

Q2 Holdings, Inc. NYSE:QTWO

FQ3 2024 Earnings Call Transcripts

Wednesday, November 6, 2024 10:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2024-			-FQ4 2024-	-FY 2024-	-FY 2025-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.36	0.44	▲22.22	0.48	1.62	NA
Revenue (mm)	173.43	175.02	▲0.92	179.62	692.52	NA

Currency: USD

Consensus as of Nov-07-2024 6:35 AM GMT

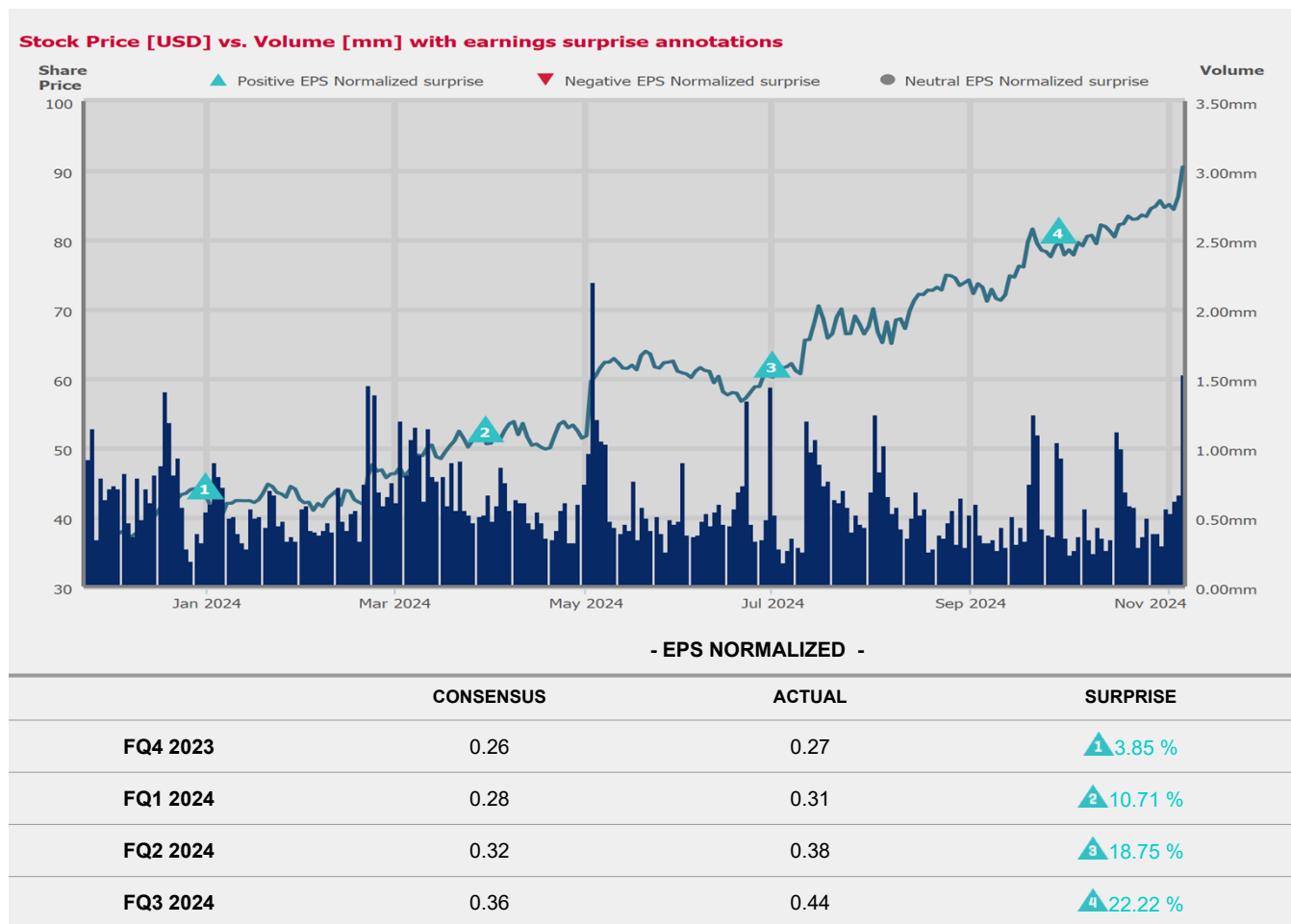


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Call Participants

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Presentation

Operator

Good afternoon, everyone. My name is Lisa, and I will be your conference operator today. At this time, I would like to welcome everyone to the Q2 Holdings Third Quarter 2024 Financial Results Conference Call. [Operator Instructions]

I would now like to turn the call over to Mr. Josh Yankovich, Investor Relations. Sir, please begin.

Josh Yankovich *Investor Contact*

Thank you, operator. Good afternoon, everyone, and thank you for joining us for our third quarter 2024 conference call. With me on the call today are Matt Flake, our CEO; Jonathan Price, our Prospective CFO; and Kirk Coleman, our President, who will join us for the Q&A portion of the call.

This call contains forward-looking statements that are subject to significant risks and uncertainties, including, among other things, with respect to our expectations for the future operating and financial performance of Q2 Holdings and for the financial services industry. Actual results may differ materially from those contemplated by these forward-looking statements, and we can give no assurance that such expectations or any of our forward-looking statements will prove to be correct. Important factors that could cause actual results to differ materially from those reflected in the forward-looking statements are included in our periodic reports filed with the SEC, copies of which may be found on the Investor Relations section of our website including our quarterly report on Form 10-Q for the third quarter of 2024 and subsequent filings and the press release distributed this afternoon regarding the financial results we will discuss today. Forward-looking statements that we make on this call are based on assumptions only as of the date discussed. Investors should not assume that these statements will remain operative at a later time, and we undertake no obligation to update any such forward-looking statements discussed in this call.

