

OneSpan Inc (Q2 2024 Earnings)

August 1, 2024

Corporate Speakers:

- Joe Maxa; OneSpan Inc; Vice President of Investor Relations
- Victor Limongelli; OneSpan Inc; President, Chief Executive Officer
- Jorge Martell; OneSpan Inc; Chief Financial Officer

Participants:

- Gray Powell; BTIG; Analyst
- Rudy Kessinger; D.A. Davidson; Analyst
- Anja Soderstrom; Sidoti; Analyst

PRESENTATION

Operator^ Good day. And thank you for standing by. Welcome to the Q2 2024 OneSpan Earnings Conference Call. (Operator Instructions)

Please be advised that today's conference is being recorded.

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

Joe Maxa^ Thank you, Operator. Good afternoon, everyone. And welcome to the OneSpan second quarter 2024 earnings conference call.

This call is being webcast and can be accessed on the Investor Relations section of OneSpan's website at investors.onespan.com.

This afternoon after market close, OneSpan issued a press release and filed a Form 8-K with the SEC announcing results for our second quarter 2024.

In addition, the company plans to file a separate Form 8-K this afternoon announcing the appointment of Victor Limongelli as President and CEO.

Victor has been the company's interim CEO since January 4, 2024.

To access a copy of the press release, Form 8-Ks, and other investor information, please visit our website. Victor Limongelli and our CFO, Jorge Martell will join me on today's call.

Following the prepared comments, we will open the call for questions.

Please note that statements made during this conference call that relate to future plans, events, or performance including the outlook for full year 2024 and other long-term financial targets, are forward-looking statements.

These statements involve risks and uncertainties and are based on current assumptions. Consequently, actual results could differ materially from the expectations expressed in these forward-looking statements.

I direct your attention to today's press release and the company's filings with the U.S. Securities and Exchange Commission for a discussion of such risks and uncertainties.

Also note that certain financial measures that may be discussed on this call are expressed on a non-GAAP basis and have been adjusted from a related GAAP financial measure.

We have provided an explanation for and reconciliations of these non-GAAP financial measures to the most directly comparable GAAP financial measures in the earnings press release and in the investor presentation available on our website.

In addition, please note that all growth rates discussed on this call refer to a year-over-year basis unless otherwise indicated.

The date of this conference call is August 1, 2024.

Any forward-looking statements and related assumptions are made as of this date.

Except as required by law we undertake no obligation to update these statements as a result of new information or future events or for any other reason.

I will now turn the call over to Victor.

Victor Limongelli^ Thank you, Joe, and thanks, everyone, for joining the call today.

Over the last seven months, I've got to know the OneSpan team, and it's been a real pleasure to work side by side with them as we've improved OneSpan's operational performance.

I'm looking forward to further improvements.

I'm excited to keep the momentum going, and I'm honored that the Board felt the same way in making my role permanent.

As you know we've made significant progress this year, underscored by a strong second quarter, which included 9% revenue growth, 15% ARR growth, and adjusted EBITDA of \$16 million, or 27% of revenue.

We also generated \$2 million in cash from operations in the second quarter, a tremendous improvement as compared to the prior-year period when we used \$20 million in cash. And we ended the quarter with \$64 million in cash on hand.

Our focus on operational excellence and accountability throughout the company is driving profitable growth.

Over the past few years, we've continued to grow our software business. And in the first half of 2024, we've reached the point where software and services is approximately 3/4 of total revenue and hardware is about 1/4 of revenue.

In comparison, if you look at our business three years ago, the split was approximately 64% software, 36% hardware.

Our sales team has done a great job in transitioning the company to more higher-margin software revenue.

In particular, our sales team executed very well during the second quarter with bookings coming in ahead of our internal plan. The sales team has been working hard to stay close to customers so that we can continue to improve our performance in response to customer feedback.

As you might imagine, I'm very pleased with the team's performance.

In addition to the strong performance by the sales team, our renewals team has made strides in closing maintenance renewals in a timely fashion. Year-to-date, our on-time renewal rate has improved compared to 2023, and the rate of renewals closed within 30 days of the due date also improved year-over-year. That is good progress and a testament to the good work of our renewals team.

Our R&D team has continued to make improvements to our SaaS offerings, and we expect to see improved operational efficiency reflected in increased gross margins as we move through the remainder of the year.

