SERVICESOURCE®

The Digital Customer Journey Experience Company

Q1 2020 Earnings Conference Call: May 8, 2020

Prepared Remarks

Chad Lyne, EVP – Strategy, Corporate Development & IRO

Thank you, Operator, and good day everyone. Thank you for joining us and welcome to ServiceSource's first quarter earnings call to discuss our results for the quarter ended March 31st, 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, May 8th, 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 first quarter of 2020. Before diving in here, we would just like to offer our heartfelt sympathy to those who have been personally affected by the COVID-19 pandemic, as well as to express our deepest appreciation to the healthcare workers, first responders, and others who are on the front lines of this battle.

All of us are clearly dealing with unprecedented times, but we are incredibly proud of how the ServiceSource team has rallied together to support each other. Our priority has been – and will continue to be – on the safety, health, and wellbeing or our employees around the world, while ensuring we fulfill our brand promise and deliver on behalf of the clients who have entrusted us with their business.

And as you see in our results, we executed well against the things within our control to deliver solid financial performance for the first quarter. In the past few weeks, however, things outside our control – like the duration or severity of the crisis, the timing or magnitude of the economic impact, and whether or how these factors will affect our clients and their customers – have created a higher degree of uncertainty and a potentially wider range of outcomes. As a result, and in-line with our commitment to transparency, we believe it is prudent to withdraw the contextual outlook that we previously provided for the full year. Our business remains strong and resilient, and we are confident in our ability to execute to our internal objectives and priorities. We will continuously monitor the environment we are in and revisit our outlook once we feel there is greater clarity and visibility.

Moving on to the rest of our agenda --- for today's call, I plan to cover a couple topics with you. First, I will share an update on the activities and actions we have taken in response to COVID. And then I will go into our accomplishments during Q1 and the demonstrable progress we continue to make across the organization. I will then hand the call over to Rich to provide a deeper review of our financial results, before I close us out and open the call for questions.

Starting first with what I am sure is top of mind for many of you is what we have done to position the company in what is obviously a fluid and dynamic environment. Our proactive efforts throughout Q1 enabled us to mitigate risk or disruption to the business, to care for our employees, and to sustain the mission-critical work we do for our clients. Beginning early in February, we formed a COVID security and incident response team and promptly began testing our Business Continuity Plan. In close collaboration with our clients, we began taking action in early March. We made rapid, wholesale changes to our infrastructure, systems, processes, and policies to enable an entirely virtual operating model. Within a matter of days – and prior to government restrictions and lockdowns – we successfully transitioned our entire global workforce to a 100% remote work-from-home environment.

For our clients, our dedication allowed them to have a strong close to their month or quarter. We have heard a lot of positive feedback from our clients and believe we have earned goodwill due to how we have supported them and their customers. It goes without saying that there is nothing usual about the current environment, but our proactive and early response allowed us to effectively maintain business as usual in the first quarter, and we continue to recruit, onboard, train, and operate through our new model. Recognizing that many companies are facing very pronounced disruptions, we feel very fortunate that we have been able to maintain full delivery capability for our clients and that our employees can continue to earn a living in an environment that is safest for them, their families, and their communities.

With that context, I will now speak to our typical Q1 activities and highlights. We are proud of how well our teams executed to deliver financial results above our internal expectations during what has been a challenging period. As we discussed on our February call, we anticipated a tougher year-over-year Revenue comparable given the actions we took last year to optimize and right-size our portfolio. We knew we would continue to face a topline trade-off as we ramped new revenue while rolling-off more revenue from churned or proactively exited engagements. That said, we managed well through these cross currents in the first quarter, generating Revenue of 50.1 million dollars, down less than 10% from Q1 of last year. In anticipation of the lower revenue base, we demonstrated rigorous cost management and expense discipline to drive non-GAAP Gross Profit margin expansion year-over-year and maintained positive – albeit modest – Adjusted EBITDA in the quarter. And as we've discussed in the past, we have not backed-off from the targeted investments we are making throughout the business that align to our longer-term strategic roadmap. We will continue to reduce spend in some areas in order to fund priority initiatives that we believe will strengthen our value proposition, further differentiate our offerings, and enhance our client relationships and outcomes.

Moving on from the financials, we continued the progress and momentum from last year on our four transformational pillars of Inspire Success, Impact Scale, Ignite Sales, and Innovate Solutions.

First, on our people. We are seeing the benefit from our investments in talent acquisition, training, leadership development, and culture. Employee loyalty and retention continue to show strong gains, with average tenure now at 3.1 years, up approximately 25 percent from the same period last year. And with a more tenured and experienced workforce, we are realizing improvements in productivity and efficiency. Revenue per employee is up nearly 9 percent year-over-year, while total headcount is down 17 percent.