Also, unless otherwise stated, all financial measures discussed on this call will be on a non-GAAP basis. A discussion of why we use non-GAAP financial measures and a reconciliation of the non-GAAP measures to the most comparable GAAP measures is included in our press release, which may be found on the Investor Relations section of our website and in our Form 8-K filed today with the SEC. We also published additional materials related to today's results on our Investor Relations website.

Let me now turn the call over to Matt.

Matthew P. Flake *CEO & Chairman of the Board*

Thanks, Josh. I'll start today's call by sharing our third quarter results and highlights from across the business. I'll then hand it over to Jonathan to discuss our financial results and guidance in more detail. In the third quarter, we generated strong financial results coming in above the high end of our guidance. We generated non-GAAP revenue of \$175 million, up 13% year-over-year.

We saw continued strength in subscription revenue, which was up 18% year-over-year. And we had another quarter of solid improvement on profitability with adjusted EBITDA of \$32.6 million or 19% of revenue and free cash flow of \$35.1 million. In the third quarter, we met our previously disclosed goal of achieving Rule of 30 on a total revenue basis by late 2024.

In addition to our strong financial performance, we saw broad-based booking success in the quarter, highlighted by a total of 6 enterprise and Tier 1 deals, 3 of which were enterprise wins with top 50 U.S. banks, as well as significant bookings contribution from the Tier 2 space. Our sales activity spanned across the portfolio with a variety of digital banking, relationship pricing and Helix wins, which we executed through a mix of net new and expansion deals.

On the digital banking side, our bookings were driven by a combination of our ability to differentiate our offerings by the quality of the retail and commercial experiences and the breadth, scalability and versatility of our platform, allowing us to serve financial institutions at various stages of their digital transformation, whether they're evaluating stand-alone solutions or a comprehensive single platform offering. We had several examples of both scenarios in the quarter. In terms of notable stand-alone win, an enterprise top 50 bank selected our digital banking platform to service their retail customer base. This customer will leverage key components of our recently announced Q2 Engage portfolio, enabling the bank to drive personalization and differentiation in their consumer banking offerings.

We believe deals like this underscore the strength of our products and our ability to win in digital banking with some of the largest financial institutions in the industry. And in one of our single platform wins, we landed a substantial deal with a Tier 2 bank that adopted our entire platform for their retail, small business and commercial segments. This particular win was our largest digital banking deal in the quarter from an ARR perspective, showcasing our continued ability to drive meaningful bookings impact with financial institutions of all sizes.

We've also mentioned how Q2 has frequently benefited when financial institutions complete M&A transactions. And this dynamic continue to play out in the third quarter, marking the second quarter in a row where we gained a Tier 1 customer through M&A activity. In this case, a prospective customer acquired a smaller bank, which happened to be an existing Q2 customer and selected Q2 as the digital banking provider for the newly combined entity. This acquisition resulted in the addition of a Tier 1 bank that will use Q2's full digital banking platform to serve their retail small business and commercial customers. We believe this win speaks to the strength and attractiveness of our platform as the digital banking technology of the smaller institution proved to be the preferred solution. We also believe this customer will remain acquisitive moving forward. So we're excited about our potential to grow the relationship over time.

We continue to see meaningful net new activity on the relationship pricing side as well where financial institutions of all sizes are looking to drive profitability of their commercial business. In fact, our largest ARR deal in the quarter came from an enterprise win with a \$90 billion bank that purchased our relationship pricing products, ultimately replacing a competing provider in their internal tools with Q2. The ability to optimize pricing strategies for both deposit attraction and relationship profitability with our solutions proved to be a key differentiator in this win.

We're pleased with the continued momentum we're seeing in the enterprise space on this side of the business. As the deal I just mentioned is also one of our top 5 largest relationship pricing deals of all time based on contractual ARR at the time of booking. Wins like this underpin not only the strength and sophistication of our relationship pricing platform but also the viability of our technology for even the most complex enterprise financial institutions as they increasingly view their relationship profitability as a strategic priority.

We're also well positioned to continue capitalizing on expansion opportunities with our existing customers. As we've mentioned throughout the year, we believe our customer base gives us significant opportunity for expansion over time. And our performance in the third quarter illustrated this, with balanced expansion activity across our customer base, including notable expansions with Tier 1 and enterprise customers that added products like our risk and fraud management solutions. We had our strongest quarter this year for cross-sale bookings.

Q2 Innovation Studio is playing a larger role in driving expansion activity as well. Some of our top cross-sold products in the quarter were generated from our partner ecosystem, showcasing its influence not only in generating bookings but also in driving deeper engagement with our customers. This momentum is also reflected in our Innovation Studio bookings overall. While the base is still small, bookings from the first 3 quarters of 2024 have already more than doubled the total bookings achieved in all of 2023. Additionally, the majority of our net new wins in Digital Banking once again cited Innovation Studio is a key reason for choosing Q2, underscoring its importance in both customer acquisition and expansion. We believe these trends demonstrate the growing value that our customers see in our breadth of products, while validating our land and expand strategy. Moving forward, our opportunity for expansion, coupled with the value of these bookings, reinforces our belief in the longer-term revenue potential within our existing customer base.