Looking ahead, our R&D team in security is, I think it's fair to say, reenergized and is working on enhancements and new products such as FIDO hardware tokens.

Turning to our two business units.

I'm thrilled with the second quarter delivered by our team in the digital agreements business. Digital agreements grew strongly and became profitable, excluding onetime costs, which Jorge will discuss in more detail.

In Digital Agreements, we have substantially completed our transition to a SaaS model.

Our strong second quarter revenue and ARR growth rates were driven primarily by expansion contracts and, to a lesser extent, new logos.

In our Security business unit, we saw strong subscription revenue growth and overall revenue growth was on par with our low- to mid-single-digit growth rate expectation for 2024.

It also continued to be a strongly profitable business.

Our goal is to have both business units deliver growth and profitability, and we are well on our way to achieving that goal.

I am, of course, thrilled with the strong ARR growth and our improved profitability and cash flow, as well as the strong sales quarter the team delivered.

It would be too much to say the team closed every opportunity, but there were certainly deals that closed in Q2 that might have been expected to occur in Q3.

That is great, of course, and that we'd rather have the deals closed earlier, but it does make Q3 more challenging.

In addition, the third quarter, in terms of seasonality, is typically not a particularly strong bookings quarter for us. Given that context, coupled with the strong first half performance, for the balance of the year, we expect our subscription revenue to be up double-digits over the prior year, while we expect maintenance revenue to decline somewhat, largely due to the end of life of the Dealflo product as well as perpetual to term conversions.

In addition, given our current visibility into our hardware pipeline and anticipated customer hardware delivery schedules, we anticipate a decline in hardware revenues in the second half as compared to the prior year. That said, we expect both business units to be profitable in both the third and fourth quarters.

So we now expect our full-year adjusted EBITDA to be higher than previously forecast.

Finally, I'd like to note that the Board plans to undertake by year end a review of our cash generation and capital needs, balancing those factors with a desire to return capital to shareholders.

Overall, we remain committed to operational excellence and to driving efficient revenue growth to help ensure we achieve our annual profitability and cash flow commitments. With that, I will turn the call over to Jorge. Jorge?

Jorge Martell^ Thank you, Victor. And good afternoon, everyone.

I'll start by providing a brief update on our cost reduction activities.

We realized \$8.5 million in annualized cost savings from our restructuring efforts in the second quarter of 2024. Cumulative annualized savings totaled \$73.5 million.

We believe we are on track to achieve our goal of \$75 million in cumulative annualized cost savings by the end of this year.

Now turning to our second quarter results. ARR grew 15% to \$165 million, and our net retention rate was 112%, up from 107% last quarter.

During the quarter, we saw a strong increase in digital agreements in new ACV and strong increases in contract expansions (technical difficulty) from existing customers in both business units.

Second quarter 2024 revenue grew 9% to \$60.9 million as compared to the same period last year, driven by 4% growth in Security Solutions and 30% growth in Digital Agreements.

Subscription revenue grew 29% to \$29.6 million including 19% growth from Security Solutions and 41% growth from Digital Agreements.

The strong growth in subscription revenue was partially offset by a modest decline in maintenance revenue, which is by design as we transition to a SaaS and subscription license model. Hardware revenue was flat year-over-year.

Second quarter gross margin was 66.2% compared to 61.5% in the prior-year quarter. Gross margins were impacted by 2.4 percentage points in Q2 2024 and by 2.8 percentage points in Q2 2023 due to onetime costs. Excluding these onetime costs, the increase in gross margin was primarily driven by favorable product mix due to growth in subscription revenue, partially offset by an increase in depreciation of capitalized software costs.

Second quarter GAAP operating income was \$7.6 million compared to an operating loss of \$17.8 million in the second quarter of last year.

Increases in revenue and gross profit margin, combined with a decrease in operating expenses, primarily from lower headcount-related costs and lower restructuring costs, led to the improved performance. GAAP net income per share was \$0.17 in the second quarter of 2024 compared to a GAAP net loss per share of \$0.44 in the same period last year. Non-GAAP earnings per share was \$0.31 in the second quarter of 2024. This compares to a non-GAAP loss per share of \$0.18 in the second quarter of 2023.

