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BLKB - Q4 2018 Blackbaud Inc Earnings Call

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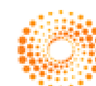

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PRESENTATION

Operator

Good day, and welcome to the Blackbaud, Inc. Q4 2018 Earnings Call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Mark Furlong. Please go ahead.

Mark Furlong - *Blackbaud, Inc. - Director of IR*

Good morning, everyone. Thanks for joining us on Blackbaud's Fourth Quarter and Full Year 2018 Earnings Call. Today, we will review our financial and operational results and provide commentary on our performance in the context of our 4-point growth strategy.

Joining me on the call today are Mike Gianoni, Blackbaud's President and CEO; and Tony Boor, Blackbaud's Executive Vice President and CFO. Mike and Tony will make prepared comments, and then we will open up the call for your questions.

Please note that our comments today contain forward-looking statements subject to risks and uncertainties that could cause actual results to differ materially from those projected. Please refer to our most recent Form 10-K and other SEC filings for more information on those risks.

We believe that a combination of both GAAP and non-GAAP measures are more representative of how we internally measure our business. Unless otherwise specified, we will refer only to non-GAAP financial measures on this call. Please note that non-GAAP financial measures should not be considered in isolation from or as a substitution for GAAP measures.

A reconciliation of GAAP and non-GAAP results is available in the press release we issued last night and a more detailed supplemental schedule is available in our presentation on our Investor Relations website. Please also note that unless otherwise specified, we will refer to 2018 results and comparable 2017 results as adjusted to reflect our adoption on January 1, 2018 of ASC 606 related to revenue from contracts with customers.

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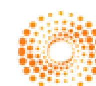

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Before I turn the call over to Mike, I'll briefly cover our upcoming investor marketing activity, which is available on our Investor Relations website. During the first quarter, our team will be attending the Raymond James Institutional Investor Conference in Orlando and Stifel Executive Summit in Streamsong. We will also be holding meetings with investors in New York, Chicago, Milwaukee, Houston and Kansas City.

With that, I'll turn the call over to Mike.

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

Thanks, Mark. Good morning, everyone, and thanks for joining our call today.

I'm pleased to report a solid finish to 2018 as we furthered our strategic initiatives and positioned the company for long-term success. We've continued to shift towards a reoccurring revenue model with our reoccurring revenue mix comprising 90% of total revenue in 2018, and we continue to accelerate our pace of innovation to digitally transform the markets that we serve.

There's no question that 2018 was a banner year for Blackbaud's innovation. The Blackbaud SKY platform has reached a level of maturity that enables us to both rapidly advance our existing applications and bring new solutions to market, such as our entirely new Cloud Solution for Faith-based Communities, expanded Cloud for Higher Education Institutions and Nonprofit Resource Management, which is a joint development partnership with Microsoft.

And our Blackbaud's SKY powered solutions continue to lead the industry, scoring high marks with market researchers like Forrester, Gartner and IDC. We're committed to driving social good through innovative new software technology and create lasting value for our customers, employees and shareholders.

In 2018, we released our first-ever social responsibility report, which provides insight and transparency into our global social responsibility, governance and ethical practices. And I'm pleased with the progress that we've made in our program initiatives, which have received national recognition, such as our recently awarded Top Employer for Diversity in America from Forbes.

We have a lot to cover this morning, and we want to get to your questions. So let's get started with the progress that we've made against our 4-point growth strategy.

The first of our 4 strategies is integrated and open solutions on the cloud. We've created a very high-velocity engineering environment that leverages the latest and modern cloud software technology, which is unmatched in our industry. No one else in this space is taking our approach.

We've made several major innovation announcements in 2018, demonstrating our ability to rapidly innovate, address customer needs and grow our addressable markets. We introduced our entirely new comprehensive cloud solution for faith-based communities, which will bring together our proven strength in financial management, fundraising, marketing, payments and analytics together in a completely new set of Church Management capabilities.

We've early adopters using the new Church Management solution today in close collaboration with our product teams and our Blackbaud SKY platform is enabling us to incorporate real-time customer feedback to rapidly advance the platform. Churches finally have a comprehensive, modern cloud solution built for the way they work from a single, accountable provider who can reduce their IT footprint and digitally transform their operations.

We also significantly expanded our higher education cloud by introducing enrollment management, learning management, content management, student information and tuition management capabilities. This broadened cloud will enable higher education institutions to manage the complete student life cycle from admissions to alumni engagement inside one comprehensive solution.

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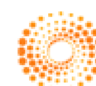

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Just like the faith markets, this is a massive opportunity for Blackbaud to deliver innovation with a connected cloud experience in a space that's comprised predominantly of disparate legacy point solution software. And Blackbaud's Cloud for Higher Education Institutions takes full advantage of the rapid innovation, modern user experience, enhanced capabilities made possible by our Blackbaud SKY platform.

Blackbaud SKY enabled us to extend our proven K-12 private school solutions upmarket to higher education with significantly advanced functionality. Our development didn't start from scratch and we've moved quickly by leveraging pre-existing capabilities available of Blackbaud SKY. That's the power of this platform.

We also took another major step forward in our partnership with Microsoft with the announcement of our Integrated Cloud Initiative for Nonprofits. This is a joint investment initiative to accelerate cloud innovation in areas that address critical market needs across the mission life cycle of nonprofits. As a part of this initiative, we announced our first jointly developed solution called Nonprofit Resource Management, which is a breakthrough in helping nonprofits effectively source, track, distribute and measure the impacts of their resources across core business processes from managing their distribution material goods, to financial and human capital distribution.

Nonprofit Resource Management solutions suite is currently in development in collaboration with early adopters. The solution will be sold jointly through Blackbaud and Microsoft partners through sales channels and will work seamlessly with Blackbaud solutions providing a connected experience for our customers. This is another step forward in an evolving partnership between Blackbaud and Microsoft to jointly develop, co-market and co-sell innovative software technology that will advance the industry, and it's an interesting go-to-market optionality for us that we didn't previously have in the past.

