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PRESENTATION

Operator

Good day, and welcome to the Blackbaud's Q3 2019 Earnings Call. Today's conference is being recorded.

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

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

Good morning, everyone. Thanks for joining us on Blackbaud's Third 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 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 attending MorningStar's Management Behind the Moat Conference in Chicago, Stifel's Midwest One-on-One Growth Conference in Chicago, Crédit Suisse's 23rd Annual Technology Conference in Phoenix, NASDAQ's Investor Conference in

London; and Raymond James Technology Conference in New York. We will also be holding meetings with investors in Boston, New York and the Ohio Valley.

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

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

Thanks, Mark. Good morning, everyone, and thanks for joining our call today. We continue to gain momentum in our aim to drive digital transformation across the social community and all the markets that we serve. As many of you know, we held our annual conference bbcon earlier this month, and it's clear that the progress we've made is having a major impact on the individuals that use our solutions every day. We had a packed agenda and introduced more than 80 product and innovation updates to over 3,000 attendees who joined us at Nashville, making it the most well-attended bbcon to date.

There's no question that our customers and prospective customers are excited about the pace of innovation being driven by Blackbaud and our partner ecosystem, which was evidenced by the overwhelming positive audience reaction that a long list of mainstage announcements and the constant flow of attendees in our innovation expo hall and over 300 breakout sessions.

We are uniquely positioned to enable the digital transformation within social good organizations through our cloud software services, expertise and data intelligence. But our focus on this industry extends beyond our cloud software technology and solutions. We have a culture built on an unmatched commitment to powering social good and that includes our participation in this ecosystem. In fact, 89% of Blackbaud employees have volunteered in the past year. Employees participate in Blackbaud's matching gift program at over 2 times the national median, and 1 in 4 employees' serves on our nonprofit board or committee. And we're incredibly proud to be named as a leader on the AnitaB.org 2019 top companies for Women Technologists for the second consecutive year.

Just last week, we released our second annual corporate social responsibility report highlighting our environmental, social and governance accomplishments in the past year as we continue to think critically about our responsibilities as a technology provider, employer, public company, environmental steward and member of the global community.

For example, as the owner of the industry's largest data set, we were an early adopter of industry-leading cybersecurity and data privacy standards. Blackbaud's cybersecurity team reflects 400 years of combined experience, including service in key government offices and Fortune 500 companies.

This year, we launched the Consumer Privacy Center of Excellence, a collective of subject matter experts from different departments, all trained in privacy and how to access data used in their respective departments. Lastly, social good is at the heart of who we are as a company, an employer and a brand.

As usual, Tony will provide more detail on our results, and I'll provide an update on the context of our 4-point growth strategy. The first of our 4 growth strategies is delight customers with innovative cloud solutions. We made a slight modification to the strategy to highlight our relentless focus of driving value and outcomes for our customers through our solutions. Blackbaud SKY, our platform for innovation is a core tenet of this strategy and continues to power an unprecedented level of innovation by our engineers and enable a growing ecosystem of developers. We're also passionate about our social good to create amazing new capabilities that often look and feel like Blackbaud built capabilities.

For the first time in the history of the company, there are now significantly more outside developers developing on our platform than Blackbaud engineers. In fact, third-party developers have defined over 1,000 Blackbaud SKY applications, and nearly 2/3 of these applications have already been enabled by our customers. We're providing the developer community and our partner network with the tools to extend and enhance customers' Blackbaud solutions, helping them create truly connected offices. For example, staff at Saint Leo University are using SKY APIs to run an automated daily integration between our fundraising solutions in their student information system. Instead of spending hours entering data to keep their records in sync, the integration creates new constituent records and appends new degree information to existing records.

With a large segment of their nontraditional students graduating all year round, this integration creates an average of 75 new records per week, so they can now leverage the power of Blackbaud's Raiser's Edge NXT to immediately identify the major gift prospects among new graduates, and allow the alumni officers to start engaging with them right away.

