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PRESENTATION

Operator

Good day, and welcome to BlackBaud's Third Quarter 2020 Earnings Call. Today's conference is being recorded. I would now like to turn the conference over to Mark Furlong, Senior Director of Finance. Please go ahead, sir.

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

Good morning, everyone. Thanks for joining us on BlackBaud's Third 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 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 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 fourth quarter, our team will be virtually attending the Stifel 2020 Virtual Midwest One-on-One Growth Conference, Benchmark's Virtual Technology Conference, The 10th Annual Needham Virtual SaaS One-on-One Conference, the Stephens Investment Conference 2020 and the Raymond James Technology Conference. We will also be participating in virtual meetings hosted by Baird.

With that, I'll hand 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. Our third quarter results clearly show that we are pivoting more towards profitability and earnings growth with a keen focus also towards improving our revenue growth rate coming out of this pandemic. This morning, I'll share a few brief updates from the quarter before turning it over to Tony to cover the financials in more detail.

First, I want to start by saying thank you to our employees for their dedication to serving our customers at a very high standard and the tremendous job they've done in 2020 adopting to the new work environment. I'm incredibly proud of how we have stepped up to support the unique needs of our customers as we all navigate these new challenges. It's really a testament to the people and culture of Blackbaud and our unmatched commitment to the social good sector.

I would also like to provide a brief update related to our recent security incident. It's unfortunate the cyber attack happened. And again, on behalf of Blackbaud, I'd like to apologize to our customers involved in this incident. These types of cyber threats are on the rise, and over the last several years, Blackbaud has invested significantly in terms of dollars and human resources to enhance our cyber security program in preparation for an attack like this. Our top priority is supporting our customers and being diligent in our efforts to help them through this and ensure they have the information they need.

Through our forensics investigation, we were able to understand exactly how this occurred, and we've remediated the vulnerability, which was tied to one of our early generation products. We are incorporating lessons learned from this incident to continue improving our cybersecurity program and further harden our environments, while being transparent with our customers on our progress. I'll remind you, the majority of our customers and the majority of our private cloud environment were not part of this incident, and it did not involve solutions in our public cloud environments.

As can be expected, the security incident resulted in a number of legal claims and regulatory inquiries. We carry insurance policies that we believe will provide coverage for a significant portion of current and expected future losses and expenses related to this security incident, although this is inherently difficult to predict.

Turning to the quarter, each of our vertical markets continue to contend with the unique challenges posed by this pandemic, but one universal theme is the need to employ new strategies to advance their missions with a more digital-first mindset, and we're hearing this in the market as organizations plan -- begin to plan for the future beyond the pandemic.

Digital transformation has shifted from a long-term strategy to a daily reality as organizations across the market have adopted to new and distributed ways of working. We believe this shift will play a powerful role in our long-term opportunity as new customers seek market-leading software solutions for their organizations and existing customers consider expanding the Blackbaud solutions in their tech stack. The uncertainty and complexity of today's environment has created some short-term challenges for these organizations. And as a result, impacted our team's ability to build new pipeline and elongated sales cycles, which are resulting in bookings falling short of budget for the quarter and year-to-date. We expect this shortfall to put pressure on both 2020 and 2021 revenues. And as I've said before, we believe the challenges our markets face today will be a catalyst for driving digital transformation across the social good sector, and having cloud software in place to support the missions of these organizations has never been more critical.

It is clear, social good organizations agree as evidenced by the record-setting attendance at our annual user conference, bbcon, earlier this month. The reimagined virtual format enabled us to significantly expand the reach of the event as we welcomed over 38,000 registrants from over 70 countries. That's equivalent to well over a decade of our historic levels, and by far, the greatest number of prospective customers we've ever hosted, which shows the significant interest in Blackbaud and how our cloud solutions can help solve the challenges and opportunities social good organizations face today. The resounding theme throughout the conference was the resiliency of the social good community, and we've received high marks for the interactive and engaging experience we're able to bring to our customers.

Since the pandemic started, we've been agile as an organization with a relentless focus on driving value and outcomes for our customers in enabling them to quickly pivot their own operations and strategic efforts. In addition to the immense number of resources we provide to the market at no cost, we've also been reprioritizing and expediting product enhancements to support our customers' changing needs.

