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Guidance Software, Inc.

First Quarter 2016 Earnings Call

May 5, 2016

CORPORATE PARTICIPANTS

Rasmus Van der Colff, *Vice President, Finance and Chief Accounting Officer*

Patrick Dennis, *President and Chief Executive Officer*

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CONFERENCE CALL PARTICIPANTS

Kevin Liu, *B. Riley & Co.*

Michael Kim, *Imperial Capital, LLC*

Ben Klieve, *Noble Financial Capital Markets*

PRESENTATION

Operator:

Greetings and welcome to the Guidance Software First Quarter 2016 Earnings Conference Call. At this time, all participants are in a listen-only mode. A 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.

I would now like to turn the conference over to your host, Rasmus Van der Colff, Vice President of Finance. Please go ahead, Sir.

Rasmus Van der Colff:

Good afternoon and welcome to Guidance Software's First 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, May 5, 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 reconciliation of these non-GAAP financial measures to the most directly comparable GAAP results, which can be found in today's press release and on Guidance Software's 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 First Quarter 2016 Earnings Conference Call. On today's call, I will discuss highlights from our financial performance for the first quarter and provide an update on the progress we are making on the strategic plan and sustainable growth. Following my remarks, Barry will take us through the first quarter financial results in more detail. After that, we will open the call for questions and answers.

Most importantly, after a strong finish to 2015 that included fourth quarter revenue and non-GAAP EPS exceeding the high end of our guided range, we maintained our momentum in 2016, delivering excellent results in the first quarter. Total revenues were $25.8 million, ahead of analyst consensus expectations for the quarter and we grew 3% on a year-over-year basis. In fact, we delivered first quarter year-over-year revenue growth for the first time since 2013.

This is all evidence that the strategic plan is taking hold and that we are continuing to refine our product engineering and go-to-market execution engines. This is all accomplished during a Proxy Contest, which was launched in February and ultimately settled. We believe this settlement serves the best interest of the Company, our stockholders, customers, partners, and employees. Let me assure you that the team at Guidance remains 100% focused on executing our strategic plan.

In the event you have not read our full statement about the settlement, here are the most important details of that agreement. Shawn McCreight and Chris Poole have resigned their Board positions. The Company has appointed two of Mr. McCreight's nominees, Michael McConnell and John Colbert, to serve as new Directors. Mr. McCreight has agreed to vote in favor of the Company's slate of directors at the Annual Meeting. The litigation between the Company and Mr. McCreight has been dismissed. Mr. McCreight and Mr. McConnell have agreed to a standstill extending through the middle of January 2018.

We are glad to have this matter behind us so we can continue building on the positive momentum in our business since late last year. This momentum isn't just isolated to our financial performance. We have made tremendous progress in our product engineering organization, which is more productive than ever. This team is developing 30% more code every quarter than they did last year, all at improved quality levels. The faster velocity of new product releases has resulted in growth in demand for our security products, improved renewal rates, and improved customer satisfaction. This coupled with the continued improvements to our channel distribution strategy and our new global account program, all contributed to our strong first quarter performance.

We are especially pleased with the commercial revenue driven from our Forensic Security Suite. This suite of purpose built and packaged products includes EnForce Risk Manager, which was announced in Q1 and is available for revenue beginning in Q2, and EnCase Endpoint Security, which drove our security growth in 2015, and EnCase Endpoint Investigator, which brings our proven forensic technology into the commercial cyber security marketplace. This product suite allows Guidance to bring best-of-breed products to our customers and sell a broader set of solutions into the high growth cyber security market. The performance of our Forensic Security Suite is an important measure of our strategic plan's progress.

In Q1 '16, 60% of revenue came from the Forensic Security Suite, up from 30% in the year prior. Additionally, the average deal size doubled between Q4 and Q1. I would like to remind you that Q1 did not include EnForce Risk Manager revenue, which we expect to begin having an impact in Q2 and in the second half of the year.