The customers we serve require vertical-specific business solutions to automate their operations, and we build integrated purpose-built cloud solutions that solve these business needs. Among the many product and innovation updates across all of our vertical markets, we announced the general availability of Blackbaud Church Management, which is already transforming the church technology landscape.

Within just 1 year of announcing plans for Blackbaud Church Management, we now serve churches in more than half of the 50 U.S. states, representing congregations of all different sizes and spanning more than 10 denominations. This case of innovation is extraordinary in our industry.

We've built an environment of rapid innovation through a combination of our modern cloud architecture and industry standard methodologies. Our early adopter customers have a significant role in shaping our new solutions. And our Blackbaud SKY platform enables us to rapidly iterate based on their feedback before releasing the solutions to the general market. This culture of innovation led to the general availability of Blackbaud Church Management and the process is highly repeatable. We're well underway with early adopters in our higher education vertical as we extend our proven education management portfolio up market. Our early adopters are excited with 1 saying and I quote, "We looked at a number of solutions in addition to Blackbaud, you name it, we looked at it. But our 20-plus year history with Blackbaud and its solutions for higher education help the promise of providing everything we wanted to achieve and more."

This brings me to our second growth strategy, which is to drive sales effectiveness. As you know, we have a large market opportunity extending across our vertical markets. And we spent the last several years organizing for scale and laying the foundation for our sales people to be more successful. This year marks an important milestone in that process as the structural transformation of sales is now largely complete, enabling our account executives to focus on leading with total solutions selling by vertical, driving more products for customer, higher ASPs and overall increased customer lifetime value. With the structural changes behind us, our focus is on improving overall sales productivity. This effort extends beyond just the sales organizations into areas like marketing, where we're investing in the necessary technology and resources to efficiently drive an increased number of quality leads and better cover our large addressable market.

Over the last 3 years, we've tripled the number of accounting executives dedicated to prospect accounts, and these investments are just one way we're equipping our growing salesforce to be more effective.

I'll now turn to our third strategy, which is TAM expansion. Earlier this year, we acquired YourCause, a market leader in the corporate social responsibility software, and our ability to move fast on back-office integration is enabling the team to further differentiate our solutions from the competition. As corporate social responsibility programs are implemented around the world, it's becoming increasingly important for companies to have acute local knowledge in the countries where employees are accessing the programs to remove any functionality barriers.

Just last week, we announced expansion in the YourCause global footprint by developing in-market partnerships to advance employee giving and nonprofit support globally, while also implementing key product features for universal functionality. For example, our partnering with GiveIndia, India's largest and most trusted giving platform, YourCause and the employees they support worldwide will now have access to GiveIndia's network of nearly 1,000 verified nonprofits in India alone, which ensures that employees are donating the vetted organizations. Our total addressable market currently stands at over $10 billion, and we remain active in the evaluation of opportunities to further expand our TAM through acquisitions and internal product development.

Our final strategic initiative is a focus on operational efficiency to strengthen the business and position us for long-term success. This continuous effort spans the entire organization as we drive towards a more scalable operating model that creates efficiency and consistency in how we execute through infrastructure investments, productivity initiatives and organization alignments.

For example, we're now selling a portfolio of modern cloud solutions, which is driving a shift away from onetime services as we reduce the hours needed for implementation and integration of our solutions. In order to effectively scale as we continue to grow as a company, we've been building out our partner ecosystem, which includes partnerships to implement our cloud solutions. We made significant progress building out this program in 2019 and look forward to continuing the effort in 2020.

Overall, I'm pleased with our execution through the third quarter and we're focused on maintaining our momentum heading into the fourth quarter of 2019. We're continuing to execute against our strategic plan, which is strengthening the business and enabling us to deliver greater innovation for our customers.

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

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

Thanks, Mike. Good morning, everyone.

Please refer to yesterday's press release and the investor materials posted on our website for the full detail of our Q3 financial performance. Today, I'll focus on key highlights, so we can get to your questions.

