8x8, Inc. (NASDAQ: EGHT)
Q1 FY2018 Earnings Conference Call
July 27, 2017 - 4:30 PM EDT

Joan Citelli, Director of Investor Relations:

Thank you operator and welcome everyone to our call. Today, I'm joined by 8x8's Chief Executive Officer, Vik Verma, and our Chief Financial Officer, Mary Ellen Genovese, to discuss 8x8's first quarter fiscal 2018 financial results for the period ended June 30, 2017. The earnings press release, which was issued today after market close, conference call script and accompanying slide presentation are available on the Investors section of 8x8's website at www.8x8.com. Following our comments, there will be an opportunity for questions.

Before I turn the call over to Vik, I would like to remind all participants that during this conference call any forward-looking statements are made pursuant to the Safe Harbor provision of the Private Securities Litigation Reform Act of 1995. Expressions of future goals, including financial guidance and similar expressions using the terminology may, will, believe, expect, plans, anticipates, predicts, forecasts, and expressions which reflect something other than historical fact are intended to identify forward-looking statements.

These forward-looking statements involve a number of risks and uncertainties, including factors discussed in the risk factor sections of our Annual Report on Form 10-K, in our Quarterly Reports on Form 10-Q and in our other SEC filings and company releases. Our actual results may differ materially from any forward-looking statements due to such risks and uncertainties. The company undertakes no obligation to revise or update any forward-looking statements in order to reflect events or circumstances that may arise after this conference call, except as required by law.

I would also like to note that during this call we will provide financial information that has not been prepared in accordance with Generally Accepted Accounting Principles (GAAP) in addition to our GAAP results. Management uses these non-GAAP financial measures internally to analyze our financial results and believes they are useful to investors, as a supplement to GAAP measures, in evaluating the Company's ongoing operational performance. Please refer to today's press release for a reconciliation of GAAP to non-GAAP financial performance and additional disclosures regarding these measures.

I'd now like to turn the call over to Vik Verma, Chief Executive Officer of 8x8.

Vikram Verma - Chief Executive Officer:

Thank you, Joan, and thank you all for joining us to review 8x8's progress and results for our first quarter of fiscal 2018.

Let's begin by reviewing our quarterly results. In Q1, 8x8's service revenue grew 21% on an adjusted basis to $65.1 million. Service revenue from mid-market and enterprise customers grew 33% on an adjusted basis. Total revenue for the quarter was $69.1 million, representing an 18% year-over-year increase on an adjusted basis. Our non-GAAP service margins remained strong at 84% and non-GAAP pre-tax income was $3.3 million, or 5% of revenue.

While these results demonstrate the continued success of our business model, our traction moving upmarket and our commitment to profitability, I believe they only partially represent what 8x8 is capable of achieving. The mid-market & enterprise segment of our business, which we have defined as customers billing over $1,000 in monthly recurring revenue, is inflecting and now represents 57% of our service revenue. With recent enhancements to our global R&D, sales, marketing, customer support and internal business systems, along with our renewed emphasis on demand generation, we are now better positioned than ever to capture more than our fair share of the $50 billion plus global market opportunity before us. We intend to fully leverage all of our core key assets to our newly guided levels of profitability in order to further advance our technology leadership and accelerate growth.

Our strength and differentiation in the market continued to serve us well during the quarter as we again witnessed meaningful adoption of our services by larger and larger businesses. This led to the acceleration of our mid-market, enterprise and channel bookings in both the US and the UK with 14% year-over-year growth on an adjusted basis.

We're seeing more and more prominent, well-established corporations adopt the 8x8 Communications Cloud. This is as sure a sign as any that the cloud is here to stay and that 8x8's solutions are meeting, and we believe exceeding, the expectations and requirements of the most discerning enterprise organizations. The catalysts for the shift to cloud-based solutions are more compelling than ever with the continued demise of the legacy infrastructure and the tremendous ROI, productivity and overall business benefits 8x8's solutions deliver to its customers.

Let me remind you all that while we are seeing growing adoption of cloud communications services by businesses of all sizes, we're only still scratching the surface, as the market remains significantly underpenetrated with more than 90% of businesses worldwide still relying on legacy systems.

