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PRESENTATION

Operator

Good day, and welcome to the Blackbaud Q2 2017 Earnings Call. Today's conference is being recorded.

At this time, I'd like to turn the conference over to Mr. Mark Furlong, Director of Investor Relations. Please go ahead, sir.

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

Good morning, everyone. Thanks for joining us on Blackbaud's Second Quarter 2017 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 line 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 substitute 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 marketing activity, which is available on our Investor Relations website. During the third quarter, our team will be attending the KeyBanc conference in Vail, [Citi] conference in New York, Deutsche Bank conference in

Las Vegas and meeting with investors in Boston, Chicago, Milwaukee, New York and Seattle. Please reach out to Investor Relations if you're interested in connecting at one of these events.

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

Michael P. Gianoni - *Blackbaud, Inc. - CEO, President and Non-Independent Director*

Thanks, Mark. Good morning, everyone, and thanks for joining our call today. I'm pleased to report that we posted another solid quarter and the market remains very strong. Just recently, Giving USA reported that charitable giving in the United States grew to $390 billion last year, and our giving index suggests that giving online is growing at approximately 10% this year.

We continue to see very positive traction with our next-generation cloud solutions, and the pace of innovation we're delivering is unmatched in the industry. Forbes recognized Blackbaud on their world's most innovative growth companies list for the second year in a row. Gartner featured us as a leader in their FrontRunners report, which analyzes the nonprofit donor management software market. These are fantastic accolades evidencing the success of our industry-leading solutions, and we're particularly excited about the impact our solutions are driving for our customers.

We've had a solid start to the year, are positive about the second half of 2017 and we are reaffirming our full year financial guidance, which improves upon last year's performance and implies achievement of our long-term aspirational goals.

Tony will provide more detail on our financial results, and as usual, I'll provide an update in the context of our 4-point growth strategy. So let's get started.

The first of our 4 growth strategies is integrating an open solution to the cloud. The Blackbaud SKY cloud platform is allowing us to innovate at a more rapid pace, including delivering enhanced integrated analytics capabilities that surface directly in our software through SKY AI and SKY analytics, components of our broader Intelligence for Good approach that combines AI, analytics, the industry's most robust dataset and expertise to drive powerful insights for our customers.

We recently introduced Affluence Insight, a new donor management segmentation tool enabling the identification of annual, mid-level and major gift prospects. It offers the ability to use AI-powered analytics to identify high-value donor prospects and predict a prospect's likelihood to give with unparalleled accuracy.

In higher education institutions, for example, we released a new athletic giving solution designed specifically to help athletic departments raise more money through the university community and athletic program supporters. With a dynamic and diverse set of individuals engaging with universities on a regular basis, higher education institutions are looking for intelligence that identifies visiting VIPs in real time so they could build relationships with potential donors.

In healthcare, we've released a new solution that leverages proprietary donor data for advanced insight to include new capabilities for population health management and patient marketing. The solution leverages a universal patient identifier or identity management resolution and offers a new suite of personal wellness and financial insight that enables both geographic-based prospecting and patient marketing campaigns. We're clearly leading the industry in this space, and were just recently given the Best Use of AI for Charity award at the inaugural AI Innovation Awards founded by CognitionX.

Last month, we held our annual 3-day K-12 user conference, which has more than doubled in attendance over the last 3 years. We convened private school professionals from across the sector to discuss industry best practices, collaborate with peers and participate in over 90 hands-on training sessions. It's quite clear that the pace of innovation we're now delivering is resonating with customers.

The St. John's School executive director and CIO commented that, "The reason I keep coming back is because Blackbaud is a company that listens to its customers, and the user conference is a chance to sit down and have a conversation about where software is going." In fact, we have a K-12 advisory board made up of customers to ensure we're delivering exactly what the market needs, and our full base of customers are able to submit ideas that are continually incorporated into our solution road maps. At the conference, we're able to share with our users how we've already implemented their recent suggestions into the software they use, moving rapidly from customer insight to value delivered through our cloud delivery model. Blackbaud's purpose-built, high-impact integrated and open solutions are changing the technology landscape for K-12 private schools, and this is a prime example of the success we can achieve in organizing our business around subvertical opportunities.

Now let's move to our second strategy, which is to drive sales effectiveness. We're on the path to creating a world-class sales organization at Blackbaud to drive healthy top line growth and penetrate our large and expanding total adjustable market, which today stands at over $7 billion. We continue adding to our sales team, improving market coverage by deploying sales headcount into the field, and we're focused on enabling our expanding sales teams with training, processes and tools to improve effectiveness and drive revenue growth. The move to selling pre-integrated solution suites instead of individual point solutions continues to be successful, and we furthered our go-to-market shift with a concentrated focus by subvertical.

