8x8, Inc. (NASDAQ: EGHT)
Q2 FY2018 Earnings Conference Call
October 26, 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 second quarter fiscal 2018 financial results for the period ended September 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 on our second quarter fiscal 2018 earnings conference call.

This has been a very busy and productive quarter for 8x8. I'm pleased to report that we have made significant progress implementing the strategic initiatives we laid out last quarter. I'll review this progress shortly, but let me first begin with a high level summary of our financial performance during the quarter.

8x8 posted solid top and bottom line results for our second fiscal quarter with an 18% increase in service revenue to $68.1 million and a 15% increase in overall revenue to $72.5 million. Service revenue from mid-market and enterprise customers, those billing greater than $1,000 in monthly recurring revenue, increased 28% and now represents 58% of total service revenue. Our non-GAAP pre-tax net income was $4.2 million, or 6% of revenue, and service margins remained strong at 83%.

The market continues to inflect, and we see tremendous opportunities for accelerated growth across the core customer segments we serve, from small business to midmarket and enterprise. Our goal is to drive revenue growth across our entire business with a continued focus on mid-market and enterprise customers along with new initiatives to accelerate revenue growth from small business customers.

In order to position ourselves most effectively for our next phase of growth, we've identified and have begun to execute on several strategic initiatives.

First, we are aligning global business units around our core market segments to optimize for growth. At the beginning of October, we segmented our internal sales operations into two separate business units - Small Business & eCommerce, aimed at businesses with 1 – 99 employees, and Mid-market & Enterprise aimed at businesses with 100+ employees. We determined that establishing two separate business units will enable us to unlock the growth potential of each unit and allow us to optimize our sales and marketing strategies around the specific needs of each customer segment. These business units will align sales and delivery and be tightly coupled with demand generation, services and support to drive segment revenue growth and profitability globally. Small Business & eCommerce will focus on our high-volume, transactional business, with an aim to accelerate growth and productivity through eCommerce and self-service. Midmarket & Enterprise will focus on both creating and leveraging channel relationships and building our direct sales force to drive a consultative approach to our land and expand strategy for larger accounts in the US, EMEA & APAC.

Second, we've appointed top industry talent to newly created executive leadership positions in our marketing and sales organizations to align with our new business units and accelerate adoption of our solutions across all market segments. With these changes, we are aggressively gearing up to accelerate growth.

Third, we've expanded our global field sales organization with both Mid-market and Enterprise Sales Executives and Channel Development Managers. Our field sales executives work directly with customer prospects to understand and customize the optimal communications solution for their business, while Channel Development Managers are responsible for recruiting and enabling partners in their respective territories, evangelizing the 8x8 brand and growing the sales pipeline with partners. In Q2, we had 21 new partners participating in our Channel Enablement Program with six of them already bringing us deals in the August and September timeframe. Five of our top 10 deals in the September quarter were brought in by our channel partners. Our unique differentiation in the market, driven by our internally owned voice, collaboration, contact center and analytics technologies, makes us a highly desired vendor partner to Master Agents and VARs that are rapidly evolving their business models to accommodate the transition from legacy to cloud communications that is occurring today.

Fourth, we laid the groundwork for some new marketing, branding and lead generation initiatives designed to highlight the true value of our solutions over those of both legacy vendors and cloud competitors. 8x8 has the most comprehensive set of cloud communications, contact center and analytics capabilities in the industry. Over the past several years, we have created, assembled and expanded the building blocks to reinvent the business communications market. We have transformed our core Virtual Office communications platform into an open platform with APIs, Script8, extensive integrations and the leading global voice quality in the industry. In parallel, we have added a full spectrum of contact center and customer engagement capabilities with the acquisitions of Contactual, which brought us high-end contact center capabilities, and DXI with their innovative, easy-to-use contact center functionality for business teams. With the acquisitions of Quality Software and Sameroom, and their leading edge technologies, we are ready to further leapfrog the industry with speech analytics "for everybody" and next generation collaboration capabilities.