Our solutions continue to satisfy our customers. Here are some of the key wins and highlights from Q1 that demonstrate forensic security is a real customer need. We had EnCase Endpoint Security wins at General Motors, Wynn Resorts, US Immigration and Customs Enforcement, and USCENTCOM. In addition, we extended our deployment at Thales, a Fortune 500 company and one of the world's leading aerospace defense and security companies who purchased Endpoint Security for new European deployments. I would also highlight that GM invested in EnCase Endpoint Security because the universal agent works across the full suite of products with best-in-class visibility.

I have previously commented on the intersection of cyber security and traditional forensics as an emerging trend. Our EnCase Endpoint Investigator Q1 results demonstrate this trend is real. We secured important wins with companies like Sony, Procter & Gamble, and one of the world's top 10 banks. To use Endpoint Investigator, the bank will deploy our universal agent to more than 400,000 notes across all employee and server systems. This win highlights that the universal agent creates a natural on-ramp for future Endpoint Security and EnForce Risk Manager sales as the bank upgrades to the full suite overtime.

We also announced the brand-new EnForce Risk Manager in February. This is the only purpose built product of its type in the world. EnForce Risk Manager helps organizations identify, classify, and remediate sensitive data based on their own information security policy. Performing these steps reduces an organization's overall information risk profile and makes it more difficult for an adversary to compromise or acquire their critical information. We think of this as reducing the information attack surface area. This approach also aligns with the most modern data protection mandates and global regulations. This product is definitely fulfilling a real customer need. In a survey we conducted with 580 organizations, 60% felt that they did not have well-established solutions to address data privacy and risk requirements, and approximately 85% felt this issue was a priority and 46% felt it was a top three initiative this year.

Seventy five percent of all demonstrations we provide result in a request for a budgetary quote. All the Forensic Security Suite products were refreshed during Q1. EnForce Risk Manager was available to a limited number of customers, EnCase Endpoint Security shipped version 5.12, which fixed (phon) enhancements as we previously announced. EnCase Endpoint Investigator shipped version 7.12 with several improvements inherited from its EnCase Forensic sister product.

We remain committed to delivering new software capabilities every quarter. In Q2, we will be releasing EnForce Risk Manager version 1, Endpoint Investigator version 8, and Endpoint Security version 5.13. Endpoint Security 5.13 will include our latest innovation in real-time monitoring. This technology automates the process digital forensic incident response experts use to establish a chronological view and understanding during the incident response investigation of endpoints. This capability is more scalable and more efficient than Carbon Black's continuous monitoring, and it offers deeper and more comprehensive system visibility than Tanium. We think it's a smarter, more efficient way to secure endpoints.

The release will also contain additional detection and response improvements for searching memory, locating anomalous connections, and identifying suspicious DLLs. The Endpoint Security roadmap is aligned to the increasing customer demand and spending for rapid detection and response solutions that Gartner highlighted in their January Endpoint Report.

Like Gartner, we continue to see spending shift for rapid detection and response solutions like ours. Within our classic forensic business, we also released EnCase Forensic 7.12. This version also provided law enforcement, government, and enterprise investigators with enhanced system support, investigative capabilities, and reputation lookup. The reinvestment in the classic EnCase Forensic products was aligned to an outbound customer upgrade program. This program was targeted at moving EnCase version 6 customers on to the version 7 platform and the associated roadmap.

We are pleased to report that in Q1, we achieved the highest forensic renewal rates in seven quarters. We should also acknowledge the strong sales execution from our forensic sales organization, who grew new license revenue double-digits in the quarter. We have unquestionably reestablished our commitment to the investigative community. This quarter we will be releasing EnCase Forensic version 8 at our upcoming Enfuse Conference in Las Vegas. I will refrain from spoiling the excitement of that announcement, and as always, we would enjoy hosting you at that event if you are able to attend.