Finally, I'm excited about our recently announced acquisition of Plano, Texas-based YourCause, an industry leader in enterprise, corporate social responsibility and employee engagement technology. YourCause stood out as an innovative, flexible and scalable software provider with an impressive customer portfolio, including Fortune 500 companies and small businesses alike, along with exceptional customer satisfaction and retention.

Hundreds of companies like Dell, AT&T and Samsung have chosen YourCause to enable over 8 million people to process roughly $250,000 in donations every business hour. YourCause has coordinated, tracked and rewarded more than 30 million volunteer hours for its customers. Our combined footprint in corporate social responsibility and employment engagement positions us as the global industry leader in providing cloud solutions for both nonprofit organizations and for-profit companies committed to social issues.

Adding YourCause's innovative and differentiated capabilities in workplace giving and volunteering to Blackbaud's unmatched cloud software platform, data intelligence services and expertise in philanthropy and engagement is a game changer in driving effectiveness for companies and the broader social good community.

This leads me to our second growth strategy, which is to drive sales effectiveness. Selling modern, integrated cloud solutions that are purpose-built for our customers' needs is a key competitive differentiator for our sales teams. The transformational change that's taken place in R&D tightly aligned with our selling strategies by design. Our sales account executives are now leading with a total solution selling strategy by vertical, focused on reoccurring revenue and driving more products per customer, higher ASPs and overall increased customer lifetime value. As you know, we've been steadily pouring the foundation to develop a highly productive and scalable sales model, and we started the second half of 2018 ramping our sales hiring more significantly than past trends.

I'm pleased to share that we increased our total direct sales headcount by roughly 20% in the second half of 2018, which is more than double our historical pace of annual hiring. We'll continue investing into sales in 2019 and beyond to better address this massive market opportunity, and the focus going forward will be adding additional sales headcount, improving productivity and a greater focus on adding net new logos.

We made big strides over the course of the year to simplify our program and refine our methodology and approach in a uniform way to better enable our salespeople with process and practice. Our sales transformation structure is largely done. And we plan to carry that momentum into 2019 with our expanded sales organization.

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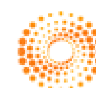

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We had some really terrific wins in 2018, adding to our growing customer base of over 45,000 customers. I obviously can't cover them all, but I wanted to give you a sense of momentum that's building with customers choosing to partner with Blackbaud, where even higher education institutions like Clemson University, some of the largest K-12 private schools in America like the Punahou School in Honolulu, well renowned organizations like the George Bush Presidential Library Foundation, the Boston Bruins Foundation, large health care organizations like Dartmouth-Hitchcock Health, nonprofit coalitions like The United Way of Portland and faith, one of the largest Catholic dioceses in United States that selected Blackbaud as partner organization inclusive of several hundred parishes and over 100 K-12 private schools.

Our partnership with Microsoft is gaining momentum as well, with Microsoft introducing us to new joint selling opportunities like Ducks Unlimited, which chose to partner with both Blackbaud and Microsoft to advance their mission and organizational objectives.

Now let's turn to our third strategy, which is TAM expansion. We're continuing to expand our TAM into new and near adjacencies with acquisitions and product investments. We've been executing this strategy for several years now, primarily expanding TAM through acquisitions until 2018, which is a banner year for Blackbaud innovation. We've made 3 organic TAM expansion announcements, introducing the Blackbaud Cloud Solution for Faith Communities, our expanded Cloud for Higher Education and Nonprofit Resource Management with Microsoft.

We're demonstrating that we're now able to organically build and not just require incremental TAM and each solution introduction added approximately $2 billion to our addressable market. We also acquired Reeher in the second quarter of 2018 that bolstered Blackbaud's extended performance benchmarking capabilities.

And we're very excited about the recent acquisitions of YourCause, which closed in the first business day in January 2019 and adds another $0.5 billion to our TAM. Our total addressable market now stands at over $10 billion, and we remain active in the evaluation of opportunities to further expand our TAM through acquisitions and internal product development.

Our final strategic initiative is to focus on operational efficiency, to strengthen the business, position us for long-term success. We continue driving towards a more scalable operating model that creates efficiency and consistency on how we execute through infrastructure investments, productivity initiatives and organizational realignments. In 2018, we executed a comprehensive workplace strategy to better align our organizational objectives with our geographic footprint.

We designated Charleston, Austin, London and Sydney as our hub locations, and we're leveraging a more flexible office strategy to replace and upgrade some of our existing offices and expand our footprint into new locations for customer-facing roles. This operational flexibility allows us to evolve our business to better meet both our employee and customer needs. Overall, the key for us is optimizing our office utilization, improving our geographic sales coverage and enhancing our employees' daily experience to improve productivity and effectiveness. We continue this initiative into 2019 and expect it to be largely complete by the end of this year.

Overall, I'm pleased with the continued transformation in the business and shift towards reoccurring revenue. And I'm particularly excited about the accelerated pace of innovation that we're delivering for our customers and the reaction in the market. Our new cloud solutions have significantly expanded our addressable markets and cover a greater share of customer IT spend. Our commitment to develop a fully integrated end-to-end cloud are game changers for the industry and a massive opportunity for Blackbaud.

I'll now turn the call over to Tony to cover our financial performance in greater detail before we open it up for Q&A. Tony?

Anthony W. Boor - *Blackbaud, Inc. - Executive VP of Finance & Administration and CFO*

Thanks, Mike. Good morning, everyone. Over the course of 2018, we strengthened the business, delivered greater value to our customers and better positioned ourselves for future growth and scale.

Our fourth quarter results allowed us to exceed the midpoint of our updated full year revenue guidance and exceeded the high end of our updated ranges for both profitability and cash.

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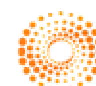

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I will refer to yesterday's press release and the investor materials posted to our website for the full detail of the quarter and the full year financial performance. Today, I will focus on key highlights, so we can get to your questions.

We continue to successfully reduce the mix of onetime services and other revenue, which is positive for us long-term, but creates a significant drag on our total company revenue growth in the near term. Onetime services and other revenue represented only 10% of total revenue mix and declined $6 million in the quarter, which is a 21% decline versus Q4 of 2017.

