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BLKB.OQ - Q4 2020 Blackbaud Inc Earnings Call

EVENT DATE/TIME: FEBRUARY 09, 2021 / 1:00PM GMT

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PRESENTATION

Operator

Good day, and welcome to Blackbaud's Fourth Quarter and Full Year 2020 Earnings Call. Today's conference is being recorded.

Now I'll 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 Fourth Quarter and Full Year 2020 Earnings Call.

Joining me on the call today are Mike Gianoni, Blackbaud's President and CEO; and Tony Boor, Blackbaud's Executive Vice President and CFO. Mike and Tony will make prepared comments, and then we will open up the line for your questions.

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

We believe that a combination of both GAAP and non-GAAP measures are more representative of how we internally measure our business. Unless otherwise specified, we will refer only to non-GAAP financial measures on this call. Please note that non-GAAP financial measures should not be considered in isolation from or as a substitution for GAAP measures. A reconciliation of GAAP and non-GAAP results is available in the press release we issued last night and a more detailed supplemental schedule is available in our presentation on our Investor Relations website.

Before I turn the call over to Mike, please note, Blackbaud will host a virtual investor session on March 25, and we invite members of the investment community to register for the event by visiting our Investor Relations website. I'll also mention that during the first quarter of 2021, our team will be virtually attending Raymond James' 42nd Annual Institutional Investor Conference.

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. Q4 was a very solid quarter and a strong finish to what has been a unique year to say the least. As we discussed during our December event, where we outlined our long-term goals and strategic outlook, our pivot to place a greater emphasis on profitability positions us for significant improvement on the Rule of 40 as we exit the pandemic, including a return to a sustainable revenue growth rate in the mid-single digits or greater.

Our results are a solid early indicator that over time, the Rule of 40 is within our reach. We achieved 30 on the Rule of 40 for the fourth quarter and we were within 10 basis points of the Rule of 40 in the month of December as our organic revenue growth rate strengthened toward the end of the quarter. Without a doubt, this past year has tested the industry and underscored the resiliency of our customers and our market as they serve such a critical role in solving the challenges we face as a society.

2020 put a spotlight on the need for digital capabilities as social good organizations were forced to quickly pivot their own operations to ensure they continue to deliver on their missions in this environment. For example, while the shift to online and virtual fundraising has been reshaping the landscape in this market for many years, that shift has rapidly accelerated. In 2020, we saw over 20% year-over-year growth in online giving with more than 1/4 of donations made on a mobile device, and end of the year giving grew nearly 30% year-over-year. For more than 2 decades, less than 10% of giving has been done online. But this grew to 13% last year and now mirrors the digital adoption experience in online retail sales. This is a significant milestone for online giving.

The current environment is not just causing a shift to a digital-first mindset within our customer base, but also a shift in how donors, students, employees and others expect to engage with social good organizations going forward. This is an acceleration of a long-term transformation that we believe will drive significant demand for cloud software solutions in the upcoming quarters and years.

Looking ahead, the progress being made to distribute COVID vaccines bodes well for the return of in-person events this year. And I'm increasingly bullish on the outlook for our market, our customers and our company as we move through 2021.

I'd like to make a point to say thank you to our employees for stepping up in a big way this year to support each other, our customers, our communities and Blackbaud. We know that 9 out of 10 employees say Blackbaud's mission and the customers we serve was important to their decision to join the company and perhaps more than ever that unmatched commitment to the social good community was on display in 2020. We've given back to the entire social good community through hundreds of free resources, philanthropic gifts, service on boards and more. Looking back at the last year, I'm incredibly proud of our achievements as a company.

After a solid start to the year in 2020, we shifted quickly in response to the pandemic and took early action to ensure our business continuity while remaining hyper-focused on protecting the welfare of employees, supporting our customers and delivering increased value to our shareholders. After transitioning our global workforce to a remote operation in a matter of days without business disruption, we recognized our employees would be our support as all of our personal and professional lives begin to overlap. We provided additional financial support to all employees earning less than $75,000, launched the Blackbaud after-school program to support employees globally who are balancing work and child care, offered a onetime technology stipend to support home office needs, increased professional development training opportunities and introduced many more resources focused on maintaining physical, mental and social wellbeing, while working in a virtual environment.

Although we suspended our company-funded 401(k) match program as part of our cash conservation measures in response to the pandemic, we've been able to fully reinstate that program and our strong finish to the year enabled us to fund a discretionary match for participating employees late in the fourth quarter. Our people are essential to our success, and we have an unwavering commitment to build on our strong culture by creating employee experiences and programs and further develop and attract the best talent as well as promote a diverse and inclusive environment.

In 2020, we hired a Head of Diversity and Inclusion, recognizing that now, more than ever, the topic of equality needs a strong unified voice at Blackbaud. We continually seek diverse talent to join and lead our company as well as serve on our Board of Directors, and this is not new for us. We have strong gender diversity within our company, with approximately half of our employees being female, but we recognize we can always do better. Blackbaud supports greater diversity in the tech industry as a whole. And we will continue to push for progress because with more inclusion, we can drive greater social good and financial results. I believe when our leadership and workforce reflects the diversity of our customers and their communities, it enhances the way we connect.

Taking a step back, we know the investment community increasingly values ESG and social impact. And it's clear to me, Blackbaud has a tremendous opportunity to build on it's already strong reputation as a leader in sustainability and social responsibility. We've created a formal program committed to advancing our ESG efforts, beginning with the adoption of SASB standards and participating in the UN Global Compact. At Blackbaud, driving social impact isn't a side project, it's our business. All of our software solutions enable social impacts. We're proud to be a proof point that it's possible to provide exceptional products, generate shareholder value and do good in the world. By keeping mission aligned, we built not just a successful business model, but an innovation engine that's played a role in driving advances on social issues of every kind.