We also continued to mature the global go-to market model during Q1. We achieved our targeted channel sales equilibrium in Q4 and carried it into this quarter. I would also like to draw your attention to the recent announcement of our new partnership with Arrow Electronics. Under the agreement, Arrow's Enterprise Computing Solutions business will distribute Guidance Software Security products. Arrow joins Westcon and immixGroup as our primary distributors for the North American market.

In the global markets, we added distribution through EliteVAD and Vision Valley supporting the Middle East and Africa. This also resulted in the addition of value-added resellers in the region like Fireware and Alive (phon) Technology who secured business at Abu Dhabi Aviation with our EnCase Endpoint products.

We feel that we have established a global distribution capability on which we can scale global selling capacity. I should also point out that our Global Account Program is gaining traction. In Q1, the accounts that are part of this program contributed approximately 40% of new license revenue. We are pleased with the progress we are making in both the channel and global account programs and expect this to continue throughout the year.

In conclusion, we are continuing to show progress against all elements of our strategic plan. I am confident that our product engineering organization will continue to deliver world-class products. I am confident that our sales organizations are well-positioned to compete and win cyber security business. Finally, we are all confident that we can drive year-over-year growth for the first time in three years.

Now I'd like to turn the call over to Barry to cover the financials and share his thoughts on the first quarter financial results in more detail. Barry?

Barry Plaga:

Thank you, Patrick. In my section, I will focus on two areas. First, I will cover our first quarter 2016 performance in more detail and second, I will cover our outlook and guidance for the year. Our first quarter revenues were $25.8 million, an increase of 3% from $25 million in the prior year. As Patrick mentioned earlier, Q1 2016 was our first year-over-year growth in Q1 since the first quarter of 2013. Although a modest growth amount in percentage terms, it gets 2016 off to a good start despite the distractions during the first quarter.

In addition, Q1 revenues exceeded analysts' consensus expectations and were on the high-end of our preannounced results. Total product revenues were $7.5 million compared to $7.1 million in the first quarter of 2015. The increase in product revenue was primarily driven by strong performance in our forensic products. Importantly, as a result of our increased focus on delivering quarterly content updates to our security product line, 60% of Enterprise Software sales were attributed to our Security Software Suite, up from 30% in the same period last year. We are extremely pleased with this performance and we will continue to report on this metric going forward.

I would like to highlight some geographic performance, which is the direct result of our go-to market strategy. In EMEA, our Endpoint Security products contributed to our improved product revenues, with commercial bookings in EMEA up 20% year-over-year. Additionally, our Global Account Program accounted for almost 50% of EMEA commercial bookings in the quarter. In our North America commercial software business, bookings through the channel in the first quarter grew 22% year-over-year.

Gross margin on total product revenue for Q1 was 74%, in line with the fourth quarter of 2015 and down slightly from 76% in the prior-year period. Services revenues were $8.5 million compared to $8.2 million in the year-ago period. Incident Response Services continued to show its strength, which is due to an improved coverage model. Customers are now demanding both incident response service solutions as well as software solutions for incident response forensic investigations and data risk management.

Gross margin on our Services business was 41% in the first quarter compared to the 28% in the prior year. Maintenance revenues, which represent our recurring revenue stream, were $9.8 million, consistent with the prior year. Renewal rates continued to be strong during the quarter. This quarter we had the highest forensic maintenance renewal rate since the second quarter of 2014.

Our gross margin on maintenance revenues was 94%, in line with historical periods. Then our total gross margin increased to 70.9% in Q1 versus 67.7% in the prior year. To support the growth in our plan, our expenses will increase in 2016. To achieve higher growth rates, especially in security, we need to increase our investment in the channel, in our marketing and in our new product releases.

Research and development expenses were 21% of revenues, selling and marketing expenses were 35% of revenues, and G&A was 19% of revenues.

Non-GAPP net loss for the first quarter was $2.2 million or $0.08 per share as compared to a non-GAPP net loss of $1.6 million or $0.06 per share in the prior-year period.