We also saw meaningful activity with Helix in the quarter, highlighted by a major renewal and expansion with one of our top 5 largest Helix customers and our first Fabric win. This significant win was with Envisant, a credit union services organization that will utilize Fabric to optimize and grow their prepaid card offering across the credit union customer base. As a front-to-back retail tech stack supported by our modern Helix core, digital banking front end and expansive partner ecosystem, Fabric allows our customers to pursue their unique growth objectives by helping them easily launch a variety of fee-generating and deposit gathering services, both of which are top of mind across the industry. And while the Envisant partnership is just one example of what customers can do with Fabric, we believe opportunities like this highlight its versatility in helping a broad range of customers facilitate their own use cases to diversify their strategies and differentiate themselves.

Overall, our third quarter sales performance demonstrates our sustained ability to capture the market opportunity in front of us. Demand remains strong and we executed against our profitable growth strategy while obtaining our Rule of 30 target in the quarter. Before handing it off to Jonathan to discuss our financials, I'd like to take a moment to thank David for his time at Q2 as Chief Financial Officer. We're grateful for the many contributions he's made to the company over the past 4 years, and I appreciate his dedication to ensuring a smooth transition.

And now Jonathan will step into the role of Chief Financial Officer. Jonathan has extensive experience in corporate finance and investment banking, deep knowledge of the fintech space, and has spent nearly 7 years at Q2 working closely with David and his teams while leading key areas of the company, including corporate strategy and emerging businesses. We're excited to welcome him into the CFO position.

With that, I'll hand it over to Jonathan to discuss our financial results in more detail.

Jonathan Price

Thanks, Matt. I would first like to thank David and echo Matt's appreciation for his many contributions to Q2 over the past 4 years. He's been instrumental in ensuring a smooth transition, and we're grateful for the long-term value he's brought to Q2. I'm excited to step into this role as the CFO and build on the great work David and his teams have done as we continue to execute against our profitable growth strategy. With that, let's turn to our financial results for the quarter.

We're pleased with our performance across several key metrics, including the achievements in the quarter of our previously discussed Rule of 30 targets. This milestone, along with both revenue and adjusted EBITDA surpassing the high end of our guidance, underscores the strength of our business model and solid execution. We've seen robust growth in our subscription-based bookings, which is reflected in our ARR growth.

Notably, our subscription revenue in the third quarter accounted for over 80% of our total revenue, highlighting the success of our ongoing strategic shift towards higher-margin recurring revenue streams. Furthermore, we've made substantial progress in our free cash flow generation, which has seen a meaningful year-over-year increase. We believe this improvement in cash flow, coupled with our strong revenue growth and expanding margins, positions us well to continue executing against our 3-year target financial framework.

I will now discuss our financial results in more detail and conclude with our updated guidance for the fourth quarter and full year 2024. Revenue for the third quarter was \$175 million, an increase of 13% year-over-year and up 1% sequentially. Our total revenue growth was driven primarily from subscription-based revenues, which grew 18% year-over-year and 3% sequentially. As I mentioned earlier, subscription revenue comprised over 80% of our total revenue, highlighting the ongoing shift in our revenue mix towards our highest margin revenue stream. The year-over-year and sequential growth was primarily driven by a combination of new customer go-lives and expansion with existing customers.

As a recurring theme we've discussed throughout 2024, revenue from expansion sales, including cross-sold solutions and improved contractual terms, typically materializes more rapidly than that from net new wins. This dynamic has been a key factor in our subscription revenue outperformance throughout 2024. Our services and other revenues declined by 11% year-over-year.

As we have mentioned previously, this trend is primarily driven by the reduction in our professional service revenues, which are more discretionary in nature. Given the persistent pattern we've seen throughout the past several quarters, including an average year-over-year decline of roughly 12% in 2024, and our strategic focus on higher-margin growth opportunities, we anticipate these headwinds in our Services segment to persist into the foreseeable future. Total annualized recurring revenue, or total ARR, grew to \$796 million, up 15% year-over-year from \$694 million at the end of the third quarter of 2023. Our subscription ARR grew to \$655 million, up 20% year-over-year from \$547 million in the prior year period.

Our year-over-year subscription ARR growth was driven primarily from net new customer wins as well as expansion bookings with existing customers. Looking ahead at the fourth quarter, we expect that our subscription ARR growth rate will moderate to somewhere between 12% to 14% year-over-year as we compare against the fourth quarter of 2023, which was our strongest bookings quarter in company history.

Our total ARR growth continued to be negatively impacted by the decline in professional services-based revenue we previously discussed. Our ending backlog of over \$2 billion increased by \$78 million sequentially or 4% and a record \$467 million year-over-year, representing 30% growth. The year-over-year and sequential increases were primarily driven by expansion-based bookings, including renewals and additional solutions added by existing customers as well as net new customer wins.

In addition, the sequential growth benefited from our best cross-sell quarter of the year as well as continued strength in renewals. As we have mentioned previously, the sequential change in backlog may fluctuate quarter-to-quarter based on the number of renewal opportunities available within that quarter. Gross margins were 56% for the third quarter, up from 53.9% in the prior year period and from 55.7% in the previous quarter.

The year-over-year increase in gross margin was driven by an increasing mix of higher-margin subscription-based revenues and increased efficiencies within our delivery and support functions. Total operating expenses for the third quarter were \$73 million or 41.5% of revenue compared to \$71 million or 45.8% of revenue in the third quarter of 2023 and \$74 million or 42.7% of revenue in the previous quarter.

The year-over-year and sequential decline in operating expenses as a percent of revenue came primarily from improved scaling of sales and marketing expenses relative to revenue. As a reminder, the sequential decline in sales and marketing expense was primarily a result of our annual client conference, Connect, which impacted sales and marketing expenses in the prior quarter by approximately \$1.5 million.

