

Q3 2018 Earnings Call

November 7, 2018

Important Information

- This presentation contains forward-looking statements that involve risks, uncertainties and assumptions, including guidance, projections, and estimates of future financial condition and results of operations. If the risks or uncertainties materialize or the assumptions prove incorrect, our results may differ materially from those expressed or implied by such forward-looking statements. Typically, these statements contain words such as “if,” “believe,” “may,” “will,” “estimate,” “continue,” “anticipate,” “intend,” “expect,” and similar expressions.
- The forward-looking statements in this presentation are based on estimates and information available to us at the time of this presentation. These statements are subject to risks and uncertainties that could cause actual results and events to differ materially and are not guarantees of future performance. Except as required by law, we undertake no obligation to update the forward-looking statements to reflect subsequent events or circumstances. A detailed discussion of these and other risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included in our Report on Form 10-K for the 2017 fiscal year end and our other periodic reports filed with the Securities and Exchange Commission, which can be accessed at <http://www.sec.gov>.
- This presentation refers to certain non-GAAP financial metrics. See the GAAP to non-GAAP reconciliation tables 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.

Q3'18 Non-GAAP Operating Expense

Non-GAAP

In \$ millions except EPS

	Q3 2018	Q3 2017
Cost of Revenue*	\$ 38.3	\$ 36.7
<i>% of Revenue</i>	67.1%	63.1%
Sales & Marketing*	7.5	6.7
<i>% of revenue</i>	13.2%	11.5%
Research & Development*	1.3	1.0
<i>% of revenue</i>	2.3%	1.6%
General & Administration*	8.9	10.1
<i>% of revenue</i>	15.5%	17.3%
Total Expenses*	56.1	54.4
<i>% of revenue</i>	98.1%	93.5%
Adjusted EBITDA*	\$ 3.1	\$ 5.7
<i>% of revenue</i>	5.4%	9.9%
Non-GAAP Net Income*	\$ 0.7	\$ 2.0
Non-GAAP EPS*	\$ 0.01	\$ 0.02
Shares used in calculating basic net Income (in the millions)	92.1	89.5

Please Refer to Appendix for GAAP
to Non GAAP Reconciliations

* Financials are Non-GAAP and exclude, where appropriate, stock-based compensation expense, amortization of internally developed software, restructuring and other costs, impairment loss on investment securities, amortization of contract acquisition costs related to the initial adoption of ASC 606, litigation reserve, and non-cash expenses relating to the convertible note and revolving line of credit.

Q4'18 Guidance – Key Metrics*

Q4'18 Guidance

Please Refer to Appendix for GAAP to Non GAAP Reconciliations

In \$ millions except EPS	Q4 Low	Q4 High
Revenue	\$ 60.0	\$ 63.0
<i>y/y growth</i>	-9.1%	-4.6%
Adjusted EBITDA*	\$ 4.0	\$ 6.0
Non-GAAP Net Income*	\$ 1.5	\$ 3.5
Non-GAAP EPS*	\$ 0.02	\$ 0.04

* Financials are Non-GAAP and exclude, where appropriate, stock-based compensation expense, amortization of internally developed software, restructuring and other costs, impairment loss on investment securities, amortization of contract acquisition costs related to the initial adoption of ASC 606, litigation reserve, and the revolving line of credit.

FY'18 Guidance – Key Metrics*

FY'18 Guidance

In \$ millions except EPS

FY Low

FY High

Please Refer to Appendix for GAAP to Non GAAP Reconciliations

Revenue	\$ 237.0	\$ 240.0
<i>y/y growth</i>	-0.9%	0.4%
Gross Margin*	34.0%	35.0%
Operating Expense (% of revenue)	32.0%	32.5%
Adjusted EBITDA*	\$ 12.0	\$ 14.0
Non-GAAP Net Income*	\$ 2.5	\$ 4.0
Non-GAAP EPS	\$ 0.03	\$ 0.04
Free Cash Flow **	\$ (9.0)	\$ (7.0)

* Financials are Non-GAAP and exclude, where appropriate, stock-based compensation expense, amortization of internally developed software and purchased intangibles, restructuring and other costs, impairment loss on investment securities, amortization of contract acquisition costs related to the initial adoption of ASC 606, litigation reserve, and non-cash expenses relating to the convertible note and revolving line of credit.