Now let's move to our third strategy, which is TAM expansion. Our approach is to expand TAM into new or near adjacencies with acquisitions and product investments. We closed the acquisition of AcademicWorks at the beginning of Q2, which we covered on our last earnings call. As you know, AcademicWorks is the market leader in scholarship management software for higher education institutions, foundations and K-12 private schools.

A back-office consolidation and solution integration is underway. Performance is tracking to our internal expectations and we're already seeing early success of the sales front resulting from the combined businesses.

University of Baltimore Foundation, for example, an existing Blackbaud customer, purchased the AcademicWorks scholarship management solution. They recently adopted Blackbaud's next-generation fundraising and financial management solutions, and we're looking to streamline the scholarship management process, further improve donor relations and increase scholarship awareness among students.

Today, they manage hundreds of student scholarships in Excel, which is a common practice for universities and be quite cumbersome given the unique requirements for each scholarship.

Now with AcademicWorks, they will have the ability to automate and scale as well as improve the relationships between donors, students and the university. It was clear to University of Baltimore Foundation, based on their experience of Blackbaud, that we were their best long-term partner, given the pace of innovation we're now delivering with our integrated purpose-built modern cloud solutions.

At the end of Q2, we announced that we've entered into an agreement to acquire United Kingdom-based online fundraising services provider, JustGiving, whose online social giving platform has played a powerful role in the growth of peer-to-peer fundraising. The acquisition will enhance our capability to serve both individual donors and nonprofits, expanding the peer-to-peer fundraising capabilities for Blackbaud, offers today through TeamRaiser and everydayhero, which are used by leading nonprofit organizations to connect their causes to the individuals who support them.

JustGiving will also add personal crowd fundraising to our portfolio, which is an offering we previously did not provide in a fast-growing segment of charitable giving. Our intent would be to roll out these new sets of capabilities to the U.S. and elsewhere as well as better position Blackbaud to serve the U.K. market, where we have been for over 2 decades and where JustGiving is the fundraising leader. We expect the acquisition to close later this year after we conclude the U.K. competition and markets authority review.

Both AcademicWorks and JustGiving fit squarely within our acquisition criteria, which is to expand [TAM to near] adjacencies, fuel revenue growth, improve profitability and accelerate our move to the cloud. We remain active in the evaluation of acquisition opportunities to broaden our portfolio, provide better integrated solutions for our customers, differentiate us from our competition and accelerate our financial performance.

Our final strategic initiative is to focus on operational efficiency to deliver improved profitability. We set a long-term aspirational goal back in 2014 to improve operating margins annually and deliver at least 300 basis points of improvement by the end of 2017 at constant currency. Since setting that goal, we've improved margins annually inclusive of heightened investments to fuel future growth and in the midst of migrating our customers to the cloud.

We will deliver on our goal based upon the midpoint of our 2017 financial guidance, and we see future opportunity ahead to further improve profitability through the infrastructure investments we've made in the back office for scale, focus on operational excellence and achieving our productivity initiatives. Overall, I'm very pleased with our performance in the second quarter and the first half of 2017. Execution against our 4-point growth strategy is driving solid financial performance and delivering greater value for our customers.

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. - CFO and EVP*

Thanks, Mike, and good morning, everyone. I'm pleased to report that we had another solid quarter, positioning us to achieve our full year financial guidance. I'll direct you to yesterday's press release and the investor materials posted to our website for the full detail of our Q2 financial performance.

Today, I'll focus on the key highlights so we can get to your questions. Our second quarter revenue was $192.5 million, an increase of 5.1% on an organic basis over 2016 at a constant currency, keeping us on track for the full year. AcademicWorks is tracking to our internal expectations and is predominantly subscription-based revenue with a small services component. Important to note that AcademicWorks is and will be excluded from our organic revenue calculations for 2017.

Recurring revenue continues to climb, representing 82% of our total revenue, which is 360 basis points higher than Q2 of 2016 and 9.1% growth on an organic basis. Recurring organic revenue growth is a key metric for us as it represents the core of the business and is expected to continue to grow as a percentage of total revenue as we further shift towards subscription-based recurring revenue.

Subscriptions accounted for roughly 65% of total revenue in Q2, which is a 710 basis point improvement over Q2 of 2016, representing revenue growth of roughly 17% on an organic basis. Subscriptions continue to exhibit strong performance as we move to integrated and open solutions in the cloud and shift our mid-market customers to NXT.

We remain pleased with market traction to date and economics of shifting customers to next-generation cloud solutions in a subscription model.

Services, licenses and other revenue declined 12% versus Q2 of 2016 and represented a reduced 18% of our total revenue. The decline in consulting services is more pronounced than we expected when we set our annual guidance for 2017. We originally expected services revenue to be relatively flat versus 2016, but we are now seeing the shift of our offerings towards innovative and modern cloud solutions requiring less implementation and customization services, and that is accelerating our planned reduction in services.