Recurring revenue increased 8.6% over Q3 of 2018 and 5.6% on an organic basis. We posted solid recurring revenue growth for the first 3 quarters of the year and anticipate carrying that performance through the end of 2019.

We continue to see a healthy shift in mix as recurring revenue represented 93% of total revenue in the third quarter. As you know, we now have 1 global compensation plan for our salespeople that puts an increased focus on driving recurring revenue bookings.

Through our sales effectiveness programs, we continue to focus on opportunities to further shift our bookings mix towards ARR to optimize the mix of business within the ARR bucket, ultimately, incenting and prioritizing offerings with the best economics. Onetime services and other revenue represented only 7% of our total revenue mix and declined nearly $5 million in the quarter, which is a 24% decline versus Q3 of 2018.

Through the first 3 quarters of 2019, onetime services and other declined 22% compared to the year-to-date 2018, and we still anticipate the rate of year-over-year decline to accelerate to roughly 25% for the full year 2019, which is healthy for the long run. I'll remind you that last year, onetime services and other declined 17%.

Turning to profitability. Our third quarter gross margin was 59.5%. We generated operating income of $37 million, representing an operating margin of 16.5% and diluted earnings per share of $0.56.

Our third quarter operating margin performance is inclusive of strategic investments to further expand our selling footprints, bring new solutions to market and our shift to third-party hosting. The investments we're making in the R&D are delivering tremendous value for our existing customers, and we've created entirely new product opportunities in our higher education and faith verticals. The investments in the sales and marketing are improving our ability to scale, increase our selling footprint and position us to drive future growth.

And as Mike mentioned, we've seen early traction building out our partner network, including third-party implementation partners. We're planning to continue these heightened investments through the end of the year.

With 3 quarters behind us, we are positioned to land within our full year guidance for operating margin of 16.7% to 17.2%. Given our planned pace of investments and incremental costs associated with the growth of our partner program, we're anticipating coming in towards the low end of our guidance range for operating margin.

Moving to the cash flow statement and balance sheet. Our Q3 free cash flow was $63 million, which puts us on track to deliver our full year guidance of $124 million to $134 million. We continued making necessary innovation and infrastructure investments to support our move to the cloud, amounting to $3 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 in cash dividends to shareholders and ended with $474 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 just under 2.5x.

In summary, we continue executing against our strategic plan, which is allowing us to strengthen the business and reiterate our full year financial guidance. We're maintaining our disciplined approach to balance investments that drive growth with improved profitability, and we will continue to execute on our capital deployment strategy to maintain a strong balance sheet, return capital to shareholders and create growth and scalability.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We will now take our first question from Brian Peterson from Raymond James.

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

Congrats on the quarter. So maybe just start off on the sales hiring. It looks like you're through some of the structural changes so far this year. Curious where you are in terms of your hiring plans so far? What should we expect maybe in the fourth quarter? As we think about 2020, anything or any commentary you can make on the magnitude of the sales and marketing investments?

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

Yes. We continue -- it's Mike, Brian. We continue to hire in sales, and that's going to continue for a while. We're kind of moving toward a continuous hiring model, if you will. It's going to be a little lumpy this year, like it was last. But the plan is to move more towards a continuous hiring model going forward. So still the same plan.

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

Got it. And maybe a follow-up, Mike. Just on the SKY architecture. I know with the faith-based offering now generally available. Curious, how you're looking at some potentially new markets in any appetite versus build versus buy?

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

Yes. Sure. So the SKY engineering platform just gets better every month, every quarter, given all the engineers that are contributing to the base engineering system. Church Management platform is now in general availability. We have a lot of customers in implementation right now. We're not looking to build a new vertical market solution today, because we have enough plate to execute in both the education management and higher ed and in faith-based, and those are both going quite well. But I think your question is also related to build versus acquire. We're still and always are sort of in the market looking for tuck-in opportunities that make sense in the vertical markets that we are in. And with this engineering platform now, we're in a much stronger position to build versus just to buy as we demonstrated in the faith-based marketplace.

