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Blackbaud Inc 2018 Full-Year Financial Outlook Conference Call

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PRESENTATION

Operator

Good day, and welcome to the Blackbaud call. Today's conference is being recorded. (Operator Instructions) I would now like to turn the conference over to Mark Furlong, Director of Investor Relations. Please go ahead, sir.

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

Thank you, operator. The purpose of this call is to cover the press release that we issued today updating our full year 2018 financial outlook. I remind you that we're in our quiet period, not speaking specifically on Q3 results, and we will be hosting an investor session Wednesday from our user conference, bbcon, which will be webcast.

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

Note that we have limited time for your questions due to customer events at our user conference, bbcon, this evening.

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. Please also note that unless otherwise specified, we will refer to 2018 results and comparable 2017 results as adjusted to reflect our adoption on January 1 of ASC 606 related to revenue from contracts with customers. With that, I'll hand the call over to Mike.

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

Thanks, Mark. Thank you, everyone, for joining us on this call. I'll keep my comments brief, so we can get to your questions. As you know, we issued a press release to update our 2018 full year financial outlook. Our revision to guidance can be explained in 3 major categories, and I want to be very clear that this revised guidance does not change the strategic direction or the long-term opportunity of the business.

Category 1 is onetime services revenue. This is roughly half of the variance to plan since we last updated you on our Q2 earnings call. We're shrinking our onetime services revenue by design, which has been a part of our strategy for several years now and a positive shift in our business model. For the second year in a row, the rate of decline in onetime services and other has exceeded our initial estimates. Our latest projections now have us declining at roughly $16 million for the year, which is a similar decline from what we experienced in 2017 and a faster rate of decline on a percentage basis.

There are a few key drivers here. First, we focused our selling efforts on booking recurring revenue. I'll remind you that on January 1 of this year, we moved all of our North American sales associates onto 1 common compensation plan focused on ARR bookings. Second, our modern cloud solutions now require less time to implement; have fewer customizations; and in many cases, no longer require integration. This means significantly less hours for customer engagements. And third, we had pilot program in Q1 with 1 product to embed services into subscriptions. Based on the success of that program, we decided to roll this pricing model out over several solutions. This removes the upfront service cost for our customers but spreads our revenue recognition out over a more extended period. To summarize, onetime services revenue accounts for roughly half of the total revenue change.

Let's move to the next category. Category 2 is transactional revenue. This category is nearly as large as variance to plan as category 1. We've seen some recent shifts in consumer behavior that are impacting our transactional business. The transactional nature of this business makes it the least predictable in our recurring portfolio or forecast. And although our sales teams have improved our ability to attach transaction-based solutions onto new deals and have successfully closed larger deals, we're experiencing slower-than-expected growth due to consumer behavior in a few major onetime events -- sorry, fewer major onetime events.

There's a number of factors at play here. For example, in North America, we're seeing fewer events being driven by natural disasters like Hurricane Harvey in 2017 and smaller average donation size at charities in the overall industry versus our original expectation. In our K-12 business unit, less tuition is being paid on credit cards versus our expectation. We're also seeing more payments being made on time, which is impacting follow-up fees. And in the U.K. market, we're seeing fewer events such as natural disasters, less overall giving in general and less giving based on what we believe is due to the lack of confidence in U.K. charities resulting from some recent high-profile scandals in the market. To summarize, category 2 is transactional revenue which accounts for the second largest variance to our previous guidance.

Category 3 is subscription revenue and the least material variance to our guidance change. There's no question that we have a substantial opportunity to both improve our existing productivity and layer on incremental sales associates to better cover this exciting market. We're now underway with a major project to more aggressively ramp sales headcount and continue to drive sales productivity. We're more than 3 quarters of the way through our sunset program which has gone quite well, and we're actively migrating customers onto our Blackbaud SKY powered solutions, which is an entirely different customer experience at significantly higher retention rates. However, during the transition period, we have seen and continue to expect to witness modestly heightened attrition rates. To summarize, category 3 is subscription revenue and the least material of the 3 variances.

So to reiterate, category 1 is onetime services revenue. We've been driving this category down for several years now and accounts for roughly half of the variance. Category 2 is transaction revenue which is associated with fewer onetime events and consumer behavior and is a variance nearly as large as category 1. And category 3, which is subscription revenue, is the least material variance.