For example, during BBCON, we highlighted a variety of innovations across our verticals that help customers adopt during COVID-19, such as fitness tracking integration in Blackbaud's peer-to-peer fundraising portfolio, a new virtual prayer wall that enables congregates at faith organizations to share and respond to prayer requests online, text messaging capabilities for scholarship directors and higher education institutions to ensure no funds were going unutilized. And the expansion of the global capabilities of YourCause CSRconnect make it easier for companies to bring employees across geographies together in support of causes around the world. These are just a few of the many product announcements made during the quarter.

As you know, the first of our 4 growth strategies is delight customers with innovative cloud solutions, and our commitment to innovation also extends outside the walls of Blackbaud as we recognize the unique needs of social good organizations across the markets we serve.

Our Blackbaud SKY platform is powering an unprecedented level of innovation, fueled by our engineers and enabling a growing developer community and our partner network with the tools to extend and enhance customers' Blackbaud solutions. Many Blackbaud products are built with open APIs, allowing for seamless integration with software from other providers, making it easier than ever for our customers to meet their organization's unique needs.

Now in addition to the option to create a custom solution, we recently released the Blackbaud Marketplace, offering curated third-party apps, enabling organizations of all types and sizes to discover new ways to amplify their impact by enhancing their best-of-breed Blackbaud solutions with specialized capabilities like connecting the bidders at a fundraising auction, texting volunteers about an upcoming event, tracking branded merchandise purchased in an online store, or automating outreach to donors eligible for a matching gift.

Also, building on our partnership with Microsoft, we've recently released a Microsoft power platform certified connector, enabling nondevelopers at social good organizations to integrate data and improve workflows between Blackbaud's Raiser's Edge NXT and hundreds of other applications. And we announced a robust integration of Luminate Online and TeamRaiser with Salesforce, enabling organizations leveraging Salesforce as their CRM to drive truly multichannel campaigns and leverage the best-in-class fundraising and engagement functionality within the Luminate Online and TeamRaiser platform.

In addition to openness in our products, we're also committed to building a more inclusive tech community focused on social good. Last year, we announced the Social Good Startup Challenge in partnership with One Million by One Million. And this year, we've announced we've expanded this initiative into the Blackbaud Social Good Startup Program, a year-long accelerator designed to support innovative start-ups with potential to impact the ecosystem of good. And in alignment with our commitment to diversity in the tech community, we will be focusing our January 2021 cohort on diverse founders.

Blackbaud is steadfast in our commitment to innovation to enable the success of our customers, which is why we're accelerating investments in areas like R&D, security and the shift to third-party cloud service providers. And delivering rapid innovation is just one way we're positioning the company to be stronger post pandemic.

We've also been taking the lessons learned over the past several months and reevaluating elements of our workforce strategy as we define the future of work at Blackbaud in anticipation of our offices' reopening. We have a culture built on creating employee experiences and programs that further develop and attract the best talent and promote a diverse and inclusive environment. For us, this means adjusting our workforce strategy to provide more flexibility for employees to work remotely. We've proven we can operate effectively as a remote workforce, and this change enhances the positive employee experience we want every employee to have at Blackbaud. It also expands our access to a larger and more diverse talent pool, empowers our leaders to make decisions based on skills and business need rather than location, and it creates efficiencies within our real estate strategy as we optimize our footprint and shift toward more collaborative workspaces within our offices.

We're also applying a digital-first mindset to how we operate, both in support of our employees and our customers. This includes the investments we've made in digital marketing to enhance our digital footprint and enable us to be more prescriptive and cost-effective in our marketing efforts. We've seen some solid early proof points, such as our investment in market-leading conversational AI software, allowing us to engage with customers on their time, enabling us to qualify leads 24x7 without adding headcount, ultimately increasing lead generation and accelerating sales cycles.

Given the early success, we expanded this functionality globally in Q3. We believe the impact of COVID-19 will accelerate the existing trends, driving adoption of modern cloud solutions in our market, and this is just one example of how we continue to put a heightened focus on lead generation and driving sales effectiveness as we look ahead to 2021 bookings.

