expansion rate, which we define as the year-over-year growth in ARR from existing customers, was 116% in the second quarter. It was impacted, in part, by a handful of e-signature-based, pandemic-related customer contracts which declined in size year-over-year following the reduction of the North American Federal Government Program related to the CARES Act.

Turning to recurring revenue:

Subscription revenue grew 60% to $10 million. This includes strong growth in e-signature and an increase in contributions from cloud authentication.

Term-based software license revenue grew 19% to $6 million. As Steven noted, mobile security revenue grew in excess of 50%. This growth was partially offset by a reduction in authentication software revenue, after it posted a record quarter in the second quarter of 2020, driven by pandemic-related demand.

Maintenance revenue grew 8% year-over-year to $13 million. We expect maintenance revenue growth to moderate over the balance of 2021, as we continue to transition our business model towards subscription and term-based software licenses.

Recurring revenue increased 24%to a $29 million in the second quarter of 2021, and accounted for a record 88% of software and services revenue. In the year ago quarter, recurring revenue accounted for 76% of software and services revenue. Total software and service revenue grew 7% to $33 million and was impacted by our shift in recurring revenue, hardware revenue declined 20% to $19 million, and total revenue declined 5% to $52 million.

Gross margin in the second quarter of 2021 was 68%, compared to 67% in the second quarter of 2020. The difference in gross margin is primarily attributed to product mix within software and services and within hardware.

During the quarter, non-recurring proxy contest-related expenses impacted GAAP operating expenses by approximately $3 million.

Adjusted EBITDA, or adjusted earnings before interest, taxes, depreciation, amortization, long-term incentive compensation and non-recurring items, was negative $1 million in the second quarter of 2021. This compares with a positive $3 million in the second quarter of 2020.

GAAP loss per share was $0.17 in the second quarter of 2021, compared to a loss of $0.05 per share in the second quarter of 2020. Non-GAAP loss per share, which excludes long-term incentive compensation, amortization, non-recurring items and impacts of tax adjustments, was a negative $0.04 in the second quarter of 2021, compared to non-GAAP earnings per share of $0.02 in the second quarter of last year.

We ended the second quarter with $109 million in cash, cash equivalents and short-term investments, as compared to $115 million at the end of 2020, and last quarter. During the quarter, we used $2.9 million to repurchase 111,000 shares of common stock.

Geographically, revenue trends were similar to last quarter, with growth in North America offset by a declines in EMEA, Asia-PAC and Latin America. Year to date, the Americas grew 28% and accounted for 33% of revenue, EMEA declined 16% and accounted for 50% of revenue, Asia-PAC declined 23% and accounted for 17% of revenue.

I will now turn the meeting back to Steven.

Steven Worth

Thanks, John.

We continue to see strong demand for our e-signature and mobile security solutions. However, we are seeing slower progress with some of our solutions and expect increased labor costs, gross margin pressure and some pandemic resurgence to pressure our results for the remainder of the year. Therefore, we believe it is prudent to adjust our full year guidance at this time.

We currently expect second half 2021 revenue to approximately meet or exceed first half 2021 revenue. We plan to continue investing for growth and currently expect second half Adjusted EBITDA to be at or below first half Adjusted EBITDA. For the full year 2021, we expect total revenue to be in the range of $205 million to $215 million, as compared to our prior guidance range of $215 million to $225 million; recurring revenue to be in the range of $115 million to $120 million, as compared to our prior guidance range of $120 million to $125 million; ARR growth to be in the range of 17% to 20%, as compared to prior guidance range of 22% to 26%; and Adjusted EBITDA to be in the range of negative $12 million to negative $15 million, as compared to our prior guidance of approximately breakeven.

We want to reiterate that the core demand drivers for many parts of our business remain strong. Our customers need for mobile security, e-signature and related solutions, and anti-fraud solution continues to be very important. The continued growth and sophistication of hacking attacks, identify theft, account takeover fraud and new account fraud, along with the need for remote digital workflows, will drive our growth.

