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OneSpan Inc.

Fourth Quarter and Full Year 2021 Earnings Conference Call

February 22, 2022

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CONFERENCE CALL PARTICIPANTS

Chad Bennett, *Craig-Hallum Capital Group*

Stefan Schwarz, *BTIG, LLC*

Catharine Trebnick, *Colliers Securities, LLC*

Anja Soderstrom, *Sidoti & Company, LLC*

Rudy Kessinger, *D.A. Davidson & Co.*

PRESENTATION

Operator

Good afternoon, and thank you for attending today's OneSpan Fourth Quarter 2021 Conference Call.

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

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

Joe Maxa

Thank you, Operator. Hello, everyone, and thank you for joining the OneSpan Fourth Quarter and Full Year 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.

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 results for our fourth quarter and full year 2021. 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 “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 filing 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 February 22, 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.

With that, I will turn the call over to Matt.

Matt Moynahan

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

In today’s call, I will cover a handful of topics, including our Q4 results, our value proposition and relevant growth drivers, and a few key customer wins. Equally important, I will provide an update on the progress with our long-range strategic planning efforts. After that, Jan Kees will walk you through our financials, before opening the call to questions.

First, I would like to begin by sharing my perspective on the Company. I joined OneSpan at the end of November, and I’m excited by the strength of our solution portfolio and market position, as well as the potential to enhance our operations and overall customer value proposition. Two months into my tenure, I have to say that I’m encouraged by the progress we’ve made on the development of our long-term strategic plan, and I’ve been impressed by the talented people in our Company who will execute on the opportunities that lie ahead of us. I am also confident in our ability to drive revenue growth, while increasing profitability, as we transition to the next generation of OneSpan.

I joined the Company because OneSpan has an exciting and relevant value proposition, and I truly believe we can unlock significant shareholder value by increasing our focus, leveraging our competitive advantages to improve our growth profile, all the while enhancing our operational performance and capital efficiency.

We operate in two important markets, in cybersecurity and digital agreements, both of which will only become more important to enterprises in the years to come. We also have a tremendous asset in our top-tier customer base, that includes many of the largest and most security-conscious companies in the world, companies that trust us to mitigate their risk of fraud and help them comply with regulations, while delivering compelling user experiences across such technologies as e-signature, identity verification, video signing, mobile authentication, mobile app shielding, transaction signing, and more.

Turning to the quarter, Q4 revenue of $59 million was the highest level achieved in eight quarters, and revenue ARR and Adjusted EBITDA exceeded our expectations.

In December, we announced a cost savings plan that is expected to result in pre-tax savings of approximately $10 million to $12 million for Fiscal Year ’22, primarily from headcount-related actions and reduction in leased office spaces.

Now, turning to our strategic action plan, we’ve made significant progress in the evaluation of our markets, prioritizing our product portfolio, and aligning our investments in operations to execute against our most compelling opportunities. We are on track to update you on the details of our go-forward strategy at our Investor Day in mid-May. Stay tuned for more information.

But, today, I would like to share with you my initial observations. In short, I believe we have a strong suite of e-signature and security solutions that provide us with a solid platform to both enhance our go-to-market and also introduce new innovative solutions that will deepen our customer relationships. We also believe we can establish a clear and disruptive leadership position in the markets we serve by leveraging our identity, security and compliance DNA to deliver trusted agreements and transactions as a core differentiator.

We’re fortunate to have a strong market position as we progress in our transformational journey. Our selling efforts will continue to focus on providing new and existing customers with our core security and e-signature solutions. We will strengthen our go-to-market strategy, with an increased focus on account expansion, cross-selling, new customer targeting, and creating sales leverage through strategic alliances, such as our recently announced partnership with Smart Communications. This partnership combines their smart digital forms with OneSpan Sign to improve the customer experience, increased application completion rates and reduced document errors, while maintaining the strictest security and compliance standards. We expect to form additional partnerships, including OEM relationships, in the coming months.

We also have a significant opportunity to drive increased demand for our security and e-signature solutions. Recent customer wins demonstrate our value as a strategic provider of essential solutions that enable our customers to execute trusted and user-friendly digital agreements and transactions. Improving the end user’s experience is as important for our customers as is mitigating the risk of fraud, as a rising trend of identity and credential theft increases regulations and accounts for billions of dollars in losses each year.