Turing to our customers. We've been agile as an organization with a relentless focus on driving value and outcomes. Our deep expertise in each of our vertical markets positioned us to respond quickly to the unique challenges facing our customers as a result of the pandemic. We announced free universal access to our entire e-learning curriculum, created webinars with thousands of customers attending, introduced new pricing and financing offers based on the changing needs of our customers and launch new innovation, helping them more aggressively move to digital capabilities. We were quick to expedite product enhancements to support our customers' changing needs. A few of these innovations include fitness tracking integration and Blackbaud's peer-to-peer fundraising portfolio, a new virtual prayer wall that enables congregants at faith organizations to share and respond to prayer request online, text messaging capabilities for scholarship directors and higher education institutions to ensure no funds were going unutilized and the expansion of the global capabilities of YourCause, making it easier for companies to bring employees across geographies together in support of causes around the world.

This industry has been undergoing a digital transformation in which we have been the global leader and that has accelerated as the pandemic has highlighted how modern, scalable and secure cloud systems are now a required standard.

In 2020, we showed why we continue to be the trusted leader in this space. Customers around the world leveraged our solutions to effectively fundraise for COVID-19 research in essential equipment, including vaccine development, low-cost ventilator production and methods to treat the virus and slow it's spread.

Food banks relied on our solutions to manage the rapid influx of donations needed to keep up with massive surges in demand. In fact, we processed over 350% more online donations for these customers in 2020 than in 2019. JustGiving power the largest individual led online product fundraising campaign in history. And during Giving Tuesday, in Q4, our platforms process record-setting levels of transactions, enabled over 138 million e-mails to be delivered in a single day. Our scalable platforms enable events like this to happen.

We also recently updated the Blackbaud Marketplace, offering curated third-party apps, enabling organizations of all types and sizes to discover new ways to amplify their impact by enhancing their best-of-breed Blackbaud solutions with specialized capabilities. A few partner solution examples include connecting the bidders at a fundraising auction, texting volunteers about an upcoming event, tracking branded merchandise purchased in an online store or automating outreach to donors eligible for a matching gift. And the number of apps listed in the Blackbaud marketplace nearly doubled in 2020, progressing our strategy to build a robust partner ecosystem.

We are steadfast in our commitment to innovation to enable the success of our customers, which is why we're accelerating investments in areas like R&D, security, customer success and the shift to third-party cloud service providers.

While we're well underway in our efforts centered around delighting our customers with industry-leading cloud solutions, we're also further optimizing our go-to-market model in driving operational scale and efficiency, all while enhancing the future of work at Blackbaud for employees and delivering increased value for our shareholders.

We've taken lessons learned throughout 2020 and reevaluated elements of our go-to-market strategy with a digital-first mindset, and we have a significant opportunity to leverage the investments into digital to reduce our customer acquisition costs and increase our sales velocity, ultimately driving a more scalable and cost-effective, go-to-market model.

We've also adjusted our own workforce strategy to provide more flexibility for our employees to work remotely going forward. This not only enhances the positive employee experience we want everyone to have at Blackbaud, but also expands our access to a larger and more diverse talent pool, empowering our leaders to make decisions based on skills and business need rather than location. This created an opportunity within our real estate strategy as we completed the optimization of our footprint, rightsizing and exiting certain offices around the world. And with existing offices, we shifted towards more collaborative workspaces for when we return.

Looking ahead to 2021 and the next several years, very optimistic about the opportunity in front of us. The market has once again proven to be more resilient than many expected, and we continue to believe the durability of our customer base is significantly underestimated. In 2020, our renewal rates trended ahead of plan for the year. Our customer retention rate increased from 92% to 93%. And despite the challenges faced last year, our customer count increased and remains above 45,000 customers.

I've occasionally been asked how many of our customers go out of business each year? So I'll address that by saying, it is an immaterial amount and significantly less than 1% in terms of both revenue and customer count. In fact, we saw fewer customers close their doors in 2020 compared to 2019, and we expect the resiliency of our customers to continue into 2021.

As the vaccine rollout continues, we believe physical events will start to come back, and we're already hearing from customers that they're planning for this to happen this year. As you know, we have near-term variability in our revenue outlook, driven mostly by the subset of our transactional revenues tied to events in a somewhat tougher selling environment. We have high confidence in our ability to drive meaningful acceleration in our financial performance post pandemic, inclusive of a sustainable organic growth rate in the mid-single digits or greater.

Our view is this is not fully reflected in our valuation. And therefore, under our recently expanded share repurchase program, we purchased approximately 1.2 million shares of our common stock outstanding in the months of December and January. We made great progress last year, moving toward the Rule of 40. We are already underway executing against the strategic plan that will move us further toward our long-term aspirational goal of achieving Rule of 40. We have a lot to be excited about as a company in 2021.

With that, I'll turn the call over to Tony before we open it up for Q&A. Tony?

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

Thanks, Mike. Good morning, everyone. Today, I'll cover our results for Q4, the full year and our outlook for 2021 before opening up the line for your questions. You can refer to today's press release and the investor materials posted to our website for the full detail of our Q4 and full year 2020 financial performance.

Turning to our results. Fourth quarter revenue increased 1.9% versus Q4 of 2019, with recurring revenue growth of 4.3% on an organic basis, inclusive of a very strong finish to the quarter. I'll reiterate Mike's comment that our customer base is healthy overall with our customer retention improving to 93% for the year.

Our renewal rates exceeded our pre pandemic expectations for the year, we had a greater mix of our customers opt-in for longer renewal term periods, and we ended the year with better-than-expected accounts receivable aging. All of which are positive indications of the health and resiliency of our industry and customer base.

