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PRESENTATION

Operator

Good day, and welcome to Blackbaud's First Quarter 2020 Earnings Conference Call. Today's conference is being recorded.

I will now turn the call over to Mark Furlong. Please go ahead, sir.

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

Good morning, everyone. Thanks for joining us on Blackbaud's First Quarter 2020 Earnings Call. 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 the line for questions. Please note that our comments today contain forward-looking statements subject to risk 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. Before I turn the call over to Mike, I'll briefly cover our upcoming investor engagement activity, which is available on our Investor Relations website. During the second quarter, our team will be virtually attending the Needham Technology and Media Conference, Baird's 2020 Global Consumer Technology & Services Conference and Stifel Cross Sector Conference. 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. Before turning to our results, I know many of us have spouses, partners, family members or friends who are on the front lines of the COVID-19 response. So I want to take a minute to say thank you. Blackbaud has been serving the social good community for nearly 4 decades, and the leadership role we serve in this market is especially critical in the current environment. We continue to be inspired by the resilience, innovation and determination demonstrated by social good organizations around the world during

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these challenging times. We've taken measures to ensure our own business continuity while remaining critically focused on customers, employees and shareholders. This morning, I will share our actions taken related to COVID-19 and outline our priorities as we continue to execute against our strategic initiatives and ensure the long-term success of the company. I'll then turn it over to Tony to cover the financials in more detail. We had a strong start in 2020 against our financial plan. As the COVID-19 pandemic began to evolve, we moved quickly to enact plans with our immediate priority being the welfare of our employees and continuing to be a strong partner for our customers. In March, we closed our offices worldwide and made the shift to a global remote workforce with no extra effort. You've heard me talk a lot about the transformational changes we've made in the business, and that has created a scalable operating model that has been tested with this global crisis, and we haven't missed a beat operationally. Our internal IT and organization structure changes over the last several years allowed us to immediately go virtual and have all of our global employees working from home as if they continue to come into the office every day. Customers didn't notice a difference as a high level of support just continued to perform. Our support teams immediately became an efficient mobile call center. It's been impressive to achieve an uptick in our customer satisfaction with scores reaching into the high 90s. I our implementation services teams had already largely shifted to a remote implementation model pre-COVID and are fully equipped to continue customer engagements uninterrupted. In fact, less than 10% of scheduled project hours have been delayed thus far. And just last month, we completed a successful virtual implementation of our Blackbaud CRM enterprise offering with University of South Carolina, which is the most complex and labor-intensive in the portfolio. We spent the last several years reorganizing our business to focus on vertical go-to-market teams with a centralized back office, consisting of global centers of excellence. And it's clear those changes are now paying off. Many of our customers have had to cancel or postpone their planned in person fundraising events and our agile engineering teams have moved quickly to respond to these customers. We've been reprioritizing and expediting product enhancements to support their changing needs. Examples range from pivoting to virtual fitness events to putting new live stream fundraising tools in the hands of both organizations and individuals. In terms of our go-to-market efforts, we've been investing in sales and marketing to better address our large market opportunity as part of this effort, we've implemented software tools to enhance our digital footprint and drive efficiency. The investments we've made enable us to quickly adapt to changing market conditions, including competitive opportunities. Our ability to ensure business continuity for our customers' performance scale and pivot to offer solutions to the changing needs of our customers has become a new differentiator for Blackbaud, and we've moved quickly to capitalize on these early opportunities by leveraging our enhanced go-to-market capabilities. While the disruption caused by this virus has caused some deal pipeline to push out to Q2 in the second half of 2020, we've been able to showcase ourselves as the best long-term partner for social good organizations. And we remain very well positioned as a leader in this market. As part of our cost control measures, we've put a freeze on hiring across the company, including sales. Blackbaud employees are committed to social good professionally and personally, and I'm incredibly proud of how our teams have risen to the challenge to help our customers and our company to remain strong in the short-term as we plan for long-term success. Turning to our customers. The need for funding, support and resources is significant, associate good organizations work to pivot their models, activate supporters and minimize disruptions to their services and operations. I encourage you to look at our recent press releases, for example, of how COVID-19 is impacting some of our customers and the role Blackbaud plays in combating the challenges posed by the virus. Many social good organizations have been thrown into crisis mode. We've seen they are pivoting to rely even more on technology and cloud solutions to run their operations. I believe this crisis will be a catalyst for the industry to move even faster to purpose-built cloud solutions.