We're now selling a portfolio of modern cloud solutions, which is driving this shift away from onetime services. Recurring revenue mix represented 90% of total revenue, which is 260 basis points higher than Q4 of 2017 and 2.8% growth on an organic basis.

On a full year basis, we delivered $851 million in revenue, which exceeded the midpoint of our updated guidance and represents 7.6% growth over 2017 or 2.7% on an organic basis. Recurring revenue represented 90% of total revenue, which is 300 basis points higher than 2017 and 5.6% growth on an organic basis.

Onetime services and other revenue represented 10% of total revenue mix and declined $18 million, which is a 17% decline versus 2017. We successfully drove an accelerated decline in our Professional Services business, and that rate of decline exceeded our initial expectations from the beginning of 2018.

Turning to profitability, our fourth quarter gross margin was 58.8%, which is a 50 basis point increase versus Q4 of 2017. For the full year, our gross margin was 60.8%, which is 90 basis points improvement over 2017.

We generated full year operating income of $171 million, representing an operating margin of 20% and diluted earnings per share of $2.59. Both operating margin and diluted earnings per share were strong and exceeded the high end of our updated full year financial guidance.

It's important to note that our operating margin performance was inclusive of our 2018 investments into innovation like our entirely new faith cloud, expansion of our higher education cloud, integrated cloud initiative with Microsoft, acquisitions of Reeher and investment to ramp sales hiring that we began in the third quarter adding roughly 20% to our sales headcount year-over-year.

Moving to the cash flow statement and balance sheet. In Q4, we generated $51 million in free cash flow. We continued making necessary innovation and infrastructure investments that support our move to the cloud, amounting to $2 million in CapEx, primarily associated with our new headquarters and investment in infrastructure and $11 million for capitalized software development.

For the full year, we invested $15 million in CapEx for property and equipment and $38 million for capitalized software development, which landed within our expectation of $45 million to $55 million for the full year.

Our full year free cash flow was $149 million, which exceeded the top end of our updated guidance range due to overperformance in profitability.

Free cash flow increased $11 million or 8.2% when compared to 2017, and our free cash flow margin of 17.5% for the full year was roughly flat year-over-year.

We didn't pay cash taxes in 2018 and received a refund in the amount of roughly $7 million. During the quarter, we paid out $6 million in cash dividends to shareholders and ended with $356 million in net debt. Our capital strategy calls for a debt-to-EBITDA ratio of less than 3.5x. And at the end of Q4, we stood at 1.9x. I'll note that this excludes the acquisition of YourCause, which closed the first business day in 2019. Had we closed the acquisition before year-end, our debt-to-EBITDA ratio would have been approximately 2.6x.

Now let's turn to 2019. We're guiding to non-GAAP revenue of $880 million to $910 million. Non-GAAP operating margin of 16.7% to 17.2%. Non-GAAP diluted earnings per share of $2.11 to $2.28 and free cash flow of $124 million to $134 million. We have several key assumptions contemplated in the development of our guidance. The acquisition of YourCause is included and expected to be accretive to revenue and dilutive to profitability and cash flow for the year.

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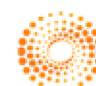

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From a revenue perspective, we're expecting the drag from onetime services and other revenue to continue for our third consecutive year and anticipate the rate of year-over-year decline to accelerate to roughly 25%.

YourCause is expected to contribute $20 million to $25 million in annual revenue, and will be excluded from our organic revenue calculations in 2019. We're taking a conservative approach with the inclusion of YourCause in our guidance, which is closer to the low end of that $20 million to $25 million range, as we anticipate that YourCause will cannibalize some of our corporations and foundations revenue as we integrate the business into our core offering.

From a profitability and cash flow perspective, 2019 is an investment year to better position the business for accelerated growth and long-term success. We aggressively ramped sales hiring in the second half of 2018, and in 2019, we will incur the full year expense impact of those hires. We expect to continue this heightened pace of investment to support the future growth of the business. We're also investing in innovation for our customers. We, in essence, created 2 entirely new businesses with the announcement of our Cloud Solution for Faith-based Communities and expanded Cloud for Higher Education. Then we acquired another with the YourCause acquisition.

Our estimate for 2019 combined capital expenditures is expected to be $45 million to $55 million, which is roughly equivalent to 2018 and primarily consists of costs required to capitalize for software development. We're anticipating CapEx to decrease year-over-year with the fit-out of our new global headquarters now behind us.

As Mike mentioned, we're continuing to execute against our workplace strategy, which we've accelerated into 2019. We're currently expecting to incur before tax restructuring costs associated with these restructuring activities of between $8.5 million to $9.5 million, of which $5.4 million has been incurred through 2018, and we expect the remaining cost to largely be incurred in 2019.

Our updated estimates reflect the more aggressive actions we've taken to relocate and consolidate some of our offices during 2018. We expect to gain operating efficiencies beyond 2019 with future annual before tax savings of between $5 million and $6 million per year, beginning in 2020.

Our non-GAAP tax rate will remain consistent with the 2018 range of 20%. And we're expecting to pay minimal cash taxes in 2019. Our free cash flow will be impacted from the investments we're making in the business. A 2018 cash tax refund of $7 million, which won't repeat in 2019, accelerated restructuring associated with our workplace strategy and the impact from acquisition of YourCause.

Our deployment in capital strategy hasn't changed. We will continue to pay a dividend, invest in our growth and operating initiatives and continue paying down debt, providing capacity for expansion opportunities.

From a new accounting standards perspective, we will be adopting ASC 842 for leases in Q1 of 2019. We expect that the impact to our P&L and statement of cash flows will be minor. The largest financial impact will be related to recognizing lease liabilities and right of use assets on the balance sheet for substantially all of our leases.

I'll close by saying that we continued to execute against our strategic plan. We're maintaining our disciplined approach to balance investments to drive growth and profitability. And we will continue to execute on our capital deployment strategy to maintain a strong balance sheet, return capital to shareholders and create growth and scalability.

