OneSpan

Third Quarter 2021 Earnings Conference Call

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CORPORATE PARTICIPANTS

Joe Maxa, *Vice President of Investor Relations*

Steven Worth, *Interim Chief Executive Officer*

Jan Kees van Gaalen, *Interim Chief Financial Officer and Treasurer*

CONFERENCE CALL PARTICIPANTS

Catharine Trebnick, *Colliers Securities, LLC*

Gray Powell, *BTIG, LLC*

Anja Soderstrom, *Sidoti & Company, LLC*

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

PRESENTATION

Operator

Good afternoon. Thank you for standing by and welcome to the OneSpan Third Quarter 2021 Earnings Conference Call.

At this time, all participants are in a listen-only mode. All lines have been placed on mute to prevent any background noise. After the speakers' remarks there will be a question-and-answer session. Please note, today's call is being recorded.

I would now like to hand the conference over to your first speaker today, Joe Maxa, Vice President of Investor Relations. Please go ahead.

Joe Maxa

Thank you, Operator. Hello everyone and thank you for joining the OneSpan Third 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.

Joining me on the call today are Steven Worth, OneSpan's Interim 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 third quarter 2021. To access a copy of the press release and other investor information, including a presentation reflecting our third quarter financial results, please visit our website. Following our prepared comments today we will open the call for questions.

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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. 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 November 2, 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. Thank you for joining us on today's call.

Before we get into our third quarter results, I'd like to welcome Jan Kees van Gaalen to OneSpan. Jan Kees joined the Company as Interim CFO and Treasurer last month. He brings a wealth of accounting, finance and consulting experience, including 15 years in chief financial officer roles where he was instrumental in implementing significant cost saving efforts. We believe Jan Kees' skillset matches our needs well as we look to streamline and optimize our operations in the coming months.

Our Board would also like to share an update on the CEO search, which began after the departure of our former CEO in August. The search has emphasized relevant skillsets, including demonstrated leadership in growth strategies, operational efficiencies, and transformational activities. That process continues to advance, and the Board will share more information as the process unfolds.

Now, I'd like to provide you with an update on our strategic action plan progress. Over the last three months we have been hard at work evaluating our product portfolio, the markets we serve, our investments, and our operations in order to identify ways to best leverage our strengths, enhance our growth profile, reduce cost, and drive improved performance. We have made significant progress in formulating our action plan by leveraging a combination of internal experts, Board members, industry analysts and FTI, a leading global business transformation consulting firm. We are working diligently to identify and take action on initial cost reduction opportunities and will provide a range of expected savings before yearend. We are also making progress on forming an action plan to accelerate our recurring revenue growth. We will give you more details on this strategic action plan in the coming months and we expect to host an Investor Day in early Q2.

We have great confidence in the markets we serve, where our products are uniquely positioned to win and provide us opportunities to generate additional growth. Our core offerings are performing well, and we believe we have significant opportunity to increase long-term recurring revenue growth. We will focus on our fastest growing product categories where we can capitalize on our competitive position and expand our market search. For example, we have had extremely attractive growth in e-signature subscription revenue this year as we are well positioned in that market.

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With that, I'll turn to our third quarter results which demonstrated our ability to execute through a management transition, our internal review, and harbor supply chain issues, which Jan Kees will discuss in a few minutes.

We had a strong quarter of recurring revenue growth, driven by both our e-signature and mobile security solutions. For the quarter, recurring revenue grew 38% year-over-year, with e-signature subscription revenue growing 45% and mobile security term license revenue growing even faster. We believe demand for these solutions will continue well into the future based on our internal forecast, our customer feedback, and industry analysts.

Demand for our mobile security solutions is driven by the increasing need to improve the user experience and mitigate the risk of fraud. Mobile banking and other remote financial services applications have been widely adopted around the globe. Yet, a recent study found 70% of the top 400 mobile finance related apps had security vulnerabilities. Our market leading mobile security solutions are having success, in part because they are designed to improve the user experience and mitigate that risk of fraud.

Demand for e-signatures accelerated during the pandemic. It has moderated recently yet remains strong. Our volumes continue to increase, and indications suggest that this will continue in the coming years based on growing opportunities in our current use cases, in new use cases, and in new geographies. For example, our investments in e-signature add-on offerings, such as Virtual Room and Identity Verification are gaining traction.

