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BLKB - Q1 2019 Blackbaud Inc Earnings Call

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PRESENTATION

Operator

Good day, and welcome to Blackbaud's First Quarter 2019 Earnings Call. Today's call is being recorded. And at this time, I would like to turn the call over to Mark Furlong. Please go ahead, sir.

Mark Furlong

Good morning, everyone. Thanks for joining us on Blackbaud's First Quarter 2019 Earnings Call. Today, we will review our financial and operational results and provide commentary on our performance in the context of our 4-point growth strategy. Joining me on the call today are Mike Gianoni, Blackbaud's President and CEO; and Tony Boor, Blackbaud's Executive Vice President and CFO. Mike and Tony will make prepared comments and then we will open up the call for your questions.

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

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

A reconciliation of GAAP and non-GAAP results is available in the press release we issued last night and a more detailed supplemental schedule is available in our presentation on our Investor Relations website.

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 second quarter, our team will be attending Baird's Global Consumer Technology & Services Conference in New York, and Stifel Cross Sector Insight Conference in Boston. We will also be holding meetings with investors in Baltimore, Montréal and Toronto. And finally, please note that the proxy statement for our June 13 Annual Shareholder Meeting was distributed on April 24.

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

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

Thanks, Mark. Good morning, everyone. Thanks for joining our call today. I'm pleased with our execution and results of the first quarter of 2019. We made solid progress against our strategic objectives to continue to position the company for long-term success. We continue to rapidly advance our existing applications, brought new solutions to market and closed on the acquisition of YourCause, which creates lasting value for our customers and shareholders and grows our adjustable markets.

Our sales teams are tracking well to expectations, and the sales account executives hired in the second half 2018 are currently underway, ramping to targeted productivity. And I'm incredibly proud of the recognition that Blackbaud has received on a few of our internal program initiatives. Forbes named Blackbaud as one of America's best employers for diversity, and our CTO, Mary Beth Westmoreland was just named one of the top 50 most powerful women in technology by the National Diversity Council. We're also named one of America's best midsize employers by Forbes for the 4th consecutive year and MSCI recently upgraded our ESG rating to an A, following the release of our inaugural social responsibility report.

With 1 quarter now behind us, our full year financial outlook is unchanged. We are reaffirming our 2019 full year financial guidance. As usual, Tony will provide more detail on our financial results, and I'll provide an update on the context of our 4-point growth strategy.

The first of our 4 strategies is integrated and open solutions on the cloud. We're enabling our customers with the power of fully integrated cloud and the impact is significant. For example, a recent total economic impact study conducted by Forrester Research around the Houston Zoo was able to realize a 373% return on investment, increased their operation funds by more than $450,000, increased major gift campaign revenue by $2 million and avoided nearly $180,000 in additional labor cost by leveraging the Blackbaud Target Analytics integration with Blackbaud's Raiser's Edge NXT.

Our commitment to developing fully integrated vertical-specific end-to-end cloud solutions is a game changer for the industry and a massive opportunity for Blackbaud. Last year was a banner year for Blackbaud innovation, and we carried that momentum into 2019.

During the first quarter, at the 2019 peer-to-peer professional forum, the largest annual gathering of peer-to-peer professionals, we announced the U.S. launch of Blackbaud's peer-to-peer fundraising powered by JustGiving. This new solution delivers an unparalleled opportunity for all social good organizations to empower supporters to fundraise on their behalf. Launch elevates our industry-leading peer-to-peer portfolio while disrupting the market landscape by providing our best-in-class cloud solution at no subscription cost. This is a big deal for our customers. Studies show that more than 1 in 5 Americans contribute to online social fundraising campaigns, with those numbers continuing to grow year-over-year.

Fundraising industry continues to experience radical change due to digital transformation, due to proliferation of mobile technology. Blackbaud is uniquely positioned to harness these growing trends with customers by making a direct connection between their fundraising campaigns and supporters, who can engage their networks with virtual events, giving days, live stream fundraising and more.

Since launching Blackbaud peer-to-peer fundraising in March, response of the market has been exciting. In fact, we're signing up new customers every single day with the majority of them being net new payment transaction customers for Blackbaud. We also introduced Blackbaud Purchase Cards integrated with expense management in Financial Edge NXT providing our customers with an efficient and convenient alternative to traditional procurement methods, paper-based payable processes such as checks, purchase orders and invoices. The result for our customers is decentralized daily purchasing and improved monitoring with the right controls and scalable way, enabling them to realize benefits such as reductions in procurement cycle time, increased savings through supplier discounts and working capital and cash flow improvements.

Early feedback from our processing customers highlights the value of our intuitive user experience and a substantial time savings realized through automation. We continue to progress in our Early Adopter Program for our new Cloud Solution for Faith-based Communities, but our first wave of Early Adopter Customers now lies on a Church Management Solution using interim and day-to-day operations.