With that, I'd like to open up the line for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We'll now take our first question.

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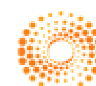

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Unidentified Analyst

So I want to tackle some of the TAM expansion here first. And you're going after 2 markets that same sort of drastically in need of some innovation. And so right place, right time, but also pretty big market. And so I'd like to hear a little bit more about -- as you think about these investments, it strikes me that it's not just 1-year investment. And the margin guidance you laid out for this year certainly positions this as an investment year and Tony, you talked about getting some leverage out of sales and out of facilities going into next year. I'd love to hear a little bit more about how long we have to think about some of the margin suppression sort of staying down in this level below historical margins. Is that a type of approach that we ought to think of being a couple of years given the type of opportunity you have here, the sales heads you need and the innovation that needs to happen? Or is this truly sort of 1 year gap year, and we ought to expect as we think a little bit further out the leverage will start to materialize even given this TAM expansion?

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

It's Mike. Yes, from an investment standpoint related to TAM, we have, I think, really expanded our TAM in the last several years by going much lighter in many of our vertical markets and that's what's happening here. So in the faith-based market, we announced the new cloud platform there several months ago, and it is just a massive opportunity. And you're right on your question that market is just in need of innovation. And I've mentioned in my prepared remarks just about one of the deals that we signed for this new platform, which includes hundreds of churches and over 100 K-12 schools. And that really pulls our -- much of our portfolio into that, not just the faith-based, but the K-12 portfolio. So big TAM expansion in faith-based. And in higher ed, what we're essentially doing is we're taking that K-12 platform that runs schools and for a while now, we've been adding capabilities for universities. And that is the new higher ed platform, TAM expansion as well. It's important to note in both of those markets, faith-based and higher ed, we're already there. We've been providing fundraising and financial solutions and scholarship management solutions in higher ed and fundraising and financials in faith-based. We're just expanding an existing base to get a lot more TAM and a lot more IT spend. And in many cases, what happens is the customer signs up and these solutions eliminate 12, 15 stand-alone software providers with 1 cloud solution. So really interesting long-run investment opportunities for us through these TAM expansions.

Anthony W. Boor - *Blackbaud, Inc. - Executive VP of Finance & Administration and CFO*

And then, Tom, I'll hit on the margin side of things. We made a stair-step increases we spoke about in plan for last year on the sales and marketing and innovation side of the business. We were relatively flat on the sales headcount through midyear, and we started to ramp in Q3 with the majority of it hitting us more so in Q4, and we ended up -- you'll see this in the K, we ended up 84 net heads up from a sales perspective. So roughly 20% growth where historically we've grown sales headcount at about 10%. So we kind of doubled the rate. And we'd expect to continue that into the future. So there will be a heightened investment on that front. We certainly had to increase R&D investments for innovation as well with the build-out of these new solutions and to increase the TAM, as Mike just talked through. The payback on those, I'd expect that we will start seeing some payback on the sales investment front late '19, much more so in '20, as we get the folks onboard and train, build pipelines, close deals and then ratable revenue recognition. We'll see more of that impact starting to come in '20, but maybe a little bit later yet this year as well. Innovation investments, those products are in marketing test and/or launching this year more sort of towards the second half of the year. We're already seeing some good traction. But again, we'll see some impact of that probably late '19, but much more so in '20 and beyond. So those will be favorable, I think, from a growth perspective in the business. The other side is onetime services strong 17% prior year and the year before. We're accelerating that with a lot of the initiatives we have in place, and we think it's going to shrink closer to 25% this year. And I think it probably bottoms out either late '19 or in '20. And from that point forward, I'd hope we actually don't see that same kind of drag on the business and may actually start seeing some growth again in onetime, which will help our total growth profile, probably in late 2021. With the heightened growth that we should get from all of those investments, then I expect we have leverage opportunity, better leverage opportunity in the business. The other thing is that increase in the sales headcount is new stair-step kind of 20% rate should start funding the future increases in sales once they're fully productive. So once we get to the new norm, I would expect we'll start seeing some benefits, and they will be able to fund the future sales ramps. The other thing that will improve margins over the longer term, we've gotten a little more aggressive, we've talked about in the script on our facilities optimization, workforce strategy. So we expect to take a little bit larger of charges between now and the end of the year. But we've also increased our annualized estimate

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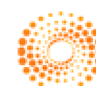

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for savings. So we're ramping all the way up between $5 million and $6 million a year in expected annual savings from this facilities optimization work, which we should start seeing in 2020 and beyond, so that will be very favorable to margins. We also are still double paying with the move to the cloud on the infrastructure side of the business. So we're still paying for our data centers and for third-party cloud. So as we finish that transition over the next couple of years, that should add to margins as well as just all the other things we're doing to gain efficiencies and leveraging the business. So I'd expect kind of a gradual stair-step improvement in margins in '20 and out-years.

Operator

We will now take our next question from Brian Peterson of Raymond James.

Brian Christopher Peterson - *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

So Tony, maybe one for you. I just wanted to make sure I understood the linearity of the investments and how that might translate into 2019. Because it looks like the sales and marketing expenses, at least sequentially wasn't up that much. So with other sources of savings maybe in the fourth quarter or just better execution that allowed you guys to have the OpEx beat this quarter. And then how should we think about those investments looking at margins through 2019? I know you guys don't guide quarterly, but just trying to understand how that could play out over the course of the year?

Anthony W. Boor - *Blackbaud, Inc. - Executive VP of Finance & Administration and CFO*

Yes, Brian. As a response on Tom's questionnaire, the headcount was ramped very late in the year. And so we didn't have nearly as much impact on the numbers as you would expect to see. So that full year bow wave will start hit to us in Q1. So you will see that there, plus in our plan continue to ramp in sales headcount as well and innovation investments will hit us. So I think if you look more so at kind of the increase in the sales costs you saw in Q4 in the detailed numbers and plan for that continued ramp, that's where the majority of the investments are going to be, it's in the sales and marketing. The second kind of biggest piece of the 300 basis points will be in innovation, so in R&D in the net expense that we record there net of the capitalization. The Q4 numbers, as always, the team pushed really hard, did a great job to control costs in the second half. After we had to update the guide, the team pushed hard to make sure that we did everything as we've done in prior years. Had a good Q4. I think there were some favorability certainly within the expense base of us just being very focused on it, much like we saw in the '17, when we had a much heightened kind of EBIT in the fourth quarter. So that would have offset some of that impact you've been seeing in the P&L.