Lastly, I want to reiterate that our strategy and long-term opportunity is unchanged. We're continuing to invest in sales and marketing because we have a large opportunity to better cover our markets. And we're going to continue to innovate because there's a tremendous opportunity to move this industry online and into the cloud. Just one example of that is a recently announced cloud solution for the faith-based market. And you'll be hearing more upcoming announcements from us this week at bbcon and this Wednesday at our investor session.

I'll now pass the call over to Tony to briefly cover our financial guidance, and then we'll open up the call for questions.

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

Thanks, Mike. With our updated financial outlook, we're now guiding to full year non-GAAP revenue of $844 million to $854 million; non-GAAP operating margin of 19.3% to 19.6%; non-GAAP diluted earnings per share of $2.46 to $2.52; and non-GAAP free cash flow of $143 million to $147 million. We're now expecting 2018 non-GAAP revenue growth to be roughly 7% and non-GAAP recurring revenue growth to be roughly 11%.

The revenue shortfall driven by the 3 categories that Mike just walked you through is what's resulting in our revision to non-GAAP operating margin, diluted earnings per share and free cash flow.

Before we open it up to questions, I want to emphasize Mike's comment that we have a tremendous opportunity ahead of us which is why we're investing in sales and innovation, and we'll continue to do so. Although this guidance change wasn't anticipated, we're pleased with our execution over the last several years, and we're confident in our ability to execute our strategy and position the company for future growth.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And we'll take our first question from Tom Roderick with Stifel.

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

So Mike, I wanted to hit on the payment side of the business here with my first question. And in thinking about this model, I mean the beauty of it is that it can move the needle positively to the upside pretty quickly. The downside, as we've seen kind of in the last quarter and now with this guidance, is that it can turn on you in the wrong direction and it takes a -- seemingly, takes a pretty decent chunk of cash flows with it. How much, as you sort of look at that dichotomy of -- and move the needle up and down quickly, how much did that influence the way you think about payments going forward? You made a number of acquisitions in this space. Is this still as appealing a segment of the market as you've always thought it to be? Or would you prefer to focus on more sort of straight subscription-based products going forward as you look at more M&A?

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

Sure, Tom. Good question. My answer is it's not really a binary one like that, that we would necessarily make that binary choice because the way that we've integrated payments into our core subscription solutions is a big opportunity for us, and it really fixes a lot of problems in the customer base because all of those things are typically separate and single-point solutions. I'll also just remind you that, that transactional revenue is not the largest part of this change, it's the onetime services revenue is the largest part of what we're talking about today that changed. But in the payment side, there's a lot of moving parts in there, different geographic areas, I'd mentioned the U.K. a little bit. And so there's some things that move around that caused lower volumes, like onetime events that didn't reoccur. And we're signing up, as I've mentioned, a lot of new customers. Our attach rates are higher, which means when we signed customers on our subscription cloud products, payment is attached from the get-go, if you will, so that's moving up nicely. So I wouldn't say that it's a binary decision to move away from that because it's such a big runway for us. And if you think about the faith-based cloud we just announced just a couple of weeks ago, there's a long runway in there for the transactional side as well as the subscription side as well.

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

Tom, this is Tony. I think the one thing I'll add is onetime service is obviously the biggest mover here which is not new for us. It's part of the strategy. I'm not going to talk about, it's a little bit of short-term pain, but certainly good for the long term. I think when Mike got here, we were selling maybe 50% onetime and 50% recurring, and that's moved more sort of about 70%/30% now to recurring, which means we don't have to replace those bookings every year, and that will continue to be a positive benefit. But on the payment side, one of the other things we've seen on the transactional side is, again, it's a -- we got 3 different buckets here or categories. It's one of those. And then within payments, we have several different drivers, so we have several things kind of line up all of the same time that I wouldn't expect to happen often in the future. One of the things we didn't speak about or Mike didn't speak to is, we also are having more success selling our whole cloud solutions like in K-12 where we've had this Tuition Management impact. And what we found is, we need to stay focused on when we work with customers to implement which components of that cloud, since they're implementing multiple products, in many cases, 7 products. And what we've seen is an opportunity where we need to get them to push to put like Smart Tuition in earlier in those implementation cycles instead of delaying them to the end, and that's actually pushed a little bit of revenue out. Even though we have the sales booked, we haven't yet implemented and turned them on. We have that same opportunity in just regular payments business also. So there's a good focus there on the sales side to try to accelerate when we start monetizing payments which will help in the future. But again, no individual one of these is a big mover of the needle, but we have 4 or 5 kind of all triangulated in about the same period of time here in the second half that caused this variance.