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Our Blackbaud's SKY platform is enabling us to incorporate real-time customer feedback to rapidly advance the platform. One of our early adopters, West Acres Baptist Church told us how encouraged and excited they are to be part of the development of our Church Management solution.

Going as far to say, and I quote, "I believe that together we can develop the best Church Management system on the market." Additionally, the market response to our expanded education management portfolio, higher education has been tremendous. The Blackbaud SKY enabling us to extend our proven K-12 private school solutions upmarket. In the first quarter, we closed our largest education management deal to date with a graduate school adopting Blackbaud's total campus solution. This deal consisted of our education management portfolio, including student information, learning management, Tuition Management as well as Financial Edge NXT and Raiser's Edge NXT.

Also we continue to build on a partnership between Blackbaud and Microsoft to jointly develop, co-market and co-sell innovative software technology that will advance the industry. Our first jointly developed solution Nonprofit Resource Management is currently in development, and we're working in close collaboration with early adopters.

While this development is ongoing, Blackbaud and Microsoft sales teams continue to meet to better align our co-selling efforts. We also participated in the 2019 Microsoft Nonprofit CXO Summit, which brought together a select group of nonprofit leaders and technology experts to explore cross sector partnerships and innovative solutions to drive social good.

This leads me to our second growth strategy, which is to drive sales effectiveness. Selling modern integrated cloud solutions that are purpose-built for our customers is a key competitive differentiator for our sales teams. We spent much of 2018 working to simplify our program or trying our methodology and approach in a uniform way to better enable our salespeople with process and practice. In the second half of '18, we ramped our sales hiring more significantly than in the past. Those new hires are progressing well as a ramp to targeted productivity.

In the first quarter, we implemented a common sales leadership framework across the company providing sales managers with best practice tools and training necessary to be successful. With the sales structure transformation now largely done, the focus going forward will be adding additional sales headcount and improving sales productivity. And we've had some great net new customers choose to partner with Blackbaud such as Kent Denver School, who recognized the value in adopting our comprehensive cloud solution for K-12 schools, including enrollment management, tuition management, student information, learning management, fundraising and financial management. It's just another example of how our sales executives now lead the total solution selling strategy, which we believe improves the customer experience, improves outcomes, drives retention and extends the customer lifetime value.

Let's now turn to our third strategy, which is TAM expansion. In January, we added another $0.5 billion of TAM. We completed the acquisition of YourCause, an industry leader in enterprise corporate social responsibility and employee engagement technology. Now we're excited about the growth opportunity in this market. In 2011, only 20% of Fortune 500 companies had a formal corporate social responsibility program. By 2015, that number had quadrupled to 80% and the number continues to rise as customers demanded, employees expected and businesses thrived because of it. Adding YourCause's innovative and differentiated capabilities in workplace giving and volunteering, the Blackbaud's unmatched cloud software platform, data intelligence services and expertise in philanthropy and engagement is a game changer in driving effectiveness for companies in the broader social good community.

We're excited about the early successes we've seen in the first quarter. With companies like DuPont selecting YourCause and Blackbaud to manage their employee volunteerism, employee giving programs. DuPont and many other notable companies told us YourCause's modern intuitive user experience, incentive capabilities with cause cards and a transparent giving model were critical in their decision to partner with us.

Our total adjustable market now stands at over $10 billion. We remain active in the evaluation of opportunities to further expand our TAM through acquisitions and internal product development. Our final strategic initiative is to focus on operational efficiency, strengthen the business and position us for long-term success. We continue to execute a strategy around operational excellence that creates a more scalable operating model, and this is a global effort.

I'll remind you a year ago, David Benjamin joined the team as President of our International Group. A seasoned executive with a deep understanding of international enterprise market. This last month, we added another seasoned executive, Allan Hoffmann, who joined David's team as President

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and General Manager of our Canadian operations. Allan brings over 20 years of experience with the high-performance teams within the technology sector, most recently as Canada's General Manager of the education, nonprofit and health care business at Amazon Web services.

Both David and Allan have delivered outstanding results throughout their careers, and we're in great position to drive growth internationally under their leadership. In the U.S., we continue to execute against our workplace strategy, looking to replace and upgrade some of our existing offices, expand our footprint into new locations with customer-facing roles. This has been a multiyear program for us, and we expect to be largely complete by the end of this year.

Overall, I'm pleased with our execution through the first quarter, our continued shift towards subscription-based recurring revenue and the opportunity ahead of us in 2019. And I'm particularly excited about the accelerated pace of innovation we're delivering for our customers and the reaction in the market.

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

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

Thanks, Mike. Good morning, everyone. Please refer to yesterday's press release and the investor materials posted to our website for the full detail of Q1 financial performance. Today, I'll focus on the key highlights so we can get to your questions. From a new accounting standard perspective, I quickly note we adopted ASC 842 for leases this quarter and as expected the impact to our P&L and statement of cash flows were minor. The largest financial impact related to recognizing lease liabilities and right of use assets on the balance sheet for substantially all of our leases.