Brian Christopher Peterson - *Raymond James & Associates, Inc., Research Division - Senior Research Associate*

Got it. And maybe just another one, I wanted to hit on the NXT upgrades. By my math, it's actually been a pretty key growth driver for you guys over the last few years. As we've reached the halfway point of that migration, how should we think about the incremental growth opportunity from that going forward?

Anthony W. Boor - *Blackbaud, Inc. - Executive VP of Finance & Administration and CFO*

Yes.

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

Yes, I mean, that's been a good program and it continues to be a good program. We keep evolving that platform. In fact, the faith-based cloud announcement we made several months ago and the way we're driving that, the whole Church Management solution is sort of a derivative of NXT, if you will. So its completely bundled at the core architectural level. So it's been expanded to really drive that vertical solution. So the product is going well. The platform now really drives -- based on the SKY architecture, drives a lot of capabilities, and it's continuing to expand.

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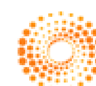

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Operator

We will now take our next question from Rob Oliver of Baird.

Matthew Steven Lemenager - *Robert W. Baird & Co. Incorporated, Research Division - Junior Analyst*

It's Matt Lemenager on for Rob. Mike, I have a question on YourCause. How much integration work needs to be done to kind of align that with Blackbaud's core products? And then the go to market for YourCause, will all the reps be carrying it in their bag of products, or will that be kind of limited to an initial set of reps and expand it out later? I think Tony mentioned there may be a little bit of cannibalization in that $20 million to $25 million guidance number for the full year.

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

Yes, sure. So YourCause, we're reusing a playbook we've used before, where the YourCause business is a business unit within Blackbaud. What that means is there's not a ton of integration required. We will integrate quickly the corporate functions. We have already expanded the sales team from another part of the company that was in a similar market. So we've already added that to the YourCause team. But the YourCause leadership team and business unit will drive their business forward, and we're just adding resources and reducing some of the burden and cost of corporate functions, if you will, in internal IT and things like that. The really cool fit with YourCause is, it gives us a very large global footprint with businesses in a very near adjacency, which is giving and volunteering. And so it's very much a close near adjacency for us. And that platform has provided donations to over 100,000 nonprofits. And there are over 300,000 nonprofits globally registered in over 170 countries. And as I've mentioned in my prepared remarks, there is over 8 million employees on the platform that give almost $250,000 every business hour. So that it's a big reach and it creates an interesting opportunity for more of a network effect for us, given the number of nonprofits that have received donations, arguably many are not Blackbaud customers. So it's a really great fit, really great platform, nice new adjacency for us, and we're just investing in a larger go to market as we speak.

Matthew Steven Lemenager - *Robert W. Baird & Co. Incorporated, Research Division - Junior Analyst*

Great. If I could squeeze in a quick follow-up. Tony, as we look at the 2019 guidance, is there any change in the assumption for renewal rates, or I guess, churn rates all that's included or embedded into the 2019 guidance?

Anthony W. Boor - *Blackbaud, Inc. - Executive VP of Finance & Administration and CFO*

Nothing that we guide to, Matt. So we would have contemplated in there the normal impacts of just where we are with relation to our sunset plans, migrations and impact those have. All of those various things that are going on within the business would have been contemplated in there, but no specific guidance that we've given on retention.

Operator

We will now take our next question from James Rutherford of Stephens Inc.

James Paul Rutherford - *Stephens Inc., Research Division - Research Analyst*

My first question is around sales productivity. I know this has been a big focus for you and the team. Do you think you're done with some of the big changes in territories, comp structure, et cetera that you've done? And maybe just provide some additional commentary on how you think those initiatives are going the way you expect kind of for the 2019 sort of per rep billings growth directionally?

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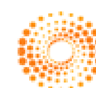

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Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

Sure. We've made a lot of changes in the last several years in sales to create one global selling engine, if you will. And yes, most of those changes are behind us. We just made quite a few changes to start the year this year, mostly around the number of folks we've just hired in the last several months, as Tony mentioned, up 20% in headcount, and a couple of new cloud announcements that really expanded our TAM and addressable IT spend in those verticals. So -- but most of the changes are behind us. We now have one comp plan in the world for the company for the first time ever. And it's really focused solely on driving reoccurring revenue. We had to consolidate multiple plans over the last several years. And our sales teams, as you might know, are now fully focused in vertical markets. They are separated into hunters and farmers, back to base and new logo, if you will. And those changes have been coming for a long time. But yes, structurally, we're done. Now driving continued execution and productivity is a whole new management playbook, that's in place, lots of new hires. So structurally, we're done. Now it's just about continuing to drive productivity and continuing to add headcount.

James Paul Rutherford - *Stephens Inc., Research Division - Research Analyst*

Okay. Helpful. And then Tony, my second question is around the implied organic growth guidance for 2019. So recurring revenue growth organically was 5.6% in 2018 and 2.8% in the fourth quarter. So based on the math I'm doing what you gave us around onetime services declines and the YourCause contribution in 2019, it seems like the full year 2019 recurring revenue organic guide is around 5% or better. So correct me if I'm wrong there. But that's an acceleration over the 2.8% in the fourth quarter. I'm just curious what gives you confidence in that sort of implied organic growth accelerations from the fourth quarter?

