

Fourth Quarter and Full-Year 2018 Earnings Call

February 20, 2019

Important Information

This presentation refers to certain non-GAAP financial metrics. See the reconciliations of GAAP to non-GAAP financial measures contained in this presentation and our earnings press release posted on the Investor Relations portion of the ServiceSource website for a reconciliation of the non-GAAP metrics to the closest GAAP financial measures.

GAAP Statement of Operations Q4 2018 Compared to Q4 2017

	Q4 2018	Q4 2017	\$ Change
	<i>(in thousands, except per share data)</i>		
	(unaudited)		
Net revenue	\$ 61,471	\$ 66,024	\$ (4,553)
Cost of revenue	40,557	41,980	(1,423)
Gross profit	20,914	24,044	(3,130)
Gross margin	34.0%	36.4%	(2.4)%
Operating expenses:			
Sales and marketing	8,488	8,211	277
Research and development	1,745	1,195	550
General and administrative	8,335	13,058	(4,723)
Restructuring and other related costs	—	1,049	(1,049)
Total operating expenses	18,568	23,513	(4,945)
Income from operations	2,346	531	1,815
Interest and other income (expense), net	89	(2,331)	2,420
Income (loss) before income taxes	2,435	(1,800)	4,235
Provision for income tax (expense) benefit	(156)	1,874	(2,030)
Net income	\$ 2,279	\$ 74	\$ 2,205
Net income per share, basic and diluted	\$ 0.02	\$ 0.00	\$ 0.02
Weighted average common shares outstanding, basic and diluted	92,721	90,205	

GAAP Statement of Operations Full-Year 2018 Compared to Full-Year 2017

	FY 2018	FY 2017	\$ Change
	<i>(in thousands, except per share data)</i>		
	<i>(unaudited)</i>		
Net revenue	\$ 238,340	\$ 239,127	\$ (787)
Cost of revenue	164,693	163,709	984
Gross profit	73,647	75,418	(1,771)
Gross margin	30.9%	31.5%	(0.6)%
Operating expenses:			
Sales and marketing	35,600	33,001	2,599
Research and development	6,436	5,729	707
General and administrative	47,288	53,087	(5,799)
Restructuring and other related costs	209	7,308	(7,099)
Total operating expenses	89,533	99,125	(9,592)
Loss from operations	(15,886)	(23,707)	7,821
Interest and other expense, net	(6,591)	(9,886)	3,295
Gain on sale of cost basis equity investment	—	2,100	(2,100)
Impairment loss on investment securities	(1,958)	—	(1,958)
Loss before income taxes	(24,435)	(31,493)	7,058
Provision for income tax (expense) benefit	(450)	1,647	(2,097)
Net loss	\$ (24,885)	\$ (29,846)	\$ 4,961
Net loss per share, basic and diluted	\$ (0.27)	\$ (0.33)	\$ 0.06
Weighted average common shares outstanding, basic and diluted	91,636	89,234	

GAAP to Non-GAAP Reconciliation Q4 2018 Compared to Q4 2017

	Q4 2018	Q4 2017 <i>(in thousands)</i> <i>(unaudited)</i>	\$ Change
Net revenue	\$ 61,471	\$ 66,024	\$ (4,553)
Gross profit			
GAAP gross profit	\$ 20,914	\$ 24,044	\$ (3,130)
Non-GAAP adjustments:			
Stock-based compensation	304	367	(63) (A)
Amortization of internally-developed software	762	2,934	(2,172) (B)
Amortization of purchased intangible assets	—	246	(246) (C)
Non-GAAP gross profit	<u>\$ 21,980</u>	<u>\$ 27,591</u>	<u>\$ (5,611)</u>
% of revenue	35.8%	41.8%	(6.0)%
Operating expenses:			
GAAP operating expenses	\$ 18,568	\$ 23,513	\$ (4,945)
Non-GAAP adjustments:			
Stock-based compensation	(264)	(2,921)	2,657 (A)
Amortization of internally-developed software	(311)	(216)	(95) (B)
Amortization of purchased intangible assets	—	(131)	131 (C)
Restructuring and other related costs	—	(1,049)	1,049 (D)
Amortization of contract acquisition costs - ASC 606 initial adoption	(316)	—	(316) (E)
Non-GAAP operating expenses	<u>\$ 17,677</u>	<u>\$ 19,196</u>	<u>\$ (1,519)</u>
Net income			
GAAP net income	\$ 2,279	\$ 74	\$ 2,205
Non-GAAP adjustments:			
Stock-based compensation	568	3,287	(2,719) (A)
Amortization of internally-developed software	1,073	3,149	(2,076) (B)
Amortization of purchased intangible assets	—	378	(378) (C)
Restructuring and other related costs	—	1,049	(1,049) (D)
Amortization of contract acquisition costs - ASC 606 initial adoption	316	—	316 (E)
Non-cash interest expense	14	2,441	(2,427) (H)
Income tax effect on non-GAAP adjustments and impact of normalizing the effective income tax rate	(1,013)	(5,276)	4,263 (I)
Non-GAAP net income	<u>\$ 3,237</u>	<u>\$ 5,102</u>	<u>\$ (1,865)</u>