Turning to the balance sheet and some related metrics, cash and cash equivalents as of March 31 totaled $20.4 million, as compared to $19 million as of December 31 and $24.4 million as of March 31, 2015. Cash flow from operations for the first quarter was $2.3 million compared to $5.8 million in the prior year. The decrease in cash flow year-over-year was primarily related to realignment costs of $2.2 million, $700,000 in proxy contest expenses and $1.1 million in non-executive incentive compensation. In terms of total expenses related to the proxy contest, we expect to incur an additional $1.2 million including payments of expenses on behalf of our dissident shareholder of $650,000 in the second quarter of 2016.

Now, I'd like to discuss our forward-looking guidance. We are returning to our format of providing full year guidance and then updating such each quarter. For the full year, we anticipate that revenues will be in the range of $108 million to $112 million, with the non-GAAP EPS loss of $0.36 per share to $0.30 per share. Here are some items I'd like to note relating to that annual guidance. First, we are in a transitional year. We've restructured our go-to-market channel and Global Accounts programs, we restructured our product development organization, we've revised our pricing structure, and we've weathered the removal and proxy fight against our founder, all in the first quarter of this year.

Second, while we are guiding modest growth of 1% to 5% for 2016, please recognize this will be our first growth year since 2012 and that specific year was impacted by significant acquisitions. Third, we expect our security suite of products to dominate commercial bookings by year-end. Despite the transitional nature of the items I just mentioned, we posted a strong bookings growth in our security product suite and one-third of that suite, EnForce Risk Manager, was not available in Q1 for revenue, but will be in Q2 and the rest of the year. Fourth, with improved coverage model with the channel and with an improved focus on global accounts, we expect a meaningful increase in our average deal size, which in Q1 increased over 100% in the first quarter, and was within 5% of our average deal size in the first quarter of 2012.

In terms of P&L metrics for your models, we expect non-GAAP expenses as a percentage of revenues as follows. Overall gross margin of approximately 69% to 70% versus 68.1% in the prior year, research and development expense of approximately 20% to 21% versus 18.2% in the prior year, selling and marketing expense of approximately 37% to 38% versus 35% in the prior year, G&A expense of approximately 16.5% to 17% versus 15.3% in the prior year, and depreciation expense will be flat at approximately 4%.

In addition, we expect a fully diluted share count of 28.8 million shares and income tax expense of $300,000 for the year. For seasonality, we expect the second half of the year to be stronger than the first half as is our historical norm. Finally, we expect our market segments to play out as follows in 2016. Security will grow to 37% to 38% of revenues, up from 30% in 2015; forensics will stay flat at around 31% to 32% of total revenues; and e-discovery will decline to 31% to 32% from 39% in 2015.

Now, I will hand the call back over to Rasmus.

Rasmus Van der Colff:

Thank you Barry. Before going to Q&A, I'd like to again mention our upcoming Enfuse Conference in Los Vegas during the week of May 23. We hope to see many of you there as well as at the B. Riley Investor Conference in Hollywood on May 26, followed by the Benchmark Conference in Milwaukee in early June.

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

Operator:

Thank you. We will now be taking questions. 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 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 please while we poll for questions.

Our first question comes from Kevin Liu from B. Riley.

Kevin Liu:

Hi, good afternoon. First question here is just in terms of new channel partners like Arrow, can you speak to how long it takes a partner like that to ramp and then how material you feel that could become relative to your current channel partners today?