Moving on to a recap of our progress in Q1, let's begin with an update on our performance in the mid-market and enterprise business segments. 62% of the new monthly recurring revenue booked during the quarter came from customers within these market segments. These customers' buying preferences are similar to what we've seen in previous quarters, with five of the top 10 deals calling for both Virtual Office and Virtual Contact Center services, three for Virtual Office and two for our Virtual Contact Center solution. Our differentiated, integrated suite of services continues to resonate with large mid-market and enterprise customers while our Virtual Contact Center solution on its own is beginning to gain traction in the marketplace.

8x8's ownership of the core technology underlying all of our pure cloud solutions has not only garnered industry recognition by respected third party organizations such as the Tolly Group, it also continues to resonate directly with customers as they determine which provider they will trust to handle their mission critical communications. Our integrated UCaaS and CCaaS solution, robust feature set, global service delivery capabilities and enterprise grade security and reliability are some of the common themes you'll hear as I highlight a few of our noteworthy customer wins during the quarter.

One of our marquee customer wins in our first quarter of fiscal 2018 was a major feature film production and distribution company. We're excited to be working with this new customer to upgrade their communications capabilities from a legacy, on-premises Avaya system to our Virtual Office and Virtual Office Analytics solution. We participated in an extensive RFP process with two other pure cloud providers and were selected because of our robust feature set and, most notably, our Virtual Meeting web and videoconferencing service. Our initial deployment of approximately 750 seats will cover four sites – Culver City, Beverly Hills, Australia and London – and we look forward to an opportunity to further support their communications requirements with additional seats and services in other global locations.

We were also selected by a well-known brand that operates the nation's leading digital platform serving consumers across the entire movie lifecycle. With corporate headquarters in Southern California and plans for expansion, this customer was seeking a reliable cloud solution that would scale to support the company's growth from a single platform. We're looking forward to supporting all of this company's communications requirements beginning with a combined Virtual Office, Virtual Contact Center and Virtual Office Analytics deployment of approximately 500 seats.

WGBH, the largest PBS station in the country based in Boston, came to 8x8 last quarter through Softchoice, one of our newest channel partners. This is another combined Virtual Office/Virtual Contact Center deployment of nearly 1,000 seats, replacing a traditional on-premises Avaya system. We won this deal over two pure cloud competitors and are planning full deployment throughout New England and one California location by the end of next month.

OnSolve, a leading global provider of SaaS-based critical communication solutions for enterprise, SMB, and government customers, also selected 8x8 in Q1 for Virtual Office, Virtual Contact Center and Virtual Office Analytics services. OnSolve's requirement for high reliability to support the delivery of life-saving notifications and a unified communications platform connecting all employees were the primary reasons for the selection of 8x8. This U.S. based deployment consists of nearly 400 combined seats across seven corporate U.S. locations.

Our 8x8 Solutions team in the UK had a great quarter, bringing in five large enterprise deals. One of these, a 5,000-seat Virtual Office deployment for a UK industrial manufacturer, came through the UK arm of our partner CDW. Other large enterprise deals included 1,500 Virtual Office seats for a consumer goods packaging company and a Virtual Contact Center deployment of nearly 400 seats for the UK Ministry of Justice. Our focus on the UK public sector is paying dividends with this recent large win following last quarter's win with a legal aid authority. 8x8 Solutions' service revenue, which is primarily from mid-market and enterprise customers, grew 37% year-over-year.

Expansion revenue from existing customers was again strong during the quarter with orders of 1680 Virtual Office seats from our large office supply retail customer, 200 Virtual Contact Center seats from HomeAway and 300 Virtual Office seats from Lyft. We are also now at over 22,000 Virtual Office seats and almost 700 Virtual Contact Center seats deployed for Regus.

Our focus on the channel is another strategic initiative we're making good progress with. In June, we announced a new consolidated Channel Distribution model aligning individual partners with Master Agents and Distributors that provide sales enablement and support for 8x8 Communications Cloud solutions. This is enabling our partners to accelerate their marketing and sale of 8x8 Communications Cloud services, while providing a clear blueprint for expanding their reach partnership into new regions.