The need to comply with government regulations is a key driver of innovation in our markets. A recent study found 85% of global banks need technology vendors to be trusted advisors to help navigate the changing in regulatory environment. Tough challenges for financial institutions are fraud, safeguarding sensitive data and keeping pace with changes in consumer privacy laws. To help them comply with regulations, banks are partnering with trusted companies, like OneSpan, to put innovative solutions, such as digital remote identify verification, in place.

We had a number of six-figure digital security contracts close during the fourth quarter, as customers continue to roll out our mobile and other security solutions. We also closed a number of six-figure e-signature contracts, driven by increased transaction volumes, expansions to additional business units, and competitive displacements, including from DocuSign.

Let me provide you with a few examples:

- First, a major digital security customer in the United Kingdom increased annual commitment ninefold to approximately $900,000 ACV.

- Similarly, a major e-signature customer in the United States expanded its e-signature deployment across multiple lines of business, increasing its ACV with us from $50,000 to $1 million.

- A major leading global HR and temporary staffing firm selected OneSpan Sign over their previous well-known e-signature provider in a mid-six-figure ACV deal.

- Lastly, a major North American and long-time digital security banking customer selected OneSpan Sign with identity verification over their incumbent provider for use in their insurance arm. OneSpan's trusted provider status in this $300,000 ACV deal was a key reason for the win.

Beyond our strong product portfolio, we have a significant opportunity to become more capital-efficient across our organization, by better aligning our costs with our growth opportunities. I look forward to addressing in more detail these topics at our upcoming Investor Day.

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

Jan Kees van Gaalen

Thank you, Matt. Good afternoon, everyone.

For the full year 2021, we exceeded the high end of our revenue and Adjusted EBITDA guidance ranges provided to you in early November. Annual recurring revenue, or ARR, grew 20% year-over-year to US$125 million and came in at the high end of our guidance range. ARR specific to SaaS subscription and term-based subscription contracts, grew in excess of 30% and accounted for approximately 70% of our total ARR.

DBNE, or dollar-based net expansion rate, which we define as the year-over-year growth in ARR from existing customers, was 115% in the fourth quarter.

Total recurring revenue, which consists of SaaS and term-based subscription and maintenance licenses, increased 4% year-over-year to US$32 million in the fourth quarter of 2021, and accounted for 91% of software and services revenue. For the year, total recurring revenue increased 18% to US$120 million, coming in at the high end of our guidance range, and accounted for 89% of software and services revenue.

SaaS subscription revenue grew 15% to $10 million in the fourth quarter and 38% to $38 million for the year. Growth in Q4 e-signature and cloud authentication was partially offset by a decline in legacy deal flow revenue. In addition, the revenue recognition timing of a handful of large subscription contracts adversely impacted our Q4 results. For the year, e-signature SaaS subscription revenue grew 40%.

Term-based subscription revenue grew 8% to $9 million in the fourth quarter and 23% to $30 million for the year. Mobile security and server software were the largest contributors.

Maintenance revenue declined 6% to $13 million in the fourth quarter and grew 4% for the year.

Total Company revenue increased 12% to US$59 million in the fourth quarter and declined 1% to $214 million for the full year 2021.

Hardware revenue grew 51% to $24 million in the fourth quarter and declined 3% to $80 million for the year, in line with our expectations.

During the fourth quarter of 2021, we identified and corrected immaterial prior period classification errors related to certain costs directly attributable to the production and distribution of hardware products. This resulted in an understatement of product and license cost of goods sold and an overstatement of sales and marketing expense. It did not, however, affect overall profitability. Additional details, including the adjustments to prior periods, can be found in our earnings press release and in our 10-K filing published today.

Gross margin in the fourth quarter of 2021 was 63%, compared to 72% in the fourth quarter of 2020. The difference in gross margin is primarily attributed to product mix, with software and services contributing 59% of total revenue in Q4 '21, as compared to 69% in Q4 '20. We also recognized revenue from a higher mix of lower margin authentication tokens in the quarter and experienced global transportation and supply chain disruptions, which increased our reliance on air freight. These supply chain challenges are expected to continue in 2022.