Turning to the quarter, our recurring revenue mix represented 92% of total revenue, which is 320 basis points higher than Q1 of 2018 and 5.7% growth on an organic basis. We continue to successfully reduce the mix of one-time services and other revenue, which is positive for us long term that creates a significant drag on total company revenue growth in the near term. One-time services and other revenue represented only 8% of our total revenue mix and declined $6 million in the quarter, which is a 24% decline versus Q1 of 2018. I'll remind you that last year one-time services and other declined 17%. We anticipate the rate of year-over-year decline to accelerate to roughly 25% for the full year 2019, which is healthy for the long-term.

Turning to profitability. Our first quarter gross margin was 60.4%. We generated operating income of $36 million, representing an operating margin of 16.6% and diluted earnings per share of $0.51. It's important to note that our operating margin performance was inclusive of heightened investment in innovation and our investment to ramp sales hiring that we began in the third quarter of 2018.

As Mike mentioned, we also continue to execute against our workplace strategy, which we've accelerated in the 2019. We're currently expecting to incur total before tax restructuring costs associated with these restructuring activities of between $8.5 million and $9.5 million, of which $7.3 million has been incurred to date, including $2 million in the first quarter.

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

Moving to the cash flow statement and balance sheet. Our Q1 free cash flow was a negative $22 million. I'll remind you the first quarter is typically our seasonal low and our results include our heightened investment in sales and innovation as well as restructuring and severance payments associated with our workplace strategy. We're still expecting the full year cash flow to land within our guidance range of $124 million to $134 million. We continued making necessary innovation and infrastructure investments to support our move to the cloud amounting to $1 million in CapEx, primarily associated with our global workplace strategy and investment in infrastructure and $11 million for capitalized software development.

During the quarter, we paid out $6 million cash dividends to shareholders and ended with $558 million in net debt. Our capital strategy calls for a debt-to-EBITDA ratio of less than 3.5x. And at the end of Q1, we stood at just under 3x.

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In summary, continued execution against our strategic plan is allowing us to strengthen the business and reiterate our full year financial guidance. We're maintaining our disciplined approach to balanced investments to drive growth and improve 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 call for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

We will take our first question from Tom Roderick with Stifel.

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

So Mike, it's been topical. I know you've been getting questions on it. I'd love to hear your thoughts on Salesforce acquiring and formally wrapping in Salesforce.org. And I guess, specifically, kind of 3 elements of the question, I'd love to hear your thoughts on. Then I'll jump back in the queue. So we'll make it a 3-parter 1 question here. The first part here is, you've commented in the past that you don't really see Salesforce that much competitively in the marketplace. Seems they've played a little bit sort of SMB and mid-market, but they have built what looks to be a $250 million trailing business growing 40%. So on that point, how does that encourage you to think about the TAM and then other segments of the market you want to move towards that might be showing more growth? Second element here is, do you expect that this will change any of their competitive response or positioning in the enterprise? And how does that make you think about your own sales force? And then the last part here, you mentioned Microsoft as a growing partner. It would seem that they have even greater incentive now to deepen their relationship with Blackbaud, wondering what you're seeing and hearing from Microsoft on that front with respect to your partnership in the nonprofit space?

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

Thanks, Tom. Everyone, first I want to mention I had some slight challenges last night, so I didn't make it back to Charleston. So Tony and I are not in the same room. We'll try to do our best to coordinate our answers. On that specifically, couple of things there, Tom. First, I'm not surprised that this happened. They always work together very, very closely since they were founded over a decade ago. So no surprises there. One thing I'll mention and I kind of repeat myself, we're a vertical software company and we build very specific solutions for the markets that we serve. Just some of the examples in my prepared remarks around JustGiving peer-to-peer launch now in the U.S., expansion of our financial platform with purchase cards around procurement and expense management and supplier management for our customers integrated with FE NXT, faith-based in Church Management, education management in that space, both K-12 and higher ed. We've got a student information system integrated with learning management and enrollment in tuition and fundraising and financial. So very, very vertical specific solutions we build for the markets that we're in. And we do not see any competitor in many of our markets, including Salesforce that hasn't changed in a long time.

So secondly, I'll say that we're obviously quite different, now we are a vertical software company too. We're really focused on a very large TAM. There's a lot of competitors. They're different by vertical. The TAM is big and growing. We keep expanding our TAM. So there is a lot to go get out there.

And lastly, on the Microsoft, yes, the partnership continues to get stronger, Tom. We are going to market together. It's a great synergistic fit. The field compensation plans are synergistic. The products are, because they're a platform company and their footprint and just things like Office 365 is obviously significant. The partnership using Azure for us for scale is the big one across the board. So our competitive landscape is what it's been. I'm not surprised on that acquisition, and we just keep doubling down on innovation, specific to our verticals and ramping up our sales headcount.

