SERVICESOURCE®

The Digital Customer Journey Experience Company

Q2 2020 Earnings Conference Call: July 30, 2020

Prepared Remarks

<u>Chad Lyne, EVP – Strategy, Corporate Development & IRO</u>

Thank you, Operator, and good day everyone. Thank you for joining us and welcome to ServiceSource's second quarter earnings call to discuss our results for the quarter ended June 30th, 2020. On the call today are Gary Moore, ServiceSource's Chairman and CEO, and Rich Walker, 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 of this call 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, July 30th, 2020, 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, Chad, and welcome everyone to our earnings conference call for the second quarter of 2020. Before we jump in, I want to address the organizational change that we announced last night. Debbie Dunnam, who has served as our COO since late 2018, will be leaving the Company in Q3 to take on a new assignment. I have had the good fortune of working with Debbie for many years, first during my time at Cisco and subsequently since I helped recruit her to ServiceSource. During her time here, she built and mentored a strong leadership team with a deep bench of tenured and experienced professionals that has strengthened many facets of our operating model. Key members of this team will continue in their roles on my Executive Leadership Team and will assume expanded scope and responsibility as we work to continue the important progress we are making as an organization. On behalf of the Board and my leadership team, we wish Debbie the very best in her next endeavor.

For those who joined our call in the first quarter, you will recall that we highlighted our rapid response to the COVID-19 pandemic and our strong execution on behalf of our clients amidst heightened uncertainty and volatility. Although we are operating through a time of ongoing and unprecedented economic disruption, in the second quarter we continued to demonstrate the resilience of our business model and the value of our solutions in the market. Our teams embraced our new virtual operating model and executed well with a client-first mentality, delivering year-over-year gains on multiple financial and operational metrics.

For today's call, there are two main topics I plan to cover. First, I want to share some context on what we are encountering in the market. And second, I will review our strategic priorities and the things we are doing to make further progress throughout the business. From there, I will hand it over to Rich to take you through our second quarter financial results before we open the call for questions.

Turning first to the market context and perspective --- the current recessionary environment has caused disruption and dislocation throughout the economy. Although we are seeing instances of near-term challenges and headwinds, we are also encouraged by areas of longer-term opportunities and tailwinds.

As you would expect, the technology sectors we serve are not immune from the broader macro headlines. According to industry analysts, global IT spending is expected to decline anywhere from 5-10% this year. This obviously can have downstream implications to expense and investment priorities for many tech companies. We have experienced some of this pressure, with sales cycles that have been prolonged or put on-hold and budgets that have been reallocated or reduced. That said, we have also seen upside instances where the environment has prompted companies to reevaluate their in-house and third-party partner mix. Where we encounter these situations, our business model and value proposition resonate well. We are able to commit to driving better outcomes with a variable, performance-based pricing model that delivers a very compelling ROI.

Prior to the pandemic, the shift to as-a-service offerings, subscription pricing plans, and cloud-based delivery models was causing companies to rethink their customer acquisition, engagement, growth, and retention strategies. Business leaders knew they would need to find ways to be more customer-centric in order to gain share and win in the markets where choice and competition were becoming more prevalent. The current environment has brought this focus on the customer to the forefront, as IT buyers and end-users are scrutinizing and rationalizing their spend. We hear from market participants that many companies are facing weaker sales pipelines, lower product usage, and higher customer churn. These themes are often more pronounced in their mid-market or SMB customer tiers, where the effects of the economic contraction are being felt more acutely. Although this has impacted our own operating environment, we believe it also creates a catalyst for greater opportunity.

In recent years, we have methodically expanded the scope of our solution suite from a renewals-only business to one that now addresses the full Customer Journey Experience. For companies dealing with pipeline challenges, our Digital Sales solution can generate greater velocity and performance throughout all stages of their sales funnel. For companies experiencing lower adoption rates, our Customer Success solution can ensure that their users are onboarded with a white glove treatment to position them for success and growth from day one. And for companies now encountering higher levels of churn or pricing discounting, our Renewals expertise can help stem attrition and expand customer lifetime value. The capabilities underpinning our value proposition are important for our clients in any economic cycle. In disruptive times like these, however, we hear that our offerings and proven ability to execute are becoming even more mission-critical as they seek to emerge from the recession in a position of strength.

In any operating scenario, there always is a measure of uncertainty in trying to assess the relative impact from various headwinds and tailwinds like the ones I just discussed. In the current environment, however, weighting probabilities and predicting outcomes has become more challenging for many companies, ServiceSource included. Year-to-date, we believe we have taken balanced and appropriate measures in the face of this greater uncertainty. We will continue to focus on the things that we can directly influence, while also taking steps to ensure we can respond to future unforeseen circumstances.