We also saw a year-over-year reduction in expenses as a percent of revenue within both research and development and G&A, demonstrating our continued focus on operational efficiency and our ability to scale while maintaining our commitment to delivering best-in-class innovation to our customers. Total adjusted EBITDA was \$32.6 million, up 66% from \$19.7 million in the prior year period and up 9% from \$29.9 million in the previous quarter.

We ended the quarter with cash, cash equivalents and investments of \$408 million from \$372 million at the end of the previous quarter. We generated cash flow from operations in the third quarter of \$43 million, driven by improved profitability and continued effective working capital management. For the quarter, we also generated free cash flow of \$35 million resulting in free cash flow year-to-date of \$70 million, which is up meaningfully year-over-year from the \$10 million generated through the first 9 months of 2023.

We now expect our free cash flow as a percentage of adjusted EBITDA for the full year to be over 70% for the full year of 2024, significantly exceeding our initial expectations heading into the year. Let me wrap up by sharing our fourth quarter and full year 2024 guidance. We forecast fourth quarter non-GAAP revenue in the range of \$178.1 million to \$181.1 million, resulting in full year non-GAAP revenue in the range of \$691.5 million to \$694.5 million, representing year-over-year growth of 11% for the full year.

As we approach the end of 2024, we expect our full year subscription revenue growth to reach approximately 16% year-over-year, significantly outpacing our initial projection of 13% for 2024 that we made a year ago. This substantial full year outperformance reflects the consistent strength of our expansion-based bookings and successful new customer go-lives throughout 2024.

This acceleration in full year subscription revenue growth reinforces our confidence in our 3-year annual average subscription revenue growth target of 14%. And looking ahead to 2025, we continue to anticipate full year subscription revenue growth to be approximately 15%. We forecast fourth quarter adjusted EBITDA of \$34.3 million to \$36.3 million and full year 2024 adjusted EBITDA of \$122 million to \$124 million, representing approximately 18% of non-GAAP revenue for the year.

In conclusion, our strong third quarter results and updated full year guidance showcased the durability of our business model and our solid execution, highlighted by achieving the total revenue Rule of 30 target we shared at the beginning of 2023. Our performance marked by subscription revenue growth exceeding expectations, enhanced operational efficiency and accelerating cash flow conversion, demonstrates significant progress towards our 3-year financial targets. We remain dedicated to delivering growth, profitability expansion and improved capital efficiency and believe that our results to date collectively illustrate our progress and potential as we continue to evolve our business and drive shareholder value.

With that, I'll turn the call back over to Matt for his closing remarks.

Matthew P. Flake
CEO & Chairman of the Board

Thanks, Jonathan. In closing, we rounded out a great third quarter with strong financial performance and solid sales execution across the business. On the sales front, we saw a broad mix of bookings success with Tier 1 and Tier 2 customers, highlighted by multiple enterprise wins with top 50 U.S. banks.

We continue to land a combination of net new and expansion deals within digital banking, relationship pricing and Helix, including our first Fabric win and 1 of our top 5 largest relationship pricing deals of all time. We believe our sales performance in the quarter reinforces our competitive differentiation and our ability to capitalize on a range of opportunities across our lines of business.

On the financial side, our results exceeded the high end of our guidance, and we continued to deliver improved profitability in accordance with our long-term financial targets, enabling us to achieve our Rule of 30 target in the third quarter. As we begin to close out 2024 and look ahead to 2025, we're confident that we'll continue to drive shareholder value with our strong product portfolio, solid

sales execution in terms of both net new and expansion opportunities and our proven ability to execute against our profitable growth strategy.

Thank you. And with that, I'll hand it over to the operator for questions.

Question and Answer

Operator

[Operator Instructions] We'll go first to Dan Perlin, RBC Capital Markets.

Daniel Rock Perlin

RBC Capital Markets, Research Division

Great quarter. I wanted to just dive in a little bit, if we could. Your subscription AR and backlog here again, accelerated year-over-year when we look at kind of on a sequential basis. So maybe, Matt, if you could just -- can you touch on this a little bit? But maybe like dive into maybe how some of these deals are evolving a little bit. You're clearly winning bigger banks and financial institutions. But it also feels like the types of deals that you're signing are a little bit more holistic within your product portfolio. So if you would mind us maybe revisiting that with a little more detail, that would be great.

Matthew P. Flake

CEO & Chairman of the Board

Yes, Dan, we continue to be pleased with the demand environment out there. Deposits are critical for everybody, and our system drives retention, acquisition and growth of those deposits. And then our relationship pricing product, it's not a rate-sensitive product, but it's a much more complex environment to price relationships. And so you're seeing the \$90 billion bank we signed with it. I would say that upmarket on the enterprise and Tier 1 deals, there's -- they get one product in and they continue to expand with more products down the road.

So if you just think about our business, we have 100 customers that are greater than 5 billion Tier 1 customers, and more than 50% of them only have one major product SKU. So we have a lot of opportunity to expand within that 100, then we have 230 customers that are greater than 5 billion that are not digital banking. And they're obviously -- that number is even greater than 50% for them where we can expand. So there's a lot of opportunity there as well.

As far as we talked about the mix being different in '24 than it was in '23. As I sit here today at the end of the third quarter, we've signed almost twice as many deals in '20 at the same time as last year at this point. So demand environment remains strong, and we talked about the Tier 2 that bought the whole suite of products. We're seeing that happen in the Tier 2 and Tier 3 space where they do buy a more robust set of products. But really happy with the demand environment and we think sets up for a nice fourth quarter as well. So just pleased with the execution of the sales team and the ability to close these deals.