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Operator

Our next question will come from Brian Peterson with Raymond James.

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

So I wanted to start on the organic recurring revenue growth, that was a little higher than I modeled. I was at mid-single digits for the year and it looks like you guys came in close to 6%. So any color that you guys can give on what drove that expectation? That would be helpful.

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

Thanks, Brian. This is Tony. We've had 2 good back-to-back quarters now on our contractual subscription side of the business from a bookings perspective. So we're really happy with the initial results of this ramp in hiring and the reallocation and all the structural changes we've made over the last couple of years in sales that's seeming to pay off. We've seen a nice continued shift in mix towards recurring revenue. As you've seen we're up to 92% of our total revenues recurring this quarter. One time continues to drop off. We're actually seeing as we expected when we put guidance together, spoke about last quarter. Acceleration in the deceleration of one time, we saw probably 24%, 25% reduction in one-time sales and services this quarter. Last year and the year before, I think we ran at about 17% rate of decline. So that's accelerating, which is good for the long term and right in line with our strategy and little painful on overall growth. And that services will continue to be a bit of a drag. I think for the next year or so, we hope as we spoke about last quarter that will bottom out sometime late this year, next year going into '21 will be our expectation.

We're now really focused on continuing to add more sales at a higher clip rate, so we'll continue to add sales folks and related marketing and sales op support through this year at a higher rate. Hopefully, we won't wait until the end of the year to do it like we did last year. I think we added 84 net new sales adds, but largely late Q3 and into Q4, so it's taken some time to ramp as we spoke about, but we're starting to see good results, and I think you're seeing that come through on that occurring -- that organic recurring revenue growth rate if you're speaking to. And then the acquisition had positive impacts on us although we don't break that. That's obviously carved back out from the organic growth number, so I think we'll see some positive benefits of that going into next year as well.

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

And if I can follow-up just on the higher education side, it sounds like your product suite are resonating pretty well there. I'm just curious as we think about that opportunity, I know, you have a strong presence there already, how should we think about the split of that opportunity with expansion from existing institutions versus new logos?

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

Brian, this is Mike. Yes, we think it's a great opportunity there, and it's a greenfield for us moving over into the operating side of higher ed. We've got both a cross-sell and a net new logo opportunity there. We've got a great footprint in higher ed in the foundation department, if you will, the foundation space, where they focus on fundraising. And frankly, our progress there and presence in win rates in the last several years have been really fantastic. So it's an opportunity to cross-sell and expand over on the operating side in the areas of things like tuition management, enrollment, student information system, learning management system and then just net new logos as well. There are several smaller legacy competitors in that space and the advantage that we bring as we've really taken our success in K-12, and it worked a couple of years to add significant capability to that school management platform for universities. So it's a big opportunity for us in an expansion in our existing platform. And in my prepared remarks, I mentioned that we just closed the largest deal to date as well. So it's early days there. We're still in early adopter mode. That will get flipped over to general availability a bit later this year, but -- yes, good opportunity for us both cross-sell and new logo.

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Operator

Our next question will come from Rishi Jaluria with D.A. Davidson.

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

Number one, I wanted to just start Tony with the recurring gross margins. Maybe a little bit more detail if you could provide on why there was a little bit of contraction on this line both relative to last year, but even maybe controlling some of those factors? Is it down relative to Q4, which typically is seasonally your weakest quarter from a recurring gross margin perspective given the heavy payments delay? So any color there you could provide would be helpful.

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

Absolutely, I kind of look at it from total gross margin as well from a compared perspective and jump into the recurring. But overall, I think one of the things to look at, last year in Q1, our gross margin was a bit inflated because some one-time adjustments we had for some rebates related to the transactional side of the business. And I think you can see that on the full year gross margins came in at 60.8% versus that much higher kind of Q1 '18 number that we had so I look at that more so on the full year compare. Our overall gross margin in Q1 came in about 40 basis points below that annual number last year. The big drivers on total gross margin amenities are also the same on the recurring. We've continued to shift some of our offers from one-time services into recurring, so we've started to embed implementation services, et cetera, into the subscription, which will be a nice benefit for us long term as those contracts renew, but in that initial period it does create some gross margin pressure because you're taking lower-margin effective services business and embedding it into the subs cogs line. We're also making substantial investments and have to put to it cost as we've talked about for several quarters now, moving out of our COLO data centers and us owning the hardware into third-party cloud. And so we still have a bit of that another 2 to 3 years probably we'll be incurring those duplicative costs. With the ramp in bookings and the positive momentum we're seeing on some of the NXT and cloud-base products, where also have to take on a bit more investment in the cloud sooner than expected. It's driving that -- those costs a little bit higher.