Adjusted EBITDA was negative $1 million for the fourth quarter of 2021. This compares to positive $3 million in the fourth quarter of 2020. Adjusted EBITDA margin was negative 1% in the fourth quarter of 2021, versus positive 6% in the year ago quarter. For the full year 2021, Adjusted EBITDA was negative $5 million and Adjusted EBITDA margin was negative 2%, outperforming our expectations.

Fourth quarter 2021 income tax expense included an $8 million attributed to an increase in the valuation allowance recorded on U.S. deferred tax assets.

GAAP loss per share was $0.35 in the fourth quarter of 2021, compared to $0.04 in the fourth quarter of 2020. Non-GAAP loss per share, which excludes long-term incentive compensation, amortization, non-recurring items and the impact of tax adjustments, was $0.24 in the fourth quarter of 2021, compared to non-GAAP earnings per share of $0.03 in the fourth quarter of last year.

We ended the fourth quarter of 2021 with US$98 million in cash, cash equivalents and short-term investments, compared to $115 million at the end of last year. Cash utilized in operations during the year was $3 million. Also, during the year, we used $7.5 million to repurchase approximately 342,000 shares of common stock.

Geographically, our revenue mix by region in the fourth quarter of 2021 was 53% from EMEA, 30% from the Americas and 18% from Asia-Pacific. For the full year 2021, the revenue mix by region was 49% from EMEA, 32% from the Americas and 19% from Asia-Pacific.

Thank you. I will now turn the meeting back to Matt.

Matt Moynahan

Thank you, Jan Kees.

As mentioned previously, we will update you on our go-forward strategic plan at our Investor Day in the second quarter, including how we plan to become more efficient at better focusing and aligning our organization from a go-to-market perspective. I do believe we have an opportunity to establish a clear and disruptive leadership position in the markets we serve by leveraging our strengths in identity, security and compliance. For instance, by leveraging our security and transaction signing expertise, we believe we can provide significantly differentiated e-signature and other digital agreement solutions.

While we have work to do, including optimizing our solution portfolio, I am confident we have the ability to unlock shareholder value by improving our execution in core markets and better aligning our cost structure and routes to market to our most promising growth opportunities, thereby improving our capital efficiency. While we have much of what we need today, we plan to add pertinent pieces to drive increased growth and profitability in the coming years.

As you can see, we ended the year with solid momentum and have made strong progress in the development of our long-term strategic plan, but there is more work to be done in fleshing out the details, and recognizing the work to be done ahead of our mid-May Investor Day and the desire to share more fully the details of our long-term plan, we will not be providing detailed 2022 guidance at this time. However, and importantly, for 2022, we expect revenue to meet or exceed 2021's level, and for Adjusted EBITDA to be breakeven, or better, for the fiscal year.

In closing, I'm excited about the future of OneSpan and look forward to discussing the details and metrics of our full year outlook and long-term plan at our Investor Day in just a quarter's time.

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

Operator

Thank you. Our first question is From Chad Bennett with Craig-Hallum. Chad, please proceed.

Chad Bennett

Great. Thanks for taking my questions. Welcome, Matt, and look forward to working with you in the future.

I guess a couple things. First, on the subscription line, just in terms of—I guess the first question would be if there's any quantification on the revenue rack impact on that line from—I think you indicated a few large transactions, that just timing-wise didn't hit in the quarter. Is there any quantification you could provide there?

Matt Moynahan

No, we're not prepared to do that.

Chad Bennett

Okay. So, I guess, maybe, more importantly, going forward, is there—how should we view the growth of the subscription business going forward, and related to that, is there—have your thoughts changed? It seems like you're pretty optimistic about e-sign and being able to sell that in more places, and digital agreements being a big part of that, and whatnot. Do you think the growth rate of the e-sign business, do you think that was a business that kind of had some pull-forward in the last four to six quarters, where a growth rate of 40% plus is going to be more challenging, or how do we think about overall subscription growth going forward?

Matt Moynahan

We do anticipate sequential growth throughout 2022, and we're working through some of the elements of that mix now in our long-term strategic plan. I am absolutely laser-focused on the subscription side of the business, but given the continued material portion of our total revenue that does come from hardware, which is perpetual, you do see, from time to time, a dampening effect with the overperformance on the hardware line.