Operator

We will now take our next question from Tom Roderick from Stifel.

Matthew David Van Vliet - *Stifel, Nicolaus & Company, Incorporated, Research Division - Associate*

Matt Van Vliet on for Tom. I guess following up on the last question, as you look at the opportunity for the Church Management products versus something like the higher ed, where it is a little more organic and adjacent build out from what you've been doing in the K-12 market and your historical, some penetration in the higher ed market. Tony, just curious on how each of those products can sort of flow into the model as we look out into the fourth quarter and more importantly, out into the next couple of years. What kind of build in terms of a revenue waterfall are you expecting? How quickly can this ramp-up in the pretty significant contribution?

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

Yes. Matt, it's Mike. Tony, follow-on if you want to. The build in the higher ed and faith are a little different but not that different. So we took our K-12 operating platform, if you will and moved it up to the higher ed. And it's been very successful in K-12, and that's -- for that whole program is going well. In the faith-based market, we did build Church Management net new on the engineering platform where we already had a presence in fundraising and financials in the faith-based market, and this is connected to an extension of that. So we've gone from fundraising and financials over to the operating side in faith-based.

Both of those will just continue to build. We are selling in market. We're implementing both. We announced general availability for the Church Management platform. I mentioned in our investors' session at our conference bbcon, a couple of weeks ago, we have over 70 customers right now in implementation on the church platform. We continue to sell every week, every day, both those platforms. And we anticipate the continued build of the reoccurring revenue from those platforms in the subsequent years moving forward. Now it does take a while for that to happen, but we're pleased with both those launches and the presence and the reception in both those markets.

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

And Matt, maybe I'll follow-up on your waterfall question. I think that both of those new products, be new entrants per se, both in higher ed and in church, it will take a little bit of time to build out our footprint in those markets. We've done a good job, I think, of getting a good base sales and marketing team and investment and awareness built in both of those markets. We just, as Mike said, announced, general availability of the Church 1, so a little further ahead there. We'll continue to ramp sales and marketing investments in both of those, think of about the startups. I'd expect what we'll see as we get both of those GA'd is some good traction on bookings, although a very small base in '20 and more of that starting to turn into revenue as we go into '21, and that will kind of align with our sales and marketing investments. Folks building territories, pipeline, et cetera, then to turn those into bookings and bookings ultimately into revenue.

Operator

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

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

I was hoping to dig in on the gross margins a little bit. Tony, you've seen some year-over-year compression here for 3 quarters in a row I believe. Can you just enumerate some of the main drivers of this? And give us an idea how long these headwinds might persist?

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

Sure. I think the largest is one we've been talking about for a couple of years now, which is our move to the cloud. That one is going to continue to push down on margins for the -- at least for the foreseeable future as we migrate out of all of our colo data centers into the cloud. There is a slew of just complicating factors as we make that transition. We have licensing issues and other things that we have to deal with. But as we get out of the old products, complete rewrites on NXT and some of those others, it will free up some costs. And then as we get out of the colos, turn off those networks and those rigs and data centers themselves, you'll free up costs. I'd expect we'll see kind of this increased pressure or at least the next 2 or 3 years, with it starting to lighten after that. The other 2 things that are hitting us is software amortization just with all the innovation we've done over the last few years, the amount of amortization is increasing, so that's putting a little bit of downward pressure, and that will continue for the next couple of years as well till that plateaus.

And then more recently in the quarter, as we've started to build our partner networks more fully, we actually started utilizing implementation partners in the last couple of quarters, and you can see that in the onetime and other margins has put some pressure there from using those third parties, which is great for the long term. We'll have some near-term pressure on our gross margins. We'll look at those models potentially start shifting some of that on to their paper as we determine we've got partners that we can trust to work with on that front. But that's something that will be a little bit of a moving target as well. But those are the 3 major drivers on margin pressure, they'll continue for the -- at least for the foreseeable future.