While near-term disruption occurred starting in the back half of March, in the weeks since the crisis came to the forefront, several Blackbaud customers creatively switched in person events to virtual fundraisers, establish virtual volunteering options for employees and increased matching gift programs, galvanized lobbying efforts for legislation and create an array of COVID-19 funds and grant opportunities. K-12 schools swiftly moved classes online as they've been forced to shut their doors. Religious organizations have provided online resources while coordinating support given the increased need for offerings. Zoos, aquariums and other cultural organizations, which have lost revenue from in-person attendance and events have provided content for all to enjoy online while pivoting to drive more online fundraising. We've seen over 1000% increase in online donations processed for some food banks as they look to narrow the funding gap required to meet surges in demand. As financial staff are forced to work from home, there continues to be demand for our cloud financial solution, Financial Edge NXT. This industry has been undergoing a digital transformation in which we have been the global leader, and that has accelerated in recent weeks. Our move over the last several years to cloud solutions, purpose-built for vertical markets has proved to be the right strategy as this crisis has highlighted how important, modern, scalable and secure cloud systems are now a required standard. In many cases, Blackbaud technology is a critical component to helping our customers quickly mobilize and adapt to a more digital and virtual environment. For example, private K-12 schools, like Louisville High School, Open Window School and River Oaks Baptist school have been able to quickly move to becoming a virtual school, keeping students, parents and teachers productive using our solutions. After making the decision to transition their school online, the Head of Schools for River Oaks Baptist School said, and I quote, " As we are preparing from the transition to distance learning, we relied on the recommendation of our technology team to use our Blackbaud solutions to institute an asynchronous only classroom experience. It's the best decision we've ever made. Not only does it give our families the flexibility needed during these challenging times, but simplifying the transition, which is so key. In fact, we're seeing more opportunities to use this technology in the classroom, which will extend well beyond the pandemic." Because of our open architecture, our solutions are integrated with essential EdTech and video conferencing services and usage of Blackbaud Learning Management System has drastically increased compared to last year with some features being used nearly 10x more as schools have moved to Blackbaud technology to support distance learning.

The business impact of the virus continues to manifest itself in different ways across the vertical markets that we serve. We continue to closely follow market trends, including charitable giving, which can be crucial for many of our customers as they look to close funding gaps. I'll remind you the growth in Giving in the U.S. has been closely correlated to U.S. GDP for decades, and the mix of giving continues to shift toward online donations. For historical reference, total charitable giving was approximately $300 billion in 2008 and declined 8% in 2009 before growing again in 2010. Since then, it has grown to over $400 billion annually. Also, the number of registered nonprofits grew during the same time period. Moving back to this year, early trends showed a decline in donations processed by our customers as events had to be postponed and canceled. However, in the weeks since the crisis began, many have creatively pivoted to virtual fundraising in events, and we see this in the data. For example, our JustGiving platform has seen a sharp increase in COVID-19 related campaigns with appeals raising tens of millions of dollars to support causes focused on combating this crisis. Among them is a campaign in the U.K. to rate support for the National Health Service staff and volunteers caring for COVID-19 patients with an original goal of GBP 1,000 the campaign has raised over GBP 30 million pounds for well over 1 million supporters across more than 80% of the countries in the world. Our scalable platforms allow events like this to happen. This is just one of the many examples that make this market so resilient as communities, philanthropist, celebrities, corporations and others step up to support social good organizations in this time of need. Another example is Direct Relief to rely on Blackbaud Luminate Online and Blackbaud Raiser's Edge NXT during historic peak and donations and included high-volume celebrity fundraisers. Direct Relief, VP of Partnerships and Philanthropy told us, we're deeply grateful to Blackbaud for ensuring that our technology background for philanthropic efforts is robust and scalable. Blackbaud's commitment ensures that the extraordinary generosity from individuals and institutions to help keep health care worker safe is immediately put to use to help those who help others. Long term, we believe the impact of COVID-19 will significantly accelerate the existing secular trends toward adoption of modern cloud solutions in our market. Overall, Blackbaud remains highly committed to the success of our customers, our company and the entire social economy during these challenging times.

We quickly transitioned our global workforce to a remote operation with 0 business disruption, and we've supported our employees as they continue to enable thousands of customers to quickly pivot their own operations and strategic efforts. We've had webinars with thousands of customers, helping them more aggressively move to digital capabilities. Our teams launched new innovation in response to pandemic-specific needs that arose. We've given back to the entire social good community through hundreds of free resources, philanthropic gifts, service on boards and more, and we've maintained our commitments to customers including a very high standard of service and support. This crisis has put a spotlight on a critical need to move to the cloud and to partner with a software provider like Blackbaud. We're hearing this in the market.

Lastly, we've acted quickly to take measures to ensure that we have the necessary liquidity and financial flexibility to continue supporting our customers, protect the welfare of employees and deliver increased value to our shareholders.

With that, I'll turn the call over to Tony 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. I'm going to briefly cover our key first quarter highlights, then shift to our early observations and the actions related to COVID-19 before opening up the line for your questions.

You can refer to yesterday's press release and the investor materials posted to our website for the full detail of our Q1 performance. Please note, we also issued a press release on April 6 outlining the actions taken as of that date to bolster our liquidity, increase related borrowing capacity and redeploy capital to reduce our debt load. These actions had minimal impacts on the first quarter, but will materially benefit profitability and free cash flow as we look ahead.