** Excludes restructuring and other costs

Appendix

Q3'18 GAAP to Non-GAAP Operating Expense

GAAP to Non-GAAP Reconciliation

(In thousands)

(Unaudited)

		Three Months Ended September 30, 2018
GAAP operating expenses		\$ 22,924
Non-GAAP adjustments:		
Stock-based compensation	(A)	(2,301)
Amortization of internally-developed software	(B)	(265)
Litigation reserve	(J)	(2,250)
Amortization of contract acquisition costs - ASC 606 initial adoption	(F)	(367)
Non-GAAP operating expense		<u>\$ 17,741</u>

Q4'18 Guidance GAAP to Non-GAAP Reconciliation Tables

Q4'18 Guidance GAAP Net Loss to Non-GAAP Net Income & EPS

GAAP to Non-GAAP Reconciliation

(In thousands, except per share data)

(Unaudited)

	Three Months Ended December 31, 2018		Three Months Ended December 31, 2018
GAAP net loss	(\$3,100) - (\$1,100)	GAAP diluted net loss per share	(\$0.03) - (\$0.01)
Non-GAAP adjustments:		Non-GAAP adjustments:	
Stock-based compensation	(A) 3,000	Stock-based compensation	(A) 0.03
Amortization of internally-developed software	(B) 1,200	Amortization of internally-developed software	(B) 0.01
Amortization of contract acquisition costs - ASC 606 initial adoption	(F) 300	Amortization of contract acquisition costs - ASC 606 initial adoption	(F) 0.00
Income tax effect on non-GAAP adjustments and impact of normalizing the effective income tax rate	(H) 100 - 100	Income tax effect on non-GAAP adjustments and impact of normalizing the effective income tax rate	(H) 0.00 - 0.00
Non-GAAP net income	<u>\$1,500 - \$3,500</u>	Non-GAAP diluted net income per share	(I) <u>\$0.02 - \$0.04</u>
		<i>Certain totals may not add due to rounding</i>	
		Shares used in calculating diluted net (loss) income per share on a non-GAAP basis	<u>91,386</u>

Q4'18 Guidance Net Loss to EBITDA

Reconciliation of Net Loss to Adjusted EBITDA

(In thousands)

(Unaudited)

	Three Months Ended December 31, <u>2018</u>
Net loss range	(\$3,100) - (\$1,100)
Income tax (benefit) provision	500
Interest & other expense, net	-
Depreciation & amortization	<u>3,300</u>
EBITDA range	\$700 - \$2,700
Stock-based compensation	(A) 3,000
Amortization of contract acquisition costs - ASC 606 initial adoption	(F) <u>300</u>
Adjusted EBITDA range	\$4,000 - \$6,000

FY'18 Guidance GAAP to Non-GAAP Reconciliation Tables

FY'18 Guidance GAAP to Non-GAAP – Gross Margin

GROSS MARGIN - GAAP TO NON-GAAP RECONCILIATION

(In thousands)

(Unaudited)

	Twelve Months Ended December 31, 2018	
GAAP gross margin	\$71,700 - \$75,100	
Non-GAAP adjustments:		
Stock-based compensation	(A)	1,000
Amortization of internally-developed software	(B)	7,800
Amortization of purchased intangible assets	(C)	100
Non-GAAP gross margin	<u>\$80,600 - \$84,000</u>	
GAAP Gross Margin	<u>30.0% - 31.0%</u>	
Non-GAAP adjustments:		
Stock-based compensation	(A)	0%
Amortization of internally-developed software	(B)	3%
Amortization of purchased intangible assets	(C)	0%
Non-GAAP gross margin	<u>34.0% - 35.0%</u>	
<i>Certain totals may not add due to rounding</i>		

FY'18 Guidance GAAP to Non-GAAP – Net Loss & EPS

GAAP to Non-GAAP Reconciliation

(In thousands, except per share data)

(Unaudited)

