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GUID - Q3 2014 Guidance Software Inc Earnings Call

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Mark Schappel *The Benchmark Company - Analyst*

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PRESENTATION

Operator

Good afternoon, everyone, and welcome to Guidance Software's Q3 2014 earnings results conference call. After comments by management, we will go directly to a question-and-answer session. As a reminder, this call is being recorded.

At this time, for opening remarks and introductions, I would like to turn the call over to Rasmus van der Colff, Vice President, Finance and Chief Accounting Officer. Please go ahead.

Rasmus van der Colff - *Guidance Software, Inc. - VP of Finance and CAO*

Thank you. Good afternoon, everyone, and thank you for joining us today to discuss Guidance Software's third-quarter 2014 results. With me today are Shawn McCreight, our Chairman of the Board and CTO; and our interim CEO and current 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 provisions 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 6, 2014. And Guidance 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 our website.

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

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

Shawn McCreight - *Guidance Software, Inc. - Chairman of the Board and CTO*

Thanks, Rasmus. Good afternoon, everyone. I just wanted to say a few words and then hand the call back over to Barry.



First, the Board and I would like to thank Victor for his 11 years of service to the Company. Victor led us from our days as a small forensic software company to a Gartner Magic Quadrant leader in eDiscovery. He also began the push into Security Products all the way back in 2009 when we released our first version of EnCase Cybersecurity. The Board deliberated at length over this change, but we recognize that new leadership is needed to complete our mission of becoming a leading security software company.

We also know that Barry Plaga is the right person to take over the helm. Barry, our CFO for the past six years, is a trusted and seasoned executive. Barry has his own ideas of how to move our Company to the next level, and I look forward to seeing us get stronger and more nimble under his leadership. Although we are going to open up a search, we feel that Barry has the leadership qualities and the organization skills necessary to make Guidance a leader in the security space, and to drive the revenue growth and profitability that our shareholders expect.

Finally, I would like to emphasize to you how excited I am about the prospects for the upcoming release of EnCase 8. Combining the power of big data storage with the ease-of-use of our patent-pending link review technology, I expect EnCase 8 to be a game-changer for Guidance Software and for our customers.

Now let me turn the call back over to Barry.

Barry Plaga - *Guidance Software, Inc. - CFO and Interim CEO*

Thank you, Shawn. I'd like to thank Victor also, as he and I worked closely together over the past six years. Given the circumstances in the past 24 hours, I'd like to focus my comments on a few key topics, all of which confirm that our mission and our strategy is still crystal clear.

These topics include -- one, our transition from forensic and eDiscovery to the broader security markets, and in doing so, becoming the clear leader in endpoint security. And two, driving sales and marketing efficiency around the globe to contribute to consistent double-digit product revenue growth and bottom-line profitability.

We know our investors, including Shawn, have been frustrated with our performance over the past several quarters. We will endeavor to be more transparent about our progress with our security initiatives, because, from the outside, it is sometimes difficult to assess whether we are making progress. As outlined in our earnings release today, our Cybersecurity business in particular has been making great progress.

In Q3, we added 49 new cyber customers and 27 new analytics customers. Our Cybersecurity product revenue has grown close to 90% this year -- yes, 90%, albeit on a very small base right now. I will continue to share this statistic with you as we move through the transition.

But despite this great growth in security, the question remains, why are we not growing? Well, we have three distinct headwinds that, until security becomes a larger share of the product revenue, will continue to dampen our growth prospects in the short-term. These three headwinds are -- first, penetrated forensic business and our law enforcement customer base that is growing at a slow rate; second, a small addressable market in the eDiscovery market, where most large Fortune 1000 companies have already made a decision on what product to use. In addition, the eDiscovery market is currently moving downstream with small and medium-size businesses where the price points are much lower than they were three or four years ago.

In addition, our declining SaaS hosting business, which again is eDiscovery-related, is subject to the same market issues as our eDiscovery product. Unfortunately, our SaaS acquisition did not pan out as we expected, and we found that customers are very sticky. So sticky, in fact, that it is a challenge to pry them away from their current provider.

The third headwind we face is our federal business, which was subject to large deal risk and revenue lumpiness. Given our performance in Q3 in the federal sector, I think we have eliminated most, if not all, of that risk now.

I believe we sold eDiscovery to the federal space very effectively over the last six years. On the upside, we have not penetrated that large addressable market in Cybersecurity at all, and we are confident that Version 8 of EnCase will drive customers to our security offerings, especially in the federal sector.



Let's talk about some positives, despite these aforementioned headwinds. We added 247 new customers on our Enterprise products in Q3, and 724 through the nine months ended September. And we are on track to achieve our goal of 1,000 customers for 2014.

As I mentioned, we added 49 new cyber customers and 27 new analytics customers. I'd like to note that in any given year, our total cyber customer adds have only been in the 50 to 60 range; and now we are closing that many in one quarter. As noted, our security-related product revenue has grown 90% nine months to date. And excluding federal, our Enterprise product bookings were up 22% year-over-year in Q3.

We continue to launch new product offerings with our technology partners, including HP ArcSight and Blue Coat, and our tableau product line bounced back dramatically in Q3, and benefited from the new offerings that it released during the September quarter.

Now let me turn the call over to Rasmus to go into the specific financial results.

Rasmus van der Colff - *Guidance Software, Inc. - VP of Finance and CAO*

Thank you, Barry. Total revenues in the third quarter of 2014 were \$27.8 million, below our original expectations. Our product revenue line item includes revenue from Enterprise products, but also from our forensic software and hardware products. In Q3, total product revenue decreased slightly by 3% year-over-year, with Enterprise revenues down 16% year-over-year. That said, our forensic product revenues were up 8% year-over-year.