Anthony W. Boor - *Blackbaud, Inc. - Executive VP of Finance & Administration and CFO*

Yes. I think your math is roughly in line assuming we end up having the decline in onetime and then where we're getting info on YourCause is guiding kind of to the lower end of that $20 million to $25 million just because of the potential for some cannibalization early on. I think the confidence, a couple of different fronts. We took a different approach to the budgeting and forecasting process this year on onetime. As you know, that's been a really hard and tough area for us to get right. There's just a lot of moving parts there. As we move more to the cloud, we need less implementation. We're certainly doing less customizations. As more of our base moves to the cloud, they're doing less integrations with other third-party solution sets as well. So there's a lot of piece on that front. We started to embed more services. We are also changing a lot of the offers that were onetime in the past to be recurring. So we've started to sell a lot of the training and learn-type stuff in a subscription right along with RE NXT, FE NXT, ON products, et cetera. And so that's moving things out of onetime to recurring. So a lot of things that are affecting that onetime services number. We took a completely different approach this year for forecasting that. Feel really good that we've got a better handle on that. It will take a lot of the variability out of our guide on the revenue front. Then on the recurring revenue side, it's a lot more predictable. I think the place we had any difficulty has really been on the transactional side of the business. And so that one done a lot of work as well. I feel good we've got the right process and taking the right approach. The growth is really driven by our investments. So we feel good, like Mike said, we're through all this transition stage and all the noise that might create. And so really now it's about how do we keep improving productivity and adding headcount. We feel good about our ability to add sales headcount based on what we did in Q3 and Q4. We feel good about how quickly we can train and ramp those folks, and we'll monitor that very closely. I think the new process is going to help with productivity. All those things should drive growth. And so based on the investments made last year and planned investments this year, the added TAM, the launch of the new products for faith and higher ed and Microsoft partnership, all those things, we should have gotten to a point where we're largely bottomed out and start seeing acceleration going into '20 is our intent and plan. And then just one clarification to make sure that everybody is aware, YourCause will not be counted in our organic growth for 2019. So we will have a benefit of that higher growth profile in '20 when we get there, but it is not included in our planned organic growth in '19 per our policy.

Operator

We will now take our next question from Justin Furby of William Blair and Co.

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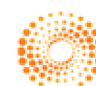

Justin Allen Furby - *William Blair & Company L.L.C., Research Division - Research Analyst*

Maybe just to start off going back to the NXT, the migration, I think you said recently you're a little bit over half of the way through that. Can you just remind us, Tony, a few years ago, you talked about 15%, 1.5 to 2x lift on the maintenance. What does that look like most recently, and sort of how you assume that to play out this year and for the next few years? And then I've just got a quick follow-up for Mike on YourCause.

Anthony W. Boor - *Blackbaud, Inc. - Executive VP of Finance & Administration and CFO*

Yes, Justin. We are more than halfway through. And so from a comparative growth basis, obviously, we won't see the level of support to grow going forward now. We're past the top of the Bell curve on that side of things. The uplift on those where we're still truly selling those migrations in the base and moving them over, we're still seeing good uplift. We're now, though, on the backside of the curve and starting to evaluate programs is more focus. And I think we've talked about this before, more focused on retention for the long run and get it and converted over. And we started to begin some programs that are more migration focused versus sales, if that makes sense, of course, more intent on getting them to move to the new platform, so we can keep them for the next 20 years versus merely focused on the potential uplift on the sales side. And so I do think that average uplift we saw through these first few years will start to decline now that we're on the backside of the Bell curve as we move with more focused towards retention. I think we'll see more aggressive programs that help with the migration, et cetera. So I do think it creates a tougher compare from an organic growth perspective going forward, now that we're on the backside of that curve.

Justin Allen Furby - *William Blair & Company L.L.C., Research Division - Research Analyst*

Okay. That's helpful. And then Mike, just one thing I missed in all of this with the YourCause acquisition. Can you just sort of back into the incremental TAM, I know you acquired a company, MicroEdge, a number of years ago that I thought to be one of the primary competitors to YourCause in this space. So what's the incremental for you in terms of this acquisition? And do you continue to invest on the MicroEdge platform as well?

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

The incremental TAM is $0.5 billion. It was -- with MicroEdge, there's one small product that was a direct competitor to YourCause, not MicroEdge in its entirety, and the TAM expansion, again, is $0.5 billion.

Operator

We will now take our next question from Rishi Jaluria of D.A. Davidson.

Rishi Nitya Jaluria - *D.A. Davidson & Co., Research Division - Senior VP & Senior Research Analyst*

Tony, I appreciate the granularity on the guidance. I wanted to circle back to that. So I'm also getting something in the neighborhood of 5% to 6% organic recurring growth next year. You said in the past that this market is growing at 7%, if I'm not mistaken. So just help me kind of understand why are your organic recurring growth rates slower than the market. Is that a function of maintenance being dragged and still converting maintenance dollars to subscription? Or are there other factors there? And then I've got a follow-up.

Anthony W. Boor - *Blackbaud, Inc. - Executive VP of Finance & Administration and CFO*

Yes. Rishi, there is a lot of things at play as we kind of finish executing against the strategy we've rolled out several years ago when Mike came onboard. Some of the pieces that still pull against growth are going to be the sunsetting of the products, the migration of the legacy products, and those typically will have heightened churn because you put those customers in market when you're trying to move them to your new platforms, like we're doing on our RE NXT and FE NXT, et cetera. The transactional business certainly provided more lift in the early years, and so as that base

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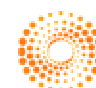

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has gotten bigger and we've penetrated more of the base, we've got to replace that growth rate with accelerated growth elsewhere. Certainly from a total growth rate, you've got onetime services that has dropped off dramatically as part of our strategy. As I answered, I think it was Tom's question earlier, the prior 2 years, we've seen a 17% decline each year in onetime services. We're expecting that to be a 25% decline. I think the key for us as well is the base has gotten a lot bigger and we had kind of stuck to that same number of sales headcount. So I think we were trying to implement a lot of the other pieces of our strategy and the last key piece was this investment in sales and marketing that we really had just begun here in late '18. So I think the ramp sales, the increased productivity in sales, all of those things, expansion of TAM that we're doing should bode well for future growth, once we get to the final last year or 2 of implementation of the strategy.