With that overarching context and market backdrop, I will now touch on our Q2 highlights and strategic priorities. On the financial front, our teams performed well as we helped our clients navigate through some challenging circumstances. Although Revenue was down nine percent year-over-year to 47.6 million dollars, we carried forward the cost discipline and productivity improvements that you saw last quarter. In our new virtual operating model, we remotely hired, trained, and ramped more than 140 new employees in the quarter. Average headcount was down approximately 17% year-over-year on a net basis, primarily tied to non-core engagements that we exited over the course of the past several quarters. This allowed us to improve Revenue-per-employee by more than 9% year-over-year and contributed to our non-GAAP Gross Profit Margin expansion year-over-year. Adjusted EBITDA improved slightly compared to Q2 of last year, and we accreted net cash in the quarter. Rich will provide additional color on the financials when we get to his section, but I would sum it up as a solid quarter that exceeded our internal expectations, particularly in light of some fairly choppy market conditions.

On the strategic priority front, we continued to make good strides on our four key pillars of Inspire Success, Impact Scale, Ignite Sales, and Innovate Solutions. As I have done in the past, allow me to speak first about Inspiring Success with our people. Throughout my career, I have been fortunate to lead some great organizations and teams. And from my first day here at ServiceSource, I was very impressed by the caliber of our people and the depth of our leadership bench. I saw an organization that had great potential in our human capital, but we needed to do a better job developing and subsequently retaining our talent. One metric my leadership and I have been very focused on is employee retention. Over time, this can clearly drive a financial benefit through lower recruiting and training costs, but the real ROI is in having more tenured and experienced staff that can consistently deliver at a higher level for our clients. Although the current labor markets are likely having some influence, we were very encouraged to see our employee retention rate increase again this quarter. We intend to continue investing meaningful resources to ensure that ServiceSource is an inclusive and diverse workplace where our people can build fulfilling and rewarding long-term careers.

Turning now to our Impact Scale pillar, our focus remains on redesigning processes and leveraging technology to drive greater standardization and consistency in our execution. This pillar is both Cost and Revenue oriented. On the cost side of the ledger, our progress here is evidenced in the employee productivity and profitability metrics I touched on in my earlier remarks. On the Revenue side, the broader objective is to ensure we deliver business outcomes that promote higher levels of client satisfaction, referenceability, and growth. We are encouraged by the progress we are making. We recently completed our annual client Net Promoter Score survey, where we had an increase in our NPS score and an uplift in client satisfaction rates. Importantly, we are seeing the improved sentiment from the survey turn into real-world results. Year-to-date through Q2, we successfully renewed or extended more than 90% of the contract value that came up for renewal. And on a trailing twelve-month basis, we grew Revenue with 5 of our top 10 clients.

Shifting to the Ignite Sales pillar, our go-to-market team did a good job on both the new logo and expansion front, despite the pandemic's disruption to business travel, conferences, and related marketing events. We did see some decisions put on hold or opportunities push out of the pipeline as executives confronted changes in their markets and businesses, but overall we continued building momentum from the first quarter. We signed two new logo wins in Q2 that we discussed with you on our May call, both of which are now live and in production. And at three of our largest clients, we signed new expansions in the quarter that were each worth more than one million dollars. For a productivity software client, we added a sizable European delivery capability; for a storage and networking company we expanded into a separate business unit; and for an open source cloud provider, we added a high-touch customer onboarding and health check program. Our sales bookings performance in the second quarter improved, both on a year-over-year basis and sequentially from Q1 2020. And so far in Q3, we continue to track good early progress. That said, we are also maintaining an appropriate degree of caution, knowing that a resurgent pandemic and any prolonged economic uncertainty could adversely impact purchase decisions or timelines.

Finally, on the Innovate Solutions pillar, our teams continue their work to productize and launch newer value-added services and internal enhancements – including our Salesforce Org Health Management offering, our digital commerce capabilities, and a Robotic Process Automation tool. We are also laying the groundwork for a robust alliances and partnership ecosystem, which we believe will be a valuable force multiplier for our go-to-market efforts. We look forward to sharing more on these efforts in subsequent quarters as we anticipate seeing greater traction down the road.

In summary, I will reiterate what I shared with you on our last call. Despite a more difficult economic environment than anyone envisioned at the start of the year, we feel we are executing well against the things we can control and influence. We will also continue to take actions to be responsive to things that may arise outside of our current field of view. Many companies within our end markets are facing near-term challenges, but this also provides an opportunity for us to demonstrate that the work we do on our clients' behalf is even more meaningful and important to their success. The fundamentals of our value proposition, the nature of our business model, and our results through two quarters highlight the resilience of our company. Although we see areas of potentially greater uncertainty in the second half of the year, we enter this period with a healthy balance sheet and an unwavering focus on our longer-term objectives.