And then thirdly, the rate at which we've been driving innovation, Mike spoke to this in his prepared remarks just in that prior question, a much larger percentage of our R&D spend is going into true innovation, which is required to be capitalized on GAAP and the amortization of that cap software gets in COGS largely all in our recurring subscription line. And therefore that's having some negative impact on those gross margins. Overall, like we said, gross margins appear to be a little low compared to consensus, looks pretty good compared to our expectations. Again we're reiterating our full guide and feel good about both gross and operating margins when we come out on the year.

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

Got it. That's helpful. And then turning to the Microsoft partnership, good to see some early signs out there. But with the launch of NRM in the future, can you give us a sense for how the go-to-market on that and what the co-selling sales motion might look like? And maybe alongside that, directionally, what would the revenue share for that product be?

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

Sure. I'll take that, this is Mike. So we are in market with Microsoft in a lot of different ways, not just with that new solution we're co-selling now in a lot of markets, which is great and it's a really good approach for the customers as well. Specifically, with that solution, we're codeveloping that with them. It's underway, going well. We'll both be selling that as well in the marketplace as partners. There is a lot of integration happening there between the 2 companies as well. So I think that's going to have a big impact. I'll remind you that, that solution is in the category of supply chain management for a large global nonprofits, and that's progressing well. I'm not going to break out any specific financial details at this point, but we're excited about the partnership, and that really took us in another layer of relationship with Microsoft to codevelop a new solution with them. So we're excited about that.

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Operator

Our next question comes from James Rutherford with Stephens, Inc.

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

I want to start on the recurring revenue line again and there have been a few questions here already, but taking another crack at it. Nice to see the step up in recurring growth here in the first quarter. Obviously, you have a lot of difference of sub-verticals, a lot of different products, can you give some color on perhaps what the biggest sub-verticals or products were that drove this? And were these more back to base selling or more new logo wins?

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

Certainly, this is Tony. I'll take it. We've seen really good traction across the portfolio. I wouldn't earmark this or place this improvement on any individual product or product set or vertical. We've made positive investments and positive changes in structure and approach to sales productivity in our marketing efforts. We've realigned most of the sales force, we've realigned comp plans, all those things we have been working on over the last few years are starting to pay dividends as well as the ramp -- accelerated ramp in sales hiring. I think that we are very consistent across all of the verticals. I'd say, we are excited about the opportunities of future. I don't think we've seen a lot of that drivers hold yet, but I think the expansion Mike spoke about with our new solutions set in the higher ed, the Microsoft partnership, our new Faith Cloud, those things are still in their infancy, but we would expect to see some really nice growth from those in the coming years as those rollout general market availability, and we start ramping efforts on that. We have started to put sales and marketing efforts towards those already, but not had a material impact, but we'd expect it would from the future. But there is a nice balance that we've seen with no specific individual product or solution set that's really driving more growth than others. Over the years, the payments business might have historically been a little higher growth, because we were penetrating that market that was largely nonexistent before, Mike got here, but that's now a fairly large piece of business and that growth rate has certainly come back more in line with the rest of our pieces of business and offerings. So nothing that jumps out today that's a specific higher growth driver, I think, it plays back into all of our strategy.

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

This is Mike. I'll just jump in and add that we're pleased with the strong bookings performance in core subscriptions as well. Go ahead, you have another question.

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

Great. Yes, just a follow-up on that actually. You mentioned on the gross margin question earlier that you're kind of rolling in some of those one-time services into your subscription line, which is something we knew. I'm just curious is that providing any benefit to the growth in that recurring line?

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

So it would obviously add to the ASP on the product. The interesting thing on that one is the rev rec when 606 come into play creates complications of when that is recognized and then also the ASP impact would not be -- we typically would not be trying to spread those costs over the first term of the agreement. So in many cases that may spread out over years to exceed the initial 3-year kind of average contract term. So you wouldn't get 100% kind of uplift and then you have to evaluate the difference in potential timing of recognition under 606, although that said, most implementations would fall largely in the first year, although being within recurring. And then, it is driving some of the offset that is well within the one-time revenue line item. So there is some kind of migration or geographic change that are on those fronts, but it wouldn't be a one-to-one. We do lose and then you are not necessarily going to get a 100% uplift on the ASP part of what we're trying to do is reduce the barrier to purchase

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for folks in that first year. And so we are being very cognizant of the incremental cost to trying to help spread that from a customer perspective to hopefully drive more unit volume going forward.

Operator

Our next question will come from Rob Oliver with Baird.

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

Matt Lemenager on for Rob this morning. I had a question on the -- so the direct sales hiring was up about 20% in the second half of last year, has that stepped up level of direct sales rep hiring continued into the first quarter? I know there has been hiring, has it been at the same stepped-up level? Or are you starting to reach kind of the capacity that you're looking for there?