Virtual Room provides businesses with the ability to conduct remote, mediated transactions that combine digital and human interaction to improve the customer experience. Two recent examples include a customer serving the legal community that launched a product providing a complete digital process for verifying the identity of individuals. They are using our Virtual Room because it provides a secure, encrypted, online video conference service where the lawyers and business professionals are able to meet virtually and electronically sign documents with verified participants.

A second example is a banking customer of ours that is launching a closing room product, supported by our technology to drive their commercial real estate business. This will allow lenders and borrowers to meet virtually to complete a mortgage transaction using e-signatures and Virtual Room, replacing the more costly and time consuming in-person meetings that utilized paper-based processes. The bank intends to expand this offering into other high value lending use cases.

We also won several contracts that utilize our recently integrated identity verification and e-signature capabilities. Some of the use cases include remote bank account openings, title insurance agreements, and automobile financing.

I'll now pass the call over to Jan Kees to take you through our financial results, and then I'll come back to provide additional comments, along with an update on our outlook before opening the call to questions. Jan Kees?

Jan Kees van Gaalen

Thank you, Steven.

I'm excited to be here at OneSpan and look forward to contributing to the team as we take the next steps in our strategic transformation. Now, I'll take you through the quarterly results.

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Annual recurring revenue at the end of Q3 was $119 million, representing a growth rate of 24% compared to the prior year period. ARR specific to subscription and term-based contracts, which accounts for approximately two-thirds of our total ARR, increased more than 40%.

Dollar-based net expansion rate, or DBNE, which we define as the year-over-year growth in ARR from existing customers, was 115% in the third quarter. As mentioned last 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 a reduction in North American federal government programs related to the CARES Act.

Now, turning to recurring revenues. Subscription revenue grew 37% year-over-year to $10 million, primarily driven by strength in the e-signature solutions and an increased contribution from cloud authentication. Term based software license revenue more than tripled to $8 million. Mobile security and service software accounted for the majority of the year-over-year growth, and maintenance revenue grew 3% to $13 million. We are expecting modest full year 2021 maintenance revenue growth as our business model continues to transition to a subscription and term-based software licenses.

Total recurring revenue increased 38% year-over-year to a record $31 million in the third quarter of 2021 and accounted for 89% of software and services revenue. In the year-ago quarter, recurring revenue accounted for 74% of software and services revenue. Total software and services revenue grew 16% to $34 million. Hardware revenue was impacted by shipping issues within our supply chain and declined 17% to $18 million during the quarter. We have been proactively addressing our supply chain and recently brought a new European manufacturer up to full capability during the quarter. We currently expect hardware revenue to improve sequentially in the fourth quarter.

Total company revenue increased 2% to $52 million. Gross margin in the third quarter of 2021 was 72% compared to 70% in the third quarter of 2020. The increase in gross margin is primarily attributed to product mix, with software and services accounting for 66% of total revenue, as compared to 58% in the year ago quarter, and a favorable product mix within hardware.

Adjusted EBITDA, or adjusted earnings before interest, taxes, depreciation, amortization, long-term incentive compensation and non-recurring items was $2 million in the third quarter of 2021. This compares to $3 million in the third quarter of 2020.

A GAAP loss per share was $0.02 in the third quarter of 2021, compared to $0.04 per share in the third quarter of 2020. Non-GAAP earnings per share, which excludes long-term incentive compensation, amortization, non-recurring items, and the impact of tax adjustments was $0.03 in the third quarter of 2021 compared to $0.03 in the same quarter last year.

We ended the third quarter with $98 million in cash, cash equivalents and short-term investments, as compared to $150 million at the end of 2020, and $109 million at the end of last quarter. During the quarter, we used $4.6 million to repurchase approximately 231,000 shares of common stock.

Geographically, we continue to benefit from strong revenue growth in the Americas region, which grew 43% year-over-year in the quarter. We also had nice growth in the Asia PAC region. In EMEA, our largest market, we continued to see headwind related to our transition to a recurring software revenue model, which was exacerbated this quarter by the hardware supply chain issues mentioned previously. Year to date, the Americas region grew 33% and accounted for 33% of revenue. Asia PAC declined 15% and accounted for 20% of revenue. EMEA declined 17% and accounted for 48% of revenue.

I will now turn the meeting back to Steve.

Steven Worth

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Thanks, Jan Kees.

As you can see from our strong third quarter results, demand for our solutions is robust and we expect this to carry through into the fourth quarter. As such, we are updating our guidance to raise the midpoint of our expectations. For the full year 2021, we currently expect total revenue to be in the range of $209 million to $213 million as compared to our prior guidance range of $205 million to $215 million.