Second quarter adjusted EBITDA and adjusted EBITDA margin was \$16.1 million and 26.5% compared to negative \$3.8 million and negative 7% in the same period of last year, respectively. Turning to our Security Solutions business unit. ARR grew 9% in the second quarter to \$105 million. ARR growth was negatively impacted by approximately

1.5 percentage points due to the relocation of identity verification products to our digital agreements business unit at the beginning of this year.

Second quarter revenue increased 4% to \$45.5 million.

Subscription revenue increased 19% to \$14.9 million, driven primarily by expansion of licenses from existing customers for authentication solutions. Maintenance and support revenue declined by less than \$1 million year-over-year to \$9.7 million with growth from on-premise subscriptions, offset by the expected declines from legacy perpetual contracts. Digipass hardware token revenue was basically flat with the prior year at \$19.7 million. Q2 2024 gross profit margin was 67% as compared to 59% in the second quarter of 2023. The increase in margin is primarily attributable to favorable product and customer mix.

In addition, Q2 2023 gross margin was impacted by approximately 3.5 percentage points related to an inventory write-off charge.

Operating income was \$20.7 million and operating margin was 46% compared to \$8.5 million and 19% in last year's second quarter. The increases in revenue and gross profit margin, combined with reduced operating expenses, primarily attributed to restructuring and other cost reduction activities throughout the majority of the improved performance. Turning to our financial results for our digital agreements business. ARR grew 25% to \$61 million.

ARR growth benefited by approximately 3 percentage points due to the relocation of identity verification products to digital agreements at the beginning of this year.

Second quarter revenue grew 30% to \$15.5 million, driven primarily by both new contracts and expansion of renewal contracts, and to a much lesser extent, the relocation of identity verification products.

Subscription revenue, consisting of 100% cloud-based solutions in both Q2 2024 and in the prior-year quarter, grew 41% to \$14.8 million.

Second quarter gross profit margin was 63% as compared to 72% in the prior-year quarter.

During the quarter, we made a decision to discontinue R&D investments in our Trust Vault blockchain product.

Excluding onetime costs related to this decision, Digital Agreements' Q2 2024 gross margin would have been 10 percentage points higher.

Operating loss was \$0.2 million as compared to an operating loss of \$7.1 million in Q2 last year. The improved performance was driven by an increase in revenue and a decrease in operating expenses, primarily attributed to restructuring and other cost reduction activities and was partially offset by an increase in cost of revenues. Excluding onetime

costs of approximately \$1.8 million, Digital Agreements' second quarter 2024 operating income would have been positive.

Now turning to our balance sheet.

We ended the second quarter of 2024 with \$64.3 million in cash and cash equivalents compared to \$42.5 million at the end of 2023.

We generated \$2 million in cash from operations during the quarter and used \$2 million in capital expenditures, primarily capitalized software costs.

We have no long-term debt. Geographically, our revenue mix by region in the second quarter of 2024 was 41% from EMEA, 35% from the Americas, and 24% from Asia-Pacific. This compares to 48%, 33%, and 19% from the same regions in the second quarter of last year, respectively.

I will now provide our financial outlook.

For the full year 2024, we are reaffirming our previously issued revenue guidance.

We are increasing our ARR guidance to reflect its year-to-date strength, partially offset by some second half contraction related to previously sunset products, and we are increasing our adjusted EBITDA guidance to reflect an increase in operating leverage. More specifically, we expect revenue to be in the range of \$238 million to \$246 million; ARR to end the year in the range of \$166 million to \$170 million, as compared to our previous guidance range of \$160 million to \$168 million; and adjusted EBITDA to be in the range of \$55 million to \$59 million, as compared to our previous guidance range of \$51 million to \$55 million. Absent share repurchases, we continue to expect to end the year with more than \$70 million of cash.

That concludes my remarks. Victor?

Victor Limongelli^ Thanks, Jorge.

We had an excellent second quarter and first half of 2024.

Looking at the second half of the year, we know that we have more work to do in order to deliver an excellent year.

I'm excited and proud to be leading the OneSpan team, and we're going to continue to focus our efforts on delivering value to our customers and thereby creating value for our shareholders. Jorge and I will now be happy to take your questions.

QUESTIONS AND ANSWERS

Operator^ Thank you.

At this time, we'll conduct a question and answer session. (Operator Instructions) Our first question comes from the line of Gray Powell with BTIG.

Gray Powell^ Okay. Congratulations on the good set of results.