Payments transaction volumes exceeded our expectations and were the primary driver of revenue growth for the quarter. Transactional revenue grew $14 million year-over-year in the fourth quarter. This strong performance also highlights the often underappreciated resiliency of our market. As expected, the shortfalls in bookings that began at the start of the pandemic put pressure on our contractual recurring revenue growth in the fourth quarter, though on a full year basis, contractual revenue grew year-over-year.

There's no question that the current environment has put a greater emphasis on investing in digital and cloud-based solutions, and we're optimistic that this will materialize in improving pipeline and bookings as we progress through 2021. We were pleased to see a solid start with January bookings coming in ahead of plan, though it's early, and January is a seasonally low month for bookings.

On a full year basis, our revenue grew to $913 million, despite lower usage-based transactional revenue and bookings due to pandemic and the continued decline in onetime services and other revenue. Onetime services and other revenue declined approximately 22% after normalizing for the reclassification of retained and managed services, and this decline was amplified in the fourth quarter, due in part to our pivot to offer our annual user conference at no cost in 2020.

Despite the challenges faced this year, our full year revenue was only about 3% below the midpoint of our original guidance heading into the year. I'll also remind you that for the full year, we reclassified approximately $17 million of retained and managed services that would have historically been presented in recurring revenue to onetime services and other revenue. This reclassification reduced our organic recurring revenue growth rate by approximately 200 basis points or 140 basis points after normalizing 2019 for the change. For more detail, please refer to the supplemental schedule included in our investor presentation available on our Investor Relations website.

Moving to earnings. Our fourth quarter gross margin was 57.1%. We generated adjusted EBITDA of $69 million, representing an adjusted EBITDA margin of 28.4% and diluted earnings per share of $0.85. As you know, our actions in response to the pandemic improved our liquidity and generated significant cost reductions, which substantially elevated our profitability for the quarter and the full year, and allowed us to continue making critical investments in the business related to areas like digital marketing, engineering, security, customer success and our continued shift of cloud infrastructure to third-party cloud service providers.

For the full year, we generated adjusted EBITDA of $242 million, up $53.1 million, representing an adjusted EBITDA margin of 26.5%. Full year diluted earnings per share was $2.94, an increase of $0.70 per share and 25% above the high end of our original guidance coming into the year.

Again, not all of the cost actions taken in 2020 will repeat this year or continue into the future. For example, we have fully reinstated our company-funded 401(k) match program for 2021 and we will return to cash-based merit and promotional salary increases for eligible employees. That said, we have high confidence in our ability to operate in an increasing margin profile going forward, given the progress made this year and the additional plans we have for the coming years.

The evolution of our go-to-market strategy with a digital-first mindset has substantially reduced our go-forward cost base in sales and marketing. And we've largely completed 1 major initiative last year when we revisited our real estate strategy with a focus on optimizing our footprint for the future of work at Blackbaud, including the purchase of our global headquarters building and exiting certain office leases around the globe.

As a result, we enter 2021 having roughly halved our real estate footprint. This drove $23 million in onetime expense in 2020, but we estimate this will generate approximately $14 million in run rate cost savings going forward. It will also give us additional flexibility as we evolve our workforce strategy. With our heightened focus on operational efficiency and in light of our flexible workforce strategy going forward, we also revisited elements of our tax planning strategy and wrote off certain tax assets, resulting in an increase in our effective tax rate for the fourth quarter that will not repeat in 2021.

That brings me to the cash flow statement and balance sheet. Our Q4 free cash flow was $25 million, and our full year free cash flow was $76 million, representing a full year free cash flow margin of 8.3%. The real estate actions I just mentioned resulted in fourth quarter and full year cash outlays of approximately $20 million and $39 million, respectively, which reduced our full year free cash flow margin by roughly 430 basis points, and we do not expect this to repeat in 2021.

We ended the quarter with $495 million in net debt. Our capital strategy calls for a debt-to-EBITDA ratio of less than 4.0x and at the end of Q4, we stood at 1.8x, which is our targeted optimal leverage ratio, and we had $429 million of borrowing capacity.

In 2020, and we eliminated our dividend as a cash conservation measure. However, we will continue to deploy our capital in close alignment with our capital strategy, which includes the option for opportunistic share repurchases. As Mike mentioned, though the month -- through the months of December and January, we repurchased 1.2 million shares of common stock for $69 million. As of January 31, we had approximately $180 million remaining and available under the current share repurchase authorization.

Now let's turn to 2021. From a revenue perspective, we're encouraged by the strong finish to 2020 and the durability of our recurring revenue streams. The obvious challenge continues to be accurately predicting the duration and magnitude of the pandemic and the ultimate impact on our revenues, particularly transactional revenue.

On 1 hand, we can see potential upside from an acceleration of key trends like the shift to online giving that could very well be sustainable. But on the other hand, it's hard to be certain when in-person events will return. This heightened level of variability in transactional revenue makes it difficult for us to put out definitive guidance ranges like we've done in the past, but I do want to provide some insight on our best estimates for 2021 in the form of 3 scenarios.

The first and most likely scenario based on our modeling suggests that we will generate roughly $900 million in total revenue. Our base assumptions for 2021 start with the continued decline in onetime services and other revenue, which we expect to decline $15 million to $20 million year-over-year. To some extent, the 2020 shortfall in bookings will drive less implementation services revenue in '21. But overall, the strategic mix shift we've been driving for years, and it continues to be a positive move for us over the long run.

Moving to recurring revenue. We anticipate our contractual recurring revenue, representing roughly 2/3 of total revenue, will be modestly above 2020 levels. Our customer base is stable, with customer retention increasing in 2020 to 93% and renewal rates that were ahead of our plan for the year.