We've had a singular focus on the social good sector for nearly 40 years, and we remain very well positioned as a leader in this market and the best long-term partner for social good organizations. I'm excited about the changes we're making to enhance the future of work at Blackbaud for our employees, while delivering unmatched innovation.

Our customers are resilient and continue to find creative ways to ensure they can continue to deliver on their missions. The challenges posed to our customers during the pandemic have created short-term uncertainty in our revenue outlook and will limit our ability to drive near-term revenue growth. As such, we've made a pivot to place greater emphasis on delivering shareholder value through increased profitability and cash flow, which are more controllable.

Over the long term, we see an opportunity to drive meaningful earnings growth as we execute our balanced strategy with a sharper focus on profitability.

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'll briefly cover our key third quarter highlights and underlying trends 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 Q3 performance.

Turning to our results. As we said, the current environment is putting pressure on near-term revenue growth, and third quarter revenue declined 2.9% versus Q3 of 2019, with recurring revenue declining 2.6% on an organic basis. This was largely in line with our latest planning scenarios. The decline in recurring revenue was primarily driven by lower transactional revenue in the quarter as customers continue to be challenged with pandemic-related declines in admissions and in-person events that have had to be shifted online, postponed or altogether canceled. While we've seen encouraging signs of customers offsetting the temporary losses in volume tied to these activities with online events and campaigns, transactional revenue remains at least our least predictable revenue source, given uncertainty around length and durations of the pandemic.

Our contracted recurring revenue performed well as renewals continue to trend ahead of our original plan with over 3/4 of 2020 now behind us.

Looking ahead, we expect the shortfall in pipeline and bookings will put pressure on our fourth quarter and more so on full year 2021 revenue. Consistent with Q1 and Q2 of this year, we reclassified approximately $4 million of retained and managed services that would have historically been presented in recurring revenue to onetime services and other revenue. This reclassification reduced our organic recurring revenue growth rate by approximately 200 basis points or 140 basis points after normalizing 2019 for the change. For more detail, please refer to the supplemental schedule included in our investor presentation available on our Investor Relations website.

Moving to earnings. Our third quarter gross margin was 60.1%. We generated operating income of $48 million, representing an operating margin of 22.4% and diluted earnings per share of $0.73. Similar to last quarter, our early actions in response to the pandemic generated a significant cost reduction for the quarter. While not all of these actions will repeat next year, the third quarter is indicative of our ability to elevate our margin profile, inclusive of near-term pressure on revenues and critical investments in the business related to areas like engineering and security and our shift of cloud infrastructure to third-party cloud service providers.

Many of you are familiar with the Rule of 40. We're confident in our ability to deliver a sustainable 20-plus percent operating margin going forward. And we believe we have ample room to improve on the Rule of 40 through the combination of growth and long-term opportunity to scale profitability much more significantly.

Now let's turn to the cash flow statement and balance sheet. Our Q3 free cash flow was $41 million, representing a free cash flow margin of 19.2%. During the quarter, we completed the purchase of our Charleston headquarters building and adjacent land, which we currently lease. The upfront cash outlay of the transaction was approximately $16 million, which reduced our third quarter free cash flow margin by roughly 740 basis points.

This is part of our newly expanded real estate strategy focused on optimizing our footprint for the future of work at Blackbaud, including new exit plans for certain office leases around the globe. These urban lease terminations will generate significant cost savings going forward and will give us additional flexibility as we evolve our workforce strategy. We expect the majority of these lease terminations are closed during the fourth quarter with a onetime cash outlay of between $20 million and $25 million.

We ended the quarter with $478 million in net debt. Our capital strategy calls for a debt-to-EBITDA ratio of less than 3.5x. And at the end of Q3, we stood at 2.0x, with $230 million of borrowing capacity. Our current debt is scheduled to mature in June of 2022, and we are currently in the process of amending, expanding and extending our debt facility to provide us additional capacity and flexibility for the future.

In summary, our customers continue to navigate the challenges caused by the pandemic, which will put pressure on our ability to drive near-term revenue growth in 2020 and 2021. Despite the uncertainty of today's environment, we believe we have a significant opportunity in front of us, and we are well positioned to continue making the critical investments necessary to ensure the long-term success of the business.

