SERVICESOURCE®

The Customer Journey Experience Company

Q1 2021 Earnings Conference Call: April 29, 2021

Prepared Remarks

Elise Brassell, Head of Corporate Communications

Thank you, Operator. We appreciate everyone joining us today and welcome to ServiceSource's earnings call to discuss our results for the first quarter ended March 31st, 2021. On the call today are Gary Moore, ServiceSource's Chairman and CEO, and Chad Lyne, our CFO.

As a reminder, our SEC filings and the earnings release we issued yesterday after market close are available on our website at www.ir.servicesource.com. In addition, we have posted earnings slides to accompany our comments today. Shortly after this call, we will post an audio replay and a copy of our prepared remarks to our website.

Before we begin, I would like to remind you that during the call we will make projections or forward-looking statements that involve risks related to future events. All statements made during the call reflect our views as of today, April 29th, 2021, and are based upon the information currently available to us. All projections and forward-looking statements should be considered in conjunction with the cautionary statements in the earnings press release and the risk factors included in our SEC filings, including our report on Form 10-Q. These documents contain and identify important factors that could cause actual events and results to materially differ from those contained in our projections and forward-looking statements, and we disclaim any duty to revise or update any forward-looking statements.

In addition, during the call we will also be discussing certain non-GAAP financial measures, which we believe provide additional information to enhance the understanding of how management assesses the operating performance of the business. The reconciliation of the GAAP and non-GAAP measures can be found in the earnings release that accompany this call.

And with that, I will turn the call over to Gary.

Gary B. Moore – Chairman and Chief Executive Officer

Thank you, Elise, and welcome everyone to our earnings conference call for the first quarter of 2021. I'm happy to join you today to discuss our first quarter results. In our last call, we shared our expectations that our path to growth and improved profitability would become more apparent later in the year based on anticipated improvements in our go-to-market and operational execution. Today, I'm pleased to share that we continue to make progress on our objectives, and we are gaining greater confidence to reach the future we envision.

While there are certainly still elevated levels of uncertainty globally, we are encouraged by early signs of strengthening in the markets we serve. Market research firm Gartner this month raised their global IT forecast for 2021 from 6.2% year-over-year growth to 8.4%, and we share this optimism that conditions will continue to recover as the year progresses.

Perhaps part of this belief is due to technology's ability to connect all of us. It's worth noting that the events of the last year have reminded everyone of the value of personal connection and relationships. Social and business networks have gotten smaller and more focused on those that add value to our daily lives. Our clients too are focused on getting closer to their customers and fortifying the value of their existing relationships.

As a company that enhances and preserves relationships, ServiceSource has seen underlying momentum from this alignment of market need with our business strategy.

We have focused on solid execution across the business to start the year, and also on our ability to successfully deliver the deeper, stronger connections that our clients need well beyond the pandemic.

In our first quarter business highlights, you can see the evidence of our relentless focus on creating quality relationships between our clients and their customers. Overall for Q1, we performed broadly in line with the cadence we shared with you in February, while we also had some areas of outperformance compared to our internal expectations.

From a financial snapshot perspective, we adjusted quickly to be responsive to the revenue headwinds we told you we would face in the first half of the year. Our non-GAAP expense reductions offset about 98% of our year-over-year revenue contraction and we accreted cash in the quarter. Chad will give you a closer look at these factors in the financial section of our call.

Turning to our client-centric results, I'm pleased to see that the work we're doing to instill a Clients for Life mentality in everything we do, is taking hold. While Clients for Life is not a new concept, it's an important one that we are bringing front and center in our culture.

We often counsel our clients on the value of nurturing installed base accounts, and we also practice this advice ourselves. Our top 10 clients have been with us approximately 11 years and over the trailing twelve months through Q1, we've grown revenue with half of them. In the quarter, we secured new expansion wins with 6 of our top 10 and expect to take on more work for them throughout the year.

In addition, we focused heavily on renewals in the quarter, with more than $50M of contract value up for renewal. I'm pleased to say that we renewed or extended more than 95% of this total value.

Within this effort, we brought home two important wins at different ends of the size spectrum that I want to highlight.

First, for one of our top three accounts in the software and cloud vertical who has been with us for about 12 years, we set a goal not only to renew the relationship, but to secure a multi-year renewal in Q1.