Turning to profitability. Our gross margin was 60.6%, which is a 60 basis point improvement over Q2 of 2016. We generated operating income of $40.6 million, representing an operating margin of 21.1%, and diluted earnings per share of $0.54.

Execution against our operating efficiency initiative continues to result in improved profitability while we are simultaneously making increased investments into the business to drive long-term growth. We planned key investments into IT and cloud delivery this year that are much more heavily weighted towards the second half of 2017 and will better enable us to serve our customers in the cloud.

Moving to the cash flow statement and balance sheet. Our Q2 cash flow was $31.8 million, an increase of $0.9 million when compared to recast Q2 2016. We continue making necessary innovation and infrastructure investments to support our move to the cloud, amounting to $2.9 million in CapEx for property and equipment and $7 million for capitalized software development. We're expecting a total amount of software capitalization to start leveling off in 2017 after a ramp over the last several years.

We also paid out $5.8 million in cash dividends to shareholders during the quarter and ended with $370.4 million in net debt. Our capital strategy calls for a debt-to-EBITDA ratio of less than 3.5x, and at the end of Q2, we stood at 2.2x. The $50 million acquisition of AcademicWorks closed on

April 3 and was financed with debt, and we plan to use debt to finance the purchase of JustGiving upon closure of that deal, which we anticipate will be finalized later this year.

As Mike stated earlier in the call, we are affirming our full year 2017 guidance that we originally issued back in February. We will not consider JustGiving within our financial guidance framework until after the deal is final, which we are expecting to occur later this year. But I'll note that given the timing of the estimated close, the acquisition is expected to be slightly dilutive from an operating margin perspective in 2017 but accretive in 2018.

We are guiding to non-GAAP revenue of $775 million to $795 million, non-GAAP operating income of $155 million to $163 million, non-GAAP operating margin of 20.0% to 20.5%, non-GAAP diluted earnings per share of $2.06 to $2.18 and non-GAAP free cash flow of $120 million to $130 million. Our free cash flow expectation is particularly strong when taking into account that we are now a full cash taxpayer, and overall, our 2017 financial guidance allows us to achieve our long-term aspirational goals first introduced back in 2014.

From a new accounting standard perspective, we continue to evaluate the potential impact of ASC 606, which we will adopt beginning with our 2018 fiscal year. Based on our early evaluation, we are still expecting the largest financial impact to relate to the deferral of commissions expense. We expect to defer a greater amount of commissions for a longer period of time using the estimated expected period of benefit versus our current practice of using the average initial contract term. We also expect some limited impact to revenue associated with the allocation of transaction prices or contracts where we still sell perpetual software licenses. We will continue to keep you updated on our anticipated impact going forward.

Finally, I'll remind you that on June 2, we entered into a new credit facility agreement. The credit markets are strong for companies with solid financial performance, and we took advantage of this market as our existing credit facility would have expired within 2 years and we have largely outgrown the size of our prior facility. The new facility provides Blackbaud with lower capital costs and extended maturity and increased borrowing capacity for continued execution against our strategic priorities.

The new agreement expires in June of 2022 and is an aggregate amount of $700 million, including a $300 million senior secured term loan and a $400 million senior secured revolving credit facility, with capacity to incrementally expand the facility by an additional $200 million or more, subject to certain terms and conditions. This agreement offers us the operational and financial flexibility to pursue our strategic objectives and grow the business.

In summary, continued execution against our strategic plan is allowing us to strengthen the business and improve the underlying fundamentals of the company. We're maintaining our disciplined approach to balanced investments that drive growth with improved 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 from Tom Roderick with Stifel.

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

So I guess the question I kind of want to get to this morning is in thinking about a lot of the investments you've made on the sales and marketing side, particularly new sales hires. You certainly ramped up that investment in the past year, and we've seen the advancements of product and product in development really have an impact on the product itself. How should we think about when you start seeing some more productivity out of last year's sales hires, what you're seeing in real time and then when that translates to some accelerating top line features? From the perspective of there's a lot of moving parts that we can't necessarily see with respect to the headwinds of some churn and sunsetting and features like that, but you guys have the data in real-time in front of you, how do you feel about those productivity now? And when should we translate that to the top line?