Turning to our results. First quarter revenue increased 3.3% over Q1 of 2019 and recurring revenue grew 3% on an organic basis. We had a good start to the year, overachieving the revenue planned through February, though, as Mike mentioned, and as you all know, the impacts related to COVID-19 began to manifest in mid-March. Given the recurring nature of our revenue, the impact of the pandemic to our Q1 revenue were minimal. During the quarter, we reclassified $4 million that would have historically been presented in recurring revenue to onetime services and other revenue. We have a continual review process internally to evaluate the performance of our portfolio, and that process drove the determination that these newly introduced services offerings are more onetime in nature, based upon the typical contract length and related renewal rates. This reclassification reduced our organic recurring revenue growth rate by approximately 220 basis points or 130 basis points after normalizing 2019 for the change.

Moving to profitability. Our first quarter gross margin was 58.4% and which is a 200 basis point decline versus 2019. We generated operating income of $34 million, representing an operating margin of 15.2% and diluted earnings per share of $0.51. As you know, we're underway in a multiyear effort to enhance our scalability by migrating our cloud infrastructure to leading public cloud service providers, and we anticipate continued pressure on gross margins as we incurred the necessary costs to make the shift. Our first quarter operating margins also reflect our heightened investments with a focus on optimizing our go-to-market model and driving cloud innovation to support the future growth of the business. That brings me to the cash flow statement and balance sheet. Our Q1 free cash flow was negative $38 million, and I'll remind you that we are typically a net borrower in the first quarter given the seasonality of our business. As we discussed on the Q4 call, we outperformed our financial plan in 2019, resulting in a higher bonus accrual that was paid out during the first quarter, and this was the primary driver of the year-over-year decline in free cash flow.

We also continued making necessary innovation and infrastructure investments to support our cloud operations amounting to $3 million in CapEx and $11 million for capitalized software development. As part of our cost control measures, we will be carefully evaluating planned future capital expenditures. During the quarter, we also paid out $6 million in cash dividends to shareholders and ended with $506 million in net debt. Our capital strategy calls for a debt-to-EBITDA ratio of less than 3.5x. And at the end of Q1, we stood at 2.6x, with $151 million of borrowing capacity.

With the first quarter behind us, there is now a great deal of uncertainty ahead in terms of how this COVID-19 disruption will impact our market, the economy and our company. We acted quickly to preserve our strong balance sheet and ensure we have the financial flexibility needed to manage a wide array of outcomes that may result from this pandemic. We outlined actions taken, which create over $300 million of additional annualized borrowing capacity. First, our Board of Directors has eliminated the payment of future quarterly cash dividends on Blackbaud's common stock beginning with the second quarter of 2020. Second, we implemented several cost-reduction measures. We suspended the company-funded 401(k) match until the end of the year. We put a temporary freeze on our hiring efforts. Mike announced he will for go with his paycheck for the foreseeable future. We restricted nonessential employee travel and put in place other operating cost reductions.

Third, we converted certain cash compensation to equity-based awards. We replaced employees 2020 cash merit increases with a onetime restricted stock grant, and we replaced cash bonus plans for 2020 with a onetime performance stock grant. And finally, as part of these actions, we also announced an employee relief measure providing all worldwide employees that have a base salary equal to or less than USD 75,000 with additional financial support in the form of a onetime bonus of USD 1,000. In addition to the initial actions we've taken to date, we will continue to evaluate further actions should they become necessary. Given our inability to accurately predict the duration and magnitude of the potential impacts associated with COVID 19, we are not providing financial guidance for 2020 at this time. Predictability is particularly challenging from a revenue standpoint. As there are 3 primary revenue areas with related business drivers that we continue to monitor closely.

The first is contractual recurring revenue, which is roughly 2/3 of our total company revenue. As a reminder, our typical subscription contract term is 3 years billed annually upfront, and we've started successfully shifting our customer base away from annual renewals and moving them onto multiyear renewal contracts. Approximately half of our contracted recurring revenue comes up for renewal in 2020 with the seasonal high for renewals and collections falling in the third quarter, driven largely by midyear fiscal year-end and timing of the school year. To date, our renewal rates are trending ahead of our pre-COVID expectations, which is very positive, and we're monitoring trends and accounts receivable aging and bad debt with no concerns thus far.

The second category is our transactional revenue, which is noncontractual and less predictable, giving us the accessibility to certain drivers, such as timing of and number of events and marketing campaigns as well as fluctuations in donation volumes and tuition payments. Transactional revenue represented approximately 1/4 of our total revenue in 2019, and we typically see seasonal highs in Q4 tied to year-end getting campaigns and Q2 when a large number of events are held.

The early disruptions caused by COVID-19 drove sharp initial declines in transactional volumes. Though in recent weeks, we've seen a nice rebound in volume in the form of online events and campaigns, which is an encouraging sign as customers look for innovative ways to close funding gaps.