Daniel Rock Perlin

RBC Capital Markets, Research Division

Yes. I mean it sounds like you just continue to gain momentum. The follow-up to that real quick, if I could. As you -- as these wins are becoming larger, maybe more holistic deals. And just given the sheer size of the backlog now, are there any concerns that like the implementation teams need to be kind of beefed up a little bit? I know you always give the timing of how these things are going to roll in. But I mean these are trying to need to be pretty big numbers. And I just -- I often wonder if that doesn't catch companies off guard. So anything there would be great.

Matthew P. Flake

CEO & Chairman of the Board

Yes, Dan. It's a fair question. And in the history of 20 years of the business, we have been caught off guard, but our implementation sales and finance organization work very closely on demand and capacity planning and I don't anticipate any problems like that in '25.

Operator

We'll go next to Cris Kennedy, William Blair.

Cristopher David Kennedy

William Blair & Company L.L.C., Research Division

16% subscription revenue growth this year, at least 15% next year, and then compares to your long-term targets. Any way to think about kind of the trajectory there?

Jonathan Price

Yes, Cris, it's Jonathan. I'll take that. So yes, as we've said on the call, we feel really good about the performance. In particular, that 16% relative to the 13% we sort of saw and provided as guidance coming into the year. We've really seen overperformance in particular, when it comes to cross-sell, when it comes to the renewals that we've seen, both in terms of the economics we're getting on those renewals, but also how we pulled in renewals out of scope from the year, which has helped the performance.

And so that's really led to the overachievement that you're seeing in that first year, the 16%. And then as we think about the 15% sitting here today, obviously, we still have a fourth quarter that we're looking at, that hopefully will be strong on the cross side, too, so have an impact there. And then we'll give more color around what the shape of it from a '26 perspective looks like on the February call. But all in all, sitting here today, feel really good about the dynamic and just got to continue executing at a high level, but very, very pleased with the results to date.

Cristopher David Kennedy

William Blair & Company L.L.C., Research Division

Great. And then, Jonathan, just a quick one for you. Can you just talk about kind of -- you've been at the company for a long time, but have a new seat kind of what your key priorities are going forward?

Jonathan Price

Yes, definitely. So I would say from a philosophical perspective, very much continuing down this path of profitable growth, and we're still early days when it comes to a lot of the execution. And I know we've seen a lot of progress in terms of the profitability of the business, but we still feel like we have a long way to go. And we want to do that while we're maintaining an elongated runway of the type of growth profile that you're seeing from us.

So really, it's around continuing down this path of profitable growth. We're going to invest in areas that help maintain and drive our leadership position in the market. And we've talked a lot about it, but you see in the call today, the cash flow position of this company is strengthening. That leads to a stronger balance sheet, and that's really going to be a priority for us as we continue to strengthen the balance sheet and put the company in a strong position to, over time, be in a position to strategically act where there's opportunity.

And so right now, we're just heads down and executing. But very much pleased with the year so far and heading into '25. I think we're going to have a lot of opportunity to continue a lot of the great work that David and his team have done and then continue exploring new opportunities to move the ball forward.

Operator

And Terry Tillman from Truist Securities is up next.

Robert William Dee

Truist Securities, Inc., Research Division

This is Bobby Dee on for Terry. So you all continue to report great success coming in on the winning side of M&A. I'm curious, what are your expectations for the bank M&A environment heading into next year? And how big of a tailwind is M&A for growth in a normal or elevated M&A year? And then I have one follow-up.

Matthew P. Flake

CEO & Chairman of the Board

Yes, it's hard to predict what's going to happen. I think generally, the view is you're going to see M&A pick up in '25. There's a backlog of deals that are sitting out there. I don't want to get too much into forecasting it. But I do anticipate picking up after Trump takes office, and you'll potentially see more and more deals happen, which is, as you know, historically for us, we're up to 90% win rate where we retain the customer and pick up the acquisition.

We had a great story that I mentioned in the prepared remarks around smaller financial institutions got acquired by a bigger one, and they adopted our platform. So not sure what that number could look at whether that's going to be a one-off or more common, but the platform is highly differentiated, and I think you'll see it pick up. As far as the revenue lift, I don't know if you can quantify that.

Jonathan Price

Yes. I would just say we're examining the deals that are out there that are in backlog. The way I think of it, though, is you have a real time lag between when the deal is announced to when it closes, to when the migration would occur, and then you have the opportunity

for onetime services dollars. And then depending on the negotiation and the nature of the contract in terms of their user counts, there's opportunity for upside on the subscription side of the equation as well. But there's a lot of factors, and every deal is sort of its own snowflake. So hard to predict the deals that haven't happened yet.

Robert William Dee

Truist Securities, Inc., Research Division

Great. And then secondly, we've seen various reports on private company vendor challenges in the space. Have those been a driver of pipeline or new booking success in 3Q? And how do you see the competitive landscape evolving going forward?

Matthew P. Flake

CEO & Chairman of the Board

Yes. I mean we -- there's plenty of examples of people that struggle to get the product live. They try to do different new entrants and features and functions, especially on the commercial banking side, which are the crown jewels of our customers, the banks, and moving those customers is very risky.

Our ability to point out 100 customers, more than \$5 billion, we've converted on every core from every system multiple times. Customers are happy. They're referenceable for us. So it's a tough business. The integrations are tough. The customer experiences stuff, the conversion stuff. It just takes time to get there.