Michael P. Gianoni - *Blackbaud, Inc. - CEO, President and Non-Independent Director*

Sure, Tom. It's Mike. Yes, that whole program is going really well. As you know, we started a couple of years ago to build more muscle around sales operations and then started to add more headcount, about 10% more last year, roughly looking to do the same this year. And it takes, on average, let's say, 5 or 6 months for an entry-level person and then a little bit longer if they're selling enterprise deals and focused on that market. And we continue to add to the sales ranks, both entry level, mid and sort of the higher-end enterprise folks just given the opportunities that we see. So productivity is improving across the entirety of sales and getting better with new hires as well because, in the last 18 months, we've revamped onboarding and training and support and built more muscle around infrastructure to support the growing sales team. And obviously, they're quite focused on selling our cloud solutions. So the results you see in the quarter and the year-to-date on the subscription line and the reoccurring revenue line, subscriptions at 17% roughly for the quarter and 18% year-to-date and recurring about 9% for the quarter and 10.5% year-to-date are great results, and we're really pleased with that. We put a press release out just to give some indication in higher ed, if you recall that, just a couple of weeks ago. It named, I don't know, 6 or 8 customers in that just to show some momentum. Just that the -- most of the sort of high, mid-tier to enterprise-type customers with longer selling cycles, so really good momentum. We've hired some great folks, including in sales leadership roles around the company, out in the regions as well. So we're quite pleased with operationally how that is coming together. It's been a good focus for us, and it's going quite well. And what's also great is given the results of the company, we're starting to get a pretty long line at the door of sales folks and sales leadership who want to potentially join Blackbaud.

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

Excellent. That's great. Tony, quick follow-up for you just on the impact of AcademicWorks. Could you just kind of take us through your thinking in terms of how this impacts the model? It looks like it was just a little bit over $2 million of non-GAAP revenue contribution for the quarter, so kind of $6 million, $7 million, not a huge number, but you didn't change guidance for the year. Should we think about the guide sort of drifting to the high end of the range? Or given what you sort of see in services thus far, is this sort of offsetting that impact from services and, therefore, should kind of keep at the midpoint of range from our expectations?

Anthony W. Boor - *Blackbaud, Inc. - CFO and EVP*

Yes. I think, keeping with the overall range, Tom, AcademicWorks, to your point, I think was just over $2 million in the quarter, so you can extrapolate that out for the rest of the year. It's more so subscription weighted with a bit of services for mix. As you know, we didn't update the guidance last time just because it fit within that $20 million guidance range we had on revenue due to the immaterial size of it. Services, coming into the year, when we set that guidance, as you recall, we thought we'd be relatively flat on services revenue. We expected to be down in software, which is combined into that services, software and other line now because of the loss of -- decline of back-to-base for RE and FE with the move to NXT and then also moving BBCRM to a subscription model for some of those sales. And then we also expected some currency, so we had a couple kind of hundred basis point decline in anticipated growth rate because of those things. Services now -- services and others down about $8 million, I think, through the first half. We'd expect to see some continued decline there year-over-year in the back half as well. So that would leave me to say that, that probably offsets all of the positive we get from AcademicWorks, maybe even a little bit more, depending where services falls for the year. That said, the trend in services is a little bit a short-term thing, but very positive on the long-term for the mix of the business. And we've seen, as you [think of] the numbers, a very positive shift in that organic recurring revenue moving up to 82% and subs moving to 65%. I think that's up from 58% or 59% last year, so a really nice improvement in the mix of the business. Again -- so it's a short-term pain, but a nice positive mix. And then our services margins, Walter and team continue to do a really good job there. So we've seen some really positive trends on the services margins, so that helps the margin structure as well.

Operator

Our next question comes from Justin Furby with William Blair & Company.

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

Mike, I wanted to start and -- with you and ask about payments. I think there's another company reporting this morning that's not that much smaller than you guys in terms of revenue, and their payments business is quickly 50% or nearly 50% of revenue. It seems for you guys it's much smaller, in the 10%, 15% range. And I wonder why you think that is for you because I know it's a focus. Is there anything you can do from an innovation standpoint or go-to-market to increase that business to something more meaningful? And then I've got a quick follow-up for Tony.

Michael P. Gianoni - *Blackbaud, Inc. - CEO, President and Non-Independent Director*

Yes, sure. It remains important part of the company, and you're right, it's nowhere near half our company. Part of it, Justin, is really just market as well. Remember, less than 10% of this market is online, so some of it's just maturity of digitizing this whole market, is a part of it. But our payments business remains strong and fast growing. And again, it's not half our company, and as you know, we don't have a product that sort of dominates the revenue line, which is great because we see pretty healthy growth across all of the cloud solutions, including payments. We do invest quite a bit in payments around innovation. We invest a lot in integration, which is sort of the winning recipe for us in the marketplace, and we measure attach rates and what have you. And so it's a healthy growing business. I don't think that any of our products are necessarily going to kind of all of a sudden pop out and significantly dominate the revenue line of the company, but they're all -- our go-forward cloud solutions are all in a very healthy way contributing to that year-to-date organic subscription growth, a little over 18%.