Recurring revenue to be in the range of $118 million to $120 million as compared to our prior guidance range of $115 million to $120 million. ARR growth to be in the range of 18% to 20%, as compared to our prior guidance range of 17% to 20%. Adjusted EBITDA to be in the range of negative $6 million to negative $8 million as compared to our prior guidance of negative $12 million to negative $15 million.

We are happy with our team's execution in the third quarter and are committed to continue delivering solid business performance while we progress in forming our action plan to enhance long-term shareholder value. With that, Jan Kees and I will be happy to take your questions. Operator?

Operator

Thank you. Our first question comes from Catharine Trebnick from Colliers Security. Catharine, please go ahead.

Catharine Trebnick

Hi. Nice quarter. Now, I'm perplexed as to why you didn't give your first phase of cost cutting as part of the go forward initiative. Can you give me a background on why you're waiting until the end of the year?

Steven Worth

Well, it is November so we are pretty close, I would say. We're working on the deep dive analysis of which items to talk to you about first. Because some items are independent in the nature of just plain good business decisions, and other items are directly connected to our final strategic decisions. There are a few layers of complexity that we're going to work through in the next 30 to 60 days.

Catharine Trebnick

Okay, and then the follow up question is, is the ARR your best 18% to 20% growth? Which components of that are you seeing as the better growth drivers?

Steven Worth

Well, certainly, e-signature and mobile security are the real growth drivers there. They account for approximately two-thirds of our recurring revenue. Then the balance is really that maintenance piece that's largely driven by historical perpetual license sales and that maintenance piece is a drag, if you will, on the overall growth rate.

Catharine Trebnick

All right, thanks. I appreciate the time.

Steven Worth

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Sure, thank you.

Operator

Our next question comes from Gray Powell from BTIG. Gray, please go ahead.

Gray Powell

Great, thanks for taking the question and congratulations on the good numbers.

Steven Worth

Thank you, Gray.

Gray Powell

Yes, absolutely. Net AR, net new AR additions in Q3 doubled off of the pace of Q2. Was there any catch up in delayed deal activity in Q3 from Q2? Then I'm just trying to think through, how should we think about seasonality into Q4? Yes, thanks.

Steven Worth

Yes, I would say, not in our subscription business, in our term license business, that can be a little bit lumpier than subscription. There are some situations where, at the end of the quarter, we've got the team still working on renewals that can bleed into the beginning of the next quarter. There was a little bit of that in Q3 this year. But overall, we've got—then there's individual, large term deals that may skew things. Also, the term license duration can move the numbers around a bit. We'll continue to have a little bit of that type of volatility within the term license line.

Gray Powell

Okay, great. That actually leads into my next question. Just so on the reported revenue side, there's always a few moving parts. Just, how should we think about this shift from perpetual license and multiyear term impacting headline revenue growth? Do you feel like you're at the tail end of this transition? I know it's early to ask about 2022 outlook, but should we expect the headwinds that we've seen on the perpetual license side this year start to abate next year?

Steven Worth

Yes, with respect to the transition from perpetual buying tenants term, we have—I wouldn't say we're at the end of the journey, but we can start to see that finish line. You will see that that decrease has been and will be significant in 2021 over 2020. We should get to a number by the end of the year that is small enough that you won't see as much of that transition continuing to occur in 2022. We'll get to a spot where it's going to be driven more on a case-by-case basis if we have large, important historic customers that prefer to purchase that way. The conversations that we have with them about it will end up determining whether the number stays where it's at at the end of the year or goes a step lower.

Then I would say in terms of overall term contracts, we have picked back up a little bit longer in contract duration, and that's partly driven by the needs and wants of our customers, and partly driven by a little bit more flexibility we have given to our sales team to entertain multiyear contracts where it makes sense in a particular opportunity. I suspect that we will continue to have that same philosophy going into next year.

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Gray Powell

Got it. Okay. It sounds like—I thought in the past that you were trending towards one-year term license deals and it sounds like there was a tick back up in Q3. Is that basically what you just said?

Steven Worth

That's correct, yes.

Gray Powell

Okay, perfect. Thank you very much.

Operator

We now have a question from Anja Soderstrom with Sidoti. Please go ahead.

Anja Soderstrom

Hi. Thank you for taking my question and congratulations on the good numbers.