Again, hardware is not a bad thing, as part of our total solution portfolio, but it should become a decreasing portion of our total revenue on a go-forward basis, and we're right in the middle of that transition right now. But, we'll have much more detail for you on that plan as we disclose it in the May timeframe.

Chad Bennett

Got it. Appreciate you taking my questions, thanks.

Matt Moynahan

Thanks, Chad.

Operator

Thank you, Mr. Bennett, for your question. Our next question is from Stefan Schwarz with BTIG. Mr. Schwartz, please proceed.

Stefan Schwarz

Hi, this is Stefan on for Gray. Thanks for taking my questions.

Matt Moynahan

Hi, Stefan.

Stefan Schwarz

I wanted to ask—hi, thank you. So, related to the dampening effect created from perpetual, I just wanted to ask how should we think about that shift for perpetual and multi-year term impacting headline revenue growth for the year, and how close do you think you are at this point to the end of that transition?

Matt Moynahan

I think last year was when we largely concluded the transition from the legacy business model, if you will, to a subscription-based business model. As you know, the subscription model is comprised of term and more traditional SaaS subscription from our e-signature business, and I would say we've largely gone through that migration, and what we have now is a laser-focus on the elements of ARR drivers, which are new customer acquisition, obviously better cross-selling, as I alluded to in my comments, and then making sure that we're laser-focused on ensuring customer churn rates are low. That's really where I'm most excited, is not so much moving beyond the business model shift in and of itself, but the operationalizing of our strategy to go drive ARR, and we're hard at work doing that now in our long-range plan, but also, equally important, bringing a level of transparency to the investor community about how they should be viewing the business in total, but also these two different dynamics that exist inside of the Company.

Stefan Schwarz

Got it, thanks, and then just one more. It looks like you had a few e-signature wins. I was hoping maybe you could drill down, maybe why you win particularly against DocuSign, which I think you mentioned.

Matt Moynahan

Yes, I am very heartened by what I've seen and hear. When we do the right things with the right customers, the natural behavior of a land-and-expand is happening. I think what we can benefit from is being more focused in the segments of our horizontal segmentation, where we win the most.

What's one significant benefit for OneSpan, relative to DocuSign, DocuSign was born in more of an SMB environment, real estate, and they've worked themselves into a nice enterprise company, obviously. OneSpan was born in the enterprise, in very discriminating environments, and very complex heterogenous environments.

So, I've been pleased, through my customer conversations, to feel like we have significant feature parady in the areas that customers count on most, so that the features aren't a big discriminator—or lack of a discriminator against DocuSign, who is significantly larger, but where we are winning is that we seem to be more enterprise class and working in a heterogenous environment that has very high regulatory and compliance requirements, and, in many cases, integration requirements in their systems, and that is our background. I would say that is a unique differentiator for us, in addition to our DNA on the identify and verification side of the house.

Stefan Schwarz

Got it. Thank you very much.

Matt Moynahan

Thank you.

Operator

Thank you, Mr. Schwarz, for your question. Our next question is with Catharine Trebnick with Colliers. Ms. Trebnick, please proceed.

Catharine Trebnick

Thank you. Thanks for taking my question. Mine's on the subscription SaaS piece of it, it grew 15% year-over-year. Had you closed these deals or moved into the quarter, what would that growth have been for the quarter?

Jan Kees van Gaalen

You would have had a couple of percent more in terms of the OSS subscription numbers.

Catharine Trebnick

Got it. Then, was there anything else outside e-signature that would have been in the subscription line or other SaaS (inaudible)?

Jan Kees van Gaalen

We mentioned that there is a little bit of a decrease in the legacy deal flow product.

Catharine Trebnick

Okay, got it. Then, on gross margin, you're down to 63%. Can you give a little bit more detail on that mix shift and where the low margin is coming from? Is it from the hardware?

Jan Kees van Gaalen

There was significantly a big shift in the overall composition, with less software and a higher component of hardware than in the comparable quarter in 2020. If you normalize it, we had about $1.2 million related to increased cost of freight, air freight, primarily, and then we had about $2.5 million-ish which was related to a shift to somewhat lower margin authentication products, and that happens from time to time at year end. So, those are the big components in that shift, in that lower margin.