The third quarter reflects our ability to manage a wide array of possible outcomes that could result from the pandemic, while remaining committed to driving increased shareholder value through profitability and earnings growth. With that, I'd like to open up the line for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We will now take our first question from Tom Roderick of Stifel.

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

So Mike, let me ask you the first question just around the transactional side of the business. I mean we look back at last quarter, and you put up a pretty nice upside to the quarter relative to a tough time, and I think the postmortem on it was the transactional business delivered particularly well. But that can be -- that can kind of swing both ways, and I wanted to dive in a little bit and see if you can give us a sense as to how much of that business on the payments transactional side is being driven by events versus other sort of giving endeavors.

And then from the perspective of what you can do to gain some visibility in that process or even just the outstanding question of when do we start seeing events coming back, how do you sort of think about the outlook of that piece of the transactional business?

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

Yes, sure, Tom. A couple of things here. So in Q2, we talked about the transactional and sort of consumption business. We have a couple of revenue lines there. So it's usage and payment transactions. And in Q2, we saw some shifts. So we saw some customer types drop, some customer types go up, based on what was happening in the world, and that drove some pretty decent results in Q2.

Q3 is interesting on that, and it's a great question because Q3 is the summertime, right? Lots of events in the summertime, right? A lot of our nonprofit customers do galas, runs, bikes, all of those kind of things. And with COVID, those didn't happen much in the summertime, right?

So that was under pressure for Q3, and that was why that revenue didn't do all that great in Q3. The good thing about that, though, is those customers are still customers, right? Those customers don't need to be reimplemented. They just need to start having events, and we will drive revenue from that. So we're in contact with all those customers. They're planning on firing up events again. It's kind of hard to tell the macro, where that's going to come back and at what level it's going to come back. Some have rescheduled a little bit for Q4, but not in the main. So it's kind of hard to tell.

So for us, there's future good upside there because all those customers are current customers. None of them are at risk. Our retention remains high. But really, it's just activity in the summer months around those actual events coming back. So we saw some weakness in the third quarter related to that.

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

No. I'm certain we're all excited for all those events to come back.

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

Yes.

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

And then I'll let either you or Tony take this whoever wants to, but thinking about that commitment to an operating margin level that's higher than we've seen historically, it sounds like you're happy to commit higher than 20%. That's great.

Curious how you think about the investments as it relates to sales and marketing and, maybe not as much new product, but how you get into some of the newer markets you were pushing into before the pandemic hit. Faith-based and higher ed have been sort of particularly hard hit during this time frame. How do you think about the resources you want to put into that and what you get out of those resources over the next 12 to 18 months by putting you come into those 2 markets?

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

Sure. I'll take that. So a couple of things there. There's some moving parts there. We're actually increasing investments in R&D in several areas that will drive further innovation. So we're doing that, at the same time, we're increasing margin in the company. Sales and marketing-wise, we've seen some really good returns on our digital investments. So we've really ramped up digital investments across the company. And then actually have learned a lot since March with all of our folks working at home. So all of our folks are selling via Webex and Teams online, remote. We're doing demos that way. We've really ramped up our investment in digital lead generation, which is great. So I have a lead -- cost per lead is a heck of a lot less that way. We've really scaled up our investments in systems and people who are experts at that and seen a good return.

I mentioned in my prepared remarks, we put some new tools in like conversational AI tools, which is sort of a 24/7 way to qualify leads through a software tool. So really good scalability. So we're looking to drive better scale that way and keep driving a good level of our expected bookings, although obviously, this year is tough on bookings because of COVID. So our digital investments are really proven out. In my prepared remarks, Tom, I talked about just bbcon, right, just was fantastic. 38,000 registrants, which is like 10 years of bbcons and a huge percentage of that is prospects as well.

The other thing that I'd like to just mention kind of tied to your question around Tony's comment on driving more margin and long term, so we're going to have an Investor Day that we're going to schedule, not quite sure when we'll have an Investor Day. And we will once again have long-term aspirational goals, which has been -- the community has been asking for that a lot. So we're going to do that again as we make this shift to profitability, so we can talk about what that might look like on a longer-term basis.