Anthony W. Boor - *Blackbaud, Inc. - CFO and EVP*

And I think the other thing, Justin, is I'm not sure who it is you're speaking to, but we don't lead with a stand-alone payments offer. So it typically is going to drag along with one of our other products, so that may make a difference, too, in the go-to-market strategy.

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

Right. Okay, helpful. And then just, Tony, on the guidance for the second half of the year or the implied guidance, I guess, it seems like -- just given your comments you just made on services and not really expecting a rebound there in the back half, it would seem to suggest that you guys are thinking that recurring revenue growth comes back into the 10%-plus range in the back half on an organic basis. Is that the right interpretation? And I guess, just what drives the confidence in that?

Anthony W. Boor - *Blackbaud, Inc. - CFO and EVP*

Yes. We don't -- as you know, we don't guide quarterly numbers. But we do expect -- if you look at just with the reiteration of guidance and where we came in, in the first half, that would insinuate some reacceleration in the back half. A little bit of timing, maybe like last year, shifted. We saw a bit of deceleration more so in Q3 last year. We seem to see a little more of that deceleration in Q2, so we'd expect to see some acceleration in the back half. Hence, we're able to stick to the full year guide despite that services falling well below where we originally thought coming into the year.

Operator

Our next question comes from Rishi Jaluria with JMP Securities.

Rishi Nitya Jaluria - *JMP Securities LLC, Research Division - VP and Research Analyst*

I got one for Mike, and then I have a follow-up for Tony. Mike, just can you help us better understand the JustGiving acquisition? I know its biggest footprint is in U.K. and the rest of Europe. What are the plans to expand this in the U.S., especially given the presence of online fundraising companies like GoFundMe out here? Then I have a follow-up for Tony.

Michael P. Gianoni - *Blackbaud, Inc. - CEO, President and Non-Independent Director*

Sure, yes. It's a great fit for us. It's a company with a really solid history since inception. Pretty big footprint, as you mentioned, in the U.K. And we see this opportunity as contributing to our peer-to-peer environment. And like with the rest of the product portfolio, our intention will be to deeply integrate that solutions with our -- that platform with our middle and back office. And so for our traditional customers, it gives them a really solid platform for both peer-to-peer and for something new for us, which is personal crowdfunding. You mentioned like a GoFundMe. I mean these guys are basically the same, if you will, which is a new category for us. So it's a nice crossover into personal crowdfunding for us that we'll obviously bring to North American market and, in fact, all of our markets. They're predominantly U.K.-based, although they've had participants from over 100 countries, so we could really do a better job taking it global, integrating it with our middle and back office for our, if you will, B2B customers but also really enter the retail or personal market and personal crowdfunding, which we really don't exist in today. So in that part, it's a great portfolio add for us. And I will just reiterate what Tony said. The U.K. has a process similar to here in the U.S. It's called the CMA process, which is like our HSR process. And we're in the middle of that today, so don't really know when this will close exactly because we're in the regulatory review process. But everything's going well, and from a strategic fit, it's just a great fit for us.

Rishi Nitya Jaluria - *JMP Securities LLC, Research Division - VP and Research Analyst*

Okay, great. And Tony, on the gross margin side -- and I know you talked a little bit about the sequential improvement and year-over-year improvement we saw in gross margins, and especially we see a nice sequential uptick on services. Can you just help us understand what are the drivers that lifted services margins up? And then from gross margins as a whole, how should we see them trend from here?

Anthony W. Boor - *Blackbaud, Inc. - CFO and EVP*

Yes, Rishi. On the gross -- on the services margin first. We brought on a couple of COOs, gosh, what's that been? A couple of years ago now, 1.5 years, 2 years ago?

Michael P. Gianoni - *Blackbaud, Inc. - CEO, President and Non-Independent Director*

Yes, a little over 2.

Anthony W. Boor - *Blackbaud, Inc. - CFO and EVP*

A little over 2. And it was one of our strategic focuses, and they've just done a phenomenal job. If you go back and look at just the historical numbers over the last couple of years, you can just see that improvement in the gross margin on the services line, and that's just really bringing expertise in and putting in better practices and policies and approaches to how to manage that business as well as how we offer it in the market. And so we've seen good improvement there. And you've gotten a positive impact of services shrinking as a percentage. So it's dilutive to our overall. It's become a smaller piece of the total pie, and margins, at the same time, have improved. So that's helped overall gross margins. We've been fighting the battle of increased amortization of capitalized software, which is up in the subscription gross margin line, but that's been largely offset by other improvements and efficiencies that we've gained. I think the biggest thing, as you recall, we've talked about this before, to keep an eye out on gross margin is mix. So our payments business today is still very dilutive to our overall gross margins. Usage would be accretive, obviously, and recurring revenue would be accretive. And so it really, at the end of the day, the thing to keep an eye on is your assumed mix of the business to [come in line] with your gross margin target from a modeling perspective.