Catharine Trebnick

All right, thank you.

Operator

Thank you, Ms. Trebnick, for your question. Our next question is with Anja Soderstrom from Sidoti. Please proceed.

Anja Soderstrom

Hi, thank you for taking my question. A lot of the questions are asked already. I just have a question about the—I guess you touched on what affected the margin for the fourth quarter, but how should we think about the margin performance in 2022, and how much of that is going to be hampered by cost inflation and things like that?

Jan Kees van Gaalen

We see the impact of air freight and reliance on air freight in the hardware side of the house continuing at least into the first quarter, perhaps into the second quarter, but for the full year, we would expect the margins to be quite similar to what we had in the year 2021.

Anja Soderstrom

Okay, and the cost saving of $10 million to $15 million for the year, that's mainly going to come from headcount and downsizing of space?

Jan Kees van Gaalen

Yes, there are two components, not filling the positions that were open, and also, unfortunately, having to release some people from the Company, and the other side of that was also reduction in real estate leases, space predominantly, and making savings there.

Matt Moynahan

It's important to note that the execution of these actions is still continuing throughout the year, so there will not be realization of a full year benefit of that full amount, and we're also, obviously, right in the middle of our strategic planning process and evaluating whether some of the savings that will be realized will be reinvested into growth areas, and we'll be prepared to talk in detail about that in the May Investor Meeting.

Jan Kees van Gaalen

We'll also provide you with a tracker on a quarterly basis, where you can see the savings accruing.

Anja Soderstrom

Okay, great, thank you. That was all for me, thank you.

Operator

Thank you, Ms. Soderstrom, and our next question is with Rudy Kessinger with D.A. Davidson. Please proceed.

Rudy Kessinger

Thanks for taking my questions. I want to go back to subscription just one more time, I know it's been touched on a couple times, but on the sequential decline, down 4% from Q3—I know, typically, Q3 and Q4, there's some overages or usage that drives a pretty big sequential growth, 10% and 14% sequential growth each of last Q4s. So, is there a way you can quantify how much was the decline from the legacy deal flow product Q3 to Q4? It's just a bit perplexing, the Q4 subscription being even lower than not just Q3, but even Q2, as well.

Joe Maxa

Hey, Rudy, this is Joe. As you look at the overall numbers, we do have to factor in, like you said, the deal flow which came down, I think it was in the 20% range. We don't have the exact number in front of us right now. But, yes, that had overall impact on the subscription line. Some of the deals that we expected to close early in the quarter pushed out, on the e-signature side, to basically the last day of the quarter and into Q1, so we didn't recognize that revenue from those contracts.

Rudy Kessinger

Got it. Then, on the cost cuts, just going back to your last comment there, I think you said $10 million to $12 million pre-tax savings in '22, but that's not a full year realization yet. Can you quantify how much on a full year basis those cuts will equate to, be it, I don't know, $15 million or $20 million, I mean, somewhere higher than $10 million to $12 million? What will it be once you're fully realizing it?

Jan Kees van Gaalen

I think you'll see those cuts realizing in the year 2023 fully, but for the year 2022, you're probably only going to have a percentage, say, 30%, 40%, perhaps 50%, depending on how quickly certain actions can be implemented, coming through in the financial statements.

Rudy Kessinger

Okay, got it. Thank you for taking my questions.

Matt Moynahan

Thank you, Rudy.

Operator

Thank you, Mr. Kessinger, for your question.

There are no more questions waiting at this time, so I'd like to pass the conference back over to the Management Team for closing remarks.

Matt Moynahan

Well, thank you, everyone.

I'd like to end on a positive note here, that, again, I'm very excited to be at OneSpan and feel very confident in our ability to deliver a quite detailed view of the business in May. We've been hard at work at our strategic planning process, we are on track, and we have hit all of our internal milestones and deliverables. Based on what I see, I'm very excited about our path forward and our ability to offer our customers an enhanced value proposition, and hopefully look to seeing you all in person, if not virtual, in the mid-May timeframe with much more detail.

Thank you for joining the call today.

Operator

That concludes the OneSpan Fourth Quarter 2021 Conference Call. Thank you for your participation. You may now disconnect your lines.