SERVICESOURCE®

The Customer Journey Experience Company

Q2 2021 Earnings Conference Call: July 28, 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 second quarter ended June 30th, 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 today 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, July 28th, 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 second quarter of 2021.

It's a pleasure to be speaking with you today and to update you on the progress we are making. Our second quarter results highlight areas of acceleration in the business, and we expect our trajectory to continue to improve in the coming quarters. We are confident in our strategy, our capabilities are squarely aligned to our clients' most pressing challenges and opportunities, and our focused execution is driving stronger outcomes.

Last quarter we spoke about the lingering headwinds caused by COVID-19, and I would be remiss if I did not acknowledge that it continues to have an impact in particular markets and geographies. Uncertainty persists – particularly in some foreign markets – but on balance, the tone, commentary, and outlooks from our clients has shifted more to the positive. And within the small-to-midsize segment that we primarily address for our clients, we are seeing encouraging signs that companies within this tier appear to be on relatively stronger footing compared to the start of the year.

We believe we stand to benefit as our clients and their customers continue to regain confidence. The work we have done over the course of the past two years has improved our ability to be more responsive to the needs of the markets we serve. We've enhanced our solution suite and go-to-market strategy to be more focused and effective. We've transformed our delivery model to be virtual-first and more digitally enabled. We've streamlined our organization for greater speed and accountability. And we've invested meaningful time, resources, and capital to strengthen the foundation of the company to allow it to grow and scale more efficiently over the long-term.

The impact of these changes is now becoming more evident in our results. Our year-over-year and sequential revenue comparisons are moving in the right direction. Our sales engine is becoming more consistent and predictable in landing new logos and expanding the installed base. And our unwavering commitment to a Clients For Life culture is creating an environment where our clients increasingly view us as a strategic partner and trusted advisor that can help them succeed on their own go-to-market transformations.

Across the technology sectors we serve and the clients we support, we see and hear a recurring theme. In an era of premium valuations, intense competition, and rapid disruption, it's no surprise that the top-of-mind priority is growth. And not just faster growth, but also smarter growth. Growth that puts the customer at the center, built on a relationship and not a transaction.

Our integrated Customer Journey Experience solution suite assists our clients in achieving this growth mandate, more effectively and efficiently. Our digital inside sales solution allows for identifying, qualifying, and converting more new customers, ensuring our clients recognize maximum ROI on their marketing and sales investments at a lower cost of acquisition. Our customer success and renewals solution enables our clients' customers to recognize faster time-to-value, ensuring they use, consume, and buy more from our clients over a longer period of time. And our channel management solution supports our clients' indirect routes to market, ensuring their ecosystem of partners and resellers are equipped to help our clients win and retain market share. Regardless of what solution we deploy for a client, we bring the power of humanity and personalized engagement to their B2B customer relationships.

At a high-level, that's what our team of Sourcers do every day at ServiceSource. Allow me to spend a few minutes sharing some recent client stories. I think this will help make what we do a bit more tangible, and better illustrate our ability to drive results in areas that are strategic to the health of our clients' businesses.

As covered in a recent press release, we brought onboard a great new client in the second quarter. This company is an industry pioneer and category creator, and is widely recognized as a global leader in the cloud-based team collaboration and communication space. For born-in-the-cloud SaaS companies like this, growth rates are often 40-50% annually or higher. But maintaining that growth often puts tremendous stress on the post-sales organization. Focus naturally shifts to serving and supporting larger enterprise subscribers, which typically results in higher churn and lower retention rates in the SMB tier over time. This client was facing a similar dynamic, but recognized the strategic imperative of better engaging with the smaller subscribers that had contributed to its initial growth and success. Over the course of a multi-quarter pursuit, we assessed their renewals performance baseline and structured an innovative solution with a compelling ROI. Signed earlier in Q2, we are now live supporting this client with a holistic program encompassing subscriber health checks, contract quoting, and renewals and extension services. We are seamlessly integrated into the client's customer success team to help build and protect their recurring revenue subscription stream during their pursuit of above-market growth in the new digital work era. And although our initial deployment is on the smaller side, we are excited about the potential upside opportunity in supporting a company with more than 100,000 customers and run-rate revenue in excess of $1 billion.