We recently signed an agreement with Ingram Micro to add 8x8's solutions to its cloud unified communications and collaboration portfolios. With this new partnership, 8x8 will become one of the largest service providers and the first born-in-the-cloud vendor within Ingram Micro's Specialty Division for Unified Communications and Collaboration. We also during the quarter announced partnerships with Jenne, Inc., a leading value-added distributor of technology products and solutions and Softchoice, a leading North American provider of IT solutions and managed services. Finally, we are continuing to optimize our sales teams to work in concert with the channel to provide the highest quality pre and post sales support to 8x8 customers. We expect that these enhancements to our sales organization, along with advanced strategic marketing and demand generation initiatives under the leadership of our new CMO Rani Hublou, will have a measurable impact on bookings and revenue growth over the coming quarters.

We also made great strides in R&D and product innovation, our third strategic initiative, in the first quarter of fiscal 2018. First and foremost is the quality and depth of the engineering organization we now have in place under the leadership of Dejan Deklich, who joined us earlier this year as Senior Vice President of Global Research & Development. Dejan has recruited some amazing talent to his team with recent high caliber hires from some of the most respected technology companies in Silicon Valley. Collectively, this expertise will be instrumental in keeping 8x8 at the forefront of our industry as we delve deeper into leading-edge technologies such as big data, micro services, machine learning, artificial intelligence, SD-WAN, WebRTC, and more. With five newly awarded patents, for a total of 137 to date, 8x8 already possesses a strong technology foundation and industry reputation.

On the product side, our new contact center solution for teams, 8x8 ContactNow, went GA here in the U.S. in April as a complete self-service experience and the initial response has been very favorable with customer feedback reflecting the product's easy setup and use, intelligent routing and rich reporting and analytics. We also just launched new Customer Experience Analytics and

Post Call Survey features for Virtual Contact Center, as well as the next version of the 8x8 Quality Management solution.These new capabilities target today's growing millennial workforce with collaborative performance management and enhanced analytics.

Finally, our new, fully redesigned Virtual Office Mobile app which was just released to the app store provides an exceptional user interface and experience that offers communications, collaboration, and messaging in a single app, while maximizing the superior voice quality delivered by the 8x8 Communications Cloud. This is contrasted with other leading vendors that have separate apps for the full capability set.

On the global front, our fourth strategic priority, we added a new customer support center in Singapore this quarter, supplementing existing operations in the United States, United Kingdom, Philippines and Romania for global 24/7 follow the sun customer support. We also just launched our global co-selling initiative with Regus in the UK, the first of 17 countries. These developments reflect 8x8's commitment to delivering the best quality of service and customer support worldwide.

8x8 continues to earn high marks for industry leadership, most recently from IHS Markit in its recently published 2017 North American UC as a Service (UCaaS) Scorecard which profiles, analyzes, and ranks the leading cloud unified communications service providers. In this report analyst Diane Meyers states "8x8 continues its leadership for the fourth year due to its installed base of UCaaS seats, financial position, and continued execution on its market strategy."

Fiscal 2018 will be a pivotal year for 8x8. We are seeing increasing adoption by mid-market and enterprise customers, our sweet spot in the market, along with legacy channel partners rapidly moving to the cloud, given recent events in the industry. We believe we have a clear lead in the mid-market and enterprise – which brings us the highest ROI and long term customer value. As we've stated in the past, we are only minimally investing in the micro market segment of 1 to 9 lines which is growing at approximately 5%. Our core business, 10 – 10,000 plus seats, is now growing approximately 27% on a constant currency basis and represents approximately $200 million, more than 75% of our total annualized service revenue. Even more interesting to note, if you look at the mid-market and enterprise segments as defined by Gartner, over 100 seats, which is where our incremental investments have been going, we are now growing at 41% and this segment represents well over $100 million of annualized service revenue. We've successfully scaled our business to serve these enterprise customers and now is the time to step on the gas. Expanding the reach and effectiveness of our channel organization will be one of the key areas of focus of this increased investment.

With that I'll turn the call over to Mary Ellen for a more detailed discussion of our financial results and outlook.