As Mike mentioned, our teams are hyper-focused on helping customers successfully stand up virtual campaigns and events, and we think this could accelerate secular trends around online giving over the long term. The third category is bookings. Given the ratable revenue recognition model and the rule of 78 as well as implementation periods, we expect any declines in our 2020 bookings performance will have a much greater impact in 2021 revenues than 2020. Of the three categories, bookings represent the smallest potential impact on recurring revenue in 2020 and although onetime services tied to bookings would have a more immediate impact to revenue. The first quarter is typically the seasonal low for bookings with the second and fourth quarters being seasonally higher and our bookings tend to be back-end loaded within the quarters given our quarterly quota plans. Bookings fell off sharply in the second half of March, and we've seen a slowdown in pipeline build. At this point, we are currently expecting a significant shortfall in bookings versus plan on the year. The magnitude of which will be heavily impacted by the depth and duration of this current crisis. Looking ahead, we've enabled our teams to offer relief measures to help ease the financial burden for our customers and prospects with near term liquidities. For example, we have allowed, on a limited basis, for a 60-day extension of payment terms on new sales, which will delay cash collections that we expect the impact to be largely offset in Q3. We've also partnered to offer 0% financing options for new sales on a case-by-case basis. We've been modeling a wide array of possible scenarios utilizing simulation tools. The obvious challenge is predicting the duration of the pandemic and the magnitude of its ultimate impact on our business. We are continuing to take the scenarios with a focus on refining our assumptions as more information becomes available. We have reinvented the company over the last several years, shifting our revenue mix towards recurring revenue and expect that our significantly diversified customer base greatly improves our durability.

In summary, we had a solid Q1 and have acted quickly to hopefully ensure we have the liquidity and financial flexibility needed in response to current global market conditions while remaining critically focused on the success of our customers and the health and economic stability of our employees. We will continue to implement the necessary measures to ensure our viability in the short term as we plan for long-term success on behalf of all of our shareholders.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question today is coming from Tom Roderick from Stifel.

Thomas Michael Roderick - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

First question, just sort of thinking about some of your comments, Mike, relative to the structural components of your business, and in particular, it seems like the events business would be the one and for your customers that by necessity had to be turned off right away. So can you talk a little bit about how some of those pieces in the model break out, particularly the impact of events? And any signs from your customers as to when they can get those going or alternative methodologies of how they do that? I'll start with that, and then I'll ask a follow-on.

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

Yes. Sure, Tom. Yes, it's really interesting what we've seen because we've seen scenarios that are pretty broad. In the area of events, specifically to your question, physical events have been canceled or rescheduled, things like runs and walks and galas and things like that are obviously not happening now. We've had many customers flip to having virtual events using our systems and some with a lot of success as well. In the main, though, the events are not happening in Q2. We've had other customers have campaigns on platforms like JustGiving or use our Luminate platform for virtual events. And it's been pretty interesting what's going on because this COVID-19 has sort of put Blackbaud in the same playing field as our customers, meaning everyone is working from home, everyone's talking about working from home when it first started. The amount of customer interaction has been significant, the number of inbound calls. Some webinars we've had, we've had thousands and thousands of customers on webinars to teach them how to do virtual events. So in the event space, I'd say that the physical events are sort of off for Q2. There spent a bunch of -- I mean, physical events are off for Q2. A bunch of virtual events are ongoing. A lot of them have been rescheduled for summer and fall. In other parts of our market, if I can just touch on that, like arts and cultural institutions are basically closed right now. They're also doing some virtual things as well. So given all the different kinds of submarkets we're in, we're seeing very different things happening.

Thomas Michael Roderick - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Yes. Understood. That's helpful context. A follow-on question just relative to the hire freeze that you've put underway temporarily. You guys have had a lot of enthusiasm and interest in getting into new markets, particularly higher ed and faith-based. Would love to hear your thoughts about what that hiring free sort of does to some of the growth initiatives in those markets. And then Tony, I guess the context behind that question would be, as we think about building our models, obviously, you've withdrawn guidance for 2020. But perhaps you could just offer some directional evidence as to how we ought to think about when we hit the low water mark in margins for the business. As the market comes back, you probably want to start reinvesting in growth again. Would it be sort of wise to think about margins being reasonably protected this year? But next year, as the ripple through effects from lower bookings this year hits revenues, and you reinvest, could there be kind of a little bit of a double whammy where 2021 margins might be a little lower? Obviously, you're not guiding this year, so I'm not asking for next year, but just some directional thoughts on how the model plays out would be great.

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

Sure, Tom. So hiring freeze is just -- we did a lot of things to just make sure that we have shored up the business from a financial liquidity standpoint, and Tony can talk about those, but we feel pretty good about all of that. From a hiring free standpoint, related to bookings, the big issue related to bookings is COVID-19 not headcount, right? So our existing teams, and we've sort of ramped up, as you know, last couple of years, in some markets, COVID-19 is impacting bookings. In Some markets, it's less of an impact. Like for our financial platform, Financial Edge NXT, because we move that to the cloud and really advance that platform, it's had a lot of interest from a booking standpoint and from a success standpoint. In some other markets, like arts and cultural, they're not even open, right? So there's a bookings challenge there. So we felt it was prudent to put a hiring freeze on and not add a bunch of headcount in sales where some of our teams are going to struggle anyway because of COVID-19. We're going to obviously revisit that as we get through this quarter or next. So we thought it was prudent to do that. So the bookings impact is the COVID-19-related issue and how that's going to play out in the next quarter or 2, much less than an impact of the hiring freeze.