The shortfall in bookings performance last year will have a greater impact on 2021 but there is no question the current environment has put a greater emphasis on investing in digital and cloud solutions. While we don't yet have perfect line of sight into when this will materialize in increasing pipeline and bookings, we expect to see a pickup in activity in the second half of the year, and we've been making enhancements in our go-to-market necessary to capture this growth opportunity.

Transactional revenue, which is roughly 1/4 of total revenue, is the most difficult to predict given the current variability and underlying drivers, such as timing and number of in-person events and marketing campaigns as well as fluctuations in donation volumes and tuition payments. As we said, we're encouraged to see progress with the vaccine rollout and the transactional revenue tied to in-person events is expected to recover quickly as soon as customers are able to hold events again.

Our current plan assumes we begin to see this recovery in the second half of 2021. We estimate that this will be somewhat offset by a modest year-over-year decline in payments revenue as we normalize for the over performance we saw in Q2 and Q4 of 2020. That said, we anticipate total transaction revenue for the year to be roughly flat compared to 2020. Though again, we saw a substantial increase in the percent of giving done online, and it's possible this becomes the new normal as organizations have had to adopt more digital capabilities.

We've also evaluated a heavily derisked and conservative scenario. I'll emphasize upfront, we view this scenario as very unlikely, but we're sharing this to be transparent. In this scenario, we've incorporated the impact of another full year shortfall in bookings and assumed our retention rates and renewal rates decelerate, which would ultimately cause a decline in contractual recurring revenue. We've also factored in the transactional revenue impact of no in-person events again in 2021 and substantial declines in payments revenue well below 2020 levels.

If this were the case, and again, we view this as unlikely, our best estimate of $900 million in total revenue could be high by $10 million to $30 million, depending on what you assume for transactional revenue performance.

This brings me to our upside scenario, which accounts for potential acceleration in transactional revenue and bookings performance. If we continue to see elevated levels of payment volumes similar to what we saw in late 2020, and we see an accelerated recovery in transactional revenue with events coming back, then we could see substantial upside to our estimate for transactional revenue. To a lesser extent, given the ratable nature of our revenue, if we're able to generate increased pipeline and bookings earlier in 2021, we could see upside to the full year contractual recurring revenue and onetime services revenue. We estimate $10 million to $20 million of revenue upside in this scenario.

Summarizing revenue for 2021, the most likely scenario based on our modeling suggests we will generate roughly $900 million in total revenue. We anticipate a $15 million to $20 million decline in onetime services and other revenue, which is driving a year-over-year decline in total revenue.

Recurring revenue, which is the core of our business, is expected to grow modestly in 2021 and we're optimistic that this will set us up for acceleration in revenue growth post pandemic.

Shifting to profitability and cash flow. We continue to progress on initiatives like the migration of our cloud infrastructure to third-party cloud service providers, which we expect to result in future gross margin improvement as we're able to reduce our own COLO footprint and the associated duplication of costs. The enhancements we're making in our go-to-market will significantly reduce the payback period for our customer acquisition costs, while increasing sales velocity. And I do not expect our sales and marketing or customer success expense to return to pre-pandemic levels.

As I mentioned earlier, our work to optimize our real estate footprint will generate approximately $14 million of annual cost savings going forward. Our most likely scenario calls for an adjusted EBITDA margin of roughly 25%, and this is inclusive of several cost actions taken in 2020 that will not repeat in 2021. While revenue remains somewhat variable in the near term, we're confident in our ability to manage costs and ultimately profitability across these revenue scenarios.

Our pivot to place a greater emphasis on profitability positions us to significantly improve on Rule of 40 in post pandemic environment and gives us heightened confidence in our expected future free cash flow generation. The near-term variability in transactional revenue and bookings makes it difficult to be precise in our free cash flow estimates for 2021. I'll remind you, our typical contract is 3 years in term billed annually upfront and variability in bookings during the year will have a more immediate impact on 2021 cash flow.

Our capitalized software development costs have largely leveled off and we're expecting less capital expenditures in 2021 given the purchase of our headquarters drove a substantial increase in CapEx in 2020. With that said, we anticipate generating at least $100 million in free cash flow in 2021. We will also continue executing against our capital deployment strategy, which calls for ensuring access to adequate levels of capital to grow the business through balance sheet management, rigorous oversight and investments in the business, including acquisitions, and identifying and efficiently returning excess capital to shareholders, including the option for additional share repurchases.

In summary, 2020 was an exceptional year, but the resiliency of our customer base, dedication of our employees and our pivot to place greater emphasis on liquidity and profit drove solid results for the year. There are significant opportunities in front of us to continue to strengthen the business and elevate our financial profile, and we are well positioned to drive towards a long-term aspirational goal to achieve the Rule of 40 with mid- to high single-digit organic revenue growth. We believe that steady execution against this financial framework, paired with our updated capital deployment strategy will drive shareholder value in 2021 and years to come.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Tom Roderick with Stifel.

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

Happy New Year. Tony, let me start with you. I appreciate all the case 1, 2, 3 framework here for some scenario analysis, and that's really helpful. I guess the question, if I just think about the base case versus cases 2 and 3, tell me a little bit more about how you plan to manage the expense structure and when you would sort of adjust that expense structure, particularly from a go-to-market and headcount standpoint, should the environment start to diverge from the base case scenario? At what point would you look to pare back on expenses or to the contrary, what are the signs you're looking for that say we can green light some more go-to-market expenses and start thinking about more of a growth mode?