Mary Ellen Genovese, Chief Financial Officer:

Thank you, Vik, and thank you all for joining us on the call today. My commentary today will cover highlights from our income statement and balance sheet along with key operating metrics from the quarter. These will be based on non-GAAP results, unless otherwise noted, and I remind you to refer to the tables in today's earnings press release for a GAAP to non-GAAP reconciliation. You will also find an accompanying slide presentation with our quarterly results posted on our Investor Relations website.

For the first quarter of fiscal 2018, service revenue increased 18% year-over-year to $65.1 million. Adjusting for constant currency and the discontinuation of the non-core, voice-message broadcasting segment of our DXI operations, service revenue increased 21% from the year ago period. Total revenue in the first fiscal quarter grew 15% year-over-year to $69.1 million. On an adjusted basis, total revenue grew 18% from the year ago period. Service revenue from our mid-market and enterprise customers grew 29% year-over-year and 33% on an adjusted basis. 57% of our total service revenue is now coming from our mid-midmarket and enterprise customers, compared with 52% in the same period last year. Product revenue, which constituted approximately 6% of total revenue in the first fiscal quarter, declined 16% from the year ago period.

Gross margin for the quarter was 77.8%, compared with 75.4% in the same period last year. Service margin in the first fiscal quarter was 83.9%, compared with 83.2% in the year ago quarter. Product margin in the first quarter was negative 22%, compared with negative 16% in the same period last year.

Quarterly pre-tax income was $3.3 million, $0.03 per share, or 5% of revenue on a non-GAAP basis, compared with $5.5 million, $0.06 per share, representing 9% of revenue, in the same year ago quarter. Non-GAAP pre-tax income for the first fiscal quarter excludes non-cash charges and a gain of $1.4 million related to an escrow settlement from our 2015 acquisition of

DXI. To provide greater color on our non-GAAP pre-tax income for the quarter, we incurred channel commissions in excess of what we had budgeted due to robust channel sales and collections activity.

Sales and marketing expenses, which also include customer service, product management and deployment costs, were $37.7 million, or 55% of revenue, in the first fiscal quarter, compared with $29.4 million, or 49% of revenue, in the same year ago period. The increase in sales and marketing expenses was primarily due to an increase in headcount, channel commissions and advertising.

Turning our attention to the key operating metrics for the quarter, average revenue per mid-market and enterprise customer grew to $4,592, compared with $4,230 in the same year ago period. Average revenue per business customer was $432, compared with $399 in the same period a year ago. Gross monthly business service revenue churn on an organic basis, excluding DXI, was 0.6%, compared with 0.5% in the same period last year.

New monthly recurring revenue from mid-market and enterprise customers and by channel sales teams comprised 62% of the total new monthly recurring revenue booked in the first fiscal quarter on an adjusted basis. This new MRR increased 14% on an adjusted basis, compared with the same period in fiscal 2017.

Cash, cash equivalents and investments were $178 million at June 30, 2017, compared with $167 million one year ago. Cash flow from operating activities was $6.2 million in the first fiscal quarter, compared with $6.5 million in the same period last year. Capital expenditures, including capitalized software, were $4.4 million in the quarter, or 6% of revenue.

As Vik mentioned, in order to fully capitalize on the market opportunity at hand, we are lowering our full year non-GAAP pre-tax income guidance for fiscal 2018 from the previously guided range of $21 million to $26 million or approximately 7% to 9% of revenue to approximately $9 million or 3% of revenue. Our estimated non-GAAP effective tax rate is expected to be approximately 36%. Our cash taxes are expected to be less than $1 million.

Our revenue guidance for fiscal 2018 remains unchanged. We expect full year service revenue in the range of $280 million to $285 million, representing approximately 19% to 21% year-over-year increase. We expect total revenue in the range of $296 million to $300 million, representing approximately 17% to 19% year-over-year increase. Adjusting for the currency headwind and the discontinued revenue from the non-core, voice message broadcasting segment of our DXI operations, we expect fiscal year 2018 service revenue growth in the range of 20% to 22% and total revenue growth in the range of 18% to 20%.

Taking into consideration our increased investment in the business, our market leading position and the market opportunity, it is our expectation that service revenue growth will begin to accelerate in fiscal 2019 with an exit growth rate of approximately 25% in the fourth quarter of fiscal 2019.

That concludes my prepared remarks and we will now open the line for questions.