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

Got it. Helpful there. And then a follow-up to that question would be on the payments business and whether -- it's generally how that business is doing, and if that's affecting that mix towards payments is affecting the gross margin line as well?

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

No, not right now. Payments is kind of running right in line with expectations. You recall, we built a much more robust forecasting tool for that payments business coming into this year, and that's worked really well. We're right on track. Obviously, year-end is always a wild card. Tax reform from last year, those kind of things, what happens around giving Tuesday, Christmas season, all of those pieces. So still yet to see what happens here in the fourth quarter. But year-to-date, we're kind of right on track with expectations. The mix has not changed significantly, so that's not really having an impact on the gross margins.

Operator

We will now take our next question from Robert Oliver from Baird.

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

It's Matt Lemenager on for Rob Oliver this morning. I have a question around larger deals. One of the nice differentiators of Blackbaud's ability for a nonprofit to go end-to-end, thinking about tools from top of funnel marketing, the fundraising, the payments, and, I guess, all the way down to financial edge. I just I'm wondering, if you can update us, even if it's qualitatively, how larger deals have tracked this year, perhaps the pipeline looks for the fourth quarter and the importance of large deals, if that's the, I guess, prime time for those larger deals to come? So just an update around larger deals even if it's qualitatively?

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

Yes. Sure. This is Mike. We are continuing to do quite well with large deals in a lot of different markets. A few of the earnings calls going back, I mentioned, and we've got some press releases on large deals in the K-12 market with large K-12 private schools. I've mentioned universities and the large deals we've gotten with universities. And now, we've expanded our portfolio with universities that includes the new education management platform. So the opportunity is there, and it's happened with larger ASP deals, the university and the university market as well, because we're servicing the whole school, not just the foundation. The same is happening in the faith-based market as well. We're seeing the opportunity to sign contracts that cover tens or sometimes hundreds of churches or schools, where typically we've sold 1 at a time. And so we're seeing medium and large deals in multiple marketplaces, including in our international business as well.

Operator

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

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

A couple of product or 2 product lines. First, I just wanted to start on the higher ed side. Maybe help us understand when you're getting these deployments, what is it that you're replacing? Is it homegrown systems? Is it kind of a combination of 10 different point solutions, and now you can come in and have 1 broader suite of solutions that does everything? And from like a portfolio perspective, is everything kind of all the pieces in place there to be successful on higher ed? Or are there still kind of areas in the higher ed portfolio that you want more products to may be round out that portfolio, be it internally developed or acquired? And I've got a follow-up.

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

Sure. This is Mike. So in higher ed, it's sort of the repeat of the story that's been quite successful for us in K-12, where we have a big presence now in higher ed in the foundation in fundraising and in scholarship management and financials. And we've now expanded that to the operating side of the school, student enrollment and classroom scheduling and student information system. So it's a whole portfolio. So that covers most of the major departments in a university. We are starting with smaller universities. There are several thousand of them. And we also have cross-sell opportunities, because a lot of that we have a fundraising or financial footprint. And so we're starting with smaller universities, and we're going after that market. The product is pretty advanced, because again, it is the same product that's been in K-12 for years, and we've taken over 2 years and added a lot of capabilities for the higher education market, that also includes tuition management as well, which is new for us in the higher ed market.

From a competitive standpoint, we see some legacy competitors out there, mostly licensed-type installations. There's some homegrown point solutions as well. And again, at the macro level, it looks a lot like what we've been doing in K-12.

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

Got it. That's helpful. And then on the church management side, look, I think this is one of the bigger organic new product adoptions that at least I've seen in a very long time. Help us understand kind of your expectations and sort of of what the ramp looks like, because it's clearly a big market opportunity you're going after. But maybe I just want to understand, your expectations for an adoption curve and may be when do we expect this to be incremental to the top line?