This has enabled us to further disrupt the market with a new suite of products that unifies cloud communications, collaboration, online meetings, and contact center solutions with an end-to-end data analytics platform. Representing a combination of technologies from years of continuous innovation from 8x8, this launch signifies a new age of Truly Unified Cloud Communications.

In early October, we launched our new Virtual Office Editions product suite, including our groundbreaking 8x8 Virtual Office X8 Edition. Designed for easy consumption by small and mid-sized businesses from a pricing and packaging standpoint, VO Editions also includes three enterprise class business communications options provide customers with the flexibility and mix-and-match pricing model that's best suited for their needs. Our new 8x8 Virtual Office X8 edition offers a unique and powerful business communications and collaboration solution, allowing employees to interact anytime from anywhere, and includes easy-to-use contact center capabilities, such as inbound call handling, outbound campaign dialing, and rich reporting and analytics for new business insights. This new offering enables companies to connect everyone throughout the organization, including both contact center agents and employees, with a single, unified solution.

8x8 continued to execute in the market with many sizable customer wins during the quarter, including 13 large enterprise deals. 61% of the new monthly recurring revenue booked in Q2 came from mid-market and enterprise customers. One of our largest enterprise deals, carrying a Total Contract Value of approximately $7 million, came from our UK team, which continues to enjoy excellent traction in the market, specifically in the public sector with local and central government opportunities. This latest government contract with Lewisham/Brent Council calls for an initial deployment of 10,000 Virtual Office seats and 600 Virtual Contact Center seats and potentially provides an opportunity to deploy our services to 30 additional London boroughs.

We continue to win sizable mid-market and enterprise customers with our integrated Virtual Office/Virtual Contact Center solution which was present in 8 of our top ten deals in the September quarter. A new marquee customer win in the U.S. is Lenox Corporation, a market leader in quality tabletop, giftware and collectibles. For Lenox, we'll be replacing a legacy on-premises system with approximately 600 Virtual Office Seats and 70 Virtual Contact Center seats. 8x8 won this deal following a competitive RFP process that involved several other UCaaS and CCaaS providers. Another combination win was Standard Motor Products, a leading independent manufacturer, distributor and marketer of replacement parts for motor vehicles, calling for a deployment of over 2200 Virtual Office seats and 1,000 Virtual Contact Center seats. 8x8 was selected because of our integrated platform, our global reach and our superior voice quality. Collette Travel Services, a global travel agency, also selected 8x8 for a combined deployment of 530 Virtual Office seats and 140 Virtual Contact Center seats. Collette was upgrading to the cloud from an antiquated legacy system they had been using for 17 years and wanted to upgrade to the cloud. Our contact center solution was the driving factor for this global customer win.

Finally, 8x8 garnered continued recognition as an industry Leader for the sixth consecutive year in Gartner's 2017 Magic Quadrant for UC as a Service, an important validation of our continued investments to drive innovation in the cloud communications space, and an acknowledgement of the great strides we have made in delivering measurable benefits for midmarket and enterprise companies. We were also named a Challenger for the second year in the Gartner Magic Quadrant for Contact Center as a Service. And, in a recent report published by Synergy Research Group, 8x8 was named the worldwide leader in both revenue and subscriber seats in the mid-market and enterprise segments of the UCaaS market.

In summary, our second fiscal quarter has been one of significant changes which I believe over time will materially alter our growth rate trajectory. We brought some amazing new talent on board, rolled out our next generation platform, launched a highly differentiated UCaaS offering and re-aligned our business by creating two distinct go to market vehicles that will materially improve our efficiency and win rate – all within the last ninety days. However, we anticipate that the sheer volume of these changes will take one or two quarters to bear fruit. As such, we feel it is prudent at this time to reset the bar on our revenue expectations for fiscal 2018 but I feel confident that the investments we've made keep us on track for achieving 25% service revenue growth exiting fiscal 2019.