Our team completed a complex, multi-quarter negotiation that successfully ended with a renewal of our book of business for a 3-year term and expansion to support recent acquisitions and their on-going push into the cloud. I'm really proud of the team for bringing this in, especially during a time when the technology industry is generally seeing shorter-term commitments.

At the other end of the spectrum, a global medical device client that provides diagnostic imaging and other mission-critical medical equipment, was also up for renewal. This client relationship has been in place since 2017, centered around high-margin service contract renewals and warranty conversions.

Our team worked for several quarters with this client to ultimately secure a renewal with new commercial terms that expands the scope of our work by more than 30%.

There's a common driving force behind both of these client renewals, and that is, we have proven ourselves to be a valuable asset to our clients in times of business growth and change. As our clients grow through acquisition or chart a course to build market share in new sectors, they need partners that understand the go-to-market implications for their business and can ramp quickly to attack a new opportunity. Our top clients have stayed with us as long as they have in part because of our proven ability to flex and scale to support new opportunities and be a true strategic partner on their transformation journeys.

By living this Clients for Life mentality, it creates a valuable feedback loop for our sales organization as well, with our clients demonstrating an increased willingness to be advocates and positive references for prospects in our pipeline. Our new bookings had strong improvement compared to last year, and it's clear that our performance and execution here continues to accelerate.

On a trailing twelve-month basis through Q1, our bookings were up approximately 30% year-over-year.

Our sales team also added a very attractive new logo to our client roster in the first quarter. This client – which is a high-growth data and analytics market leader – fits into our cloud and software vertical and is a recently acquired business of a marquee client, who was a strong reference for us throughout the sales cycle.

We announced last week that we are now live and in production for this client with renewals management services. The goals of the relationship fit well with our strengths. We'll be working to modernize their renewals process by moving the client's customers from perpetual license contracts to subscription-based models.

The shift in IT from perpetual to subscription relationships requires a level of sales expertise and proactive engagement that many companies simply can't manage alone. We have the expertise and scale to execute this properly, which are the key reasons why we won the opportunity to help this client create a new path for success.

I'm encouraged by our solid performance with our clients in the quarter, and also by the prospective new logos we have in the late stage pipeline that we expect to close in Q2 and Q3.

We will continue to tune and refine the dials of our go-to-market execution engine, but I'm pleased to see our enhanced focus and discipline bearing fruit. We invested in building a new account-based marketing strategy, fully staffed our marketing team, enhanced our MarTech stack, and brought greater rigor to our lead generation and qualification process. With these changes and investments, we are optimistic that our go-to-market foundation is in a solid position to help us grow.

In addition to these market-facing investments, we have also devoted meaningful resources to enhance our capabilities and pioneer new innovations that we expect will continue to differentiate our business.

From a digital transformation perspective, we've begun to see early success from deploying advanced efficiency technologies such as Robotic Process Automation and Click2Renew. Both technologies replace manual and repetitive production tasks and empower our valuable selling resources to focus on higher leverage activities for our clients.

In one client example, since August of 2020, we have processed more than 20,000 quotes through our RPA system. This is significant because quoting seems like a simple task, but in reality can involve thousands of SKUs and pricing and discount information scattered across dozens of client systems. We're starting to see success with our RPA efforts, reducing manual intervention by 30% for our pilot client.

While RPA enables a faster time-to-quote, Click2Renew offers a faster time-to-buy. For one of our early Click2Renew clients, hundreds of thousands of their customers are now receiving automated self-service online quotes each quarter, and we are growing this efficient "no-touch" revenue stream for our client by nearly 40% year-over-year.

Through these automation strategies, we are quoting and closing long-tail, lower-dollar renewals faster and more efficiently than ever before, improving client service while increasing job satisfaction for our teams.

It's the strength and resilience of our teams that enables us to build upon our position as a strategic partner to leading brands across the world. As I reflect on our accomplishments, I know that behind every success small or large, are dedicated Sourcers.

From a leadership perspective, we are doing our part to care for our team in the workplace and in their lives.

From a workplace standpoint, our teams are working virtually worldwide. As the pandemic clears, we will continue to be a virtual-first company.