GAAP to Non-GAAP Reconciliation Full-Year 2018 Compared to Full-Year 2017

	FY 2018	FY 2017	\$ Change
		(in thousands) (unaudited)	
Net revenue	\$ 238,340	\$ 239,127	\$ (787)
Gross profit			
GAAP gross profit	\$ 73,647	\$ 75,418	\$ (1,771)
Non-GAAP adjustments:			
Stock-based compensation	1,056	1,335	(279) (A)
Amortization of internally-developed software	7,686	11,931	(4,245) (B)
Amortization of purchased intangible assets	55	988	(933) (C)
Non-GAAP gross profit	<u>\$ 82,444</u>	<u>\$ 89,672</u>	<u>\$ (7,228)</u>
% of revenue	34.6%	37.5%	(2.9)%
Operating expenses:			
GAAP operating expenses	\$ 89,533	\$ 99,125	\$ (9,592)
Non-GAAP adjustments:			
Stock-based compensation	(8,545)	(12,348)	3,803 (A)
Amortization of internally-developed software	(943)	(1,367)	424 (B)
Amortization of purchased intangible assets	(30)	(525)	495 (C)
Restructuring and other related costs	(209)	(7,308)	7,099 (D)
Amortization of contract acquisition costs - ASC 606 initial adoption	(1,529)	—	(1,529) (E)
Litigation reserve	(2,250)	—	(2,250) (J)
Non-GAAP operating expenses	<u>\$ 76,027</u>	<u>\$ 77,577</u>	<u>\$ (1,550)</u>
Net loss			
GAAP net loss	\$ (24,885)	\$ (29,846)	\$ 4,961
Non-GAAP adjustments:			
Stock-based compensation	9,601	13,683	(4,082) (A)
Amortization of internally-developed software	8,629	13,298	(4,669) (B)
Amortization of purchased intangible assets	85	1,512	(1,427) (C)
Restructuring and other related costs	209	7,308	(7,099) (D)
Amortization of contract acquisition costs - ASC 606 initial adoption	1,529	—	1,529 (E)
Impairment loss on investment securities	1,958	—	1,958 (F)
Gain on sale of cost basis equity investment	—	(2,100)	2,100 (G)
Litigation reserve	2,250	—	2,250 (J)
Non-cash interest expense	5,868	9,392	(3,524) (H)
Income tax effect on non-GAAP adjustments and impact of normalizing the effective income tax rate	(1,059)	(6,286)	5,227 (I)
Non-GAAP net income	<u>\$ 4,185</u>	<u>\$ 6,961</u>	<u>\$ (2,776)</u>

Reconciliation of Net Income (Loss) to Adjusted EBITDA

	Q4 2018	Q4 2017	\$ Change
		<i>(in thousands)</i>	
		<i>(unaudited)</i>	
Net income	\$ 2,279	\$ 74	\$ 2,205
Provision for income tax expense (benefit)	156	(1,874)	2,030
Interest and other (income) expense, net	(89)	2,331	(2,420)
Depreciation and amortization	3,097	5,469	(2,372)
EBITDA	5,443	6,000	(557)
Stock-based compensation	568	3,287	(2,719)
Amortization of contract acquisition asset costs - ASC 606 initial adoption	316	—	316
Restructuring and other related costs	—	1,049	(1,049)
Adjusted EBITDA	<u>\$ 6,327</u>	<u>\$ 10,336</u>	<u>\$ (4,009)</u>