Patrick Dennis:

Yeah, sure, Kevin, how are you? So, you think about the distribution capability, we started off with a very, very well thought out plan on how we're going to build global distribution. You probably remember we started that conversation with you all last year and we're excited about adding Arrow and this new agreement with Arrow to that distribution capability because it gives us access to a substantial number of other value-added resellers domestically as well as it gives us access to some resellers who can help participate overseas. So the plan around the channel right now is for us to select a limited number of value-added resellers that will help us globally. You should expect that number to be somewhere in the neighborhood of five, then we'll select some national value-added resellers here in North America as well as a limited number in the other major worldwide geos where we have direct sales. Think of those as another five, five in North America, five in the core parts of Europe and the Middle East and Africa, and then we will pick up a set of roughly five core per geography where we have dense sales coverage. So that would add another 20 core partners here in North America and a smaller number than that in the other markets that we serve. So, the focus here is really, really high quality channel partners with deep relationships. Arrow also brings to the table a bigger capability in the government sector with immix where we've had some really good interaction and traction lately.

So when we talk about kind of layering in this global channel capability, it's built on top of distribution which we set up with Westcon and Arrow and it layers our top core value-added resellers that are going to participate in each one of our target markets based upon their respective capabilities either locally or across North America. As you might imagine, one of those key partners is going to continue to be Optiv. We really have had some great luck with Optiv lately. The Executive Team feels strongly that's going to be a great relationship for us this year.

Kevin Liu:

Got it. You guys mentioned a number of areas where you need to continue to invest over the course of the year, at this juncture, what are your thoughts for kind of a rough timeframe for when you can get to breakeven and—or at least start to show a little more leverage on the various operating expense lines?

Barry Plaga:

Yes, Kevin, I think if you look at our, kind of some of our historical performance where we achieved almost 10% to 14% EBITDA margins, our revenues were around $130 million. I think we can get to EBITDA breakeven in the $117 million to $118 million in revenue range and we should see some significant leverage on revenue on top of that going against G&A, sales and marketing, and R&D. But if you look at what's going to go into the sales mix there to drive that, it's going to be primarily software, which is going to generate a higher gross margin overall and that should get it to the mid-70s to upper-70s over time.

Kevin Liu:

Understood and just lastly in terms of the EnForce Risk Manager introduction, you talked about some initial sales here in Q2; can you give us a sense for how large these deals are relative to the other products in the cyber security suite today?

Patrick Dennis:

Yes, absolutely, so, these are going to be six and seven figure transactions.

Kevin Liu:

Alright, that's all I had. Congrats on a good start to the year.

Patrick Dennis:

Thank you.

Barry Plaga:

Thanks Kevin.

Operator:

Thank you. Our next question comes from Michael Kim from Imperial Capital.

Michael Kim:

Hi, good afternoon guys. Can you talk about the pipeline opportunities on the Endpoint Security side and specifically if you can talk about your head-to-head win rate if you can describe that?

Patrick Dennis:

We've never really done that head-to-head win rate thing, because one thing we do find is oftentimes people wind up with more than one product purchased and that remains true today. Oftentimes, people procure both what I'd consider prevention technology and then they wind up also procuring rapid detection and response technology like ours. That said, more and more often customers are selecting our Endpoint Security technology, and there certainly is more momentum as I sit here in this chair today than there has ever been on that front and the wins are more substantial and with, as we talked about on this call, globally recognizable brands. So lots of strength in Endpoint Security. Broadly speaking, we do see customers shifting, they're spending towards rapid detection and response as there appears to be broad acknowledgement that prevention solutions just aren't getting the job done fully and completely. So with a much higher level of complexity in the attacks and the larger number of attacks the customers are seeing, and many of our customers are seeing sophisticated attacks to the tune of several a week. People are investing in rapid detection and response capabilities because it only takes one of those attacks being successful for a breach to occur of consequence. So I see an awful lot of customer demand, more intense focus on this part of our business than ever before, and then also broadly speaking, recognition that cybercrime is just a crime and there appears to be a renewed interest in this community about taking it very, very seriously, now that the costs are so high for organizations, and frankly security is getting in the way of many companies' digitization initiatives. So lots of customer demand, I feel we compete favorably when we have to for a budget dollar with both Tanium and Carbon Black, and we don't measure the win rates discretely that way. We have some strength there that is certainly better than it's ever been.