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

The other thing too on the TAM expansion is pretty significant. Because if you think about the products and platforms we've announced on the cloud solutions, we're covering -- we're going from becoming a departmental player to an enterprise in those verticals, which covers a lot more product and IT spend than before in verticals that we've been in for a while. So it's not just new verticals, it's expanded within the vertical. We've also grown the customer base quite a bit. We've announced in our prepared remarks that we have over 45,000 customers now. And we've got a significant part of our sales team focused on new logos, which if you go back several years ago, that was not the case. So the combo of driving sales productivity, launching new headcount, focus on new logos is fairly new for the company and the footprint has been expanding quite a bit.

Anthony W. Boor - *Blackbaud, Inc. - Executive VP of Finance & Administration and CFO*

Rishi, one other thing that we talk about a bit with folks is, we have effectively stood up 2 brand-new businesses, so it's 2 start-ups. And so a lot of these investments we're making we think about having to build out a sales team for this new faith channel. Although we sold there, we're expanding our sales team substantially, but that product doesn't launch until the second half. And so rev-rec wise, we've got to get the team hired, we've got to get them trained. We're getting the feeling that we got to start building momentum in the space with the new product and the new product doesn't launch until later in the year. And so in '19, you're just not going to see a huge contribution for those start-up businesses, much like what you expect with any start-up, but we'll start seeing real benefits hopefully exiting the year and certainly in '20 and '21.

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

Yes. I also would add one thing. We've talked a little bit about customer wins in my prepared remarks. That was just the one market of faith-based. We have been really growing the success in that market for a while now and just announced that cloud solution several months ago. But a significant proof point in what we're doing there is what I -- when I said in my prepared remarks, we had a very large institution commit hundreds of churches and over 100 K-12 schools contractually. That's a big commitment. It's a really, I think, a good indication of a proof point on what is about to come from us in the faith-based market.

Rishi Nitya Jaluria - *D.A. Davidson & Co., Research Division - Senior VP & Senior Research Analyst*

Got it. That's helpful, guys. And then just really quickly on the jointly developed NRM solution with Microsoft. I know it starts to launch later this year, if I'm not mistaken. But can you give us a sense for what is go to market and potential revenue share look like between you and Microsoft?

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

Yes. It's jointly developed and jointly brought to market. So we'll be selling it, they will be and we will be together. We have a lot of go-to-market initiatives just starting off with Microsoft. That one happens to be one where we're codeveloping a product. It's basically -- you can think of it as a supply chain management product for large global nonprofits. But we're going to market with them in education now, higher ed, nonprofit space and other markets. So it's still very new for us, both companies to go to market together. Microsoft's model is a very complementary model for their partners, including Blackbaud, where their teams are compensated on things like Azure consumption. And so there isn't a revenue share

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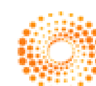

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when we go to market because it's an Azure consumption model that they use. And as we continue to shift our workload to Azure, it's a complementary field competition model, which is great for us and for them.

Operator

We will now take our next question from Kirk Materne of Evercore ISI.

Stewart Kirk Materne - *Evercore ISI Institutional Equities, Research Division - Senior MD*

Mike, given you're sort of standing up, as Tony mentioned, sort of 2 new businesses around these bigger TAM opportunities, what sort of payback time are you expecting in terms of getting sales -- new sales headcount ramped up? Meaning is this sort of a 9 to 12 months ramp for them as they build-out pipeline? You obviously have to introduce yourself to new customers. I'm trying to get sense on how you're thinking about sort of when they get to being fully productive?

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

Sure. It's a pretty wide gap between phone sales and enterprise field sales as far as ramp. On average, the ramp time is less than 9 months, if you look at all the jobs aggregated together. The other side of that is, revenue ramp for these 2 new cloud solutions, they don't even go live until the back half of this year. So revenue ramp will take a while. But we're closing deals now, as we stated, and we have early adopter customers using the platform now.

Stewart Kirk Materne - *Evercore ISI Institutional Equities, Research Division - Senior MD*

Okay. And then just one quick one for Tony. Tony, obviously, over the course of the year, the organic recurring revenue growth rate decelerated. I just want to get a better understanding of that. I assume some of that's the transactional business that you guys referred to last time you talked, and you took down the numbers. Is there anything else going on? I realize when you bring on new sales guys, I know you have to recut territories, so there might have been some pause in that. I just want to, I guess, have a better understanding of that because I think that will help to instill further confidence in your recurring revenue growth assumptions for next year.

Anthony W. Boor - *Blackbaud, Inc. - Executive VP of Finance & Administration and CFO*

Yes, absolutely, Kirk. There has been -- there's certainly been some change management that we had to work through on the sales and marketing front. As Mike alluded to, we've been working on that one for about 3 years now. We stood up customer success. We've really changed the process and approach. We went to that hunter-farmer or back to base prospect model, we move reps out into the field that were largely also -- and in Charleston, we've changed roles, we've changed the whole management process, territories. There has been quite a bit of change that we've worked through over the last 3 years. I think we're finally going to be to the point this year in '19 that we start seeing stability. So that our real focus there will be ramping additional heads and getting more productivity out of the existing base. We still think there is a lot of opportunity to improve the productivity of the existing base of 500-plus reps as well. So we have high hopes for that to help drive more growth over the coming years as we make improvements there. The other side of things outside of just the change management that we had to deal with, you spoke about obviously the transaction business last year was a bit of tough compare year, '17, we had some positive impacts from the elections that carried over into Q1. We didn't have as many onetime events. We had some change in consumer giving patterns. We talked about Smart Tuition mix of parents and affluency, obviously U.K. market and Brexit, just all the different things going on in the economy and the tax reform. It's hard to put a number on any one of those individually. But overall, certainly a tougher year last year on the transaction side that pulled down our recurring revenue growth. The other thing is we're still working through the migrations and the sunset. And as we've talked about, we are not building feature parity in all of those, and when we shut those products off, we lose customers. We put customers in market when we are going to them to make decisions on migrations to the next-gen platforms. And as you saw last year, we actually lost 1 point from a retention perspective, and that's impactful. We do expect to see retention bottom out and shift back to other direction as we get through these programs here over the next 2 to 3 years. And so that

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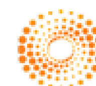

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will be a favorable impact on growth as well, but that's certainly been a drag on us over the last 3 or 4 years as we've implemented this strategy also.