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

And Tom, I'll catch the second part of that. For 2020, the impact on revenue is going to be much more so driven by shortfalls in the transactional business, which will have an immediate impact, and we've already seen that some in recurring revenue in Q1 even with the transaction business falling off in the second half of March. The other side is we've seen a big shortfall in bookings, but it's weighted much more towards onetime services and other than our recurring subscription business, which is great news. The bad news on that front is that will hit revenue sooner. And so for '20, I think the shortfalls in onetime bookings, we're seeing north of 50-plus percent shortfalls in those bookings to plan. Those will impact 2020 revenues. It will probably accelerate that decline in onetime that we've been seeing for the last several years, which I think is good for the long term. The positive on both of those things to 2020, as both of those are 2 lowest margin pieces of the business, so they'll have the least amount of impact in 2020 on our profitability. We've set a target -- the actions you saw that we took that we announced were really about ensuring we don't have a debt issue. That we don't have any concern later in the year, regardless of whether this last 1 quarter, 2 quarters or 3 quarters from a debt and covenant perspective. And so we've done the things we can do to control how we allocate capital and are very focused on the cost side of the business. We're targeting to generate an equal dollar of EBITDA in 2020 as what we had in our plan regardless of what happens on the revenue side. And we've proven before we can control our cost structure very effectively, as you know. 2021 is a bit of wildcard. We're -- as Mike said, we're going to monitor what happens. We'll have to see what shakeout in bookings, how transactions rebound later in the year. But we will adjust our cost base to whatever that new norm is going through '21. I think it's going to be very difficult if this pandemic lasts very long for us to grow significantly in '21. So I think we'll have a bigger focus on the cost side and profitability and cash flow side of the business in '21 because I think that's the best way, at least what's in our control, to ensure we generate the best possible returns for shareholders.

Operator

Our next question today is coming from Brian Peterson from Raymond James.

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

So, Mike, just starting with you, I appreciate all the color. But if we're thinking about working with some of your customers in this environment, I'm curious, if I think about some of your customers that have upgraded to your cloud solutions or more modern products, have they been able to fare better in the current environment versus some customers that are on older solutions? Any thoughts on maybe getting creative with some packaging in terms of migrating to more modern solutions? Any thoughts on that?

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

Yes, you bet. That's absolutely the case. We've had customers that have talked to us that, for example, in our K-12 market, that said, "Thank goodness, we moved to your platforms." All of our K-12 customers basically, with little effort or no effort, went virtual. And they're either choosing to be asynchronous or synchronous virtual school, asynchronous meaning they're prerecording lessons and having the kids interact that way and synchronous meaning they're going live. And we're integrated with all the platforms, the Zooms and WebEx and all of that. And so they're able to leverage those. And we've also had the opposite where we've had, I know of a couple of stories where schools decided not to make a change and wish they did because all of our schools were able to basically use the same platforms, the same learning management system, same scheduling and grading, mobile. And with the kids staying home, they're running the schools just like they were -- if the kids were coming in. We've heard the same stories in our -- with our Financial Edge NXT platform. And across the board, I've talked earlier -- with the earlier question about charities flipping from a physical event to a virtual event. And I believe that this pandemic and this scenario for all of our markets are going to drive a much higher interest for charities and all the verticals that we serve to go to the cloud and to be able to integrate and operate in the cloud and be mobile-first and cloud-first because it's proven that it's needed in this scenario. And they know that they need to go there eventually, this is a catalyst for that. So I think that it's going to drive more online Giving and drive more the desire to go to purpose-built systems in the cloud, we're seeing it.

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

Understood. And Tony, maybe just one clarification from you. I know we had the $4 million reclass from recurring to onetime. Any help on what that would have impacted 2019 in terms of revenue in the various components? Or what that was potentially looking like for 2020?

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

So I don't know that we have anything that we've given publicly I've got handy, Brian. We can circle back on that. I think what we did state, though, is that, that impact was about 220 basis points on the Q1 2020 versus Q1 2019, as stated. If you normalize Q1 2019 as well, it took that variance down to about 130 basis points. A lot of those -- yes, and Brian, just to mention, a lot of those retained services we're talking about were things that were created in late 2018 and brought to the market. So the volumes of those were much smaller, and early '19 grew throughout 2019. It's one of the areas actually we're seeing a big decline in bookings right now currently as well.

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

Okay. So not a big impact on recurring. Okay.

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

Correct, yes.

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

That's what I wanted to clear up.

Operator

Our next question today is coming from Rob Oliver from Baird.

Robert Cooney Oliver - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

So first question, when you guys put out the release talking about some of the changes you guys have made internally, I don't think you mentioned R&D, and I just wanted to touch on that, relative to some of the new initiatives you guys have obviously been keenly focused over the past few years and currently in adding functionality, adding new products, platformizing the business. And just curious if R&D was impacted. And if not, if there was any reprioritization of any of the R&D spend. And then I had a follow-up related to that.