In our annual employee survey, nearly 80% of our team members said that they enjoy the work-from-home model. In 2021, if we are able to safely open our office locations, we will do so, but we will keep our home offices as our primary work locations. Our intent is to transform and reconfigure our office spaces as collaboration and innovation hubs for our teams and clients.

As a general rule, day-to-day production work and individual activities will be delivered remotely, while we will use our sites for specific activities such as employee and client onboarding, executive briefings and business reviews, team building and collaboration.

This combination of virtual offices and in-person collaboration spaces offers a hybrid model that we see many of our clients moving toward.

To make sure the virtual-first model continues to work for our employees, we are taking steps to enhance and build our culture. In February, we held our annual ServiceSource Cares Week, dedicated to showing gratitude toward each other and supporting the communities where we live and work.

During the week, Sourcers worldwide gave their time and resources to support many important causes and non-profits throughout the world.

Additionally, we launched a Be Well initiative to support not only the physical health of our employees, but also holistically provide resources to care for the entire person, from mental health to finances and relationships.

We undertake these initiatives because they speak to the heart of our culture of caring for each other and the communities around us, and also to cultivate a thriving virtual environment for our diverse and inclusive workforce.

To wrap-up, I'd like to say that I'm as convinced as ever that our strategy, priorities and team are on the right path to building a future that we'll all be proud of.

We executed well in the quarter, saw areas of accelerating momentum in the business, and believe the market backdrop will continue to improve. I remain optimistic that the areas of stronger execution in recent quarters will begin to translate into enhanced financial results as we progress through the year.

With that, I'll turn to Chad to cover the financials…

Chad Lyne – Chief Financial Officer

Thank you, Gary. It's good to be back with everyone today and thank you for joining us.

I will echo Gary's comments that we executed well in the quarter and in many areas paced ahead of our internal expectations. There is still plenty of year in front of us and heightened levels of uncertainty continue to persist globally, but we are increasingly encouraged by some of the early market indicators we are tracking and the green shoots of activity we are seeing in the business.

Before I turn to Q1 numbers, let me touch on a few things so you understand where our attention, priorities, and investment are being directed. As a team, we continue to focus on the four pillars that underpin our multi-year transformation strategy – Inspire Success, Impact Scale, Ignite Sales, and Innovate Solutions. Throughout the company, we are pleased with the level of activity and urgency we are seeing on these pillars and the overall progress we are tracking on their respective internal KPIs.

The holistic focus and investments we have made in the employee experience – encompassing compensation, benefits, training, culture, diversity & inclusion, career development, and tools & technologies, among other areas – are allowing us to recognize tangible benefits from a more loyal, tenured, and productive team. In Q1, our employee tenure reached the highest level on record and is up approximately 85% from where it was two years ago. That's incredibly important as we primarily support complex B2B sales motions for very technical products and solutions. While there are multiple components to our value proposition, the quality of our talent – coupled with process and technology – is a key differentiator in competitive situations and "partner-vs-build" scenarios.

Having a more highly skilled, technically proficient, and on-the-job experienced workforce is allowing us to deliver improved productivity and higher and more consistent outcomes for our clients. Through these enhanced outcomes, we start to benefit from a flywheel of sorts. Happier clients are more inclined to renew their contracts and expand their level of investment with us. They are more willing to take calls from our prospects and share their success stories, which helps accelerate our sales cycles. And when those executives move on to their next opportunity, they are more willing to bring us in to their new companies, which helps improve our new logo win rates.

We are seeing early signs of these types of second-order effects. Client performance metrics are moving higher, our contract renewal rates are improving, our bookings activity is up, our pipeline is expanding, and churn is coming down…giving us increased confidence that we are making progress and on the right path.

With that context, let's jump to the Q1 results.

As I shared with you on our February call, we anticipated the first half of the year would have a more challenging year-over-year comparison due to typical installed base seasonality, the ongoing impact of the pandemic on our clients' mid-market and SMB customer tiers, and the overhang caused by the one larger client who insourced various scopes of work last year. These factors largely played through as we expected.

Revenue of $45.0 million was down $5.1 million, or 10.2% year-over-year. The new logos we won last year are in production and are in various stages of ramping to our run rate expectations. Combined, they accounted for approximately 3% of our Revenue in the quarter. However, this new logo Revenue contribution was more than offset by legacy churn and the single client headwind I referenced a second ago.