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

Yes. Thanks, Tom. Good to talk to you. I think 1 big thing to remind everyone of is that we're going to see -- we anticipate we'll see another big decline in onetime services and other this year. And hopefully, somewhere in the '22, '23 time frame, we bottom out on that front. But as we stated in the prepared comments, we expect that to be down $15 million to $20 million. That's really the only anticipated drag we have on growth for '21.

We're expecting contractual recurring revenue to be up modestly. That's -- that piece of the business, which is 2/3 of revenue, is much more easily forecasted, right? We've seen really positive trends in renewal rates even through the pandemic, they exceeded our plan last year. We had really nice performance in January to kick off the year. Although, January is a small month from a seasonality perspective, bookings were better than planned, better than prior year. Pipeline coverage has improved, looked good for Q1. Payments performance, although below last January when we didn't have the pandemic was better than planned.

Consumer and JustGiving was above plan and above last year. TeamRaiser usage came in below last year significantly, but that's because we still don't have mass participation events, and we had a rescheduling of a major event that happened in January last year. It's going to happen later this year. But renewal rates came in ahead of plan and ahead of prior year for January, and collections came in slightly ahead of plan.

So we're off to a really good start, it looks like, for January, which bodes well to kind of these 3 different scenarios that we're probably on track for that, most likely case or better. What we will do really on the expense side is much what we did in 2020 with onset of the pandemic is we've pulled back on timing of investments, and we're making those a bit later than we normally would, waiting to ensure that we're seeing positive results in advance of.

So in other words, waiting to see that the results are there before we make incremental investments. We believe the kind of baseline of the cost structure is in good shape. If we saw that, that downside scenario was looking more realistic or potential, I think that we would pare back on some of the investments that we're already making. Some of those are increased headcount, especially in the area of RDO. We're investing more heavily to accelerate getting out of our COLO data centers into third-party cloud environments.

We're accelerating fairly heavily our investments to complete the work on RE NXT and FE NXT. And then we're also investing more heavily to harden our environments and our products just because of the current environment we live in, like what we saw with fireeye and solar winds. Those threat actors are just getting more and more aggressive. And so we're making some heavier investments there as well. And I would just suggest we could pull back on some of that hiring. We can't hire all those folks in 1 month, so that will take time. But we feel really good just the way we started January that our kind of most likely case is looking pretty strong thus far, although it's early.

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

Great. Mike, just a quick 1 for you. I look at the Slide 24, if my math is right, your payments business, it actually grew into the low teens on the growth rate. So a tremendous job by you guys on that front. Congratulations on finishing the year strong there. I'd love to hear strategically what else you think you can do to grow that payments business beyond just what was obviously a great volume year and a big shift to digital?

Are there other ways that you can strategically grow that beyond just volume and new customers? And what I mean by that is are there different payment types you can start working towards? Are there different additional payment partners, different responsibilities you could take on? Just talk a little bit strategically about how you might be able to grow that in light of just a normalized year?

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

Yes, Tom, thanks. First, what happened last year was the adoption of online was a big impact. Online giving has stayed under 10% for a long time, it went to 13% last year, which is equal to like retail in the U.S. now, so it grew quite a bit. And that's across the board in all of our verticals. So there's a higher adoption for virtual and for integrated payments. And we think that can just continue.

We still haven't fully penetrated our -- even our own customer base, never mind the market, and we're a very small part of the overall market related to the giving market, and we haven't penetrated our full base either.

We also, in the last couple of years, we made a massive shift in our pricing model in the JustGiving platform that's proven to be a big win-win for us and our customers. And so I think there's more opportunities on pricing models as well as we look at our various payment platforms going forward.

Operator

Our next question comes from the line of Brian Peterson with Raymond James.

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

Congrats on the strong fourth quarter numbers. So I wanted to follow-up on the online giving component, Mike. So the 13% online. I was -- just wanted to clarify, is that a Blackbaud's specific number? Or is that more of an industry number? And I guess, longer term, where do you think that should go? Should that be 25%, 30%, 50%? I guess you would think it would go up over time. I'm just curious how to think about that longer-term framework?

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

Yes, that's an industry number, not a Blackbaud number. It's hard to say where it's going to go. It's like looking at our retail industry, if you will, and the growth there of online, which popped up a lot last year because of the pandemic. But there was also a very large growth in giving on mobile devices as well. And so we think that's a trend that's going to continue to grow and accelerate.

And what happened last year, too, is all of our customers sort of figured out how to live in a virtual world in different ways, some of it was giving, some of it was running their institution like a school. And so just the use of cloud solutions and digital tools also tied to payments and giving, I think there was -- in every vertical market we serve, there was a kind of a master class in education and how to run their business last year on our platforms.

And I think some of this is going to continue going forward because some of it drove best practices. And we have a lot of customers that drove a lot more virtual events or online giving that may continue in that way going forward, which will help them from a scalability standpoint, which will also drive the payments transaction business going forward.

So I think it's a big, big opportunity. It's a big bump up last year. But I think that the adoption of that and the learnings that happened are going to be very sticky from an education standpoint, and our customers are now skilled at focusing on payments and virtual and using cloud solutions to drive the business.

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

And Brian, this is Tony, I might add a couple of things. One, the increase in online giving is just an opportunity for us to garner more revenue from the existing customer base, right? So more is given online, we can monetize that versus a software subscription, et cetera. So that's upside. The other 2 key points is our largest TAM opportunity is still in payments, to my point. We don't have all of our products payments enabled. We have opportunities to go after the market exclusively and separate from our product set.

And then also, 1 of the things that I think folks wrestle with is volatility of our transaction business versus retention. Our payments business is very, very sticky. But it does have more volatility just because of the nature of transactional giving, right, and seasonality, et cetera. So we shouldn't correlate volatility in the volumes with retention. Because those payments customers are typically, actually better retention because they have a software product and payments. They typically have higher retention than a software-only customer. So I think that's a really important note to make.