Shifting to the delivery organization, we made extensive changes last year to simplify, streamline, and strengthen core aspects of our business. The impact on our operations continues to be encouraging. We are demonstrating more agility, responsiveness, and client-centricity that is earning us a seat at the table as a strategic enabler and trusted partner. Our teams are showing up differently and we are seeing improvements in several key areas as a result. Q1 was expected to be our single largest quarter this year in terms of contracts coming up for renewal, with approximately 55 million dollars expiring in the quarter. We successfully renewed or extended approximately 95 percent of that contract value, so it's been a great start to the year there. And in looking at our largest relationships, on a trailing twelve-month basis we grew revenue with six of our top 10 clients. Excluding the impact from one top 10 client where we are currently seeing some pronounced contraction as they reprioritize some of their go-to-market spend, the other nine clients collectively grew approximately 4.8% on a trailing twelve-month basis.

On the sales front, we remain focused on improving our pipeline size, quality, diversity, and velocity. We have made a good amount of progress here, but still have more to go to get the growth engine firing on all cylinders. That said, the traction we are seeing so far this year is encouraging. If you recall, we signed a total of three new logos throughout all of fiscal 2019. Year-to-date today, we have already won three new logos. On our February call we mentioned an early Q1 win with Absolute – the leader in endpoint resilience software – which we are now in the process of ramping. In April we welcomed two additional brands to our client roster: PTC – a leading provider of digital transformation software solutions for global manufacturers, and Firefly Educate – a leading provider of IT training programs and educational content. From an installed base perspective, we closed multiple expansion wins, signing incremental business with four of our top five clients.

In summary, we are encouraged by what has been a relatively strong start to the year. We saw continued progress and momentum building off of the foundational heavy lifting we did last year. The underlying fundamentals of the business are healthy, the work we do on behalf of our clients is relevant and important, our business model is resilient, and we are executing from a position of relative strength with a well-capitalized and healthy balance sheet.

With that, I will turn the call over to Rich to walk you through our financials, and then I will come back to close us out before we open it for Q&A. Rich…

Richard Walker – Chief Financial Officer

Thank you, Gary, and good morning to everyone.

As highlighted in Gary's remarks, we are proud of how we executed in the quarter…not just in terms of our financial results, but also more holistically in how we supported our clients and employees through the evolving uncertainty of the COVID impact. Many of the initiatives and actions we undertook last year were key enablers to allowing us to adapt and pivot our business to operate in the current environment. Although global macro uncertainty remains high, we believe we are well-positioned to build a stronger and more valuable company through this period.

There are three things I plan to cover with you today. First, I will walk you through the P&L highlights and year-over-year comparisons to Q1 of last year. Second, I will review key balance sheet, cash flow, and liquidity items. And third, I will provide some perspective on what we are seeing in the current environment in light of COVID and our decision to withdraw the full-year contextual outlook that we shared with you in February.

With that backdrop, let's move in to the specifics. In the first quarter, we generated Revenue of 50.1 million dollars, down 5.4 million dollars, or 9.7%, year-over-year. The entirety of this variance is tied to logos that were churned or proactively exited in 2018 or 2019. We generated 5.4 million dollars of revenue from these logos in Q1 of last year but had zero revenue contribution in Q1 of 2020. As Gary mentioned in his commentary and as we have shared transparently with you during the past year, where appropriate, we are willing to make a near-term revenue trade-off in order to optimize our portfolio. This is allowing us to free up capacity and resources to support new scopes of work in higher growth areas, which are in the sweet spot of our growth strategy and that we believe can be more margin accretive over time. Although we estimate most of the rationalization work is now behind us rather than in front of us, we anticipate facing similarly challenging year-over-year comparables for a couple more quarters.

Shifting to Cost of Revenue and Gross Profit --- our non-GAAP Cost of Revenue was 34.3 million dollars, favorably down 4.2 million dollars, or 10.8%, year-over-year. Our focus on expense management, productivity, utilization, and spans of control allowed us to generate non-GAAP Gross Profit of 15.9 million dollars and a margin of 31.6% of Revenue, an improvement of 80 basis points from the first quarter of 2019.

Moving further down the P&L, you will see that we remain vigilant at managing our expense base. Our objective is to be responsive to our current topline profile, while also ensuring we continue to invest appropriately in the initiatives, programs, technologies, and teams that we believe will position us for a return to long-term sustainable growth. Our Non-GAAP Operating Expenses in the first quarter of this year were 17.3 million dollars, favorably down approximately 800 thousand dollars, or roughly 4.5%, from last year's Q1.