Victor Limongelli^ Thank you.

Gray Powell^ Yes, absolutely.

So maybe Victor, to start off.

I mean you've been at OneSpan as CEO for seven months now. You posted two good reports. Do you see anything major that needs to be changed, or are there any areas where you want to maybe increase your focus and level of investments?

Victor Limongelli^ Yes. Let me talk about those results.

We're really happy with our ARR growth and the overall strength in our software business. My background, my history, 20-plus years, has been on the software side.

So I didn't know hardware, and that's a newer business for me.

But I have to say, I like that business as well.

It's a very good margin business, and we have these long relationships with customers over many years. And we are -- it's not a smooth ratable business like SaaS is, but overall, it's a good business. And we are doing some investment there.

I've said before that the goal is to have both business units growing and profitable.

We've made tremendous strides on that. The Security business, I do think needs -- could benefit from some additional investment on product refreshes. And we're starting to do that, and we'll continue to do that as we set up our 2025 plan.

Gray Powell^ Understood.

Okay. That's helpful. And then just in general, across software, it's been a fairly rough Q2 so far. And you kind of alluded to this on the call or the prepared remarks, but I mean you just added more net new ARR this quarter than the prior three quarters combined.

So I mean like, what surprised you the most? What drove the upside? And has anything changed within the business?

Victor Limongelli^ Well I think if you look at the results, and we mentioned it, but we had a lot of good results, as you commented.

But one thing that really stands out to me is the NRR number, right? It's -- if you're at 112, 110, 112, those types of ranges, it's really beneficial for the business. And of course, much, much easier to grow ARR. And the strength there was on both sides of the business.

We had strong NRR results on Security as well.

So that was great.

It was a really tremendous job by the team.

Operator^ Our next question comes from the line of Rudy Kessinger with D.A. Davidson.

Rudy Kessinger^ And Victor, congrats on the permanent title.

Victor Limongelli^ Thank you. Thanks, Rudy.

Rudy Kessinger^ Yes.

I want to just kind of dig in more on kind of Gray's question. \$10.3 million of net new ARR, that's more new ARR than you -- well about equal to this ARR that you added over the last three quarters combined. And your NRR, it's a TTM figure.

For TTM NRR to jump 5 percentage points in one quarter suggests you probably had either a price increase or some pretty massive customer expansion.

So could you just unpack the \$10 million of net new ARR and the jump in ARR and just talk to any maybe concentration you had and maybe some large expansions or pull-forwards or what? Because the numbers are pretty significant relative to the past several quarters and relative to kind of what's implied in the second half guide.

Victor Limongelli^ Yes. Thanks, Rudy.

I alluded to this in the prepared remarks a little bit.

We closed a ton of business including some large deals, and it was really a great performance by the sales team.

I'll let Jorge dive into any numbers that he wants to address, but the bookings performance was really strong by the team in the second quarter.

Jorge Martell^ Yes. Just to add to that, Vic, and Rudy, so we did see great expansion.

In particular, we saw one deal that's a low-7-figure deal that was more cross-sell. And so that's part of the NRR on the -- we saw them on the DA side of the house.

We also saw great expansion in authentication products or back-end software this quarter.

We saw similar traction last quarter. This quarter was stronger.

But the other thing to consider also, Rudy, is that we did see lower churn and contraction this quarter than we have seen in the past. Partly end of life was not really a material number.

It was about \$0.5 million this quarter.

Last quarter was a little more meaningful. And so I think we benefited on both sides.

We had really great expansion. That cross-sell that I alluded to in the DA side of the house, but also, we saw lower churn and contraction.

So we benefited all around.

Rudy Kessinger^ Okay. And just a quick follow-up on that and then I've got another question. A low-7-figure cross-sell that was low-7 figures of net new ARR from a single cross-sell on the DA, right?

Jorge Martell^ Correct.

Victor Limongelli^ Yes.

Rudy Kessinger^ Okay. That's helpful. And then I guess the guide -- the EBITDA guide, I understand like in Q1, you had some massive multi-year term licenses.

Second half, it sounds like your hardware is going to be a bit lower than as it would typically be seasonality-wise.

But still, the EBITDA guide in the second half, I think it implies roughly \$20 million in second half versus \$36 million in the first half, you're saying gross margins are going to be stronger.

Obviously you've got the cost cuts coming in.