And a lot of folks continue to wrestle with our gross margins because of the mix of payments. I remind everyone that the payments business, although it has a lower gross margin because of gross accounting treatment, is accretive to our operating margin, and you saw that in the performance in Q4, especially in December, where we came in at nearly 40 on a Rule of 40 because of growth in payments and the positive impact it had on profitability.

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

Right. No, we definitely saw that come through in the fourth quarter numbers. And maybe just 1 follow-up for me. I just -- I wanted to kind of dig into the retention and the renewal dynamic a bit. Obviously, that was a positive development this year. I'm curious as we think about 2021, how big of a year is that for renewals? And obviously, the retention from a logo perspective has been pretty good. But how do you think about the idea of maybe, I'd say, downgrading usage if people are struggling versus potentially upgrading usage because you can offer more of a suite versus your competition?

I guess I'm just curious for customers that are staying on. Are you seeing them buy more products? Or are they downgrading a little bit? How do we think about that?

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

Yes. We're seeing really positive trends. Like I said, even in the month of January. It's early. We exceeded our plan in January, which was an expected improvement in retention, whether that's gross and/or net. So we expect to see improvement in retention over the coming years. We've got a big focus on that. So we're going to be pushing to improve both gross and net dollar retention as well as customer check, and I think there were version of our historical trend where we've seen a decline in just customer retention is very positive as well. I think in the middle of pandemic, we went from 92% to 93%, speaks worlds about the resiliency, I think, of our markets and our customer base and the things we're doing as a business, and I think we have to keep that in mind. Mike, anything you would add on that?

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

Yes. I'll just add to that, that just remember that the systems that we provide are basically systems of record. So no one really downgrades to your questions. Because it's binary. You either use the system to drive revenue or you do something else, right? So our systems drive revenue. They operate schools, they drive operating margin, they drive tuition at schools, so they do lots of things that are mission-critical for our customers. So they're not optional. There's a system of records that drive the institutions.

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

And probably the last point I think you were alluding to is as we move our base to longer-term contracts, we will have a smaller percentage of contracts up for renewal each year, and that's a pretty common practice, as you know, in the software industry. So we're -- all new contracts are largely 3 years or longer with 3-year renewals, although we still have a lot of those old legacy contracts that we're working to migrate to multiyear contracts. So I'd also expect to have a lower percentage of our total base up for renewal each year going forward.

Operator

Our next question comes from the line of Ryan MacWilliams with Stephens Inc.

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

Now that things are a little more settled and you're back to your optimal leverage target, how do you think about capital allocation between buybacks and M&A going forward? And any verticals in particular that are interesting from an M&A perspective?

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

Yes. This is Mike. We've got a higher authorization on the buyback. As you know, and executed on that in December and January, so it's still an option to continue that program. Secondly, we're still active in the world of M&A. There's a lot of activity. There's a lot of companies we look at and don't pursue for various reasons. I still think there's opportunities out there to execute on that. We've got a lot of capacity with the new facility that we did last fall.

And so there's no strategy change related to how we think about M&A and expanding our footprint in the verticals that we serve. Those come up across multiple vertical markets that we serve. It's not really 1 single market. And we think in terms of how we expand our footprint in a vertical that we're in or provide kind of ancillary services to the same buyer in the verticals that we serve. So I still think there's lots of opportunity there, and we remain interested in M&A.

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

Yes. And I'd just add, if you recall, we took advantage of this great market opportunity and expanded and extended our debt facility. So we increased the size extremely low rates, we were able to lock in somewhere in that 2% range. And so we have plenty of capacity as well, actually quite a bit more capacity than we had.

And as Mike said, we expanded the stock buyback authorization for that same reason to make sure it more closely match the current size of the business because we've not done anything on that front since I came here, I think, 10 years ago.

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

We got the color. And then just sticking with the verticals across nonprofit, health care, education, larger businesses, is there any area that you're seeing better green sheets of growth as we move into 2021? And conversely, maybe which areas are taking a little longer to get back on track?

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

Yes. They are a little different because of the pandemic and the situations they find themselves in. So for example, performing art centers are largely closed. Yet other institutions like in the arts and cultural world, like museums are partially open now. And so they've figured out how to manage being partially opened. Some of our other verticals, schools are open and whether the students are remote or going in to the classroom, they remain open and they're in a different shape than a performing art center.

So it's been different by vertical. And some of them have been -- they've remained aggressively buying more cloud solutions, some of them have slowed down because they had to focus on their core operations of their business. So it's a mix.

We also see lots of opportunities in our YourCause platform. The world is driving corporate social responsibility and ESG initiatives and we have a platform for that in YourCause. And so we see lots of opportunity there as well. And frankly, that really hasn't slowed down because of the pandemic. So it's a bit of a mix in our verticals, but we closed the year well. And to Tony's point, made a good start from a booking standpoint in January. It's mixed by vertical, but pretty good start to the year.

And I think there's lots of opportunities to increasingly improve the business as we get into vaccine distribution and more verticals booking more deals with us and in-person events coming back, and I think it will just build over the course of this year.

Operator

Our next question comes from the line of Rob Oliver with Baird.

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

Tony, I just wanted to maybe double down a little bit on some of your comments. And I'll echo, but others have said, really appreciate the upside, downside scenarios and the detail there that you guys provided. It struck me, you said that bookings in January were not only better-than-expected but better than prior year. But then you guys also said that you don't really have any visibility on when bookings will turn. So I'm just curious how to reconcile those comments.

And then maybe if you can just -- I know January is a lighter month, but maybe if you can provide a little bit more color on what you're seeing in January. And if in some of the other SaaS verticals, we've certainly seen some acceleration of digital transformation, I'm just wondering whether that's perhaps what you're seeing? Or was it simply pent-up demand? And I had 1 follow-up.