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

Mary Ellen Genovese, Chief Financial Officer:

Thank you, Vik, and thank you all for joining us on the call today. My commentary will cover financial highlights along with key operating metrics from the quarter. These measures 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 reconciliation of GAAP to non-GAAP results. Foreign exchange rate fluctuations did not have a significant impact on our comparative results this quarter, as the British pound remained relatively flat versus prior year, so none of the financial information we are presenting has been adjusted for constant currency.

Total revenue in the second quarter of fiscal 2018 grew 15% year-over-year, or 5% sequentially, to a record $72.5 million. Adjusting for the discontinuation of the non-core, voice-message broadcasting segment of our DXI operations, total revenue grew 16% from the year ago period.

Turning to specific revenue line-item contributions, service revenue increased 18% year-over-year, or 5% sequentially, to $68.1 million. On an adjusted basis, service revenue increased 19% from the year ago period. Product revenue, which constituted approximately 6% of total revenue in the quarter, declined 20% from the year ago period.

Service revenue from mid-market and enterprise customers grew 28% year-over-year and 6% sequentially. 58% of our service revenue is from our mid-market and enterprise customers, compared with 53% in the prior year period and a one percentage point improvement sequentially.

Gross margin for the quarter was 77%, almost a two percentage point improvement year-over-year and flat sequentially. Service margin was 83%, flat over the year-ago period and sequentially down one percentage point due to the increase in third-party networking service costs which are attributed to higher usage. Product margin was negative 17%, compared with negative 6% last year.

Moving to operating expenses, sales and marketing expenses in the quarter, which includes customer service, product management and deployment costs, were $38 million, or 52% of revenue. This is up two percentage points versus the same year ago period as we continue to execute on our strategic initiatives around channel development and demand generation.

R&D expenses were $7 million, or 10% of revenue. This is up one percentage point from a year ago as we continue to invest and execute on our commitment to develop truly unified best-in-class communications solutions for our customers.

G&A expenses were $7.1 million, or 10% of revenue.

Quarterly net income before taxes was $4.2 million, or $0.04 per share and 6% of revenue, compared with $5.4 million, or $0.06 per share, and 9% of revenue, in the same year ago quarter.

We saw solid improvements in key operating metrics for the quarter. The average revenue per mid-market and enterprise customer grew to $4,697, compared with $4,351 in the same year ago period. Average revenue per business customer was $442 compared with $409 in the same period a year ago. Gross monthly service revenue churn on an organic basis, excluding DXI, was 0.4%, compared with 0.6% in the same period last year. Please note that third fiscal quarter revenue churn may be higher than second quarter results due to the upcoming holiday season.

New monthly recurring revenue bookings, or MRR bookings, from mid-market and enterprise customers and by channel sales teams comprised 61% of the new monthly recurring revenue booked in the quarter on an adjusted basis. New MRR was essentially flat on an adjusted basis, compared to prior year. Sequentially, we saw positive momentum across mid-market, enterprise, channel, and small business segments.

Cash, cash equivalents and investments were $167 million at September 30, 2017, compared with $170 million one year ago. Cash flow from operating activities was $5 million in the second fiscal quarter, compared with $6.9 million the same period last year. Capital expenditures, including capitalized software, were $4.8 million in the quarter, or 7% of revenue and increased 9% sequentially.

During the quarter, we repurchased approximately 1.1 million shares at a price of $13.23 for a total of $14.1 million. We currently have about $11 million available for share repurchase under our current program which goes through May 2018. 8x8 has a clear capital allocation strategy of investing cash to grow our business organically, through acquisitions and strategic partnerships, and returning cash to shareholders through share buybacks. This approach is a strategy we have been and remain committed to.

Looking ahead to the second half of the fiscal year, we continue to recruit world-class talent primarily in sales, marketing and research and development teams, while enabling our channel programs to enhance demand generation and support our global brand.

