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Guidance Software, Inc.

Third Quarter 2016 Earnings Conference Call

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CORPORATE PARTICIPANTS

Rasmus Van Der Colff, *Vice President, Finance*

Patrick Dennis, *President and Chief Executive Officer*

Barry Plaga, *Chief Financial Officer and Chief Operating Officer*

CONFERENCE CALL PARTICIPANTS

Zack Cummins, *B. Riley & Co.*

Michael Kim, *Imperial Capital*

PRESENTATION

Operator:

Greetings, and welcome to the Guidance Software Third Quarter 2016 Earnings Conference Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. If anyone should require Operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference call is being recorded.

It is now my pleasure to introduce your host, Rasmus Van Der Colff, VP of Finance. Please go ahead.

Rasmus Van Der Colff:

Good afternoon and welcome to Guidance Software's Third Quarter 2016 Earnings Conference Call. With me today are Guidance Software's President and CEO, Patrick Dennis, and our COO and CFO, Barry Plaga.

We would like to remind everyone that during today's conference call, we will make certain forward-looking statements regarding the future operations, opportunities and financial performance of Guidance Software within the meaning of the Safe Harbor provision of the Private Securities Litigation Reform Act of 1995. These statements involve a high degree of known and unknown risks and uncertainties that could cause actual results to differ materially from those to be discussed.

Please also refer to the risk factors and other disclosures contained in the Company's most recent reports on Forms 10-K, 10-Q and 8-K filed with the SEC for a more detailed discussion of these factors. The forward-looking statements made in today's conference call are based on information available as of today, November 3, 2016, and Guidance Software assumes no obligation to update such statements to reflect events or circumstances after today's date.

Additionally, unless otherwise noted, we will discuss non-GAAP results during today's call. Investors are encouraged to review the reconciliations of these non-GAAP financial measures to the most directly comparable GAAP results, which can be found in today's press release and also in our supplemental slide presentation on our website.

Lastly, I would like to remind everyone that today's call is also available via webcast on Guidance Software's Investor Relations website. A replay will also be available on the site.

With that, I would now like to turn the call over to Patrick. Patrick?

Patrick Dennis:

Thank you, Rasmus, and thank you everyone for joining Guidance Software's Third Quarter 2016 Earnings Conference call. I'm pleased to report this is the third consecutive quarter where total revenues grew on a year-on-year basis. These results continue to be driven by growth in our cyber security business. On today's call, we will discuss highlights for the third quarter of 2016, like usual, and lay out the framework for our 2017 operating model.

In addition to revenue growth, we have made significant progress against our short and long-term profitability objectives. We have seen improved financial and operational execution as a result of the increased focus on our growth businesses. We expect to finish the year strong, although having reduced the size of the workforce by approximately 100 people, or 20% to 25%, over the course of the year. We are carrying both the revenue growth and cost improvements into our 2017 model. Given the success of our year-long pivot towards cybersecurity, our preliminary model forecasts 2017 to be the best year since 2012.

Following my remarks, Barry will discuss our third-quarter financial results in more detail, as well as our updated 2016 guidance and our view of the overall 2017 model. After that, we will open the call for questions and answers.

We are pleased with the growth of all of the core financial metrics in Q3. Total revenues were $27.7 million, demonstrating both year-over-year and sequential growth. Gross margins expanded four percentage points year-over-year, driven by both growth and product mix. Earnings per share was positive $0.01 versus a loss of $0.03 last year, and EBITDA was $1 million, up 3x from Q3 2015. Product revenue also grew 24% year-over-year.

The forensic security suite continues to be the majority of our enterprise software bookings. In the third quarter, EnCase Endpoint Security grew by 193% and average selling prices doubled compared to the third quarter of 2011. Total forensic security suite bookings grew more than 400% year-on-year, now that all three products in this suite are shipping for revenue. The number of enterprise software deals over $250,000 doubled year-on-year and the channel mix remained consistent with previous quarters. Importantly, we are seeing demand for the forensic security suite from both new and existing customers.

I would like to share some of the key forensic security wins for Q3.

We beat Tanium and Carbon Black, and Cummins, a Fortune 500 Company and one of the largest engine manufacturers in the world. Cummins is an existing EnCase customer and shows our Endpoint Security solution because of our universal agent technology. We now support Cummins around the globe given our strong compliance with EU regulations for data privacy and security.

We also expanded our footprint with Wynn Resorts, one of the world's premier gaming and hospitality companies. They leverage our scalability to touch endpoints around the world, including sites in China. The team at Wynn leverages our technology against both outside intruders and insider threats.