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

Rob, it's Mike. So from an R&D standpoint, not much has changed in -- during this pandemic, except interesting enough, all of R&D is also working at home, and the productivity has been really high, which is great to see. And we measure that in things like new features being released at what frequency and things like that. What has changed recently, though -- so in the main, nothing's really changed. But what we did pivot to is given all of the interaction -- higher interaction with customers and the place that the customers find themselves, we've put a lot of things into production, specifically for COVID-19 in many of our vertical markets. So we've put some things into production a little bit different for K-12 schools. We've added some things for small group, remote management, for example, for churches. And so we've added a lot of little things that customers asked for given they find themselves working in a virtual world across many of our platforms, and we've gone fast and put a lot of those into production quite quickly across many of our platforms. So that's been the biggest change in the short run is being really proactive and reactive to needs, adding some different things from a functionality standpoint across a lot of platforms to help our customers.

Robert Cooney Oliver - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Great. And then related to that, you guys have outlined, per Tom's question earlier, on higher ed and faith-based, those are the 2 areas that you guys have sort of outlined as the longer-term growth drivers. And I think you guys were pretty explicit that they weren't going to be meaningful contributors this year. So understanding that context, just wanted to get a sense for your continued commitment to those areas, how we might think about that? And then more specifically, kind of what you're hearing and seeing. I mean higher ed seems to be in a world of pain and uncertainty right now. Conversely faith-based may be remote-tithing, maybe now is the time for remote-tithing, I would think it would be. And so just curious about some of that. And I know you guys are reliant on -- as your customers use events, physical events, that drive your business, you guys, I think, also were relying on some physical industry events to build your brand in some of these new areas. So just wanted to understand how you're thinking about those areas.

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

Yes. Sure. So I'll start with higher ed. One of the things that we have going for us is there's been a bunch of outside studies related to ROI. I think in one of our earlier press releases this year, we talked about a higher ed institution getting over a 270% ROI and reducing their operating costs and really driving revenue post-implementation of our platform. So there's a really good payback for higher ed in the foundation side, in moving ahead with Blackbaud, and we've got a lot of case studies around that. And interesting enough, Rob, we also -- our Professional Services teams really have been working remotely for a while and are effective. And we've been able to bring customers live even with our enterprise CRM platform. So this COVID pandemic didn't really impact our ability to have our Professional Services teams help drive implementation. So I think we've got a really good presence there and a really good brand related to ROI. And so I think that, that will continue. Over in the faith marketplace, yes, we've got a new mobile platform that helps them operate mobile. I just mentioned that we made some new implementations happen related to new functionality in the church market for virtual meetings and virtual events as well. So I think in both of those that there's still that long-term opportunity for us is really good ROI. In the faith market, there's a ton of legacy on-site, on-prem platforms. And I think a move to the cloud there is going to be more important, as I answered earlier as well. Those institutions are seeing the need to be able to be mobile-first and cloud-first, and I think that is going to accelerate given the current situation.

Operator

Our next question is coming from Kirk Materne from Evercore.

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

I guess the first one is for you, Mike. Obviously, virtual events are going to become sort of the norm, I would say, for the next 6 to 9 months. How does that work with your customers just in terms of is that just a feature that they're paying for already? I really [just don't] know if they're trying to monetize anything around any of this. But I guess, how does that impact you all, I guess, just from a product perspective or from a sales perspective? Is it a new opportunity? Or is it something that's just part and parcel of the platform that you're going to help your clients sort of shift in that direction? I'm just trying to understand how that works for you all.

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

Yes, it's both, Kirk, because our existing platform support virtual events. So you look at platforms like Luminate and -- integrated with our payments platform, it already supports virtual events. So for existing customers, they can just utilize that, and we've added some features to help them lately, but they can just utilize that. For folks that don't have that, that are either existing or prospective customers, it's a way to get to being able to have a platform that's a scalable platform to create virtual events. So it's both. Existing customers can use it and drive their business for virtual events, which is on our transaction and usage side of the business. And prospective customers that don't have a virtual events platform can move to those platforms. So we have other platforms like just JustGiving as well, which is different, but it's different than Luminate, but it's also a campaign-based event for individuals that is another peer-to-peer type event that's available globally. We had this big campaign run on it recently over in the U.K. that drove a significant amount of transaction and usage volume for a particular charity in the U.K. And it got donations from folks and something like 85% of all the countries in the world people donated to this campaign, and it was virtual and went viral. So the platforms basically are there for existing customers. And for -- either existing customers that have it that had physical events that can go virtual or existing customers to just drive more virtual events or for prospective customers who have seen the fact that they can go to these platforms and have virtual activity happen for them.

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

Okay. That's helpful. And then Tony, just on the services revenue that had to be reclassified. Can you give us any sense on -- is there a lot more of that, that could come over depending on what renewal rates look like this year? I'm just trying to get a sense on do you feel comfortable that what's in that recurring bucket of that type of revenue if there's any [lap down] now -- do you feel comfortable that we're not going to have to kind of keep going through this because it would seem that, unfortunately, renewal rates might be coming down around services activity?