We have work to do in the coming months to revise elements of our strategy and operations to better meet the evolving needs of our customers. Our Management Team and Board are committed to addressing these challenges head-on, and we will be evaluating our product portfolio and investments, optimizing our operations in the markets we serve, looking to best leverage our strengths and focus our efforts to accelerate the pace of change to drive improved performance.

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

Operator

Yes, thank you. At this time, we will begin the question-and-answer session. At this time, we will pause momentarily to assemble the roster.

The first question comes from Gray Powell with BTIG.

Gray Powell

Hi, and thanks for taking the questions. Yes, just a few on my side. Maybe starting off high level, how do you feel about the pipeline today and the visibility that you have on demand today versus, call it six months ago, and then how much would you say that you've de-risked your guidance?

Steven Worth

Well, I would say, in terms of pipeline, things are very steady. We have a little bit better visibility into the second half of the year, as we saw our experience with the first half of the year getting beyond the initial pandemic stages, and our ability to predict the business, I think has improved over time.

In terms of 2022, we're obviously going to be spending a lot of time in the next couple months thinking about our plans for the future, and as part of that, we're going to be looking into the demand drivers in each of our markets, and pipeline, and all of those factors.

Gray Powell

Got it, okay. Then, maybe just shifting over to the recurring side, it sounds like mobile security and e-signature had good quarters, or they had a good quarter. You said there is slower progress in other solutions. Can you maybe just drill into that a bit more, and just what was it that surprised you the most, that caused the revision to the ARR outlook for 2021?

Steven Worth

We have a lot of projects going on at the Company and it's one of the things we are looking into to see if we could focus a little bit better on our most successful products in the highest value markets. Like you said, e-signature and mobile security have performed well. Some of our banking security products, that we've invested quite a bit of time and money in over the last few years, have not been performing as we expected this year, and that has affected our results.

Gray Powell

Got it. Okay, thank you very much. I'll let somebody else ask questions.

Operator

Thank you. The next question comes from Catherine Trebnick with Colliers.

Catherine Trebnick

Thanks for taking my questions. I grabbed another call while you guys were talking. Can you just reiterate why we're seeing the ARR come in? You had really a nice clip going and it seemed to have come down to this 17% range from previously 22% to 26%. Could you just review for me why that is?

Steven Worth

Well, we have a couple different things going on. It's kind of a gradual slowness over the course of the year. Part of it is related to the—we had some tailwind impact last year for e-signature and a little bit, to a lesser extent, in banking due to the pandemic in the first six months, and now we are renewing those contracts and there's a few of those where we've renewed at lower level, and that affects ARR. Then, we've had some underperformance in some of our newer cloud-based solutions, and that affects the ARR outlook for the year.

Catherine Trebnick

On that piece right there, on the newer solutions, would you say that it's—are some of them too complicated or are the sales cycle is too long? Can you dig into a little bit what the factors are there? Because, you have changed out your salesforce to be more software-oriented and I'm just trying to grasp why some of these newer products aren't tracking better. Thanks.

Steven Worth

Sure. I would say, for the most part, we have made a lot of strides in terms of the salesforce and the approach in the sales training. Our focus in this review is going to be more on the products themselves, what are the current capabilities of the products, how do they match up against the customer needs, and taking a fresh look at the competition. In some of those categories, we're competing not only with large, established vendors that have been in these product categories for many years, but we're also competing against start-ups who have had a tremendous amount of capital invested in them in the recent years, and so the competition is pretty intense. I would say that the area that we're going to be looking into is more related to the products and the markets and less related to the salesforce.

Catherine Trebnick

All right, thanks.

Operator

Thank you. The next question comes from Anja Sodorstrom with Sidoti.

Anja Sodorstrom

Thanks for taking my questions. The first question I had was whether it was more product-related headwinds or if it was the go-to-market, and it seems like it's more product related and more intense competition. Did I understand that right?

Steven Worth

Yes, that's generally correct, yes.