Earlier in Q2, we also announced an expansion for a market leader in the cloud-based enterprise identity and access management sector. This example highlights that customer success is a global priority. Our initial deployment launched in early 2020, with our team managing an end-to-end customer success program to enhance the lifetime value of North America-based customers with $100,000 or more in annual recurring revenue. Our customer success managers assumed full accountability for these subscribers after the point of sale, with a robust playbook of proactive engagement touchpoints, ranging from week one welcome calls, to onboarding calls and health checks, to quarterly success meetings and business reviews. By building trust and fostering relationships throughout their first year as customers, our teams drove higher satisfaction and generated incremental upsell and cross-sell opportunities, delivering a strong 90%-plus net renewal rate across this important customer cohort. Through the practical demonstration of our brand promise of Trusted Business Outcomes Delivered, we were asked by our client to scale our methodology and expertise to support their growth and retention objectives in EMEA and Asia Pacific and Japan, giving the relationship a truly global footprint. Once the expansion is fully ramped, we expect the value of this client partnership will increase approximately 50% over the contract's two-year term, providing a great example of us earning the right to "land-and-expand" based on our performance.

The final example I want to share highlights the market growth opportunity for our digital inside sales capability. Late last year, an executive we had previously supported at one company moved into a new role as Chief Revenue Officer at another organization that was growing more than 30% annually. Based on his prior experience with us and the results we delivered, this executive engaged us to deploy a digitally enabled inside sales motion. This would allow his internal team of sellers to focus on larger opportunities, while we would ensure that the rest of the pipeline and leads were appropriately covered. Our initial launch delivered on the mandate to help this client win share and accelerate growth in the hyper-competitive cloud communications space. As we announced in a June press release, based on the rapid success of our initial deployment, we agreed to triple the size of the engagement. With an aggressive implementation timeline, we have now successfully ramped more than 50 professionals to support this client's high growth ambitions.

I share these success stories as I believe they are a direct reflection of the improved execution we are seeing across the business, spanning our go-to-market, client delivery, account management, and other supporting teams. We are operating more effectively using our proprietary High Performance Selling methodology, which our clients tell us is a unique differentiator for us in the market. Our Client Performance Targets, which are robust operational KPIs aligned to our clients' unique objectives, are at all-time highs. We are also engaging better with our client sponsors and executives using our Clients For Life mentality. This is best demonstrated in our recently completed client satisfaction survey, where our Net Promoter Scores increased 17 points to all-time high records. Our progress in these areas has boosted our ability to launch new programs and expansions in green status, and continue in a healthy relationship for the long-term.

You can see examples of this progress in the business highlights from our earnings release. On the sales front, we carried forward from the strong results we shared in the first quarter. On a trailing twelve-month basis through Q2, our bookings were up approximately 7% compared to the prior trailing twelve-month period. Our wins in the quarter were also broad-based across approximately one-fourth of our client base, including expansion wins in excess of $1 million each of expected contract value with three of our top ten clients. We did have several attractive late-stage opportunities push into Q3, and we look forward to publicizing and sharing these with you once we get them signed.

With respect to our installed base of clients, through the first half of the year, we had more than $70 million of contract value up for renewal and our teams did an extraordinary job executing on them. We successfully renewed or extended approximately 97% of this value. And when factoring in expansions that accompanied these renewals, our net retention rate was in excess of 100%. Client satisfaction and retention has been a key focus area for us, and these outcomes are positive signs that our efforts are paying off. I am incredibly proud of our team around the world for the great outcomes here.

In closing, our results through the first half of the year gives us confidence that we are on the right path, first to return the business to growth later this year, and second to accelerate toward to our long-term financial objectives.

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

Chad Lyne – Chief Financial Officer

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

When we spoke with you at the beginning of the year, we shared our expectation that the first half of 2021 would have more pronounced challenges from a year-over-year comparison standpoint, with a return to growth in the back half of this year. The dynamics we spoke about and first half cadence largely trended as we expected, if not a bit more favorably. With two quarters under our belt, we are encouraged by the headway we are making in the business and our stronger positioning to capitalize on a large and growing opportunity for our solutions.