Operator

Our next question comes from Ben McFadden with KeyBanc Capital Markets.

Benjamin J. McFadden - *KeyBanc Capital Markets Inc., Research Division - Research Analyst*

Mike, I wanted to start with -- you talked about, from a sales rep perspective, just the fact of you feel like you're reaching better productivity, and you've added some field -- some reps to the field. I'm just curious, relative to new revenue coming in from new customer acquisition versus revenue -- essentially, upsells from existing customers, how that mix shift is trending, whether you're seeing an uptick specifically on that new customer acquisition side.

Michael P. Gianoni - *Blackbaud, Inc. - CEO, President and Non-Independent Director*

Sure. That's been a part of our strategy for the last 18 months, is a better focus on cross-sell because our opportunity to cross-sell in back-to-base to existing customers is significant. But in addition, to separate the farmers and hunters, if you will, farmers that cross-sell, hunters of new logos, to separate the teams and so we don't have teams that are accountable for both because you naturally tend to cross-sell into your existing customers. It's a little easier to do. And so we have added to the headcount in account executives and leadership that are solely focused on new logos in the last year, and so it's a separate function focused on just new logos. And so it's a much higher focus for us. If you go back several years, the entire sales team were mixed. You could sell to existing or new logo. And now it's very separate in the last year or so, including separate leadership that we've either moved over or, in addition, hired from the outside. It's a much larger focus for us. We think there's a long runway in cross-sell from an organic revenue standpoint and a long runway to add new logos. And the new logo adds are a land-and-expand strategy, where we'll close a new deal with a new customer, then there's lots of opportunity to go back and cross-sell, depending on the customer. If you're a brand-new K-12 customer, there's a lot of opportunity to cross-sell in there or other customers. It's one of the reasons we do things like make an acquisition of AcademicWorks, because it drives cross-sell and it drives new logos. Now we can go back into -- you think about AcademicWorks. We can sign new logo for scholarship management, cross-sell fundraising and other solutions. So much larger focus on new logos structurally and from a top standpoint as well for the part of the program that's been building for a while.

Benjamin J. McFadden - *KeyBanc Capital Markets Inc., Research Division - Research Analyst*

Great. And then, Tony, I just want to ask a question on the organic subscription revenue growth. It's roughly in line with kind of the range you've been in for the last 1.5 years but a downtick relative to the last 2 quarters. I wonder if you could kind of just help us understand the puts and takes there as far as what's driving the downtick sequentially? And how should we be thinking about that number as we head into the back half of the year?

Anthony W. Boor - *Blackbaud, Inc. - CFO and EVP*

Sure, Ben. First, I'd say we're right in line with where we expected to be on that subs growth year-to-date. There's -- obviously not linear, and we've seen that over the past couple of years with some ebbs and flows from quarter-to-quarter. I think Q1, we were actually up about 100 basis points. Q2 is down a little, but we saw some deceleration, I spoke about earlier on one of the other questions, in Q3 last year. We currently feel good on the full year of where we'll come out. Again, the biggest thing that creates some of the ebbs and flows is we're still working through sunsetting a lot of products, so there's still some volatility there. Most of the products we're sunsetting were subscription-based. And again, I think overall margin-wise, we feel good. We've seen some nice improvement on the margin structure, on the subs line as well, so we feel good on the full year and sticking with our full guide despite being off in services.

Operator

Our next question comes from Rob Oliver with Baird.

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

It's Matt Lemenager on for Rob. Question on the transition to NXT and the uplift that you're getting there. Are you still seeing that 1.5 to 2x uplift? Or is there any update [that you can give] now that you're seeing in practice more as we transition more customers to NXT?

Michael P. Gianoni - *Blackbaud, Inc. - CEO, President and Non-Independent Director*

Yes, Matt. Mike Gianoni. Yes, we are. We're still seeing the same uplift, and the program continues on. I'll tie it back to an earlier question. Also, that platform, much more applicable for net new customers as well, given it's a modern cloud platform. But yes, we are seeing the same uptick, to your question.

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

That's great. And another question just on the competitive environment. I'm sure you get this a lot. Are you seeing Salesforce.org any more than maybe a year ago? We just -- we track the employee count data, and it looked like they went through 500 on LinkedIn at this point. And it's just something we monitor. Are you guys seeing them any more in the competitive environment?