With that, I will hand the call over to Rich to walk you through our financials before we open the line for Q&A. Rich…

Richard Walker – Chief Financial Officer

Thank you, Gary, and good day to everyone.

During our first quarter earnings call, we shared how the COVID-19 pandemic was creating multiple areas of uncertainty for many companies. But in the face of a fluid and dynamic environment, we remained confident in the underlying fundamentals of our company and the opportunity we had to build a stronger business through this period. That viewpoint is the same today. We see varied headwinds and tailwinds impacting our clients and their customers, which naturally drives a wider-than-normal range of potential outcomes for the balance of the year. So consistent with our philosophy from last quarter and given the reduced level of clarity, we will not be providing a more specific financial outlook for the year beyond the contextual backdrop that Gary shared in his remarks. As we demonstrated with our results in the second quarter, however, we believe we are bringing the right focus and attention to execute well in light of these challenges.

Turning to our results --- In the second quarter, we generated Revenue of 47.6 million dollars, down 4.7 million dollars, or 9%, year-over-year. Similar to last quarter's profile, the contraction was primarily driven by logos that were churned or proactively exited in prior periods as we rebalanced our portfolio. We also continued to have meaningful overhang on our results from one large client who is facing discrete cost pressures in the current environment. These two dynamics are tempering some of the growth we are seeing from other new logo wins and installed-base expansions, and these Revenue headwinds will likely persist as we look out to the coming quarters.

Shifting to Cost of Revenue and Gross Profit --- Our non-GAAP Cost of Revenue was 33.2 million dollars, favorably down four million dollars, or 10.7%, year-over-year. Our portfolio optimization efforts and resulting productivity and efficiency improvements were the primary levers here, which allowed us to expand non-GAAP Gross Profit margins year-over-year by 130 basis points to 30.2% of Revenue.

Continuing down the P&L --- We remain committed to ongoing investments in our employees, client relationships, and technology differentiators, while also lowering our overall expense structure given our current Revenue base. This vigilance throughout the organization allowed us to reduce non-GAAP Operating Expenses year-over-year by 1.6 million dollars, or 8.7%, to 16.4 million dollars.

At the bottom line, Adjusted EBITDA was negative 400 thousand dollars, roughly in-line with last year's Q2 results.

Moving to the balance sheet and cash flow highlights --- we maintained a strong balance sheet in the second quarter. We managed well through any potential downstream impacts of the economic environment on our Accounts Receivable and cash collections. DSOs were 76 days, up two days year-over-year but favorably down two days sequentially from the first quarter of 2020. Other favorable working capital swings contributed to 2.6 million dollars of positive Cash Flow from Operations in the quarter.

CAPEX – inclusive of capitalized internally developed software – was one million dollars, as we shifted some larger items that were more discretionary in nature to later in the year. Free cash flow returned to positive territory in the second quarter at 1.6 million dollars, up from 1.4 million dollars in Q2 2019 and a very nice improvement from this year's first quarter result of negative 7.2 million dollars.

We ended Q2 with a solid cash position and liquidity profile. Cash, cash equivalents, and restricted cash were 43.2 million dollars, a decrease of 6.3 million dollars in the quarter as we decided to pay down seven million dollars of borrowings on our revolving line of credit. We also took advantage of the favorable credit environment to refinance the remaining 20 million dollars of borrowings, lowering our effective borrowing rate by nearly 100 basis points.

Given the current market backdrop, we do not have any greater clarity on the depth and duration of the recession or when and how rapidly the business environment will recover. Despite this, we are confident in the overall health of our business, the strength of our operating model, and the flexibility that our cash flow and liquidity position afford us to weather these turbulent times while investing in the business for the longer term. To that end, we continue to believe our three-year target model objectives remain reasonable and attainable, and we expect to take ongoing actions that position the business to achieve an attractive growth and margin profile over that horizon.

With that, let me pass the call back over to Gary for any closing comments.

Gary B. Moore – Chairman and Chief Executive Officer

Thank you, Rich. I will be brief here. Throughout my career, I have witnessed many economic cycles and external shocks to the system. This pandemic-induced global recession is certainly unique. But in my experience, companies with compelling strategies, resilient operating models, and a focus on execution are able to turn disruption and uncertainty into new opportunity and potential. I believe we have those characteristics and mindset here at ServiceSource. We will continue to stay focused on the present while ensuring we strengthen our foundation for the future.

With that Operator, please open the call for questions.