Anja Sodorstrom

Okay. Then, if you look at the segments that are working a little bit better for you, the e-signature and subscription, you've been talking previously about going into different markets with that and expand the user case for that. Is that something you're going to push harder now then, or how do you think about that?

Steven Worth

I expect that we will, no final decisions have been made, but you can see from some of the announcements we made and the roadmap—if you take e-signature, for example, it's a horizontal solution by nature, so we are already in many target market segments, and I expect that will continue. We've also done some more targeted product extensions or enhancements, like Virtual Room, connecting with identity verification, and next year getting into online notary. So, those are examples of where we've identified specific use cases and the investment makes sense to do that extension. Mobile security is a different type of a product and in a different market, but that also has some horizontal applications, as well, and we'll be looking at that as part of our process.

Anja Sodorstrom

Okay. So, your salesforce has, more or less, been sort of redirected to do this already, there's not going to be any major changes there, or needing to ramp there, or how should we think about that?

Steven Worth

Yes, we spent a lot of time on the salesforce over the last couple years. That's an example of where we have these wonderful foundations and we have a great balance sheet and we have a wonderful customer list, we have a long history, a strong reputation, and a lot of talented people, so really taking advantage of those assets and accelerating the pace of change is our goal.

Anja Sodorstrom

Okay, thank you. That was all for me.

Operator

Thank you. The next question comes from Rudy Kessinger with D.A. Davidson.

Rudy Kessinger

Great, thanks for taking my questions, guys. I wanted to touch on—I know you said you signed your first Virtual Room customer in the quarter, and I think last quarter you had said you anticipated that that would see—I think you said significant premium in pricing, relative to regular e-signature contracts. Is there any more color you can give on kind of where that pricing came in on that first initial one and what you're seeing in talks with the ones that are in pilots right now?

Steven Worth

Well, it's a little early to get into the numbers, because the other handful that are in trials or pilots, we're not in contracting phase and finishing up numbers, but we still believe that that is the case, where we have the opportunity to capture somewhere in the range of four times our normal standalone e-signature price point.

Rudy Kessinger

Got it. Then, going back to the guide, it looks like you took $5 million out recurring and $5 million out of non-recurring. That $5 million in the non-recurring, is that primarily hardware, do you expect lower perpetual licenses, or just any other color you can give there?

Steven Worth

Well, perpetual licenses are selling at approximately the clip that we expected at the beginning of the year, and the transition for existing customers to purchase term versus perpetual is a continuous process, and I think the numbers show that, and that will continue into next year. Hardware, we're projecting hardware to be down a bit this year, but not a large decline, and I would say that that product line is fairly stable at this point.

Rudy Kessinger

Got it. Then, also, I'm curious in the guide, you went from breakeven to a $12 million to $15 million EBITDA loss after only taking the revenue down by $10 million, and so I'm curious—I know you said increased labor costs, but could you drill down more on that, just what exactly is going to drive that, you know, call it $3 million to $5 million of extra expense when you adjust for the revenue adjustment?

Steven Worth

Yes, that's a tough number, and we have to admit that we're not happy about that. Starting at the beginning of the year and moving on, our top line has come in a little bit under where we wanted it to be, because of our high gross margins have really hit Adjusted EBITDA there, and then when we're lighter on the things that have the highest margin versus our projections in January, it affects the Adjusted EBITDA number, and then on top of that you start adding things like increased freight costs and supply chain costs, and other things, and come to a number that we're not happy with, but we felt that we needed to reset that for you.

Rudy Kessinger

Got it. That's it for me. Thanks, guys.

Operator

Thank you. That does conclude the question-and-answer session. I would like to return the floor to Steve Worth for any closing comments.

Steve Worth

Thank you, and thanks, everyone, for joining. Obviously, we have a lot of change going on and we have our work cut out for us. We know exactly what we need to do over the next couple months, and we expect to have some further important news for you. We're planning on coming back early November to talk again, if not sooner, and thank you for your time.

Operator

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