	Twelve Months Ended December 31, 2018		Twelve Months Ended December 31, 2018
GAAP net loss	(\$30,200) - (\$28,200)	GAAP diluted net loss per share	(\$0.33) - (\$0.31)
Non-GAAP adjustments:		Non-GAAP adjustments:	
Stock-based compensation (A)	12,000	Stock-based compensation (A)	0.13
Amortization of internally-developed software (B)	8,800	Amortization of internally-developed software (B)	0.10
Amortization of purchased intangible assets (C)	100	Amortization of purchased intangible assets (C)	0.00
Restructuring and other costs (D)	200	Restructuring and other costs (D)	0.00
Impairment loss on investment securities (E)	2,000	Impairment loss on investment securities (E)	0.02
Amortization of contract acquisition costs - ASC 606 initial adoption (F)	1,500	Amortization of contract acquisition costs - ASC 606 initial adoption (F)	0.02
Non-cash interest expense (G)	5,900	Non-cash interest expense (G)	0.06
Litigation reserve (J)	2,300	Litigation reserve (J)	0.03
Income tax effect on non-GAAP adjustments and impact of normalizing the effective income tax rate (H)	(100) - (600)	Income tax effect on non-GAAP adjustments and impact of normalizing the effective income tax rate (H)	(0.0) - (0.01)
Non-GAAP net income	\$2,500 - \$4,000	Non-GAAP diluted net income per share (I)	\$0.03 - \$0.04
		<i>Certain totals may not add due to rounding</i>	
		Shares used in calculating diluted net income per share on a non-GAAP basis	91,359

FY'18 Guidance Net Loss to EBITDA

Reconciliation of Net Loss to Adjusted EBITDA

(In thousands)

(Unaudited)

	Twelve Months Ended December 31, 2018	
Net loss range	(\$30,200) - (\$28,200)	
Income tax (benefit) provision	800	
Interest & other expense, net	6,700	
Depreciation & amortization	16,700	
EBITDA range	(\$6,000) - (\$4,000)	
Stock-based compensation	(A)	12,000
Restructuring and other costs	(D)	200
Impairment of investment securities	(E)	2,000
Amortization of contract acquisition costs - ASC 606 initial adoption	(F)	1,500
Litigation reserve	(J)	2,300
Adjusted EBITDA range	\$12,000 - \$14,000	

FY'18 Guidance Cash Flow from Operations to Free Cash Flow

Supplemental Cash Flow Information Free cash flow analysis, a Non-GAAP measure

(In thousands) (Unaudited)	Twelve Months Ended December 31, <u>2018</u>
Net cash provided by operating activities	\$7,000 - \$10,000
Less:	
Capital expenditures	\$16,000 - \$17,000
FX adjustment	-
Free cash flow	<u>(\$9,000) - (\$7,000)</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 and 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 certain software purchases and 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 the amortization of the cost associated with an acquired company's research and development efforts, trade names and customer relationships, are items arising from pre-acquisition activities and therefore are properly determined at the time of an acquisition. Although these intangible assets are continually evaluated for impairment, amortization of the cost of purchased intangibles is a static expense, one that is not typically affected by operations during any particular period.
- (D) Restructuring and other costs. Included in our GAAP presentation are expenses associated with our announced restructuring effort, commencing in Q2 2017. Restructuring and other costs consist of: employee severance and other benefits, costs of write-off of leasehold improvements, other property, equipment, and other lease exit costs. These are one-time in nature costs that are not indicative of our core operating performance.
- (E) Impairment loss on investment securities. Included in our GAAP presentation, this impairment of available-for-sale investment securities is equal to the difference between the fair value and amortized cost basis of the securities and was required to be recognized in net income (amounts were previously recorded in Other Comprehensive Income as an unrealized loss) due to our intent to sell these securities to repay our \$150 million convertible note due August 1, 2018. This non-cash charge is not related to or indicative of our ongoing core operating performance.

Footnotes (cont.)

- (F) 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) (“ASU 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 is 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 current or future operating performance.
- (G) 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 that 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.
- (H) 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 and J on our non-GAAP net loss; (ii) the income tax rate to a normalized effective tax rate of 26.5% for three and nine months ended September 30, 2018 and 40% for three and nine months ended September 30, 2017; and (iii) non-GAAP earnings per share based on a fully-diluted share count.
- (I) Non-GAAP basic net income per share. For this per share reconciliation, basic share count was used.
- (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 September 30, 2018, the Company has accrued a \$3.75 million reserve relating to our potential liability for currently pending disputes. These reserves are one-time in nature charges that are not indicative for our core operating performance.