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

So the reclass is prospective. So any revenue associated with any deferreds that were out there will be coming through in a onetime services revenue line going forward. So there won't be any other reclasses from that perspective. Most of the, just to give you an idea of the nature of them, are 6- to 12-month term contracts that we're moving and they bill monthly. So they look a bit different than what you'd expect on a typical software or education services or analytics kind of recurring contract. That's part of why we determined to move them. And the renewal rates have been very low on those because they tend to like a lot more like a onetime-type service, and the nature of them also looks that direction. So it's not that the renewal rates will be coming down on these. They're already very low, I think, just because of the underlying nature of the offer.

Operator

Our next question is coming from Rishi Jaluria from D.A. Davidson.

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

I appreciate all the detailed commentary. First, I wanted to ask, Tony, you mentioned in the prepared remarks about -- you've had this ongoing move to have customers from single year to multiyear deals. Wanted to understand, a, with that move, has there been any sort of discounting? And then b, in this environment where you talked about extension of payment terms and financing options, are you seeing any changes on the duration side from customers that are now saying, well, we want to go to shorter-term deals just given liquidity concerns? Then I've got a follow-up.

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

Okay. Yes, Rishi. The multiyear deals typically will have a discount built in because the price increases upfront for the entire 3-year is typically how they're structured. So if you're -- and that's typical in the software space. And so if you're going to sign a contract for a 3-year renewal, we're typically going to give you a slight discount, which will make your cost lower than what it would be if you had an annual increase in each of those 3 years. We get that price increase upfront, which helps from a net present value to offset some of that discount impact. So overall, I think it's a win for the customer and a win for us. And we're typically billing those multiyear contracts again 1 year at a time in advance. We've seen a good shift towards that. Most of our new contracts are 3-year initial terms and 3-year renewal terms. Historically, we're typically selling license product with an annual maintenance. And so we are working to try and migrate any of those older contracts from 1-year renewal to 3 years. That will be -- that will take some time to migrate those folks, either they'll move to a new product set or we'll renegotiate with them to get to multiyear renewal terms. And what the effect will be is, ultimately, we will have less dollars up for renewal in any given year, which is positive, I think, for customers and their activities and for us. Extension of payment terms. Thus far, we've not seen any material increase in accounts receivable aging or customers not paying us that would give us any alarm. We do anticipate that we'll have some increased bad debt this year. Most [any a] think that we have for bad debt will really be the accounts receivable that was opened when we went into the pandemic. What we would expect we may see, which is why we're keeping a close eye on it, is that people may renew at a lower rate, i.e., more churn. Although to date, our retention rates have actually been better than we expected, pre and post. And so it's interesting, right now, renewal rates are doing very well, even compared to plan. And so we're keeping a close eye on that. I think the real critical time for us on the renewal front is over the next 3 to 4 months because we have a large portion of the business, just with the seasonality, comes up for renewal at the end of Q2 and early Q3, timing around school years and all of those other things over the years, how we've built the business. And so we'll be keeping a really close eye on how renewal rates do here at the end of this next quarter and going into Q3. That will be the point we really have a really good sense of how and if will be impacted to the negative at all with the pandemic.

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

Yes. I'll just add to that. This is Mike. The products that we sell to our customer base, they are systems of record. So they're not discretionary platforms. They run their core operations. So they just can't choose not to have a system like this, right? So that's a key point. All of our platforms are systems of record for our customers.

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

Got it. That's helpful. And then, Tony, on the recurring gross margins front, I know you've mentioned, right, the migration to Azure is naturally weighing on margins here. Just in terms of timing, at what point from -- and I know there's a number of other factors in recurring gross margins. But at what point does that one factor kind of plateau out, and we start to see the benefit of migrating and start to see an uptick in recurring gross margins?

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

Yes, Rishi. I think there's kind of 3 big impacts on gross margin within recurring, one of the largest is mix. So we'll have to keep an eye on things there of the transactional piece of the business has lower-margin structure, obviously, than the software side of things, and so mix will always be an ongoing impact on that one. So if we just assume mix stays constant, then the other 2 big drivers, you mentioned our move to third-party cloud like Azure is a big one, and the duplicate costs we have between our colo data centers and the new and then the cost to move and migrate all of those platforms over. And then the other one, we don't want to forget about, is software amortization. And so with all the innovation that we've done and the fact we're building out these 2 new verticals with higher ed, as we spoke about earlier, and faith, there's quite a bit of incremental innovation. That innovation is getting capitalized, and then that gets amortized over 5 to 7 years on average, typically. The amount of that amortization is now ramping now that we've kind of plateaued on the amount we're capitalizing, and it's going to take another couple of years for the amortization to kind of flatten out. So that's an increasing cost as well. I think that those 2 things, that increase in amortization will start to plateau and flatten out over the next couple of years. So I think that helps from a margin compression perspective, start going back the other direction, assuming we continue to grow the business getting through this pandemic. And then the move to third-party cloud is a multiyear transition. Although we will start to see incremental stair-step improvements in those costs each year over the next several years. It won't be overnight. But as we either in the live product and turn off gear and networks or migrate entire populations to the new cloud, turn off the old gear and the data centers and the networks can get out of some of the old infrastructure and supporting applications within the products for some of the legacy products, that will turn off licensing and maintenance costs for those, when you think about the old RE and FE legacy products, et cetera. So what you'll see is incremental stair-step improvements in COGS coming over the next several years as we migrate through this.