Operator

And we'll take our next question from Brian Peterson with Raymond James.

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

So I wanted to hit on the subscription dynamics here, and I realized this was the third largest factor that you guys called out. But Mike from your comments, it sounded like it was a little bit of a productivity dynamic versus your expectation. And I'm trying to marry that with the comments about really incentivizing recurring revenue this year, which I think would have helped that line. So can you maybe help clarify that on what are the softness in subscription revenue versus your expectation?

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

Yes. Again, just as a reminder, category 1, which is onetime, is roughly half of this change. Category 2, the transactional, nearly the same size as category 1. So category 3 subscription is the least material, just to make sure that I summarize that. So within the subscription revenue, again, there's always a lot of moving parts here. So a part of it is, we just moved the sales team fully on January 1 in North America, which is most of our sales headcount of the company, given the weight of the business towards North America. Just January 1, they all moved to the same comp plan which is all recurring revenue ARR. And it takes a while to recognize that revenue and get it flowing through the systems from a revenue standpoint. You get bookings first, right? And we started that in 2017 with a subset of the sales team, and we didn't do it all in '17 because we had to get it right and we had to get our internal processes right and commission processing and all of that right, and so we moved the bulk of it in the first of this year. Arguably, you could say we could have done that earlier, but we were focused on the operating mechanics of that, so it was done right. And so when we move the rest, we can handle the processing side of that. And that's, again, only back in January 1. So that was done then, which is not too long ago. And the other thing is we've been talking about this for years now. And we're very far through this whole sunsetting at some of these legacy folks. In fact, we're more than 3/4 of the way through that. And that's a little bit on the subscription side as well. But again, I'll just remind you, category 1 is about half. Category 2 is almost the same size. Category 3, is a lot less, least material.

Operator

And we'll take our next question from Rob Oliver with Baird.

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

This is Matt Lemenager on for Rob. In the prepared remarks, you mentioned fewer onetime events like Hurricane Harvey and then you also mentioned smaller donation sizes in the U.S. With the changes to the U.S. tax laws in late 2017, there's been kind of some questions around the spending environment in 2018, and I don't mean on the payment side. I guess, the question is, has there been any change in conversations around the spending environment with nonprofit IT department to kind of derive their revenue from those donations cycles?

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

Yes. So first of all, the transactional revenue, we covered a lot of different markets, right? So -- and the charity market, some classic nonprofit, so this is

not education institution or faith-based or health care or arts and culture, but the charities, we have not heard anything that tax laws are negatively impacting their donations. The biggest thing that we've heard from the market is really just in the U.K. They had a couple of scandals with charities. And so charities there have told us that there's a bit of -- they're hearing a bit of a lack of trust, that was in my prepared remarks as well. But the market in the U.K. for us in other areas, like education institution, is just performing really well, and we're having a great year at sales in our international business. And so on the transaction side, the only customer feedback, again, we have is -- we heard is U.K. And the U.K. market onto itself is actually down, mostly in the back half of this year, but nothing from large. We're still doing fine with large and midsized nonprofits and closing some really nice cost-solution deals, including payments.

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

Donation is up in the U.S. So we're not taking...

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

Donation is up nicely in the U.S.

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

I think our issue, Matt, is probably more of a math issue and with our forecast. So number of transaction are on track, number of new accounts and adoption of payments within those accounts that we're adding is on track. We've done a really good job this year of getting more high-value accounts. And so it ends up just being a mix, I think, of our whole customer base. And you have to estimate this across a big group of customers what the average donation size is going to be, and that can vary greatly, as Mike said, across the different verticals and different types of nonprofits and the different types of things are using payments to pay for, whether it's a donation or tuition or health care or whatever the case may be. And so I think it's more of a math issue just to where the actual average transaction size is coming out versus what we have expected for the year.

Operator

And that concludes our question-and-answer session. And I'd now like to turn it back over to Mike for any closing or additional remarks.

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

Okay. Thanks, operator. I'll just close the call by saying we're pleased with the transformation in the business over the last several years and we're excited about the future opportunity. Tony and I will be hosting an investor session from our user conference, bbcon, this Wednesday, 11 a.m. to provide an update on our strategic objectives, and we invite all of you to join us either at the session or via webcast. Thank you.

Operator

And that concludes today's conference call. Thank you all for your participation. You may now disconnect.