Operator

We will now take our next question from Ryan MacDonald of Needham & Co.

Ryan Michael MacDonald - *Needham & Company, LLC, Research Division - Senior Analyst*

My question is around sort of on top of that transactions business and sort of obviously 2018, like you mentioned, was a bit of a rough year there for a number of reasons. As you're looking down to 2019, can you talk about sort of what the assumptions you're building in for the transactions business in '19? And what the expectations are now particularly with JustGiving? And when that should be going live in the U.S.? And maybe what -- how that can help with the transactions business in '19 in the U.S.?

Anthony W. Boor - *Blackbaud, Inc. - Executive VP of Finance & Administration and CFO*

Yes. Ryan, this is Tony. I think from an assumptions perspective, as we spoke about even last year with the updated guide, the number of customers we've been adding, the number of customers processing, the number of large customers, high-value customers we've added into the payments platform has all been trending positively. It was really this trend in consumer behavior and a lower average donation size that we saw and part of that -- it's hard to put your hand on what drives that. Much of that can be driven just by the fact that we have less onetime kind of major incidents that drive big spikes in giving. And so we've got some pretty detailed forecasting tools at a product and customer level that we use and some seasonal trends at those levels. And so we build that out based upon all the kind of current trends that we're seeing and the rates of adding new customers and time to go live and penetration rates and the average donation size. So we feel good about from that perspective. There is just more volatility obviously in the transactional side that we can't predict. We could have a really good year this year just depending on where consumer sentiment comes in and things like U.K. market. So that one I feel good we've assumed things as accurate as it possibly can, based on what we know. The JustGiving launch was always a big plan as part of that acquisition for the U.S. market, and that will happen this year. So the team is progressing on that front very well. Again, timing of that launch and then ramp time, it won't have a huge contribution in '19, but it's just another one of those areas of growth that -- it should provide some growth in '19 and help hold that recurring revenue growth rate up. But certainly, '20, '21, '22, I'd expect to see really good things on that front as well along with faith and education cloud and the Microsoft partnership.

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

JustGiving launch in the U.S. is Q1. But to Tony's point, we won't see -- expect much revenue this year, but that's the launch in the U.S. there.

Ryan Michael MacDonald - *Needham & Company, LLC, Research Division - Senior Analyst*

Got it. And just one quick follow-up, Tony, on gross margins. As you continue to this go-to-market partnership with Microsoft and talked about the improved Azure consumption there, should we expect to see some additional leverage on that recurring gross margin side as you continue with that migration process?

Anthony W. Boor - *Blackbaud, Inc. - Executive VP of Finance & Administration and CFO*

We don't guide to gross margin today, I spoke earlier to some of the pieces that will drive our gross margin potential improvement. So that double pay that we have today moving to the cloud getting out of our COLO data centers that will be a positive impact on us. We've got a little bit of a drag still coming because we are capitalizing, required to capitalize more of our innovation spend from an R&D perspective, and so that amortization will continue to build, which will put a little pressure on gross margins. But really then at the end of the day, it comes down to mix. So our onetime

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revenue -- onetime services has been dropping, that's our lowest margin business. We expect that deceleration to actually increase this year, as we said, from about 17% to 25%. So that should help prop up gross margins dependent on the mix of the payments business and type of payments, transaction revenue that has lower margin dependent on which -- whether that is larger JustGiving or just our straight payments platform. So it typically will come more so to mix than anything else and we don't guide at that level, but we've been able to do a pretty good job in the last couple of years of holding and slightly improving gross margins. I'd hope that we could continue that for the foreseeable future.

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

Yes. Let me just jump in here to provide some clarification because your question time -- your question was around go to market with Microsoft and gross margin. And those 2 things are not related to us. We have no cost in going to market together with Microsoft. We don't give additional discounts. We don't pay fees. It's our standard pricing and standard discounting. The reason I mentioned earlier that's very complementary because we do not have to pay to go to market or provide additional discounting. Yes, the Microsoft field team gets quota credit because our solutions run on Azure. So those are not connected. So it's a really great go-to-market model, doesn't cost us anymore, and we can leverage Microsoft's reach in the market and in turn, they leverage our reach. The back end of our business, we're moving from our data centers to Azure, which will improve over time our profitability because today we have duplicate cost in that regard and we'll have less of that in the future.

Operator

We will now take our next question from Mark Schappel of Benchmark.

Mark William Schappel - *The Benchmark Company, LLC, Research Division - Director of Research & Supervisory Analyst*

Just a couple of quick ones here. Tony, was YourCause profitable?

Anthony W. Boor - *Blackbaud, Inc. - Executive VP of Finance & Administration and CFO*

We don't break out anything on YourCause other than the expectations in the guide that $20 million to $25 million. We expect that it will be dilutive to margins and free cash flow, as I said in the prepared comments, in '19. I think there is a little bit of cannibalization potentially on the revenue front. But longer term, we see some really good synergies on both the revenue and the cost structure side. We'll get that integrated very quickly into the business. And so we see really good long-term opportunity there, but it will be dilutive is our expectation to margins and free cash flow in '19.

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

But it's -- it's nicely accretive from an organic growth standpoint, not counted in organic growth this year, but it's a fast-growing business.

Operator

I would like to turn the conference back over to Mike for any closing comments.

Michael P. Gianoni - *Blackbaud, Inc. - President, CEO & Director*

Great. Thanks, operator. I'll just close by saying that I'm pleased with the progress we made against our objectives in 2018. We finished the year well, and I'm very excited with our innovation initiatives and TAM expansion. Tony and I will look forward to updating you on our progress on the next call. Thanks, everyone, for your participation.

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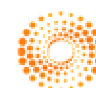

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Operator

This concludes today's call. Thank you for your participation. You may now disconnect.

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