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

Sure. So -- again, it's a full cloud for that marketplace that goes across the operating components of the church. It's across more than 10 denominations. So it's a big market. We're talking to churches of all sizes and scales up. We priced it, so it scales sort of up and down based on institution size. It also scales when we talk to an institution that is an assembly of many churches. We also have a new mobile app, MobileMission, which is a mobile app for secure donations or tithes in that market and offerings from a mobile standpoint that's integrated into the core SKY set of capabilities. So we're really excited about this marketplace. There, in our opinion, hasn't been any innovation in the space in a long time. And in the contracts we're signing, we are replacing a dozen or so single-point solutions with a single log on modern cloud. We have live customers. We have a lot in the implementation, and this will just continue to build and build. We have marketing efforts that are new in the space. We've had fundraising and financial customers in the space for a long time, but we're not that well known in that marketplace. And so we've got some marketing spend happening there in areas like lead gen and digital footprint and conferences, which we've started about a year ago. So we think there's a long runway here. And we're doing it right by building referenceable customers with a scalable, high-quality, modern cloud platform.

Operator

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

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

Mike, I guess first one for you. Can you talk about what the drivers of the YourCause international expansion was? Is this an area where you think that the domestic market is perhaps maturing quicker than expected? Or are there just a number of opportunities of customers wanting to pull you internationally to expand their efforts in this area?

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

Sure. So the YourCause acquisition was completed in January, and we remain super excited about that space and that business. It continues to grow nicely. We continue to sign up a lot of customers. There's a big backlog in implementations that we're driving. We're adding to sales headcount in geographic regions. The international expansion is just sort of the natural next step. We are already international, platforms already international. But our large customers have international footprints. We've got over 100 customers on the platform that are Fortune 500 companies. And so they need now international support. So we've been driving sort of a localization model here through both product functionality and partners in market. I think we mentioned a couple of partners, 1 in Canada. Canada helps out work. Charities Trust in the U.K., in a new partner in India called GiveIndia. And it's sort of a combination of our sort of focus on expanding internationally, organically and helping our large customers and perspective large customers have a really solid international footprint.

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

Got it. And then just a quick follow-up for Tony. You mentioned that during the -- at bbcon that, less than half of the direct sales reps were on a full qutoa for 2019. Can you give us a sense on what that progression looks like as these sales reps are ramping to full productivity? And perhaps what expectations are for a percent of reps that will be on a full qutoa into next year?

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

Yes. Ryan, we've talked about at the investor section that going into this year, in January, we may kind of the last big organizational change, which is reallocated a lot of overlay and associated account exec roles into full bag carrying sales roles. And so that created a lot of what we would look at is attrition. We look at attrition both external, do I lose the employee, the salesperson to another organization, but also do they have territory change or did they change roles. And so going into this year with that large reallocation of the workforce, we anticipated much higher overall attrition in territory for the team. We've tracked kind of right in line with those expectations. And what that resulted in then is what we call as productive full-time equivalent sales reps that we had significantly less fully productive reps because they were reramping in their new role or new territory.

It takes -- depending on the role, it takes somewhere between 6 to 9 months, 12 months probably on the outside to ramp to full quota. We made those changes largely in the first part of the year. We would have had some other attrition that resulted from all those changes kind of midyear. So I'd expect when you look at it in the whole, we will see a nice pretty significant increase in productive FTEs exiting the year probably continues through the first quarter before we get through all of this transition that we had this year, when you think about that 6 to 9 to 12-month transition period. So I think by the time we get to Q2, all this disruption we had this year from the last big organizational change should be behind us. And then we're really dealing with just normal attrition, which we're trying to make sure we don't create any more of that internally than we absolutely have to. And then obviously, trying to control the loss of our employees going to third parties, which we've been able to do a pretty good job of comparative peers. So I think we'll see a much lower overall attrition in 2020 than we saw this year, which should bode well for productivity and productive reps as well.