Michael Kim:

Is it your sense that some of that Endpoint Security budget is coming out of AV and being redirected in your area?

Patrick Dennis:

Yes, that's exactly why I don't always think that it's a direct competition between, for instance, Tanium and ourselves that’s an important factor. I do think we are displacing budget dollars from AV, other things that people would have considered part of (inaudible) protection platform if you’re into the Gartner speak. I think that Risk Manager is going to start to eat away at DLP and software DLP. So what we really have built our strategy around is using the agent as a platform to consolidate on top of security capabilities of various types so that you can address the more full set of cyber security needs with one single lightweight agent deployment and that's going to come at the expense of anti-virus suppliers, software DLP providers. It's going to probably come at the expense of some of the investment that has previously taken place in network technologies. So I think that that's the more important way to think about the opportunity for the business than perhaps just the straight-up question of whether or not we are competing favorably with Tanium and, for instance, Carbon Black.

Michael Kim:

Got it and then just lastly on guidance, can you talk a little about the step down in e-discovery, is that a function of the market environment, competitive environment or conscious effort to reduce some of your investments in that area? Them maybe a more strategic question is how investors should sort of think about that business as a long term opportunity for Guidance?

Patrick Dennis:

Well, as you know, with our size, we have to be savvy about which markets we choose to invest in and we are very fortunate to be able to compete successfully in the cyber security market, and we all know that there are growth rates there that are very, very attractive. So to some extent, we have had to curtail some of the R&D investment that we would make in e-discovery, although we did it in a very thoughtful way. We spent time gathering information about how our e-discovery customers are really using e-discovery solutions, we spent time with Gartner and other analysts thinking about what the future of that market is from a technological point of view, and then we also thought about relative growth rate for that market. We drew to a conclusion that if we build really good search and collection capabilities into our products, we can satisfy many customers whom have purchased our e-discovery software overtime. That very search and collect technology is the underpinning, for instance, of EnForce Risk Manager. So, it may not be evident today on the roadmap that we are making investments in e-discovery as everyone has thought of e-discovery traditionally, we are making technological investments that are going to help our e-discovery customers transition into what we believe will be the next phase of search and collect, including search and collect that attaches to cloud-based services like Box and Dropbox. So we think that market is changing, we think that those needs are changing, we see evidence of that ourselves, we see evidence of that with Gartner and other analysts, and we think we've picked the right strategy of how to lay down our investment dollars to meet the needs of our customers over time.

Michael Kim:

Great, thank you very much.

Patrick Dennis:

Thank you.

Operator:

Thank you. Our next question comes from Mark Jordan from Noble Financial.

Ben Klieve:

Hi, this is actually Ben Klieve with Noble Financial filling in for Mark, and just have a couple of quick questions. First, I am hoping you guys can confirm that the—those proxy expenses of $1.2 million that you are projecting in Q2 that you are not projecting anything beyond that, beyond Q2 I mean. Second, I am wondering if maybe you can provide a little guidance on the reorganization expenses beyond this quarter and kind of what we can expect there?

Barry Plaga:

Yes, so in terms of the first piece around the proxy expenses, so we had $700,000 in Q1, $1.2 million is forecasted for Q2 and then there shouldn't be anything after Q2. So we have some—we are just reconciling out all those costs and adding in with our settlement with Mr. McCreight. On the restructuring charges, those were meaningful in Q1, it was primarily related to our go-to market restructuring, which we did in January, which we announced back then and then part of it was severance related to Mr. McCreight. So we have that behind us. There'll be small amounts in Q2, but nothing of a meaningful nature in Q3 or Q4.

Ben Klieve:

Perfect, thanks guys.

Patrick Dennis:

Yes.

Operator:

Thank you. At this time we have no further questions. I will turn the call back over to Rasmus for closing comments.

Rasmus Van der Colff:

Thank you. We'd like to thank everybody for joining us and we'll talk to you next quarter.

Patrick Dennis:

Thank you.

Operator:

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