Bell Canada, a $21 billion communications giant, expanded the use of our technology as a security service provider. BCE contracts include the premier brands and agencies across Canada.

I am particularly pleased with the win at Fair Isaac Corporation. Most of us know them as FICO, the leading consumer credit risk company. FICO's brand requires them to take seriously the protection of consumer information. They selected our Endpoint Security software because of its unique compliance and privacy capabilities.

We also helped Wolf Creek Nuclear Operating Corporation comply with the Nuclear Regulatory Commission's information covenant requirements. Wolf Creek choose our EnForce Risk Manager product to help them locate sensitive information and act with surgical remediation. EnForce Risk Manager was the most compelling software product in the market to meet Wolf Creek's needs.

We also secured a corresponding utilities win with the International Atomic Energy Agency.

We are honored to be selected to protect critical organizations like these.

Our public sector business continues to grow with agencies around the world. We are not allowed to disclose their names, but we appreciate their business.

Finally, the performance of the global financial services sector was also strong, including wins with brands like Alliance, AIG and Northern Trust.

We continue to make enhancements to our forensic security suite of products and expand our partnerships and channels. This morning, we announced a partnership with DarkMatter, the fastest-growing cybersecurity solution provider in the Middle East. DarkMatter is based in the UAE and has more than 500 employees dedicated to delivering cybersecurity programs in the region.

In October, we expanded our relationship with kCura, the makers of Relativity, to enhance our e-discovery solution with the leading hosted review platform in the market. Andrew Sieja, kCura's CEO and I are both enthusiastic about the future of our joint solution.

In Q3, we delivered the previously announced EnCase Endpoint Security 5.13 with real-time monitoring, we delivered our EnForce Risk Manager 1.02 and our enhanced agent for Endpoint Investigator. The enhanced agent modernizes investigations for commercial customers by improving collections for remote mobile workers. Endpoint Investigator was also given a five-star rating by SC Magazine this quarter. I would like to read a quote from Peter Stephenson, the author of that review. "In all of our years of reviewing this fine product, this is the best release that we've seen". This quote captures exactly how we feel about all the products in our development pipeline.

I have mentioned before that our forensic security suite is fully differentiated versus the competition. I would like to bring together a few key points to support that assertion.

First, EnCase Endpoint Security is growing faster than the market. Customers are aware that prevention technology is entirely insufficient against today's modern attacks. This is proven by the roster of wins this quarter and in the quarters prior. The shift in spending towards EDR with robust rapid detection and response capabilities is meaningful.

Second, many endpoint competitors risk being disintermediated by the efforts of the antivirus suppliers. These endpoint suppliers are not differentiated enough, so their software will likely become an extension of lower value prevention technology. The combination of these technologies is often referred to as an endpoint protection platform. The lower value is driven by the limited success of signature-based solutions, which prevent as little as 45% of attacks. These companies are also challenged by the scale of the cloud, mobile and IoT bring. These are not only technology challenges. The collapse of high-value endpoint prevention solutions and low-value antivirus solutions will compress the combined solutions margin. Furthermore, while customers would prefer multi-use agent technology, we believe merging the specialized functionality of many EDR solutions with traditional antivirus isn't technically feasible at scale. Given the commoditization of these replacement players and technical limitations of their solutions, we do not intend to follow this trend. Guidance will continue to focus on our leadership position in true EDR, where we see sustainable value.

Guidance Software continues to build expert technology that scales through hundreds of thousands of endpoints with real-time monitoring, surgical remediation, Cloud and IoT support, anomaly detection for outside intruders and insider threats, all while maintaining laser focus on forensic integrity. Confirming our view is the addition of another million endpoints this quarter, bringing our total endpoint scale to more than 34 million. It is true that the antivirus total addressable market is large. It is also largely commoditized. Our hypothesis that spending would shift to rapid detection and response is playing out. Our view that forensic integrity is essential to overcoming real cybercrime is a fact. Our early consideration for privacy's implications on security software already helped us secure several wins.

We are fully committed, the Company, to cybersecurity, our leadership in EDR and our forensic security suite for all these reasons. I am very confident in our future.

Barry, can you share your thoughts on the quarter and the 2017 operating model?

Barry Plaga:

Thank you, Patrick. My prepared remarks today will focus on our third quarter performance and realignment efforts, as well as an update to our outlook and guidance for the remainder of fiscal 2016. I will also preview our 2017 operating outlook before opening the call up for questions.

Turning now to our third quarter results, our third quarter revenues were $27.7 million, up slightly compared with the prior year. This quarter represents our third sequential quarter of year-over-year revenue growth, a signal of the ongoing strength and momentum we are achieving through our focus on cybersecurity.