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

Yes. I'll just add to that. We're not standing up in a new vertical market either. So the most recent one we created was the faith-based market. But if you go back 5 years to today, we had no vertical markets. So today sales are organized in our vertical markets, K-12, higher ed, health care, arts and cultural foundations, faith-based, et cetera, and they're dedicated to the markets. And what we've seen happen is, it builds significant presence in those markets, and they are all very different. Conferences are different, language is different, competitors are different. And as we build muscle in each of those markets, we become a lot more competitive, but it will cause some disruption in sales productivity when you move folks around. But when they settle in the market and they get some tenure in the market, we see productivity go up and our ability to have a bigger presence go up in those markets. So to add to what Tony said is we are not standing up a new vertical market, we're settling into the markets that we're currently in and we already stood up.

Operator

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

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

Maybe I'll just start actually with a follow-up for Tony on that last question about sort of productive sales reps. I know that you guys have called out a fact there's a lot of moving parts this year, I guess, just the reps that have been put in seats that have been there for 6 to call it 9 months or even 6 months. Is the kind of pipeline build you're seeing in light of expectations? Meaning your -- obviously, a lot of investments in these sales reps. Is the pipe meaning has investment sort of matching up to what you hope, at least in terms of pipeline build, because they obviously need a pipeline going into next year, if they're going to be productive?

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

Yes, Kirk, we -- I think we've got this question, talk about a little bit maybe at the investor sessions as well. But we've seen pretty good productivity in pipeline build. We measure kind of that ramp across many different metrics. Are they getting enough leads generated as pipeline building, as pipeline moving to close, are they closing deals, all of those. So we've got a really robust process around that to measure. And we've been doing it really well. There's been a couple of areas that have been a little bit soft. One was just waiting for the product release in the faith market. Now that we have general market availability, we believe the traction will increase significantly there.

And then one of the areas we created a new role we never had, which was a prospect rep that's does kind of telesales. And they were again, largely in the faith-based market, because we didn't have general availability of the product. They were having a little tougher time ramping prior to that. With that market launch, I think, we'll see that pick up significantly. But everywhere else, kind of tracking right expectation, which would be what I would expect, because we built the ramps for that based upon our historical performance. And so we would have to go backwards, if we wouldn't have been in line with those ramping the expenses.

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

That's helpful. I appreciate the color. And then just maybe Mike, as you head into next year, obviously, you have church management now. You've a pretty broad suite of products. I guess, what's just sort of your thought process on M&A versus just kind of focusing on the suite of products you have already? It's obviously additive from a TAM perspective, but I'd imagine it can at times be disruptive from service sales perspective, you're adding new products to someone's bags. So I guess, just how are you kind of balancing that kind of thought process these days as you head into 2020?

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

Sure. It's been a key part of our strategy since I came, which is to have TAM expansion in our vertical markets. There's still more opportunity to do that without standing up a new vertical market. We don't cover 100% of the IT spend in every market that we're in. So it still represents opportunity for us. It's something that we're actively involved in, just given all the transactions that happen in the software world. People know we're an acquirer vertical software companies. And so we'll continue to be active and look and learn and we can expand TAM in the vertical markets we're in. And so it's not something that's ultimately required for us to hit our objectives. But we focus on how do we fill the needs of our customers. How do we create an environment where our product solutions are stickier and integration at the end of the day wins for a lot of our customers and our cloud solutions. And so it's still an active area for us, and we remain active in that part of our business.

Operator

As there are no further questions in the queue. I would like to turn the call back over to Mike Gianoni for any additional or closing remarks.

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

Thanks, operator. I'll just close by saying I'm pleased with our execution through the third quarter of the year. It's clear our progress we've made is having a major impact on the individuals that use our solutions every day. I'm excited about the advancement of church management, our higher ed platform and what's happening with YourCause. These investments we're making will ultimately create lasting value for our customers, employees and shareholders. Tony and I look forward to updating you on our progress on the next call. Thanks, everyone.

Operator

Thank you. That will conclude today's conference call. Thank you for your participation. Ladies and gentlemen, you may now disconnect.