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

Tom, it's Tony.

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

Great. Really helpful. I appreciate the comments. Go ahead, Tony.

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

Tony?

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

One follow-up on the transaction I want to make sure we covered off on. Since we pulled guidance, it's hard for me to discuss the models that are out there and how those compare to our internal expectations. But I'd tell you, the transactional revenue had actually run hot to our original plan for the year through Q2. It fell a little short to our original plan in Q3, but still exceeded our scenario forecasts in Q3. So there's a little bit of disconnect maybe where you guys and the market expectations were versus what we were expecting internally. So transactions held up really well. And to Mike's point, it's really about summer when all those runs and walks and rides and galas were not able to happen because of the social distancing and all of the other stuff we're dealing with the pandemic.

And then the other thing I'd note also that we need to keep in mind is, services has continued to be -- come in short of plan for the entire year. I think that's twofold. I think one, it's tough to get resources rounded up with our customers to do the work with the pandemic impacts. And then secondarily, it's just our continued trend of moving to the cloud, there's just less need for customization and those kind of services that we've done historically. So that trend kind of continues that we've seen for the last couple of years.

Operator

And our next question comes from Brian Peterson of Raymond James.

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

So wanted to follow-up on Tom's last question, and it sounds like there's a lot of efficiencies gained through some of the digital marketing motions and the digital motions that you guys have put in place.

I'm just curious, how should investors think about the return to growth as maybe some of these macro trends normalize? With the sales capacity and these marketing motions, obviously, we don't have a crystal ball on what the macro will be, but I just kind of wanted to understand conceptually, how we should be thinking about growth in the investments that you're making when that macro stabilizes.

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

Yes, I could start with that...

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

Mike, you want to take that one? Okay. And I'll jump in after.

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

Yes, I'll start with that. Yes, sure. Thanks, Brian. So we serve a lot of different types of customers, and they're in different situations within COVID, right? So the educational institutions are all up and running. And so we're seeing the normalcy of transactions and things we have there. Yet, the bookings slowed down there because they all scrambled to figure out what to do and how to open with COVID, right? If some of them are remote, some of them are combo remote go to class that's getting behind them now because it kind of built some operating muscle in the last 2 months running the schools. And then some others, like the big nonprofits we just talked about, where they have little or no events, they're planning when those are going to be and we're not sure at the macro, what that's going to look like for a while on the event side.

So on the one hand, we are, I believe, positioned well because they all remain customers and our retention is high, and they will have events again because it's a primary revenue driver. Some of them have switched to going more digital by having digital events with some pretty good success in the main. But it's -- with COVID, again, it's still kind of hard to predict that sector of our business going forward.

And lastly, I'll say, again, driving margin up and getting more scale in sales, lower cost through digital means and driving margin up and hiring more engineers and driving more innovation, which we're pretty excited about.

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

And Brian, maybe I'll tag on there to Mike's. From a timing perspective, as Mike spoke about when we talked with Tom, that the transactional side should bounce back very, very quickly, right?

So assuming next year in the summer, we're allowed to have the runs and the walks and the rides and the heart balls and all of those galas, et cetera, we'd expect that transactional revenue to come back almost overnight with those events being allowed. So I think that comes down to where are we as a society and do we have vaccines and those things that will really drive that. The other piece, as you're aware, that has a little longer tail, we're seeing some softness in bookings and pipeline because of the pandemic, and that's obviously going to hurt us through '21 just with the ratable revenue recognition on those bookings.

And so we're seeing a little bit of impact this year, but it's going to be more visible next year because we'll have a full year worth of revenue impact from those bookings shortfalls. I think that lag -- I assume the market comes back sometime next year, 6- to 12-month kind of lag before we work our way through that. So I would say, if we get back to normal sometime in the first part of next year, I'd hope by early '22, we kind of have rebounded and see that resurging of growth overall.

Transaction is much quicker with a little more delay just on the ratable rev rec on the subs.

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

Great that sounds -- go ahead, Mike.