Michael P. Gianoni - *Blackbaud, Inc. - CEO, President and Non-Independent Director*

No. Again, there are several verticals where they're not in at all. So we see them 0 in several verticals, and some more -- some other verticals, we see them more frequently. But we're not seeing them any more than we have. There's a page in our investor deck that kind of lays out by product type the competitors that we do see, and it's somewhat different by solution type -- it's actually very different by solution type. For example, in our financial platform, we don't see them or we only see financial companies only, and we also don't see them or anyone else in all of our verticals. So nothing's changed there.

Operator

Our next question comes from Brian Peterson with Raymond James.

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

So Tony, a quick one for you. So you mentioned some cloud and IT delivery investments that you're going to make in the back half of the year. And I know there's a lot of moving parts in the guidance, but just -- I wanted to understand what specifically those investments are and were the timing or the magnitude of those different versus your expectations coming into the year?

Anthony W. Boor - *Blackbaud, Inc. - CFO and EVP*

Yes. We don't -- Brian, as you know, we don't get into that very detailed, granular specifics, but it's infrastructure investments that support our further move to the cloud. We continue to make other security investments in the business, I think, as most folks are today with the risks that there are out there. And then the corporate IT front, it's still just making some other infrastructure-related investments. The dollar amounts are largely all in line with what we expected. It's just timing-wise is more so towards the back half versus the front half of the year. Hence, you see a little bit higher operating -- non-GAAP operating margin in H1 than what our guidance would insinuate, but right in line with what we would expect for the full year.

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

Got it. And maybe one more for you, Tony. So just on the subscription gross margins, they've actually been up pretty healthily year-over-year, 61%, despite what I'd expect is a higher payments mix. Is there anything that you can tell us longer term about where that metric might go over the next few years?

Anthony W. Boor - *Blackbaud, Inc. - CFO and EVP*

Yes. It's a good question. We don't guide to those margins, so I can't give you that. I can tell you mix is -- you've hit on one of the most important things. Payments would not be currently a higher percentage mix in that line. I think you'll see that in the MD&A when it comes out in the Q next week. Overall, we've seen some really positive leverage that we're starting to gain. Largely, the software amortization has been the biggest drag on subs margins, but we're seeing some improvements in leverage within customer support and some of the other kind of key components of COGS within subscriptions. But net-net, at the end of the day, I do think it will play largely on where mix comes out. That being said, payments is not a larger mix currently.

Operator

Our next question comes from Kirk Materne with Evercore ISI.

Tom Mao - *Evercore ISI, Research Division - Analyst*

This is Tom Mao calling in for Kirk. Just 2 quick ones. Tony, what are some of the factors behind your confidence in organic revenue growth reaccelerating in second half? Are there more deals coming off the balance sheet that we aren't seeing? Is the pipeline above plan? Or is there a reason why kind of the services and license segment wouldn't be as much of a headwind in second half? Or just trying to understand how you're thinking about the puts and takes associated with the transition.

Anthony W. Boor - *Blackbaud, Inc. - CFO and EVP*

Yes. I think the fact that we're now 82% recurring helps a lot with the predictability and visibility. So it's not nearly so much a bookings issue because we just -- we have next to no software anymore, so most of what I would need to get visibility in at least a big portion of the business is already on the balance sheet from that perspective. So we know what the runoff on deferreds are. I think deferreds was up nicely on the quarter, if you look at that. So it shows, I think, better acceleration in the overall growth numbers, so that would lead to more positive acceleration in the second half. We have good visibility into trends within the payments business. And you know that Q4 is historically the high point for giving and electronic transactions with our payments business, so we'd expect to see some good seasonality there in Q4, which helps with reacceleration. So I think, overall, we have good visibility. The services, like I said, we would expect that to continue to decline versus last year, although maybe not quite as aggressively as it did in the first half, but we would expect it still to decline versus second half last year. And so we've incorporated all those things and have pretty good comfort that we're still good on the overall guide.

Tom Mao - *Evercore ISI, Research Division - Analyst*

Got it. And just in terms of the JustGiving acquisition, is there any revenue from that deal captured in the current calendar year '17 guidance? Or would an adjustment happen after the deal closes? And just given their U.K. presence, is there -- is this kind of a start of a broader push by Blackbaud into the U.K. market for all of your products? And how does that potentially impact your margins, if at all, in terms of the investments needed?

Michael P. Gianoni - *Blackbaud, Inc. - CEO, President and Non-Independent Director*

So this is Mike, Tom. First of all, no, JustGiving is not in our guidance. As I mentioned, we're -- we've announced the deal. We're in government regulatory review, so we don't have a definitive date of when it will close. It will close, we anticipate, later this year. That's why it's not in -- that's why we didn't make any changes to guidance. So we'll revisit that once we get a firm date. So it's not in the current guidance. Secondly, it was, again, a strategic asset that was a really great fit on peer-to-peer and personal crowdfunding for us that we see as a set of solution -- or as a solution set that we will take globally. So although their current presence is predominantly in the U.K., for us, it will be a global platform, which we can partner with them and deliver on, which is a little bit difficult for them to do given the size and level of investment that they have in that size of business. So it's not necessarily a signal that is only reflected on the U.K. market. We've been in the U.K. market for a couple of decades, and we have a strong footprint there. So this is quite additive to our U.K. footprint, but again, this is a platform that's -- that will be a global platform for us.