First off, I'm just curious. You were talking about the revenue mix impacting the growth margin and you noted the favorable product mix within hardware. Can you just elaborate on that, how that product mix looks like and the margin profile for that?

Steven Worth

Sure, so within the overall mix we had more of the overall revenue coming from software and services. That was a driver to overall higher margins by a small but meaningful amount. Then within the hardware products, we also had a mix shift where this quarter we had some higher sales with some higher margin harbor SKUs. Part of that was driven by the transportation supply chain issues mentioned where some products at the end of the quarter did not make it through the port process, and those products just happened to be SKUs with lower margin.

We are happy to report that the containers did make it off the boat, and were processed and are with the customers now. But that was something that we had at the end of the quarter.

Anja Soderstrom

Perfect, thank you. Then in terms of your go-to-market strategy, I know you're looking at your strategic overview now but has anything changed there (inaudible) go-to-market?

Steven Worth

We have made a number of changes starting last summer when our new chief revenue officer took over. Those are largely behind the scenes, non-public, I would say. But that continues to evolve and we are deep right now in the process of planning our 2022 go-to-market strategy, sales competition, budgeting, all of those things are going on right now. I think we'll have more changes to see in future.

Anja Soderstrom

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Okay, and then just last one, your increased midpoint of your guidance range. It looks like if you achieve that for the full year you'll have a pretty strong fourth quarter. What gives you confidence in that and what do you see in the pipeline? What kind of visibility do you have?

Steven Worth

We're confident in where we put our guidance and we will have a solid quarter. You can infer from those guidance numbers that the Adjusted EBITDA for Q4 will be a little bit different than Q3 due to seasonality and the normal factors. But yes, we were very heartened to be able to report to you that our Adjusted EBITDA was not going to be as negative as projected earlier.

Anja Soderstrom

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

Steven Worth

Thank you.

Operator

Our next question comes from Rudy Kessinger from D.A. Davidson. Rudy, your line is now open.

Rudy Kessinger

Hi guys. Thanks for taking my question and congrats on a good quarter.

I'm curious. As I look at the guide and I back into what that implies for Q4, it looks like recurring revenue is only expected to increase by about $0.25 million sequentially in Q4 over Q3. What are the factors that went into that? Is term expected to decline sequentially or just what's driving that?

Steven Worth

I think you may have it understated a bit. When we're looking at our term license revenue, a lot of that is driven off the prior year quarter, not the previous sequential quarter due to the contract duration dynamics. That's a starting point to see what's up for renewals and then what comes from the add-ons and growth from the existing customers and then finally any of the new business. That's the thought process that we go through.

Rudy Kessinger

Got it, helpful. Then you mentioned a couple new Virtual Room customers. I think last quarter you had signed your first Virtual Room customer, said a couple were in pilot, so it's good to see you might have converted some of those. You got some new customers. But you also said last quarter you thought you were going to probably get about four times the pricing on a Virtual Room customer versus just a standard e-signature customer. Did you see that hold with the couple customers that you signed this quarter with Virtual Room?

Steven Worth

Yes, I think that is generally correct. I don't have all of the exact pricing on those particular deals in my hand, but yes. We're looking at a premium for that product, which is good. We do have a few of those

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customers came off of trials since we spoke with you last and converted. That's the examples we gave on the call here today.

Rudy Kessinger

Then just lastly on hardware. Are you able to quantify what the headwind is in the quarter, or was in the quarter and do you expect most of that headwind to be made up in Q4? Or do you think these supply chain issues could potentially linger and dampen things still in Q4?

Steven Worth

I'll let Jan Kees take that.

Jan Kees van Gaalen

Okay, I think there's a little bit of headwind for Q4 but nothing really. There's a little bit of that variability in from quarter to quarter.

Steven Worth

Yes, $1 million to $2 million I would say is what got stuck on the boat and arrived, so that should help us because they gave confirmation that it's been delivered.

Rudy Kessinger

Got it. That's helpful. That's it for me. I'll jump back in the queue.

Operator

We currently have no further questions, so I'll now hand it back over to the Management team for any closing remarks.

Steven Worth

Nothing further here but just to say thank you to all of our OneSpan customers and employees around the world, and of course, our investors that we work for every day. If there's anything else, please follow up with Joe Maxa and we can arrange a call, or he can answer your questions directly and we look forward to the next time we're together. Thank you.

Operator

This concludes today's call. Thank you for joining and I hope you have a lovely rest of your day. You may now disconnect your lines.

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