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

Matt, it's Mike. Yes, we ramped up about 20% last year. We breakout the sales headcount just once a year in the K, which obviously we'll do when that wraps around next year, but we plan on continuing to be aggressive in sales ramp this year as well. We won't wait till the back end of the year operationally. We had reasons to do that last year, so we feel good about the ramp in Q4. We're continuing to ramp now, and that's something that we'll continue to focus on. Your last comment around capacity, I'm not sure what the top end of the capacity is because we have a really big market here in the verticals that we're in. So the question really is about the rate of ramp and our ability to absorb, train and get our new folks to productivity, but the capacity could be pretty big. But I'll just say that we'll continue to add headcount.

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

Matt, this is Tony. I'll just add on that. We've expect as well -- we had a hit from a margin perspective of this increase in investment, but the expectation will be if when these folks are to full productivity that they should help fund the future classes, so we've historically added somewhere between 5% to 10% a year, right? And those were kind of self funding them once they got to full productivity. So the expectation here is that we will continue to hire at a heightened rate, but that this initial class and future classes will then start funding future classes after that, once we get to that kind of full productivity. And that we start seeing that impact in the P&L as we said in the last couple of calls. It's probably more so towards the end of '19 and certainly in '20 that we see that positive benefit closer to P&L.

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

Okay. That's helpful color. And then just a quick follow-up. The Blackbaud SKY ruling that out has allowed you to kind of increase the pace of innovation. In one area, I think, it's been around Church Management that you talked about. Taking that feedback from customers, what types of things are they asking for? Is there anything that stands out as necessary to add before that product sees more broad adoption? Or is it just kind of incremental updates? Or is there like a 1 or 2 things that they are waiting for to see that product have more adoption?

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

Yes, Matt, specifically in the Church Management space, which I think is what you're asking. Let me take a step back. So the SKY platform is our engineering solution that goes across all of our products and markets. So specifically in Church Management and the way that we build solutions now across the board within Church Management, it's an iterative process. So we build the Church Management system and then brought on early adopters. The early adopters give us feedback and then reiterate from there and we will continue to add early adopters every month now until we get to a point fairly soon and say okay, it's ready for general availability. By the way those early adopters are essentially in production, right, as well. And so they give us feedback on their needs. We have our own folks that do business analysis work to understand how to drive digital transformation

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in that Church Management space in waves through the SKY platform that hasn't been done before. And so it's an iterative process and it just builds upon itself until we're ready for general availability then it continues, right, because SKY platform allows us to put capabilities into production at the pace that we want to. And so typically we'll put new features in once or twice a month. And so it's a higher velocity early on when we have early adopters. When we go into general availability, it might be once or twice a month. We'll keep adding capabilities, but that will just continue on and that really is the power of that SKY engineering system.

Operator

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

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

Mike, I wanted to ask on JustGiving. I think you made an announcement in the last couple of months that you removed the 5% fee structure that was in place. And I wanted to understand sort of the impact to the model when you do that and then just in terms of the U.S. market and the rollout of that peer-to-peer solution, can you spend a minute on how you think that plays out over the next few years? And what your go-to-market strategy is there?

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

Sure. Yes, it's pretty simple. So 2 things, Justin. One is on the pricing model, it's basically monetized via payment transactions. So no subscription fee, so essentially free. Customers don't have to sign up with us and pay a monthly subscription. They just start using it and to monetize through our payments platform. We do not see that as having a negative impact on the revenue opportunity for that. We, in fact, see it, it's having an uptick in adoption because of the model. So that's the first part.

The second part is we've integrated JustGiving with our middle and back office solutions and that's unique. There isn't another platform like that, that's integrated with Blackbaud's middle and back office. So integrated with our fundraising solutions and other solutions, not just using our payments platform, but RE NXT and other platforms as an example. So it's unique in 2 ways, no subscription fee. Therefore, free for customers to start using that. It's applicable really in all of our markets and integrated with our middle and back office. Those 2 things make it unique. I think there is great upside there. It's a fantastic platform, big footprint, as you know, over in the U.K. A platform that's been used by folks all over the world, highly scalable, easy to start a campaign, very intuitive, mobile first. So I think it's early days, we just launched it a month ago, but we're excited about the opportunity there for us and for our customers.

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

Justin, this is Tony. Just on the U.K. piece as well. Donor still have the opportunity to provide a voluntary contribution to support the platform, and we've done a lot of testing on that end market and are confident that, that's a sustainable business model there in the U.K. It has been very, very well received across all of the various constituents in the market. So we feel pretty good about that change in that model there in the U.K. as well specifically.

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

Okay. Great. That's helpful. And then if I could ask a quick follow-up on just the overall health of the nonprofit market for Mike or Tony. I know it looks like you've changed your benchmarking to more of a quarterly cadence in terms of your release, but can you give any sense for the trends you've seen here through April year-to-date? And any observations relative to kind of how the year ended last year?