And so we see some cases of some private companies struggling and then also some of the larger historical players have a lot of different businesses that they're running right now, and they don't wake up every day thinking about how they're going to build an amazing digital experience that can drive deposits and stickiness and a real experience that make somebody feel the bank's brand as they're interacting with it, which is what's a big part of digital banking is you've got to drive an experience that the bank gets credit for. We do that really well.

Operator

And next, we'll hear from Alex Sklar of Raymond James.

Alexander James Sklar

Raymond James & Associates, Inc., Research Division

Jonathan or Matt, just in terms of the subscription bookings commentary. I appreciate the color on flagging the tougher compare. Can you just elaborate a bit more on what you're seeing in the macro or late-stage pipeline going to kind of what's normally a seasonally stronger quarter? What are some of the puts and takes why there might be -- might not be some real seasonal strength in Q4?

Matthew P. Flake

CEO & Chairman of the Board

Yes. I anticipate Q4 being a strong quarter. It's a tough compare when you signed the 2 biggest deals in the history of the company in Q4 of '23, obviously, and that was a historic quarter, but I anticipate having a strong quarter. We've got to go execute. We've got to win those deals. But I would anticipate it being the biggest quarter of the year for us and feel really good about our ability to execute on those deals.

Jonathan Price

And I would just add, when you think about -- we gave that color because I think it's important for investors and the audience at large to understand that the Q3 number was obviously very strong when you look at subs ARR. So sequentially, we wanted to make sure that people understood why the pressure in Q4. And as Matt alluded to, it's more -- it's purely a tougher comp, Q4 '23 versus Q4 '24.

I feel really good about the fourth quarter trajectory. As Matt said, we've got to go execute. But that 12% to 14% give some directional guidance around how to think about it relative to Q4 of '23 and then also puts into framing how to think about the subs growth in '25 that we provided.

Alexander James Sklar

Raymond James & Associates, Inc., Research Division

Okay. Perfect. Jonathan, maybe just a follow-up for you. The incremental margins have been fantastic this year. Obviously, you hit Rule of 40 -- hit Rule of 30 earlier than kind of planned. You've talked about the free cash flow conversion being up nicely. Just for

your seat today, like where are your big focus areas going forward on the efficiency side of the business to kind of make sure that you are in a position from a balance sheet strength going into the next couple of years?

Jonathan Price

Yes. Great question. So as I mentioned, I think there's still a lot of work to do on some of the basic blocking and tackling, and then I think we have lots of opportunity to continue pushing them all forward on new opportunities. So one of the things I'll call out, as I mentioned in the prepared remarks, we crossed the threshold of 80% subscription mix.

And while we've made tremendous progress in that from just looking back a year or 2 ago, we still think there's more to go there. And so that will certainly be one of the contributors, maybe not to the degree you've seen over the last 2 years in terms of the expansion, but we still see that mix shift continuing in through '25 towards subscription, which will have a positive impact on margin.

The other thing that we're seeing, as I mentioned on some of these renewals, is we're doing a really good job when it comes to pricing and packaging and ensuring that we're getting the value of our platform in these renewals. And so really, like new strategies, new -- trying new opportunities when it comes to how we think about pricing and demonstrating the value of the platform at the point of renewal.

We talked about efficiency when it comes to delivery, support, our upgrade process. And then I think David and team have done a great job down the path of some basic sort of OpEx opportunities when you look at how strong our bad debt numbers are optimizing our facilities footprint, procurement maturation. And we're still early days in some of those lever. So a lot more to go, and this is a company-wide mindset that we've instilled and we still think there's a lot more to do on that front. So those are some of the initiatives now that I think you were asking about.

Operator

The next question comes from Adam Hotchkiss, Goldman Sachs.

Adam R. Hotchkiss

Goldman Sachs Group, Inc., Research Division

Just curious on the Innovation Studio side, I think you said doubled year-over-year. What, in your view, is driving that, right? Is it just more partners being added? Is it because it's being referenced in almost every new deal, it's more new logos that are bringing on partner products? Are you educating folks more? Just curious what's driving that momentum.

Jonathan Price

Yes, it's a great question, and I'll take this just given the recency of the transition. The net new side has an impact, and we're certainly trying to educate our prospects and soon-to-be customers earlier so that they can think about adoption sooner and right into the go-live. But the traction that you're seeing that was mentioned on the call is primarily driven from existing customers and then doing a better job of promoting these solutions to their customers where that's the model in the marketplace, for example, and candidly, just taking up more of these products as the familiarity with the model and the value proposition is becoming more and more clear.

So because you're coming off a small base, I don't want to over-rotate to the magnitude that we talked about. But it is still very early days in the adoption cycle. And so we think there's still a lot of room for the existing customer base to take on more products and demonstrate the value of those products to their customers, which ultimately is what will drive the value proposition for all the parties involved here. So mostly driven by existing customers is the short version -- a short answer to your question.

Adam R. Hotchkiss

Goldman Sachs Group, Inc., Research Division

Okay. That's super helpful. And then just on the services side, fully recognize the headwinds there, but is there anything that's either in or out of your control that you'd look for that business to be turning around? Is it just earnings getting better? Are you hearing certain things from bank decision makers that would suggest they're changing their mind? I'm just curious what might cause that to turn around and maybe what's causing the headwind despite some of the success we've seen in the banks recently.

Jonathan Price

I'll let Kirk or Matt comment on the bank environment, what could drive maybe a resurgence in spend over time, even though that's not what we're seeing today, to be clear. But I do want to make one thing clear, as we think about this in '25 and beyond, as we

are optimizing on the profitability side that we've talked about, one of the things that we're really focusing on is ensuring that the economics of these engagements makes sense to us going forward.