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

Yes, Rob, it's interesting when we look at our plan this year, getting to your comment on expectations for bookings. We had done a lot of work in our go-to-market over the last several years walking into '20. And we had very high expectations for last year that we were going to see significant improvement in sales productivity and in total bookings.

We plan to have, as you know, a much larger percentage of our base of sales reps be fully productive because we've had a lot of turnover over the prior couple of years as we were transitioning our models to the hunter farmer and change in comp plans and all those other things. So we expected a significant improvement in productivity at an AE level and had more total AEs as well as a company.

So 2020 was actually a very significant expectation for bookings increase. That, unfortunately, was unwound because of the pandemic and that unforeseen circumstances. Heading into '21, we're expecting that some of the incremental investments we made last year and continue to make in new tools and approaches, new AI capabilities, more digital marketing, more lead-gen efforts, those kind of things will help. But we still have what we think is going to be a bit of a soft bookings environment for some period of time, at least in the first half of the year, as Mike said, until all of our prospects and customers get more comfortable that they're coming out of the pandemic and that the zoos and museums and all of the related things are going to be open back up and then get back to some sense of normality.

And so we still expect to have some softness on the bookings front first part of the year. January looked good across the board on almost all fronts. Pipeline looks good for the quarter, which bodes well for bookings. Like I said, bookings came in ahead of plan. Retention renewal rates were ahead of plan, payments performed well, consumer JustGiving performed well.

So we feel good that we're on good footing starting the year, which is a very nice place to be. That said, there's still quite a bit of uncertainty about the duration and depth of how we'll be impacted for the next few months, at least until the vaccine gets out there and we get some herd immunity and things open back up.

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

That's helpful. And Mike, I had 1 follow-up for you. Over the past couple of years, you just got asked about M&A, but maybe I'll ask a different way. As you look at some of these newer verticals for you guys, you have planted a lot of seeds like faith based, higher ed and others. Obviously, the pandemic has change the focus. But just curious how you think about those going forward? And if some of those seeds that you have planted have started to grow at all or what you see there?

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

Yes, sure. So yes, those seeds are growing. It's early days. And in some of those areas -- those verticals are strong verticals for us, as you mentioned. So we continue to invest in our product portfolio. In fact, we've increased investment in R&D starting last year and into this year because we're going to keep driving innovation, and we think there's more opportunity to just go faster in the things like data center, public cloud transition and innovation in the product portfolio.

Yes, combined with, like I said before, still interested and active in M&A. And I think there's opportunities that continue in that space.

Operator

Our next question comes from the line of Matt VanVliet with BTIG.

Matthew David VanVliet - *BTIG, LLC, Research Division - VP & Application Software Analyst*

Maybe a quick follow-up on the last one. Mike, as you look at church management and the higher ed space, I think 2 of the kind of subverticals that you've really invested in aggressively over the last couple of years. Just wanted to hear more about the bookings trends and really kind of the expectations for '21 in those 2 areas as they've mostly remain kind of operational in some capacity. In a lot of ways, they had to add virtual capabilities that maybe they didn't have before. Maybe just walk us through kind of those 2 in particular, that -- what the plans are? And kind of where you're investing incrementally to drive more growth?

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

Yes, sure. So higher ed and churches saw a bit of a different world last year. Higher ed kept operating with students being remote. Churches really had to pump the brakes on having people in attendance. And higher ed, traditionally, is more IT sophisticated because they probably have a CIO and staff and have large enterprise systems and churches are in the main small institutions with not a lot of resources.

And so I think it was more difficult. It was more difficult for churches to sort of go digital, if you will, because they weren't necessarily just set up that way being a small institution compared to a university. So that's sort of 1 set of color around the 2 different markets.

Our progress in churches was pretty good last year. I might say we did really well in our traditional systems like fundraising and financial platforms in the church space. Church management is still a growing platform for us. And you get a lot of these smaller institutions like churches or even, like I said, smaller performing art centers or smaller nonprofits, they had to solely focus on their operation early in the pandemic, not necessarily signing up for new software solutions, right? And they focused on that. They're coming out of that now. They've all done pretty well. Focused on that. We saw the online component of churches really took off. Online giving took off in churches. A lot of it was new for them. They had to get trained and get efficient there. So that really took off.

So it's been a mix. It's a difference, again, between those 2 kind of verticals when you look at those 2. We have lots of different verticals. Some are thousands and thousands of small institutions like churches, it's hundreds of thousands of small institutions. And some are bigger, like large nonprofits or hospitals or higher ed or bigger institutions with big IT staffs. They fared differently, their focus was different during the pandemic, but frankly, they've all figured it out. And so we think there's a long run, good opportunity for us in both those verticals you mentioned and kind of just across the board.

Matthew David VanVliet - *BTIG, LLC, Research Division - VP & Application Software Analyst*

Great. And Tony, on the margin and free cash flow side, I appreciate all the detail here, especially in the scenarios. As you think about kind of incremental investments on a go-forward basis, has the dynamic changed of what maybe the hurdle rate is in terms of driving top line growth versus potentially weighing on margins? Is there more focus on making sure it's kind of an accretive element to margins before you invest on the top line as you have a little more focus on that holistic Rule of 40? Just kind of curious how the mindset has changed a little bit in what looks to be still a slower end market growth for the short term?

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

Yes. I think, Matt, certainly, this year, when we're still in the midst of the pandemic, there's certainly more focus on the profitability. And frankly, because we have more control over that. And so there's -- certainly, I'm keeping a keener eye on driving that because I can't -- I don't have as much assurance that investments for growth will drive the right kind of returns because a bit of that's still out of our control due to the pandemic and related impacts.