Operator

Our next question is coming from Ryan McDonald from Needham & Company.

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

Mike, first one for you, and then I've got a follow-up for Tony. Mike, just I'm curious to see what you're seeing, if at all, an impact from the CARES Act. Obviously, as that was passed, we saw some additional funding for K-12 schools for higher ed and as well as some incentives around charitable giving from a tax perspective. Obviously, the environment is tough out there, but any sort of pockets of stability that you're seeing as a result of that?

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

No. I know that our customers are taking advantage of that, so how that translates to anything that we see is sort of hard to make that connection. So I don't know that there's any connection to Blackbaud related to that. But we've been really outreaching to the customers in a way that we've never done before. And so what's interesting about this, and it's not related to your question on CARES, I think I answered that, but we've had a unique opportunity to be quite different as far as the level of outreach that we've had in the last 6 weeks, which has been incredible, tens of thousands of customers. And I think that creates a bit of a different brand footprint for us, which is pretty exciting going forward. But related to CARES, I know that customers have taken advantage of that across a lot of different markets.

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

And Ryan, this is Tony. I think, 2 things. One, we're making sure we inform our customer base about the CARES Act to make sure they go look at that for opportunities if they're getting into financial difficulties. So that's one of the pieces we're making sure we do, make sure they're informed about the opportunity. Second, the deferral of the employer social security taxes is something that we personally are taking advantage of. So that will create some incremental cash flow for us this year. So that's something we're doing. And we'll have to pay that back over '21 and '22 is how that's going to impact. I think on the giving side, when you talk about the tax breaks for folks, it's too early to tell. I think that's something we'll see later in the year. I think there's so much uncertainty in the market and unemployment is up, et cetera, it's really hard to see what will happen with overall Giving this year.

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

Got it. And then Tony, just a quick follow-up for you in terms of capital allocation. Obviously, I understand the pulling of the dividend, but you've had about a $50 million share repurchase authorization available for a number of years. Does the pulling of the dividend change your viewpoint on how you execute or whether you choose to execute on that?

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

Yes, the dividend doesn't really have any impact on that, Ryan. The focus would really be on what's the optimal use of our available capital. And right now, because of the uncertainties that we're all dealing with, the best use of capital right now would be to reduce our debt and increase our liquidity so that we have as much flexibility as possible to do whatever we need to do. And so that's very similar to what Mike and I lived with different companies in 2008, 2009 when you run into one of these major crises, it's -- the flexibility on that side of the business and the capital structure is the most important thing we can do. That's our focus for 2021, as I spoke about earlier, will become more of how do we adjust our capital allocation strategy and our cost structure to whatever the new norm is going to be going into '21. So that's kind of our focus right now.

Operator

Next question today is coming from Matt VanVliet from BTIG.

Matthew VanVliet

I guess digging in a little deeper on some of the questions that have already been asked. But are you guys taking a more targeted approach in certain verticals? Obviously, things like arts and cultural, you've talked about the doors are completely shuttered. And while they're trying to offer virtual events and outreach, it's not quite the same as other areas where it's more of a recurring giving element that can shift online. But I guess the question specifically, is there anything in their contracts, from a subscription standpoint, that might reduce their current [O] based on certain activities not occurring, door's not open? Or in conjunction with that, are you offering some deferral of some of the hard, I guess, contractual subscription fees that you might regain in the back half as a way to sort of target certain customers to help them manage the crisis?

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

No, we are not proactively doing that. So we do have -- arts and cultural is a combination of contracted SaaS platform and transaction and usage. So the transaction usage, obviously, is quite low right now. Although, there's some virtual things going on, but the contracted is the same. And we're dealing with that on a case-by-case basis. So yes, in some cases, we're working with our customers to help them through that. But it's a case-by-case basis because we find our customers in all various different scenarios at this point.

Operator

Thank you. We reached end of our question-and-answer session. I'd like to turn the floor back over to Mike for any further or closing comments.

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

Thanks, operator. I'll just close by saying we've acted quickly to assess and react to the potential impacts of COVID-19 on our business, and I'm incredibly proud of our employees and their dedication for serving our great customers. We took initial measures to ensure that we have the necessary liquidity and financial flexibility to continue to protect the welfare of our employees, support our customers at a very high standard and deliver increased value to our shareholders. Tony and I look forward to updating you on our progress on next earnings call. Thanks, everyone, for your participation today.

Operator

Thank you. That does conclude today's teleconference. You may disconnect your lines at this time, and have a wonderful day. We thank you for your participation.

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