Total product revenues were $9.6 million, compared to $7.8 million in the third quarter of 2015. The growth in product revenue was once again driven by an increase in sales of our forensic security suite of products, supported by our continued focus on pricing and the strong performance of our core forensic products.

As Patrick mentioned, we saw solid enterprise software bookings in the quarter, primarily attributable to the forensic security suite. In the third quarter, EnCase Endpoint Security grew 193% and our average selling price was $82,000, up over 80%, compared to the third quarter of 2015. In fact, during the third quarter we doubled the number of deals over $250,000, compared to the prior quarter.

Gross margin on product revenue in the third quarter was 73%, compared to 68% in the prior year period.

Services revenues were $7.8 million, compared to $9 million in the year-ago period. Gross margin on services was flat year-over-year at 37%. The year-over-year decline in services revenue was consistent with our internal business model, as we continue to focus on product revenue generation and driving revenue through our channel.

Maintenance revenues, which represent our recurring revenue stream, were $10.3 million, up 3%, compared to the prior year. Gross margin on maintenance revenues was 95%, in line with historical periods. The increase in mix of our enterprise security revenue drove a four-point overall gross margin improvement in the quarter, to 71% versus 67% a year ago.

Research and development expenses were 20% of revenues, selling and marketing expenses were 38% of revenues, and G&A was 10% of revenues. One-time items in the quarter included $1.2 million of contract expense related to cash received from the settlement of an indemnity lawsuit related to the MyKey litigation. We also incurred approximately $400,000 in realignment expenses related mostly to employee severance.

For the quarter, non-GAAP net income was $200,000 or $0.01 per share, as compared to a non-GAAP net loss of $900,000, or a $0.03 per share loss, in the prior year.

Turning to the balance sheet and some related metrics, cash and cash equivalents as of September 30 totaled $11.7 million, as compared to $19 million at December 31, and $18 million last September 2015. Cash used in operations for the third quarter was $5.6 million, compared to cash used in operations of $2.6 million in the prior year period.

Now, I would like to take a few minutes to discuss our business outlook and the steps we are taking to achieve our plans.

I echo Patrick's sentiments of confidence in the future of our Company. As Patrick mentioned, the forensic security suite continues to make up a majority of our enterprise revenue and we feel strongly that the future guidance will be driven by growth from enterprise software and our forensic security suite. We are more competitive than ever, with a growing customer base and new and innovative products, and we remain focused on growing our leadership position in the EDR market.

In conjunction with this business transition into security, we felt that it was an appropriate time to restructure our model, to better align the cost structure of our Company. Part of these restructuring efforts included a significant reduction in our workforce over the past nine months and in the fourth quarter. We do not take these actions lightly due to the impact on our employees, but we believe it is necessary to enhance our overall operating efficiencies and long-term profitability.

On our Q2 earnings call, we announced expected expense reductions of $2.5 million to $3 million for the second half of 2016. We reduced expenses by approximately $2 million by the end of Q3, and have further accelerated and increased our expected expense reductions for the remainder of the year, resulting in an updated full year 2016 financial outlook.

For the full year, we continue to anticipate that revenue will be in the range of $108 million to $112 million, and we remain on target to be non-GAAP EBITDA positive in the second half of 2016. We also expect our leaner cost structure to significantly improve our bottom line for the full year 2016, and are further updating our expected non-GAAP EPS loss to a range of $0.07 to $0.10 per share from our previous range of a loss of $0.21 to $0.25 per share.

Our realignment efforts will continue to yield positive results in the coming year. Looking ahead to fiscal 2017, our outlook remains strong. We expect our 2017 revenue will grow to a range of $112 million to $118 million, with a non-GAAP EBITDA margin of 8% to 10% and non-GAAP earnings per share in the range of $0.28 to $0.36 per share.

In the supplementary slide deck available on our website, we outline the guidance mentioned above for both 2016 and 2017.

We expect the cost reductions to result in an improvement of 1% to 2% in gross margin and operating margin gains of four points to six points from sales and marketing, three to four points from R&D, and two points from G&A.

Thank you for your time today, and with that, I'll turn the call back over to Rasmus.

Rasmus Van Der Colff:

Thanks, Barry. Before going to Q&A, I'd like to mention that the Company will be participating at the ROTH Technology Corporate Access Day on November 16 in New York. We hope to see many of you there.

With that, Operator, please open the call for questions.

Operator:

Thank you, sir. We will now be conducting a question-and-answer session. If you would like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment while we pull for question.

Our first question today comes from Kevin Liu of B. Riley & Co. Please go ahead.