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

Sure, Justin, I'll take that. One thing just to add back to the original question on JustGiving and the pricing model changes, as you might imagine we do extensive testing before we make the changes. The platform allows us to go do a lot of testing to prove out results, and so we're pretty happy with where that's going from a pricing model standpoint. As far as health of the market, again we're in a lot of markets and it's such a huge market just on the fundraising side, it's all in front of us related to driving digital transformation and moving the fundraising to online and mobile in the pure charity marketplace, but we see really great adoption. I think the last -- today, in the last earnings call for example, in the K-12 market, I announced a handful of very large schools in which we've won the entire platform. And so that market continues to be really healthy and the differentiator for us in those verticals is the integrated platform. We are in a lot of cases displacing many single standalone single point solutions with an integrated platform and the value prop for its school is significant. So across the board, we don't see any external pressure on our markets and the fact that the markets are so big, I'll just point you back to the last time that U.S. Giving ran their report that U.S. -- the U.S. donation market grew, I think, it was $15 billion in donations year-over-year to go to $410 billion. That's an active market. They're all doing pretty well. Each of our markets, I think, represents a big TAM for us.

Operator

We'll take our next question from Kirk Materne with Evercore ISI.

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

I guess, Mike or Tony, I'm not sure who wants to take this one, but you guys have talked about sales productivity looking good in terms of the new people coming on board and obviously, Mike, I think you mentioned that bookings were good this quarter, which is great. Can you just remind us how you sort of think about sales productivity? Or how you track it? I guess, as these folks are coming on and I assume that getting them to full productivity is a -- it's a 9-month journey? Or can you just remind us kind of when that cohort that came in last year should be kind of up and running?

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

Sure. I'll take it. It's Mike. Couple of things, we have a very detailed sales management system that looks at productivity in the full cycle all the way through lead gen to lead qualify to pipeline development to competitive wins all the way through to closure, not just the back end, which is quota attainment because as we all know, it's an activity-based journey to success. So we've got a very detailed program that literally all of our sales teams in the world use the same program with the same metrics for us, and it's driving pretty uniform approach for our sales executives and for sales leadership, and it's something that we've rolled out. And I think it's a very, very good system and the metrics are very transparent internally to the company. So really happy with the methodology that we have there. Ramp time, it's different by level. If you're selling an enterprise deal, it's longer. If it's a multimillion-dollar large deal to a large institution versus a smaller deal, if you will. On average, I'd say, we are in the 6- to 12-month roughly time frame, but again it's different for very large enterprise bills executives, but to productivity takes a while to get as well. It's probably more like 18 months, 20 months to get to what we would call true full productivity and it's something that we measure. We think we're doing well. We think there is opportunity to drive better productivity. So our whole program is focused on adding new sales headcount in each of the verticals pretty aggressively and also measuring and driving productivity, and we've got the metrics and the system to see it with pretty full transparency, across the board, so we feel pretty good about that.

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

And Kirk I want to add 1 thing, we've spoken about this before. We have a keen focus as part of our strategy of driving that increased productivity, as Mike said, and we believe there is a good sizable opportunity for us over a number of years to improve our ARR to oTE. There are a lot of different levers in there, the shrinking of one-time services so I don't have to replace those bookings every single year, converting things and offers to ARR true better lead gen, better quality leads, better close rates, just all of those things that Mike was talking about come into play here. But over several years, we've got target to improve our ARR to oTE, which ultimately improves our LTV to CAC assuming retention rates hold flat or assume flat in

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that model, then you -- we're focused as well as the company on retention rates and then obviously gross margin are the key drivers there, but from a sale-specific perspective it's really that ARR to oTE. And we've talked about -- we've benchmarked -- I think you've actually done some analysis on that, you and the team. We benchmarked somewhere closer to the 50th percentile today in the peer group and we'd like to be towards that top quartile or better over time.

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

Yes, Kirk, the other thing I will add is, which is important, I talked about this in the past is we've made a lot of operational changes too. So today we've got 1 sales support and operations team globally. Everyone is on 1 compensation plan. We're divided into hunters and farmers. We're in vertical markets. So structurally we've made a lot of incremental changes, which are all behind us now. Now it's about headcount adds and productivity. Structure changes are pretty much done.

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

Okay. And just, I guess, to put a final point on it now. Given the trends look good, your organic recurring bounced up a little bit sequentially this quarter. I guess, maybe for Tony, if you weren't to see organic recurring revenue get better over the course of the year, given you are adding capacity to the system, what would have to be the offsets? I assume higher late rates of churn would be one, but it just seems like there is a pretty good setup for you all to see organic recurring revenue to potentially accelerate over the course of the year with more capacity. If that weren't to happen, I assume, churn will have to go up. If there's -- I'm just trying to make sure I'm not missing something else payment -- can you just walk me through why that -- when it happened? I'm sort of trying to make that the case for you, I guess.