From a bottom-line standpoint, we generated Adjusted EBITDA of approximately 140 thousand dollars, or 0.3% of revenue, compared to approximately 950 thousand dollars and 1.7% of revenue in the first quarter of 2019.

Now let me turn to the balance sheet and cash flow highlights. Our balance sheet and liquidity profile remain strong. DSOs came in at 78 days, favorably down 5 days on a year-over-year basis. Cash flow from operations was negative 5.7 million dollars, compared to positive 2.1 million dollars in Q1 2019, primarily driven by shifts in working capital. CAPEX – inclusive of capitalized internally developed software – was 1.6 million dollars this quarter, a reduction of approximately 46% from the 2.9 million dollars spent in last year's Q1. Free cash flow was negative 7.2 million dollars this quarter, compared to approximately negative 800 thousand dollars in Q1 2019.

We entered this year with 29.4 million dollars of cash, cash equivalents, and restricted cash on the balance sheet. As you saw in our earnings press release and the 10-Q we filed yesterday, we made a decision in March to further enhance our balance sheet and liquidity. We thought it was prudent to take advantage of our access to our 40 million dollar revolving line of credit given some of the volatility we were seeing in the broader credit markets. We drew down 27 million dollars through a six-month borrowing on this line to bring our cash, cash equivalents, and restricted cash balance at quarter-end to 49.5 million dollars. Although we do not currently anticipate any needs or uses for this capital, given the uncertainty of COVID's impacts on the economy or financial markets, we felt it was a wise course of action to preemptively strengthen an already solid cash and liquidity position.

So to summarize our Q1 financials, we had a nice start to the year with good execution throughout the business, and we are positioned with a strong balance sheet to continue to invest in our strategic priorities.

Now, let me take a step back to cover in more detail Gary's earlier comments about our decision to withdraw our directional full-year outlook, as well as some broader context on what we are seeing as we look forward. We want to be clear that although the COVID pandemic has created multiple areas of uncertainty for all companies, we remain confident in the underlying fundamentals of our business. In good times, driving recurring revenue, investing in customer success, and ensuring high renewal rates are all important mandates for the clients we serve. In the challenging environment that many companies are currently facing, these priorities take on even greater importance, visibility, and criticality. Given our domain expertise and the scope of our capabilities and solution suite, we believe we are well positioned with a very strong platform to help our clients best navigate through the challenges they are now encountering.

As you would expect, there are various factors and circumstances outside our control that may limit our visibility in the current environment. The dynamic and rapidly evolving nature of the pandemic – and any resulting downstream impact it may have on our clients and their end-users – remains unclear. Global GDP and technology spending forecasts are being revised downward, and many of our larger publicly-traded clients have withdrawn their revenue and earnings guidance. On the other hand, we are excited and encouraged as we see areas of growth and heightened demand from clients in sectors like collaboration, cybersecurity, and cloud workloads. We have analyzed and modeled a variety of upside and downside scenarios to our original outlook. To put it simply and transparently, at this point in time we don't have enough clarity to either lower, maintain, or raise the expectation we had coming into the year. As you can appreciate, new information and data emerges on a near real-time basis and we will evaluate and assess these inputs as they become available. Once we get greater clarity on the economic recovery, the outlook for the technology industry as a whole, and the trajectory for our clients specifically, we anticipate providing a subsequent update to our full-year financial expectations on our Q2 call.

With that, let me pass the call back over to Gary.

Gary B. Moore – Chairman and Chief Executive Officer

Thank you, Rich. We are pleased with what we are seeing in the business. We executed and delivered well in Q1, particularly since we accomplished what we did even as we pivoted the entire organization to a new distributed, work-from-home model. We are extremely proud of the level of interaction and engagement of the teams, the speed of decision-making, and everyone's relentless focus on driving exceptional outcomes for our clients. So a word of public thanks and appreciation to our people for doing a great job taking care of our business and our clients during this time.

The COVID pandemic may have served as a catalyst to change where or how we do things, but it hasn't changed who we are as a company, our value proposition in the marketplace, our near-term priorities, or our long-term strategy. Our strategic focus and vision remain the same. We will continue to build upon the stronger foundation we have established as we strive to create a growing, profitable, and more valuable company that we are all proud of.

Although there is a high degree of uncertainty in the broader environment, we have tremendous confidence in the health, strength, and resilience of our business, across both intermediate and longer-term horizons. We believe we have the right priorities and are doing the right things throughout the business to ensure we are prepared and positioned to come through this period even stronger.

With that Operator, please open the call to questions.