Zack Cummins:

Hi, good afternoon. This is actually Zack Cummins in for Kevin today. I just want to start off by saying congrats on a good quarter. Just starting off with some of your restructuring actions, can you go more into detail on kind of the specifics for what's going to go on in this restructuring and kind of how you're projecting your cost savings for Q4 and for FY '17?

Patrick Dennis:

So, why don't I start with, Zack, kind of what we're thinking in concept and then maybe I'll let Barry take you through some of the more specific numbers and see if there is places you want to dig in. Of course, give our best to Kevin. I appreciate you guys dialing in today. So, like we said in some of the prepared remarks, we've known that we were going to pivot this business towards cybersecurity for some time now. As with any change, we wanted to make sure we took the right actions to understand the baseline of performance we would get out of the business as we completed that pivot.

You know, as you know, and maybe some folks on the call don't, we've had a few quarters now really kind of solid execution in and around that cyber business, and we felt like now that we have a better profile of that business and our growth businesses, we could be a bit more particular about pulling in and tightening up the cost structure around some of our lower growth areas. So, kind of phase one was let's pivot the Company, phase two was let's align the cost structure based on that pivot, and now we're kind of into phase three, where not only is that cost structure having been aligned to the strategy, but we're actually digging in underneath it and getting leaner, and that's where you're starting to see some of these improvements. Now, they affected, and have affected, both the R&D, the sales and marketing and the G&A lines, and I think if you look at anyone of those lines you start to pull in two places, where we compare favourably to similar sized software companies.

So, I think there's a lot of evidence in and around this restructure that we did it from a position of strength, we did it based around the core strategy to pivot into cyber, and we did it in such a way that we can maintain what feel like the right spending levels for a company this size with this growth profile. There's some timing related issues as to when these expenses kind of really start to show through in the model, and that was one of the reasons that Barry and I thought that it was important not only to kind of give you Q3 and Q4 visibility, but also start to let you see what we think '17 could look like.

Barry, are there specific financial bits there you think would help Zack?

Barry Plaga:

Sure. So, if you look at what we discussed back in July, we said we were making a restructuring effort and some of those results and savings would flow through in the back half of the year. We were kind of expecting savings of $2.5 million to $3 million. I don't want to say we accelerated, but we kind of moved up some additional cost savings into October and November, which are going to benefit Q4 even a little more, so we should see over $3 million in back-half savings when you add up those two quarters.

Then, you look at how we go into 2017 and where do the costs come out. We're expecting about a one- to two-point increase in our gross margin, and that's going to be due to a higher software mix. We're looking at four to six points out of the sales and marketing line. If you look at the beginning of the year, we kind of peaked in our sales and marketing costs, in terms of number of headcount, because we kind of had to have two groups going on at the same time as we brought one new group in and shifted out the other. Then, in G&A, we're taking one to two points out of there, and then, finally, about three to four points out of R&D. Now that we have gotten pieces of the big product endeavor out the door in terms of Risk Manager, the new Endpoint Investigator, and the new enhanced agent, we're able to kind of streamline some of the operations in our R&D organization.

So, hopefully, that's helpful.

Zack Cummins:

That was great, that was really helpful. So, since you're stripping out all these costs going into 2017, can you talk a little bit about your visibility for revenue growth in '17, and how confident you are that you can still maintain this growth trajectory with the cut-back in expenses?

Patrick Dennis:

Why don't we actually do this one in reverse? So, Barry, why don't you cover for Zach kind of how you profiled in the model the growth and then I will layer on some of the reasons why we feel like we're confident about '17.

Barry Plaga:

Yes. So, we look at our pipeline and activity related to our reps and our sales force, we kind of layer on what they are selling and what we're doing with the products next year, what's going to come out, et cetera. In addition to that, we kind of look at where we were from a growth perspective in our different markets, and this year, year-to-date, you know, we've grown our Endpoint Security business faster than the market, so we've tempered that a bit into 2017. We still think we can exceed the market rates, but we don't have the very large ones we had this year, just from a conservatism standpoint.

Then, we've seen our services business start to stabilize. We saw some declines this year. That was planned, in terms of how we were shifting deals to the channel and assuming they were going to take on some of the services work, so that's been going as planned, and I think that's levelling out to where we'll see some modest services growth next year and it won't be a drag on the product revenue.

Then, in addition, now that we're getting some healthier deal sizes, we expect our maintenance renewal rates to increase, again, due to larger deal sizes. The bigger the investment, the customer mix, the more they're willing to keep that maintained and renew their maintenance each year, because they're very dependent upon the products, and so we should see some growth in our maintenance revenue line item for the first year next year, in a couple of years.