Now, let's turn to our Q2 results.

Revenue of $46.3 million was down $1.3 million, or 2.8% year-over-year, marking a sizable shift from the 10.2% year-over-year contraction we reported last quarter. Consistent with Q1, the new logos we won in FY 2020 contributed approximately 3% to our second quarter Revenue. The single large client headwind that we have spoken about in past quarters continued to weigh on our results as we have not yet lapped the tougher compare. If you exclude that client from both periods, Revenue in Q2 would have shown nominal year-over-year growth.

This is also the first time since 2018 where we can report topline growth from Q1 to Q2, which tends to be a seasonally softer quarter. On a sequential quarter-over-quarter basis, Revenue was up 2.9%.

Walking down the P&L, our second quarter non-GAAP Cost of Revenue was $33.2 million and Non-GAAP Gross Profit was $13.1 million, or a margin of 28.4% of Revenue, down $1.2 million or approximately 180 basis points year-over-year. As we previewed in our May call, non-GAAP Gross Profit margins were impacted by higher recruiting and personnel-related expenses as we added approximately 150 employees in the quarter to support new program launches and expansions, including the examples Gary shared in his remarks.

Non-GAAP Operating Expenses were $14.7 million in the quarter and represented 31.7% of Revenue, favorably down $1.7 million, or 10.6%, year-over-year. Looking at both our non-GAAP Cost of Revenue and non-GAAP Operating Expenses, our combined spend in Q2 was down approximately $1.8 million, or 3.7%, year-over-year, driven in large part by our flatter management structure, lower facility-related costs, and travel savings enabled by our virtual-first operating model. These savings are also net of approximately $1.4 million of year-over-year foreign exchange headwinds in the quarter, approximately 3/4th of which hit Cost of Revenue and 1/4th of which hit OpEx.

At the bottom line, second quarter Adjusted EBITDA was negative $200 thousand, approximately $300 thousand favorable year-over-year. Our approach remains consistent here – we are intentionally choosing to not maximize profitability in the near-term, given our conviction around high ROI investment areas that we believe will support the achievement of our growth and longer-term model ambitions.

Turning to the balance sheet and cash flow highlights --- we maintained a healthy cash and liquidity position. Strong working capital management was led by DSOs of 67 days, a very impressive reduction of nine days year-over-year and a two-day improvement sequentially from Q1's strong performance.

Cash flow from operations was negative $500 thousand and CAPEX – inclusive of capitalized internally developed software – was $1.1 million, resulting in Free Cash Flow of negative $1.5 million. Through the first half of the year, Free Cash Flow was negative $2.0 million, compared to negative $5.7 million in the first half of 2020.

We ended Q2 with $34.8 million of cash, cash equivalents, and restricted cash.

As noted in an 8-K filing this afternoon, last week we paid off in full the $15 million outstanding on our 2018 revolving credit facility that was due to mature on July 30th. Following that payoff, on July 23rd we entered into a new revolving credit facility with Bank of America. This new facility has a three-year tenor, a $35 million commitment, a $10 million uncommitted accordion, and bears interest at a rate equal to BSBY plus 2.0% to 2.5% per annum, or an alternate base rate plus 1.0% to 1.5% per annum. We are pleased to welcome Bank of America as a new financial partner and to successfully put in place an attractive credit facility to support our growth and working capital requirements going forward.

In summary, we are pleased with our performance in the quarter and the progression of our results through the first half of the year. The strategic changes and long-term-focused investments we have made throughout the company are beginning to enhance our momentum in the marketplace. We continue to see improvement in the trending of our operational KPIs, the health of our client relationships, and the trajectory of our financials. We are mindful that economic conditions remain fragile and outlooks are uncertain in many regions throughout the world; that said, we remain focused on the internal factors we can control. We are committed to building on the areas of internal progress we see, and believe we are tracking favorably to report year-over-year revenue growth in the third or fourth quarter. With that, Operator, please open the call for questions, and then we will have Gary come back after any Q&A to close the call.