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

Yes, I think that there is -- you hit on a couple of things. Churn obviously is a piece of that. If we saw retention rates worsen on us for some reason. The other good news and we haven't spoke about this, but we've just finished sunsetting one of our -- the largest, I guess of the 26 products, the old sphere solution has now been officially sunset. So that's been a big drag on us when we speak of churn. Attrition rates within the sales and marketing teams is another area that we're keenly focused on, and we look at a metric that we call kind of productive FTEs. And so when you go out and hire 84 new folks and then Mike said, we did a lot of reallocation of resources and changed the comp plans, all kinds of things that can cause heightened attrition, so we're keeping a keen focus on our attrition rates. Time to rehire and fill those positions, ramp times on the different types of reps, productivity by reps, et cetera. So there's a lot that goes into that, but I would say it's really about can we increase the number of productive FTEs that we have on staff and that is where we feel really good about where we're heading. What would derail that would be folks not ramping to expectations and then we might have to spend more time coaching them up or counseling them out as they just ultimately are going to get there and get the right folks in those seats and/or people may leave because of the change in expectations and reallocation of efforts and focus. So I'd say attrition on that headcount side and maybe churn on the other side. And then lastly, probably, lesser impact, what we saw some amount in that last year is you do have the transactional side of the business that still comes up through recurring revenue being the payments, Smart Tuition usage, some of those things. We could have some changes again in consumer giving or things along those lines that could cause some potential deflation, but right now I really feel good about where we're heading. We continue to add net new sales folks and get them productive in a timely manner that should bode well for long-term growth. And then if we can get better productivity out of all of the sales force overtime, that also will drive nice acceleration will be our expectation.

Operator

We'll take our next question from the line of Ryan MacDonald with Needham.

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

Mike and Tony, I guess, first starting off on YourCause. It seems like first quarter end, there was a decently nice performance there, some nice new logos. Can you just talk about sort of what you've learned, I guess, in the first quarter with that company being integrated? And maybe where you see opportunities for incremental synergies or some upside surprises with that business now that you have it in the fold?

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

Sure. This is Mike. I'll take that. I couldn't be more pleased by having YourCause join Blackbaud. There is a lot of synergy. There is cultural synergy. It's a great platform and a great team. As you might expect, we went fast on back-office integration. We're adding investments in areas like sales and go-to-market. I think it's early days there too. I think there is a lot of opportunity because the addressable market is significant, given the trend in companies of all sizes, focusing on corporate social responsibility in all markets too. So it's not constrained by a vertical market. And in fact, there is opportunities in the markets we already serve, health care, universities and things.

So I think there is a lot of upside. It's a great company, great platform and it's just early days and our ability to partner with them and help them accelerate growth. Their retention is really high. And we've got a lot of really large Fortune 500 customers and keep winning even at that level although we're winning a lot of midsize customers as well. And it takes a pretty good ability to get through the due diligence of company like a DuPont that I mentioned in the script to be their platform. We've disclosed that there would be between $20 million and $25 million in contribution for this year, closer to the bottom end of that. And also I'll just remind you that we exclude them from our organic revenue calcs for '19 because we closed on the deal in January, that will come around next year, but we do not include them in organic just in total revenue. So yes, it's a great add for us. We're excited about it.

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

Got it. And then just a follow-up, I guess, on the competitive landscape. Clearly, it's still early days with this competitive acquisition with Salesforce.org, but as you see the assumption of that company getting more competitive in this space or more investment dollars behind them now, do you just change at all the strategy that's focused around the products and the pace of the product sunsets or the customer migrations to the NXT platforms just as a maybe a way of preventing some of those customers going out to market with maybe on the larger competitor now?

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

Yes, Ryan, I mean I'm just going to remind you that we do not see any competitor in all of our markets. In fact, our competitors are not in most of our markets. They're very different by markets. All right? The Faith market has very specific competitors; the K-12 very specific competitors; charities, right, they are different. They don't cover the markets we cover, one. Two, we're a vertical software company. That's all we do. We build solutions that have business logic specific to the operations of our customers. And three, no it doesn't change our strategy at all. I mean, we're a vertical software company. We're doubling down on innovation because our solutions are purposely built for our customers. Our customers don't have large IT shops typically, so they are not able to adopt in many cases platforms that aren't specifically built. And so for Blackbaud, our strategy doesn't change. We will continue to drive innovation and add to our distribution channel, and we think we've got a long runway with a very large TAM.

Operator

And ladies and gentlemen, this does conclude today's question-and-answer session. I'd like to turn the conference back over to Mike Gianoni with additional or closing remarks.

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

Great. Thank you, operator. I just want to reiterate that I am really pleased with our Q1 results. We continue to drive our market-specific innovation. As I just mentioned, really happy about the YourCause addition and the JustGiving launch in the U.S. I think there's a long runway for both. We continue to drive digital transformation for our customers, which is helping them improve their results, which is most important. And Tony and I look forward to speaking with you on our next call. So thank you, everyone.

Operator

And this does conclude today's conference. Thank you for your participation. You may now disconnect.

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