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

Yes, the last thing I'll just add. Brian, I'll just add one more thing. Tony said this in his prepared remarks, and we're really focused on this, which is that combination of driving up the ladder on the Rule of 40. So the combination of both top and bottom line of the P&L, which we're planning on pretty -- being pretty aggressive in driving that going forward.

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

Great. That's a lot of comments. Great color there. And just a question I was getting from investors yesterday. I don't know if you had any comments to this. But just as we think about your transactional business, I know you have some kind of smart solutions there. So there's some exposure in higher ed. But I'm curious, if we were to overlay your transactional business kind of within certain end markets, what are the top 2 or 3 or anything in terms of exposure relative to the customer base? Any color you can add there?

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

Yes, sure. So the smart solution and the sort of education sector is doing just fine. And again, the pressure is what we just talked about. It's all these events in the summer that really didn't happen, is on the downside, putting pressure. It's really all that type of activity. A gala, a walk, a ride that really didn't happen in the summer because of the required social distancing.

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

Yes. And other thing I'd mention is online giving spiked because of the pandemic. So it forced people to move to online, giving anything about like tithing for the faith-based market surged dramatically. People were still giving to their churches, but they couldn't do that in person, passing the basket. And so in several areas, we actually saw a fairly significant ramp in transactional giving that plays to Mike's point. We really -- Q3 -- and again, I'll just reiterate, it was anticipated in our part because of the -- not being able to host those events. Like the usage revenue related to TeamRaiser was a big shortfall in the quarter because we didn't have the runs and the walks and the rides and et cetera, and the marathons.

So that one, again, I expect will bounce back very quickly once things open up again. I also saw a note someplace and a commentary from one of the sell-side folks, I don't remember who it was. But it had mentioned they were surprised on our gross margin that it wasn't higher, being the shortfall in the quarter was from transactions. We need to keep in mind that some of these transactional-related offers have quite high gross margins.

Payments like true credit card processing has a dilutive, lower gross margin. But things like tuition, some of the JustGiving models, usage-related TeamRaisers or some of those things, just how they're part of the pricing construct are actually really good gross margin pieces of the business. So we shouldn't think of transactions all as being dilutive. So I think that's important for folks to keep in mind that loss of some of those with good margins has a pretty significant impact on operating margin as well.

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

That's a good point.

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

Yes. And also, Brian, I just want to add something. Tony mentioned one of our platforms, which is Luminate Online or TeamRaiser, which is really kind of our big platform that drives a lot of this usage and payments. We're expanding the footprint. We announced a pretty robust integration with that platform -- with Salesforce platform. So we're expanding that across the board. We have a lot of customers that make decisions to go with us and Salesforce for different reasons. And so we've integrated that platform there, which is -- provides a future opening to more usage and payments in those kind of scenarios as well.

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

And maybe just a follow-up on that. Mike, I know the Salesforce question comes up with investors. I know you've answered it in the past with this integration. How do you feel like that impacts your flexibility to work with customers in different ways?

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

I think that opens up a lot. So a couple of things that I'd like to provide because we get asked the Salesforce question a lot. And so in the world of software, typically, what looks like competitors sometimes integrate, like we just did to Luminate.

By the way, we also announced some robust integration with Raiser's Edge NXT and Salesforce and our enterprise CRM fundraising platform with Salesforce as well in addition to Luminate and TeamRaiser.

A couple of data points on Salesforce because we get asked this a lot, and we've kind of realized we haven't provided probably enough granularity. So just a couple of things. We went back and looked several years and our win rates with -- against Salesforce have not changed, and they're basically the same win rates against our other competitors. There's no difference.

And the second really interesting, I think, data point -- because we've been saying this at the macro, but not provided data. We see Salesforce in about 5% of our total opportunities, 5%. That's a little different by vertical, right, like markets we're in. So we always would say we don't see them in all the verticals and kind of explain faith-based or this or that one, but if you look at all of our deals, we see them in about 5%. Just to be clear, just to provide more information there.

Operator

And our next question comes from Rob Oliver of Baird.

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

Great. My question is for you, and then I had a very quick follow-up for Tony. Mike, just curious, we're a few years into the Microsoft partnership. And I was wondering if you could provide us with a bit of an update on that.