Patrick Dennis:

If we kind of layer on kind of the sales force metrics that go along with this, let me call your attention to the fact, you know, we continue to see these ASPs move in a very healthy direction. We're trying to give you visibility into the fact that the deal sizes in excess of $250,000 are doubling, and this isn't the first quarter where we have said that. We're demonstrating success in security and with security comes higher deal sizes on its own, and now that the full suite of products is starting to sell—and we gave you some examples of this today—you're starting to see the cross-selling activity that's going to allow us to really take the 78 of the Fortune 100 that we've captured and half of the Fortune 500 that we've captured, and continue to push down with strong cross-sell activity across the rest of the forensic security suite.

So, we feel like we've made the right changes in the sales force to get positioned to sell enterprise software. We made the right changes in the product portfolio to allow us to sell a suite of products. We price to market. Those prices are holding and we're not seeing unusual discounting. We built a channel distribution mechanism underneath the model and we layered on technical alliances. One of the examples today was with kCura and Relativity, that's going to bring even more value to our clients. So, we feel really good about how both the technology and the sales force are positioned as we enter '17.

Zack Cummins:

Great, that was extremely helpful. So, congrats again on the quarter and I will go ahead and pass the line.

Patrick Dennis:

Thank you.

Operator:

The next question comes from Michael Kim of Imperial Capital. Please go ahead.

Michael Kim:

Hi, good afternoon, guys. With the pivot to cybersecurity and the growth in endpoint, can you talk about if some of the new enterprise wins have been enterprise-wide, or is it typically starting in a division and opportunity to expand that deployment over time and penetrate that customer?

Patrick Dennis:

That's a good question. It's good to hear from you, Michael. You know, I think the easiest thing to point to, to demonstrate what we've been doing, is actually endpoint growth. So, when we are adding a million endpoints a quarter, that's coming from substantial transactions. I know that there have been other software strategies used, where people close relatively modest-sized transactions and then go back and up sell, and, sure, we do some of that. It's not our preferred setting motion. It is not unusual—and, certainly, in the transactions we listed on the call today, there are examples of this. It's not unusual for us to take down 50,000 or 100,000 endpoints in a transaction, and when you start to get to the largest transactions in the quarter, you're starting to think about transactions that can include up to half a million endpoints on their own.

So, we've really been focused on covering an entire estate for our customers. We've had some success there. Part of that has come from the coordination of our global account program on the go-to-market side, and some of that has been because of the development efforts from R&D, where our core agent technology is just so reliable, we have customers that are running it at massive scale with confidence day in and day out.

Michael Kim:

Great, and to your point earlier, I think some of the enterprise customers view endpoint more as a compliance sale than a real security sale, just given the shortfall of legacy solutions. How are you kind of carving out budget? Do you think it's incremental, discretionary, or is it part of the existing endpoint security budget?

Patrick Dennis:

That's a really important question. Here's what I know. There is budget in antivirus today that's being displaced because it's ineffective and it's low value, and the next budget that's ineffective and low value is DLP, and we're going to take those dollars and we are going to move them into endpoint, as customers realize that they have to have a rapid detection and response capability, given the complexity of these attacks. I have never been a fan of the it's-not-if-it's-when line. I think that what we probably should be more focused on is the fact that we need to operate in a state where we're prepared to manage security operations up to and including attacks day in and day out. Most of our customers realize that at this point, and so they're shifting spending towards us. I believe that that spending is mainly coming at the expense of antivirus and DLP.

Michael Kim:

Then, just with regards to your partnership that you announced with Outlier, do you see managed services as a channel where you can continue to leverage your capabilities beyond professional service to also some of your endpoint technology?

Patrick Dennis:

I think that the managed service offer is an important offer for both a security consumer and for Guidance Software as a supplier of software to those customers. DarkMatter is one example of a channel that we could build a service distribution model with. There are others. When we talked about the Bell Canada win today, that's an example of where they use our software in a service delivery model. We'll continue to explore that market and that opportunity, and just so I'm explicitly clear, we'll explore it through partnerships and by developing relationships with those service providers. That's not a capability we plan on developing ourselves.

Michael Kim:

Got it. Great. Thank you very much.

Patrick Dennis:

Good talking to you.

Operator:

As a reminder, if you would like to ask a question, please press star, then one on your telephone.

There appear to be no further questions at this time. I would now like to turn the floor back over to Rasmus Van Der Colff for any closing comments.

Rasmus Van Der Colff:

Great, thank you, Operator. That concludes our call for today and we'd like to thank everybody for joining us. Thank you.

Operator:

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