Our first quarter non-GAAP Cost of Revenue was $32.1 million, a favorable reduction of $2.2 million, or 6.3% year-over-year, as we aligned our resources to our Revenue. Non-GAAP Gross Profit was $12.9 million, or a margin of 28.7% of Revenue, down $2.9 million or approximately 300 basis points year-over-year. Although we are seeing some nice contribution from our virtual-first operating model by way of lower facility and travel expenses, we expect our non-GAAP Gross Profit margins to be under pressure in the near-term, particularly as we continue to carry meaningful fixed costs relative to our current scale, and also as we are investing in front of Revenue for some larger program ramps that are underway.

Non-GAAP Operating Expenses were $14.6 million in the quarter and represented 32.4% of Revenue. Compared to Q1 of last year, we have lowered our Operating Expense base here by $2.8 million, or a 16.2% favorable year-over-year reduction. You have heard me say this in the past, but I feel it's important to reiterate that these are net savings, as we have been intentional about capturing and realizing some savings, while also redeploying some of the gains into areas that align to our strategic growth priorities and the furtherance of our four strategic pillars.

Turning to the bottom line, first quarter Adjusted EBITDA was negative $200 thousand, roughly in-line with last year's Q1 of positive $100 thousand. I am really pleased with the financial stewardship the team has demonstrated and the rigor and discipline that has underpinned our decision-making process to drive this result.

Shifting to the balance sheet and cash flow highlights --- we maintained a healthy cash and liquidity position that affords us the flexibility to continue to invest in our digital transformation initiatives, including the Robotic Process Automation and Click2Renew capabilities that Gary highlighted.

In the first quarter we accreted approximately $100 thousand of cash, cash equivalents, and restricted cash, primarily driven by our working capital. DSOs were 69 days, a very strong nine-day improvement year-over-year. Seasonal patterns and the mix of off-quarter clients usually cause a pronounced increase in DSOs sequentially from Q4 to Q1, so we are really pleased with how our client delivery, account management, and billing teams worked together to hold DSO flat with the fourth quarter of 2020.

Cash flow from operations was approximately $500 thousand and included approximately $900 thousand of restructuring expense to align with our virtual-first operating model and to improve our go-forward cost structure. CAPEX – inclusive of capitalized internally developed software – was $1.0 million, down approximately $500 thousand year-over-year.

Free Cash Flow in the first quarter was negative $500 thousand, compared to negative $7.2 million in the prior year period.

We ended Q1 with $36.5 million of cash, cash equivalents, and restricted cash. We maintained $15.0 million outstanding on our revolving line of credit with an effective interest rate of 2.11%, with an additional $14.7 million available for borrowing on the line. Total liquidity, consisting of cash on hand and availability under our revolver was $48.9 million as of quarter-end.

From a capital allocation standpoint, we continue to target our investments at internal organic initiatives that support our ongoing transformation. Although these investments and expenses can be dilutive to our near-term financial results, we undertake them believing they will further enhance our value proposition and accelerate our progression to our long-term target model objectives. We will continue to be disciplined about where and how we invest our resources, and we will also continue to be mindful of any potentially accretive acquisition opportunities or other uses of capital that could benefit our stockholders.

Before I open the call for questions, allow me to summarize our year-to-date results. Although we had a tougher year-over-year comparison on the P&L, it was not unforeseen and, in several respects, paced ahead of our internal assumptions. We had a comparatively strong quarter from a new bookings and churn standpoint, and we are encouraged by the momentum we are seeing on these two fronts. We added our first new logo of the year and secured some great expansion wins across our installed base. We had impressive performance renewing and extending contracts that were expiring in the quarter, including the large multi-year that Gary shared with you. So all things considered, we are really pleased with how the team performed through the first three months of the year.

We are increasingly encouraged by the tone and commentary we are hearing from our clients – as well as the more favorable market outlook more broadly – but we also recognize the road in front of us and the work we still have to do. We have not changed our expectation for the cadence through the year that we shared with you on our February call. We remain focused on our objective to return to growth later in the second half of the year, while also keeping our sights set on our target model and the value we believe we can create for our stockholders over time.

With that, Operator, please open the call for any questions.