I know you guys have said in the past that there have been a few big deals here and there that maybe wouldn't have come your way without Microsoft, particularly at this time, that's likely a channel, Microsoft was very active that you guys could lean on during the pandemic. So just curious now, a few years into the partnership, what kind of momentum, if any, you're seeing in the Microsoft channel? And then maybe, I'd love to hear some customer examples, but maybe that's something that we could get at the upcoming investor event.

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

Yes, sure. Happy to provide customer examples, Rob. So we're partnered with them mostly on enterprise-type deals in places like health care and higher ed, and it's been a good relationship. We're partnered with their executives that run those business units. Also partnered in their nonprofit business unit as well, and it's gone quite well. The relationship has matured from the Microsoft nonprofit business unit to the -- to higher ed and to health care as well.

And so we're -- we've made more contacts and more collaborative selling has happened there. The other thing is we're pushing our product road map further as well. So we've done some really great integrations with Raiser's Edge NXT and Office 365. For example, and again, we've got the relationship at the Azure -- on the Azure side as we continue to move from our COLO data centers to Azure. So I think it's gone pretty well, and the relationships are solid. And it's really -- the way that the models were, too, as far as compensation, it's complementary because their teams are really compensated on Azure consumption. And we're moving our products to Azure. And so their base plans incent them to partner with us in the marketplace to pull us in to get Azure consumption, which is where we're going anyway. So it really works quite well.

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

Great. I appreciate that color. Tony, just for you. Just on the data breach, I mean you've got a couple of set of costs here that you guys are going to face. It's certainly remediation costs. And that's something I think we can ballpark based on other examples. But you've got remediation costs, and then you've got liability ex insurance. It sounds like insurance is going to cover much, but not all of that. So just curious how you're thinking of that, and I would assume that as you guys get set up for '21 that that's something you'd be factoring in. But just wanted to maybe get a little bit more color on both of those costs.

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

Yes, absolutely, Rob. So I would say, watch our SEC filings because there'll be a lot more disclosure in those, obviously, on the topic. We have good insurance in place. Our insurers are working with us very closely. The key there is coordinating with them and make sure we're clear on what they're covering or not going to cover.

Right now, and you'll see this in the Q when it comes out, we have not recorded anything material from a liability perspective. We currently don't anticipate that we have a material amount that needs to be accrued that's not going to be covered by insurance on a net basis. So you'll see some things in there where we'll have some receivables and liabilities we'll book.

But on a net basis, right now, nothing material to the company. That said, we're obviously spending a lot of our time and utilizing a lot of our internal resources on that front. The big thing, I think, that you'll see probably in our numbers is just our continued investment in our cybersecurity resources internally, right? Continuing -- we've got a really good team in place. We've done a great job. Obviously, we caught these guys in the midst of their efforts. They weren't able to take over our systems. So I think that was great. But it's still going to be painful to work through. But there'll be plenty of disclosure on the topic in the financials, and we will certainly build any estimated costs we would incur into the '21 plan.

At this point, again, we believe the insurances will cover the majority of it other than our internal resources and time.

Operator

And our next question comes from Kirk Materne of Evercore ISI.

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

Mike, I was wondering if you could just characterize where you think the conversations with clients are today around sort of the nontransactional side of your business. Meaning are clients still just trying to sort of stabilize and sort of make sure they can function, period? Or are they starting to think ahead to where they need to be a year or 2 from now? I'm just kind of -- I realize budgets are tight, they might not want to do anything, but I'm just kind of curious, if at least the tone of the conversations has perhaps changed today versus, say, 6 months ago.

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

Yes. It's changed. Many of our verticals, they're looking forward. They realize how important digital cloud platforms are to them because they've had to use even some different things, the Zooms and Jeans (sic) [BlueJeans] and things that they maybe haven't. So they're all -- they're looking forward. The caveat to that is some of them are not. So like in our arts and cultural business, some of those institutions are open and doing pretty well. Some, mostly in like the performing art centers, haven't opened yet. So they're in a different spot. But I would say at the macro, across the board, they're looking forward thinking about, okay, we're 8 -- 7, 8 months into this COVID thing, it's going to be around for a while. We're operating. We have to continue to drive our business forward and think about the future. So those conversations have shifted that way.