And we have a real opportunity to think about if that business comes back and there's an opportunity to pick it up. What's the right type of business for us, where do we want to take it on and what are the right pricing levels to be able to do so? So I do want to caution that even if some of the macro indicators may signal an uptick in spend over the next couple of years, I think our approach is going to be more disciplined in terms of ensuring the pricing and the implied margin profile of this revenue stream looks a little different than what you've seen from us historically.

Kirk L. Coleman
President

Yes, I would just add -- this is Kirk. I'll just add that I think on balance, our customers are a little bit more optimistic than they were a year ago. And so that's good as they're going into their budget season and finalizing all those things. But that doesn't mean, to Jonathan's point, that there's going to be some huge wave of demand for the services.

We're going to certainly manage that from our side as well in terms of what's the right fit for us and things that we ought to be doing versus some other provider might do instead. So we'll manage that carefully. We think that there's still a good mix as we see some of these newer customers come on. There's -- it's -- we couldn't anticipate that it might still be choppy for a little while, while they're getting into the next year.

Operator

The next question is from Michael Infante, Morgan Stanley.

James Foster

This is James Foster on for Michael. Wanted to ask really quickly on one of the CFPB rules that came out, 1033. It would be great to get your perspective on that ruling and the feedback you've heard from our customers. And I guess we're wondering if this could be a driver of incremental attach of some of your Centrix risk and fraud capabilities?

Kirk L. Coleman
President

Yes, still a little early in I guess the -- the same thing I would say about this is that we have extensive experience in this kind of all the integrations we do to numerous cores, all the legacy technology integrations that we have. The way that we standardize and map accounts, historical transactions, kind of all the real time and scheduled transaction, kind of all the things that are relevant to open banking and kind of what our customer profile looks like.

How this kind of gets implemented and integrated across the industry, I think is -- even though the rule is written now, we still have to see how this is going to play out from a technical perspective and what's actually required by the different institutions. But we feel like we're in a really good spot to be able to help our customers and their customers.

With that, certainly, the broad space is going to be a key ingredient of this because you don't want people to be able to just be moving their accounts around without accountability for making sure that that's being done in a safe and secure way. We do a lot of that for our customers today. There's no reason we wouldn't see doing that in the future. But still a lot to be learned about how it's going to get done and out there in the field.

James Foster

Appreciate that. And another question just kind of around evolving market conditions and potential demand for product. Wondering if you can provide a bit more detail on your premium treasury pricing solution and its market reception, particularly given the current interest rate environment.

Kirk L. Coleman
President

I would say really good take up for premium treasury pricing, including with some of our largest PrecisionLender customers, which is a really positive development. But pricing commercial relationships is really difficult and really meaningful. And you can't just -- I think everyone is kind of fully on board. You can't just price the loan side correctly. You got to price the whole relationship.

So that -- we continue to see strong demand for that. We think the conditions will remain strong for that because the -- although funding costs are starting to come down a little bit, a lot of people are repricing their deposits. As they're repricing and as the interest rates come down, getting that exactly right, making sure you're balancing that with whatever fee income is, is super important. So there's some nice tailwinds there.

Operator

We'll take the next question from Dominick Gabriele, Compass Point.

Dominick Joseph Gabriele

Compass Point Research & Trading, LLC, Research Division

Great. I just was curious, I wanted to dive just maybe a tiny bit deeper on the discretionary spend of banks and the flow-through into services. Is there any chance that you'd be willing to provide a little more detail on the breakdown or how much of the roughly 11% to 12% year-over-year decline is within your control of deemphasizing those products versus the demand piece as a follow-up?

Jonathan Price

Let me give a little bit of color. We don't disclose the breakdown, but what I'll tell you directionally, when you think about the services components, the consulting engagements, consulting like engagements, what we call Premier or integrated services is certainly the largest component of the bucket, but still under 50%.

Then you have our implementations, which more tracks the bookings performance, so more control or more tied specifically to how they spend on digital. And so that will matter more to the trajectory of that in terms of the revenue profile and then we have some other services, onetime engagements, other small dollar services opportunities that are in that total bucket as well as our, what we call services and other, which would include pass-through on the Helix business.

So that's the total bucket. And again, that largest bucket, still sub-50% is where we're feeling this pressure where we can we clearly call it discretionary and we don't really have control over the spend dynamics from a bank perspective.

Dominick Joseph Gabriele

Compass Point Research & Trading, LLC, Research Division

Okay. Perfect. I appreciate that. So it looks like on the marketing side, you're getting quite a few large wins versus the historical set of wins per year, but your marketing expense, you're seeing more efficiency there. Maybe just talk about what your sales force is doing, the tenure of your sales force, why you're seeing these gains that are coming through in the numbers while you're still getting larger and larger wins.

Matthew P. Flake

CEO & Chairman of the Board

I think to some extent, we made a commitment to get into larger customers about IPO time. It takes a long -- 10 years ago. It takes a long time to get there because you've got to win the deal, you got to get them up and running. And as I always say, customers referenced up, not down, meaning a prospect wants to talk to a bank or credit union, it's larger than them to make sure you can handle the scale and the growth. It takes time to do that.

We've been very successful with that. As I mentioned earlier, we have more than 100 Tier 1 customers on digital banking. And so word of mouth spreads, the sales reps, and especially in the Tier 1 and above, are all experienced. They know the story. They know how the products work. They're professionals. They have relationships, and they drive this. It just takes time to get those done. And as I said, the commercial offerings have matured significantly.