	FY 2018	FY 2017	\$ Change
		<i>(in thousands)</i>	
		<i>(unaudited)</i>	
Net loss	\$ (24,885)	\$ (29,846)	\$ 4,961
Provision for income tax expense (benefit)	450	(1,647)	2,097
Interest and other expense, net	6,591	9,886	(3,295)
Depreciation and amortization	16,495	22,588	(6,093)
EBITDA	(1,349)	981	(2,330)
Stock-based compensation	9,601	13,683	(4,082)
Amortization of contract acquisition asset costs - ASC 606 initial adoption	1,529	—	1,529
Gain on sale of cost basis equity investment	—	(2,100)	2,100
Impairment loss on investment securities	1,958	—	1,958
Restructuring and other related costs	209	7,308	(7,099)
Litigation reserve	2,250	—	2,250
Adjusted EBITDA	<u>\$ 14,198</u>	<u>\$ 19,872</u>	<u>\$ (5,674)</u>

Balance Sheet

	12/31/2018	12/31/2017	\$ Change
		(in thousands)	
		(unaudited)	
Assets			
Current assets:			
Cash and cash equivalents	\$ 26,535	\$ 51,389	\$ (24,854)
Short-term investments	—	137,181	(137,181)
Accounts receivable, net	54,284	56,516	(2,232)
Prepaid expenses and other	5,653	6,112	(459)
Total current assets	86,472	251,198	(164,726)
Property and equipment, net	36,593	34,119	2,474
Contract acquisition costs	2,660	—	2,660
Goodwill and intangible assets, net	6,334	6,419	(85)
Other assets	4,521	3,636	885
Total assets	\$ 136,580	\$ 295,372	\$ (158,792)

	12/31/2018	12/31/2017	\$ Change
		(in thousands)	
		(unaudited)	
Liabilities and Stockholders' Equity			
Current liabilities:			
Accounts payable	\$ 2,424	\$ 4,574	\$ (2,150)
Accrued compensation and benefits	15,509	19,257	(3,748)
Convertible notes, net	—	144,167	(144,167)
Deferred revenue	—	1,282	(1,282)
Accrued expenses	3,380	6,640	(3,260)
Other current liabilities	6,894	2,740	4,154
Total current liabilities	28,207	178,660	(150,453)
Other long-term liabilities	6,540	4,603	1,937
Total liabilities	34,747	183,263	(148,516)
Stockholders' equity:			
Preferred stock	—	—	—
Common stock	9	8	1
Treasury stock	(441)	(441)	—
Additional paid-in capital	369,246	359,347	9,899
Accumulated deficit	(267,383)	(246,207)	(21,176)
Accumulated other comprehensive income (loss)	402	(598)	1,000
Total stockholders' equity	101,833	112,109	(10,276)
Total liabilities and stockholders' equity	\$ 136,580	\$ 295,372	\$ (158,792)

Cash Flows

Cash flows from operating activities:

	FY 2018	FY 2017
Net loss	\$ (24,885)	\$ (29,846)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	16,495	22,588
Amortization of debt discount and issuance costs	5,868	9,392
Amortization of contract acquisition costs	1,770	—
Amortization of premium on short-term investments	(1,204)	(12)
Deferred income taxes	33	(1,999)
Stock-based compensation	9,601	13,683
Restructuring and other related costs	458	3,063
Gain on sale of cost basis equity investment	—	(2,100)
Impairment loss on investment securities	1,958	—
Other	74	184
Changes in operating assets and liabilities:		
Accounts receivable, net	1,724	9,060
Deferred revenue	—	(2,872)
Prepaid expenses and other assets	(150)	1,670
Contract acquisition costs	(1,085)	—
Accounts payable	(2,406)	2,487
Accrued compensation and benefits	(3,542)	(2,940)
Accrued expenses	(3,730)	(1,734)
Other liabilities	2,738	(827)
Net cash provided by operating activities	<u>3,717</u>	<u>19,797</u>

Cash flows from investing activities:

Acquisition of property and equipment	(15,604)	(17,110)
Proceeds from sale of cost basis equity investment	—	2,100
Purchases of short-term investments	(480)	(56,626)
Sales of short-term investments	133,920	53,315
Maturities of short-term investments	4,240	3,506
Net cash provided by (used in) investing activities	<u>122,076</u>	<u>(14,815)</u>

Cash flows from financing activities:

Repayment on capital lease obligations	(413)	(71)
Repayment of convertible notes	(150,000)	—
Debt issuance costs	(201)	—
Proceeds from revolving line of credit	32,000	—
Repayment of revolving line of credit	(32,000)	—
Proceeds from issuance of common stock	759	1,062
Payments related to minimum tax withholdings on restricted stock unit releases	(784)	(775)
Net cash (used in) provided by financing activities	<u>(150,639)</u>	<u>216</u>
Effect of exchange rate changes on cash and cash equivalents and restricted cash	<u>(8)</u>	<u>(1,501)</u>
Net change in cash and cash equivalents and restricted cash	(24,854)	3,697
Cash and cash equivalents and restricted cash, beginning of period	<u>52,633</u>	<u>48,936</u>
Cash and cash equivalents and restricted cash, end of period	<u>\$ 27,779</u>	<u>\$ 52,633</u>