Our bookings are still pretty far off of what we planned, right? But your question was on conversations. So they have shifted that way in the main for sure, but not in all the markets.

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

Okay. That's helpful. And then I guess even thinking about your business going forward, how much of your sort of sales efforts can be shifted more virtually longer term? And does it matter between say, expansion business versus net new business? Meaning I assume you always want to have face-to-face, if you can. But is there a -- can you create more efficiencies, I guess, doing more sales virtually after this? And kind of how -- I assume that's also factoring into your confidence around margins. So I was just wondering if you could expand on that.

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

Yes, you bet. Yes. Again, I think we've -- like a lot of confidence. We've learned a lot since March. You see us being super aggressive on our real estate, right, plans. We rolled out new workforce policies already that are post-COVID workforce policies, which is a lot more remote environments across all the job types in the company. And it's going to drive efficient -- cost efficiencies, it's going to help us with access to skills and diversity, if you remove ZIP codes from job types, and digital related to sales.

I would say that if we go back 2 years, we were behind the game in investment in digitally enabled sales. We did a great job with internal IT platforms for usage for sales, but not digitally driving leads. And we started that over a year ago, brought in some experts, put in a bunch of platforms, and it's proven itself out. So all of our teams have been selling virtually since March, right? All of them are doing demos, no one is going to see folks face-to-face, whether existing or prospects.

And although it's -- our bookings are down because of COVID, it's actually operationally working quite well. So I think it's going to continue. I don't know that we're -- I predict that we're not going to go back to what we used to be at Blackbaud and a lot of software companies. I don't think so. I think there's a ton of opportunity.

The other thing for us, too, is a lot of our deals are an SMB model, which is very, very online. And frankly, we didn't treat it that way enough in the past, where we incurred too much cost in an SMB model where it could have been more digital, frankly, in the past.

We've learned we could do SMB digitally because we started to invest in it, like I said, over a year ago. COVID forced it, and we learned that we could do it digitally and scale it for the SMB, which is most of our deals are sort of SMB-type deals. So lots of good learnings here since March that will drive scalability in sales and marketing. It's an opportunity for us, both on the top and bottom line, I think, in the long run.

Operator

And our next question comes from Ryan MacWilliams Stephens Inc.

Ryan Patrick MacWilliams - *Stephens Inc., Research Division - Research Analyst*

Just one for me today. As we're in this evolving market environment and you're turning towards your leverage target, any changes to your acquisition criteria here? And given the difficulties in some of your end markets, have you seen additional target opportunities proactively reach out to you?

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

Yes. I can take that first, Ryan. Thanks for the question.

Yes, we remain pretty connected to the activities that are going on. There are some lower valuations out there because of the smaller companies that are under some pressure. Our strategy hasn't changed in the long run. In the short run, as you -- as we keep saying quite a bit, we've really pivoted toward driving -- toward the Rule of 40 and profitability, which is more controllable. And I think a really good model for us.

So the strategy hasn't changed the recent activity. We keep looking at things, but we're also driving profitability as well. So I think there will remain opportunities related to that.

And was there a -- I'm sorry, Ryan, was there a second part of your question as well?

Ryan Patrick MacWilliams - *Stephens Inc., Research Division - Research Analyst*

No, you hit on the bulk of it.

Operator

And ladies and gentlemen, this does conclude our question-and-answer session. I would now like to turn the call back over to Mike Gianoni for any closing remarks.

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

Great. Thank you, operator. I'll just close by saying that I'm proud of our execution across the board in the quarter. The pandemic has created some near-term challenges, but I believe we have a significant long-term opportunity in front of us, and we're uniquely positioned to elevate our status as a leader in this marketplace. And I think we've done some of that with things like bbcon recently.

We're currently finalizing our '21 budget and refreshing our long-term plans, which, again, puts a greater focus on profitability in the whole Rule of 40 model, and we plan to share more early in '21. As I mentioned, we'll have an Analyst Day and we'll also provide long-term aspirational goals at the Analyst Day as well. And Tony and I thank you for participating today and in today's meeting on the call. So thanks, everyone. Have a good rest of your day. Thank you.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.