Over the last several years, we invested heavily during the pandemic in our road map and our products, whether it's PrecisionLender or our fraud products, our Innovation Studio or the digital banking platform. So it just takes time to build that customer base that you can reference off of, deliver and then the expansion opportunity is a huge opportunity for us as well, as I've already mentioned earlier in the call.

So it's just a lot of work that goes into it, whether it's the sales team, the solutions consulting team, the engineering team, delivery organization. So we've just built this organization with a long-term view of what we're going to do. And so we -- I hate taking away from the Tier 2 and 3 because that's still the bread and butter of this business.

We win those deals. They're great banks and credit unions. They grow. They go make acquisitions. But to get into the space like we've done, especially over the last 2 or 3 years, it's a testament to the quality of the team and the products and the culture we have at this company.

Operator

[Operator Instructions] And next is Joe Vruwink, Baird.

Unknown Analyst

This is [Peter Caris] on for Joe. I think at one point in the year, you had said that 3Q was a bit lighter on the renewal side compared to the rest of the year. obviously, a really strong RPO results here. So is it the case where renewals came in stronger than expected? Or should this be read as just a really strong net new and cross-sell activity this quarter?

Matthew P. Flake

CEO & Chairman of the Board

Q3 is typically a slower quarter because you have the summer and then you got people coming back and they start doing planning for the next year and in September typically. One of the things to think about, it was the largest cross-sell quarter of the year for us, is that we had our client conference about a month later this year. So we did it in June as opposed to May.

The client conference generates a lot of energy and excitement around the product road map we have and the offerings that we present to them. And so that's in -- that was in early June. A lot of those decisions just got pushed into the third quarter. I don't want to take anything away from what the team did. But I think that's why you kind of -- you saw the -- having such a big renewal quarter.

But I would say that I would anticipate Q4 being a solid renewal in the quarter as well. So really happy with the performance by the customer success team, what they've gone out and done this whole year. But I'm excited about also what the fourth quarter looks like.

Unknown Analyst

Great. And then on the upside from maybe the quicker time to revenue projects on the cross-sell side benefiting subscription this year. How should we be thinking about this trend as sustainable, particularly going into the next couple of years? Is there anything unique in this year that is maybe higher in this bucket? Or do you think this is something that continue to drive upside going forward?

Jonathan Price

Yes. We're optimistic that we can continue to see strong performance here. I think what is a little unique so far that we've seen year-to-date is a lot of renewals out of scope for the year that have been pulled into '24. And that's, I think, a testament to the team ,as Matt said, but also to the clients' commitments in wanting to use and expand with the product. So that's been one of the drivers.

And then just to strengthen cross relative to plan, we're going to -- we're confident that, that can continue in the next year. I don't know that we would have projected this level of outperformance. So I don't plan for that as we think about '25. But from a demand perspective, I think it's a good spot that we're in. As Matt mentioned, when you win all these clients, both small and large, it gives us a huge opportunity to go cross-sell into it, and we're seeing that come to fruition and we certainly see that in '24, which has driven a lot of the upside in your subs growth that you've seen.

Operator

And we'll go next to Andrew Schmidt, Citigroup.

Andrew Garth Schmidt

Citigroup Inc., Research Division

Good results this quarter. Maybe we could dig into the gross margin performance. Apologies, I hopped on a little bit late, but it seems like some good success there. And I know you guys have some tech initiatives that are ongoing to improve delivery and things like that. But maybe just talk about just the drivers in the quarter and then over the next couple of years, how we should think about gross margin progression with everything you're working on there?

Jonathan Price

Yes, I would say the quarter sort of manifest itself in the improved sequential and year-over-year gross margin for all the reasons we've been talking about, whether it's the mix, as I mentioned, Andrew. We sort of surpassed 80% subs, which obviously is the

highest gross margin revenue stream we have in the company. And so that's been a contributor -- as you mentioned, the delivery efficiency, support and upgrade processes, things we've put in place over the last year or so sort of coming to fruition with more room to grow there.

Better utilization of global resources and maturation of that team and the role they're playing. And then as we've talked about, as you get sort of into '26 and beyond the opportunity there with things like migration to the cloud and such are areas for ongoing expansion beyond sort of the next 12 to 18 months. So we are pleased with the gross margin improvement we've seen, but I still think we have a long way to go, and I think that's implied within our 3-year framework that we've given as well.

Andrew Garth Schmidt
Citigroup Inc., Research Division

Got it. And then if I could switch gears to the digital lending business. I saw the Symphonix rollout. I think that's an iteration on Cloud Lending. Could you just talk about competitive there? It sounds like you guys have refreshed that product. Can you go at it with a little bit more vigor? Maybe talk about just the opportunity to drive more digital lending wins across the platform.

Jonathan Price

Yes. I think we learned a lot from the rebrand we did of Helix. When you're playing in different geographies, which Symphonix is and Helix, obviously, being a domestic product, and you're serving a different set of clients, meaning primarily nonbanks and credit unions, the importance of building that brand and identity, we sort of saw the value of that with the initiative we had in Helix a couple of years ago. So that was something we learned from and now applied it to you right, sort of the bulk of the Cloud Lending business as it used to be known. And so we think of from a go-to-market perspective, continuing down that path, we're not changing the strategy in terms of now going after sort of U.S. financial institutions.

We're still focused in the areas where we've been focused on with that business, but it allows the team to sort of be able to go to market with a clear value proposition and identity that they can benefit from and that matches sort of what they're trying to message in the market versus the conflation with the rest of Q2, which wasn't helping them.

Operator

And ladies and gentlemen, that does conclude our question-and-answer session. It does also conclude our conference for today. We would like to thank you all for your participation. You may now disconnect.

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