Footnotes

(A) Stock-based compensation. Included in our GAAP presentation of cost of revenue and operating expenses, stock-based compensation consists of expenses for stock options, stock unit awards and purchase rights under our stock purchase plan. We exclude stock-based compensation expense from our non-GAAP measures because some investors may view it as not reflective of our core operating performance as it is a non-cash expense.

(B) Amortization of internally-developed software. Included in our GAAP presentation of cost of revenue and operating expenses, amortization of internally-developed software reflects non-cash expense for software developed or obtained for internal use. We exclude these expenses from our non-GAAP measures because we believe they are not indicative of our core operating performance.

(C) Amortization of purchased intangibles. Included in our GAAP presentation of gross margin and operating expenses is amortization of purchased intangible assets. We believe amortization of acquisition-related intangible assets, such as amortization of costs associated with an acquired company's research and development efforts, trade names and customer relationships, are items arising from pre-acquisition activities and determined at the time of an acquisition. Although these intangible assets are continually evaluated for impairment, amortization of purchased intangibles is a static expense and not typically affected by operations during any particular period.

(D) Restructuring and other related costs. Included in our GAAP presentation, we incurred expenses related to our restructuring effort to better align our cost structure with current revenue levels. Restructuring and other expenses consist primarily of stock-based compensation related to the accelerated vesting of certain equity awards, employees' severance payments, related employee benefits, related legal fees, asset impairment charges and charges related to leases and other contract termination costs. These are one-time in nature costs that are not indicative of our core operating performance.

(E) Amortization of contract acquisition costs - ASC 606 initial adoption. Upon adoption of Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606) ("ASC 606") using the modified retrospective approach, we capitalized approximately \$3.3 million of previously expensed sales commissions from 2015, 2016 and 2017. Amortization of these amounts are included in our GAAP presentation as sales and marketing expense. We believe this non-cash amortization expense is not related to or indicative of our ongoing operating performance.

(F) Impairment loss on investment securities. We liquidated our investment securities during the first half of 2018 to have sufficient cash on hand to repay our \$150.0 million convertible notes due August 1, 2018. Based on our decision to sell these investment securities, we determined an other-than-temporary impairment occurred as of March 31, 2018 and recorded an impairment loss, which represented the difference between the investment securities' amortized cost basis and fair value. This charge is not related to or indicative of ongoing operating performance.

(G) Gain on sale of cost basis equity investment. In 2013, we made an equity investment in a private company for \$4.5 million, which represented less than 5% of the outstanding equity of the company. Based on unfavorable growth trends and declining financial performance of this private company, we determined that the investment was fully impaired and recorded a \$2.3 million and \$2.2 million impairment charge in the third and fourth quarters of 2016, respectively. During the year ended December 31, 2017, we sold the investment for \$2.1 million in cash and recorded the proceeds as a gain. This gain is not related to or indicative of our ongoing core operating performance.

(H) Non-cash interest expense. Under GAAP, we recognize interest expense at the effective interest rate which includes interest costs related to the amortization of debt issuance costs and debt premiums or discounts. The difference between the effective interest rate and the contractual interest rate is excluded from our assessment of our operating performance because we believe this non-cash expense is not indicative of ongoing operating performance. We believe that the exclusion of the non-cash interest expense provides investors a view of our core operating performance.

(I) Income tax effect on non-GAAP adjustments as well as the impact of normalizing the effective income tax rate. This adjusts (i) the provision for income taxes to reflect the effect of the non-GAAP items A, B, C, D, E, F, G, H and J on our non-GAAP net income; and (ii) the income tax rate to a normalized effective tax rate of 26.5% for the three months and year ended December 31, 2018 and 40.0% for the three months and year ended December 31, 2017, respectively.

(J) Litigation reserve. The Company records a contingent liability when it is probable that a loss has been incurred and the amount is reasonably estimable in accordance with accounting for contingencies. As of December 31, 2018, the Company has accrued a \$3.8 million reserve relating to our potential liability for currently pending disputes. These reserves are one-time in nature charges that are not indicative of our core operating performance.