Going forward, I think our strategy still holds. We've always talked about a balanced approach. If we see that we can get adequate returns, I don't think our hurdle rate has changed from that perspective. But if we can see we can get adequate returns from investments for growth, we will certainly pursue those. As you know, growth drives typically a higher valuation in the market for our shareholders.

And so as always, we're planning to keep a balanced focus there between both growth and profitability. That's why I like the Rule of 40, right? Both sides of that are impactful on the Rule of 40 itself. So if I can drive a point of growth and a point of margin on that growth, that's a double positive impact to the Rule of 40 itself.

So I think in the pandemic, to answer your question, a little more focus on profit because we have more control. I think post pandemic, we go back a bit more to where we were, which is kind of both growth and profitability. But I think we have the ability to do both.

Operator

Our next question comes from the line of Ryan MacDonald with Needham & Company.

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

On the online payments momentum, I'm curious, as we look at the shift to e-commerce this year, we saw that acceleration results in a number of retailers and brands really accelerate their adoption of additional channels to sell on online. Are you seeing at all in some of the conversations you're having with existing customers, a similar dynamic building momentum of sort of adopting online payments where they have lagged in the past at all?

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

Yes. This is Mike. Yes, absolutely, Ryan. That's why the market went -- online giving went from under 10% to 13% at the market level in 1-year. So yes, we're definitely seeing that. And I will equate that to the retail space.

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

Yes. Ryan, I'd add, when you think about like the church is because they couldn't have -- folks weren't able to go to mass or to church. They had to shift so many churches, especially small ones, and we're still kind of passing the basket, checks and cash. They had to go to online tithing.

So there's a significant increase in the faith-based space move online for tiding and other giving. A lot of the big nonprofits that would have the typical galas and events because they couldn't have those live, they had to move to virtual. And so that, by definition, moved to online versus checks and cash at the event. A lot of folks have gone to virtual auctions as part of their events or fundraising efforts as well, which moved those online.

So there's certainly been a shift, as Mike said. And I think that's going to continue, at least from some of the work I'm doing with nonprofits. I'd expect that to be a continued theme going forward.

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

Excellent. And just 1 quick follow-up. On the in-person events, you expect that to come back around midyear. Are you actually starting to see your customers putting those big events or plan those big events in the calendar? Obviously, they take a few months to sort of market and brand. But are you actually seeing a rise in the calendar now that give you a bit more confidence that those in person events are at least on schedule to return midyear?

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

Yes, Ryan, this is Mike. We are. Yes, they're all planning for that in the back half of this year. So that's a good sign.

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

I think some in the first half may still be having their events have been on their fiscal year, but doing them virtually. I know though, even 1 personally is a marathon, like the Atlanta marathon is actually being scheduled. I think it's late this month or early next. And all they're doing is they're changing the setup of that, and you have to register for a time slot. And so starting people in big packs. They're going to start them in more contained groups. Then you're going to have to have a mask on until you start the race.

And so people are getting creative, and we're seeing all of those come back to London marathon schedule for late this year. So yes, very positive on that front.

Operator

Our next question comes from the line of Rishi Jaluria with D.A. Davidson.

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

Nice to see some resilience in this business. Wanted to start by following up on the ESG steering committee that was announced last week. Can you give us a sense for, ultimately, what sort of goals that you want to get out of this? And outside of obviously making the stock more attractive, which makes sense just given the record inflows we've seen in the ESG funds. Are there other areas you see this going? Is this something that maybe could help your efforts on the CSR side of the equation, for example? And then I've got a follow-up.

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

Yes, sure. It's Mike. This announcement we made is just a natural fit for Blackbaud. We've had such a big CSR focus over the years. So announcing something with ESG in having this be a formal program with a working group, which is underway. It's just been a natural extension to kind of who we are and what we do.

We're looking at following the SASB standards that are out there and doing some other things that are going to be right in line with ESG. So it's a really good fit for us. It's not just for shareholders, it's for our employees and kind of who we are as a company. Very easy natural extension for us to go in this way. And it's a great way to aggregate a lot of things that are already underway at the company.

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

All right. Great. And then, Mike, I wanted to go back to a comment that you made during the prepared remarks, which is that it seems like you saw a decent acceleration in the business in December. I know that's obviously a seasonally strong month. But can you give us a little bit of color on what you saw in December? Was it payments saw an acceleration or other things? That would be helpful.

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

Yes, sure. It was predominantly payments. And we've always said that the business is very scalable because we have a situation with payments and frankly, with events, too, where -- because our customer retention is even up. We just need things like payments and events to happen. The customers are already sold and implemented. So they're kind of sitting there and activity will drive organic revenue growth. We saw that in Q4 and in December, and it was predominantly payments. The other thing that happened was we also, I think, performed well from a margin standpoint. I mentioned in my prepared remarks.

We pretty much had a Rule of 40 in the month of December, which is very strong for us. And it was really driven a lot by organic growth and some pretty good margin results. So it really, I think, proves the scalability of the company in that regard.

Operator

Ladies and gentlemen, this concludes our question-and-answer session. I'll turn the floor back to Mr. Gianoni for any final comments.

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

Great. Thank you. Thanks, operator. I'll just close by saying we have a lot to be excited about heading into this year. Our market is once again proving its resiliency. I believe we're uniquely positioned to elevate our status as a leader in this market. We believe that steady execution against the Rule of 40 financial framework and our continued commitment to disciplined capital deployment will generate substantial shareholder value.

Thank you, everyone. We look forward to providing a more comprehensive update on our initiatives to accelerate long-term performance at our Investor session in March. Thanks.

Operator

Thank you. This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.