Anthony W. Boor - *Blackbaud, Inc. - CFO and EVP*

And Tom, one other thing I would mention on JustGiving, depending on the timing of the close, they're a very seasonal business, and if it closes somewhere around the fourth quarter, if regulatory review kind of progresses on track, we expect it may be slightly dilutive to margins in the fourth quarter. But for the full year next year, we expect it to be accretive. And again, that's just because of the seasonality of the business.

Michael P. Gianoni - *Blackbaud, Inc. - CEO, President and Non-Independent Director*

But just to reiterate, not in our current guidance.

Operator

Our next question comes from Kevin Liu with B. Riley.

Kevin Liu - *B. Riley & Co., LLC, Research Division - Senior Analyst*

First question, just in terms of services growth, was curious if you could share kind of how you're thinking about that longer term with the continued transition towards cloud. Would you expect to see further declines here? Or is there some level at which you'd expect services to stabilize?

Michael P. Gianoni - *Blackbaud, Inc. - CEO, President and Non-Independent Director*

We think, in general, right, as a percentage of total, it's going to continue to be a lot smaller, no doubt, just looking at the fact that recurring is now 82% of total and just in Q2, our subscription revenue line is 65% of total, in which it was 58% Q2 of '16. So as a percentage of total, it will clearly become smaller a lot faster, also given the fact that organic subscription revenue non-GAAP was 18% year-to-date, 18.2% year-to-date. So that's, again, and we've been talking about this for a while now, is a quarter which is right in line. Services becoming smaller -- services and other becoming smaller is right in line with the model transition that we've started on several years ago in the company. We also -- as a part of services and other, there's license in there, too. And so license has really, by design, have fallen off for Raiser's Edge and Financial Edge. And we're also -- I'll remind you, our Enterprise CRM solution, we're now offering in a ratable subscription model as well, which also puts pressure on one-time license revenue, which is in that services and other line. So this is all, in our opinion, very, very solid results based on the model transition of the company to cloud revenue.

Kevin Liu - *B. Riley & Co., LLC, Research Division - Senior Analyst*

Yes, understood. And then just with respect to your sales and marketing headcount additions, you talked about wanting to add at a similar pace to last year. How far along in terms of your targets for '17 are you?

Michael P. Gianoni - *Blackbaud, Inc. - CEO, President and Non-Independent Director*

Yes. We're on plan for that. And I'll just reiterate, our focus is not just to only add new heads but to get a lot more productivity out of the several hundred folks that we have. So there's been a lot of investment in the sales back office with solutions to drive productivity with operational -- and operational excellence focused around training and support and onboarding. And so there's a significant focus on productivity for the entirety of the sales team in addition to adding the new heads. But to your question, the adds are on plan, as we expected for the first half of the year.

Anthony W. Boor - *Blackbaud, Inc. - CFO and EVP*

And Kevin, I'll remind you, we also made some fairly good-sized investments in customer success heads as well, which is within that same sales, marketing and customer success line item.

Michael P. Gianoni - *Blackbaud, Inc. - CEO, President and Non-Independent Director*

Right. Which also goes towards sales productivity.

Anthony W. Boor - *Blackbaud, Inc. - CFO and EVP*

Correct.

Operator

Our final question comes from Mark Schappel with Benchmark.

Mark William Schappel - *The Benchmark Company, LLC, Research Division - Equity Research Analyst*

Just one question for me. Building on an earlier question on sales force , I believe your sales headcount goal was to increase the number of quota carriers by about 10% this year. And I'm just curious to see if you're on target to achieve that rate.

Michael P. Gianoni - *Blackbaud, Inc. - CEO, President and Non-Independent Director*

Yes, we are. We are on target based on the first half of the year, yes.

Operator

This concludes today's questions. At this time, I'd like to turn things back to management for any additional or closing remarks.

Michael P. Gianoni - *Blackbaud, Inc. - CEO, President and Non-Independent Director*

Okay. Thank you. Thanks, operator. Thanks, everyone. I'll just close the call by saying that I'm very pleased with our progress in Q2 and year-to-date. The model transition is clearly underway to subscription in cloud. We've made great progress against our strategic objectives and our financial performance. We plan to further these throughout the rest of the year and achieve our guidance and long-term aspirational goals.

And Tony and I look forward to updating all of you on our progress on the next call. Thank you.

Operator

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