To better model third and fourth fiscal quarters, operating expense growth is expected to be in the low double-digit range versus the first half of the year. Q4 is expected to be sequentially higher than Q3 and the highest quarter of spend for the full-year.

Specifically, sales and marketing expenses will increase from added headcount, channel enablement execution, commissions, and advertising spend to support the brand and go-to-market strategic initiatives on the mid-market and enterprise. As a percentage of total revenue, we expect sales and marketing to be in the range of 55% to 56% during the second-half of the fiscal year with Q4 being the highest sales and marketing expense quarter. As a reminder, product management, customer support and deployment services is included in our sales and marketing expenses and represents approximately 14% of revenue.

R&D will increase modestly in absolute dollars to support the development of unified solutions and our cross platform real time analytics but will remain stable as percentage of revenue from previous quarter.

As a percentage of total revenue, we expect general and administrative expenses to be in the approximately 11% during the second-half of the year.

We also aniticipate our quarterly service margin to decline slightly from the second quarter level in the second-half of the year due to additional expenses related to the amortization of previously capitalized software.

In addition, we will continue to invest and deploy our capital to execute on our strategic business initiatives, while taking a very disciplined approach to share repurchases.

Having said all this, we are modifying our revenue outlook for the full-year due to three primary factors. The first factor is attributable to our UK Easy Contact Now product. During the first half of the year, service revenue from this product was largely in-line with our expectations. However, due to our strategic decision to integrate the core technology into our recent Virtual Office X8 product launch, we are now de-emphasizing selling the stand-alone product. The underlying technology is strong and has tremendous value to the business as part of our integrated platform.

The second factor is related to a large enterprise client that has revised its timeline for a major rollout of services, due to constraints on its end.

Lastly, we have recently realigned our global sales and marketing leadership teams and operating structure to support our strategic initiatives to generate revenue growth and support sales execution. We have streamlined these two important corporate business units to generate demand, accelerate bookings growth and respond more quickly to customer needs. We will also continue to build-out global functions to strengthen our leadership position in the unified communications space. Although we have made good progress to-date in our strategic initiatives, we may need another quarter or two to see improved bookings.

Taking all these factors into account, we have revised our outlook for the fiscal full-year:

- Total revenue in the $292 million to $294 million range, representing approximately 15% to 16% year-over-year increase.
- Service revenue in the $275 million to $277 million range, representing approximately 17% year-over-year increase.
- Adjusting for the discontinued revenue from the non-core, voice message broadcasting segment of our DXI operations, service revenue growth in the range of 17% to 18% and total revenue growth in the range of 16% to 17%.

We continue to expect fiscal 2018 outlook of:

- Non-GAAP pre-tax income to be approximately $9 million or 3% of revenue.
- Our estimated non-GAAP effective tax rate is expected to be approximately 36%.
- Cash taxes are expected to be less than $1 million.

Lastly, taking into consideration our increased investment in the business, our market leading position and the market opportunity, we continue to expect 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.

The series of strategic investments and initiatives mentioned earlier are all contemplated in our financial outlook. We believe this is the right time and prudent use of our capital to invest in future growth for fiscal 2019 and beyond.

We are on the right path and taking action for the long-term success of the company. We are investing in our brand, employees, product innovation, demand generation, and channel to enable our global clients to grow their business and reduce their costs.

We've made good progress on this front with many of our partners and this is a long-standing commitment on our part.

Before we begin our questions and answer session, I have one more topic. During the summer, Joan informed me of her decision to retire at the end of this month. On behalf of 8x8's management team, I would like to thank Joan for her 13 years of contributions to the company. Joan built the investor relations department, and established and nurtured relationships will all of you over the years. We wish Joan all the best in her future endeavors.

I'd also like to introduce Victoria Hyde-Dunn. She joined 8x8 four weeks ago and will be your Investor Relations contact going forward.

With that, operator we are ready for questions.

Q&A

Closing Remarks: Vik Verma:

We're going to have a very active quarter of conferences and non deal road shows and we look forward to seeing you at one or more of these events.