It seems to OpEx actually steps up in the second half.

So could you just unpack that a bit as well?

Jorge Martell^ Yes. I can chime in here.

So, I think it's going to be a little more than the number you said to the second half adjusted EBITDA, but we have, Rudy.

But obviously EBITDA is heavily depending on revenue.

As Victor said, we expect year-over-year declines in the hardware business based on the visibility we have today. And that's primarily related to the scheduled customer deliveries, right?

So we obviously recognize revenue when we do the deliveries.

So as we mentioned, Rudy, it's a lumpy business because of that. You have lead times for production and then lead times for deliveries and then correlating those with our customer base, right? So it's a whole -- it takes a lot of effort to do that on a consistent basis.

So, because of the revenue sort of like a little uncertainty on the hardware side is what we have been cautious about in our EBITDA guide.

We raised it according to our numbers and our forecast.

We hope to be more on the high end of that range, and we'll continue to update you guys as we continue to make progress.

Operator^ Our last question comes from the line of Anja Soderstrom with Sidoti.

Anja Soderstrom^ Congratulations on the great quarter and the nomination, Victor.

Victor Limongelli^ Thank you. Thank you very much.

Anja Soderstrom^ For this quarter, you're undertaking a lot of changes within the sales organization.

So how much of this tailwind is driven by demand versus your changes in execution do you think?

Victor Limongelli^ Well it's hard to pull that apart.

I think the team has executed better.

We did see good performance across the board.

It was both in security and in the DA business.

So it's hard to say how much of that is due to underlying demand.

I don't know if I could give you a precise number on that.

I'm really happy with how we're engaging with customers and making sure that we're spending time meeting with them face-to-face and seeing what problems we can solve for them.

But I can't give you a precise number on demand versus execution.

Anja Soderstrom^ Okay. Understood. And let me ask you in a better way maybe. How is the macro environment for you? Like do you still see that as challenging?

And once you're getting the execution up and running and the macro environment improving, hopefully, eventually. What are you seeing from customers and --

Victor Limongelli^ That's a good question.

For us, Europe is a huge market, and the European economy hasn't been that great, but it's not like it's in a deep, deep recession either.

So I don't like to talk about macro unless it's on the extremes, right? If the economies are booming, great, that might provide some lift, or if there's a severe recession, obviously that hurts.

I don't think the macro environment is fantastic, but it's also -- I mean we have to be able to execute through economies like this.

This isn't, I mean far from the worst economy I have experienced with having run a public software company through the Great Recession.

So I view it as okay.

I guess. Does that make sense?

Anja Soderstrom^ Yes. And in terms of the cost savings, it sounds like you almost reached your target here for the year. Are you still looking for potential further ways or you've been kind of pushing it already?

Victor Limongelli^ Jorge, do you want to cover that one?

Jorge Martell^ Yes.

So we're almost there, Anja, from a cost savings perspective. A lot of the -- as we mentioned before, a lot of these -- the incremental 10 that we announced last couple of earnings calls impacted DA, and that was related to, again, the mandate that they had, which is having both business units be growing profitably. And so now we're there.

Now obviously there will be incremental in terms of fine-tuning, right?

It could be one or two business units, I think, overall corporate as well.

So -- but I don't think we will sort of like put neon lights on it.

It's just part of running the business, right? We've just got to be conscious about and trying to improve that and expand operating margins.

So I think we're -- to your point, we're almost there, it will continue to be, but I expect more fine-tuning rather than another sort of like huge number coming out, so --

Anja Soderstrom^ And then on the cost side, Victor, you mentioned you will invest in some products and house them. Will there be any significant cost increases because of that or --

Victor Limongelli^ We are trying -- as Jorge alluded to in his comments, we're trying to keep a close eye on expenses.

We haven't done our 2025 planning yet. There may be a small incremental investment in that area.

But for the most part, we're trying to direct our team.

We have a strong team.

We're trying to direct them in the areas that can have the biggest benefit for our customers rather than just throwing dollars at it.

I don't think that's the right approach.

Operator^ I'm showing no further questions at this time.

I would now like to turn the call back to Joe Maxa for closing remarks.

Joe Maxa^ Thank you, everyone.

We appreciate your time and look forward to sharing our progress with you again next quarter. Thanks again.

And have a nice day.

Operator^ Thank you. This does conclude the program, and you may now disconnect.