Continued weakness in our US federal government Enterprise business, with bookings down 39% year-over-year, masked the success we experienced in other areas of our Enterprise business. In Q3, we added 247 new customers on our Enterprise products, including 133 new Enterprise customers and 114 new eDiscovery Cybersecurity and Analytics customers, compared to 68 new customers, of which 51 were Enterprise and 17 eDiscovery and Cyber customers, respectively, in the prior-year quarter.

Enterprise bookings in nonfederal North America and international were up 18% and 47%, respectively. Subscription or SaaS revenues from EnCase eDiscovery Review for the third quarter was \$1.7 million, down from \$2.7 million in the last year. As mentioned on previous calls, we experienced a drop off of our law firm single-case type use of the hosting platform, which is normal, as cases do eventually settle.

Total services and maintenance revenues increased 5% to \$16.7 million the first quarter of 2014 versus \$15.9 million in the prior year. For Q3 2014, we saw an 8% year-over-year increase in maintenance revenues, while Professional Services revenue was flat year-over-year at \$4.2 million. Geographically in Q3, North America revenues comprised 78%, while EMEA represented 13% and the rest-of-world 9%.

Gross margin for the third quarter was 68% versus 67% in the prior year. Gross margin on product revenue was 74%, down from 78% in the prior year. Total services margin was 69% and increased from 62% in the prior year, due to continued strong maintenance renewal rates, along with higher utilization rates in our Professional Services and training organization.

Total operating expenses decreased year-over-year to \$19.2 million in Q3 from \$21.4 million in the prior year. The decrease was primarily due to lower R&D sales and marketing costs due to the cost reductions we initiated earlier in the year. As was the case for the six months of the year, we dramatically improved EPS year-over-year in Q3.

We are reporting a third-quarter 2014 net loss of \$180,000 or \$0.01 per share as compared to a net loss of \$2.3 million or \$0.09 per share in the third quarter of 2013. We ended the quarter with a solid balance sheet, with cash and cash equivalents at December 30 of \$15.6 million and no debt. Cash flow used by operations in Q3 was \$3 million compared to cash used by operations of \$1.1 million in Q3 of the prior year.

We expect our cash and cash equivalents to be in a range of \$14 million to \$16 million at the end of Q4, and to increase sequentially in Q1 of next year, due to collections of year-end renewals of some of our largest subscription and maintenance agreements.

With that, let me turn the call back over to Barry to discuss forward-looking guidance and conclude our prepared remarks.



Barry Plaga - *Guidance Software, Inc. - CFO and Interim CEO*

Hey, thank you, Rasmus. In terms of looking at forward-looking guidance, we are adjusting our 2014 full-year revenue guidance to \$109 million to \$110 million range, and our EPS guidance of a loss of \$0.17 to a loss of \$0.14 per share. While we are pleased with our Enterprise product revenue growth year-over-year of 31%, two of our business units are behind our expectations, namely our Forensic, Software Group, and our Professional Services Group. We do feel these things will bounce back quickly over the coming quarters.

Our transition strategy from a predominantly forensics and eDiscovery business to a more robust cybersecurity company is working. We are aware that this is taking longer than anticipated. And this year, we've built a good foundation on which to have success in 2015, 2016 and beyond.

With that, we'll give the call back to Rasmus to open the call for questions.

Rasmus van der Colff - *Guidance Software, Inc. - VP of Finance and CAO*

Thank you, Barry. Operator, please go ahead and start our Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Mark Schappel, Benchmark.

Mark Schappel - *The Benchmark Company - Analyst*

Thank you for taking my questions here. Just a couple of housekeeping items here. First, I didn't catch the cash flow from operations number in the quarter.

Shawn McCreight - *Guidance Software, Inc. - Chairman of the Board and CTO*

It was negative \$3 million, used by operations.

Mark Schappel - *The Benchmark Company - Analyst*

Okay. And the forensics revenue, what was the exact forensics revenue number in the quarter?

Shawn McCreight - *Guidance Software, Inc. - Chairman of the Board and CTO*

Forensic software was right around \$2.3 million.

Mark Schappel - *The Benchmark Company - Analyst*

\$2.3 million?



Shawn McCreight - *Guidance Software, Inc. - Chairman of the Board and CTO*

Yes.

Mark Schappel - *The Benchmark Company - Analyst*

Okay. And then I heard the new cybersecurity and analytics deals, how about the eDiscovery deals in the quarter?

Shawn McCreight - *Guidance Software, Inc. - Chairman of the Board and CTO*

We did 247 total. We did 133 new Enterprise, 38 new eDiscovery, 49 cyber, and 27 analytics.

Mark Schappel - *The Benchmark Company - Analyst*

Okay, 38 eDiscovery, thank you. And -- okay, I think Rasmus mentioned security-related product revenue was up a certain percentage year-to-date. I didn't catch that number; if I could get that repeated?

Shawn McCreight - *Guidance Software, Inc. - Chairman of the Board and CTO*

Yes. The nine-month year-to-date was up 90%.

Mark Schappel - *The Benchmark Company - Analyst*

9%, okay.

Shawn McCreight - *Guidance Software, Inc. - Chairman of the Board and CTO*

Ninety -- nine-zero.

Mark Schappel - *The Benchmark Company - Analyst*

Nine-zero.

Shawn McCreight - *Guidance Software, Inc. - Chairman of the Board and CTO*

Sorry, I enunciated that correctly.

Mark Schappel - *The Benchmark Company - Analyst*

Yes, a little bit of a difference there.

Shawn McCreight - *Guidance Software, Inc. - Chairman of the Board and CTO*

Big difference. And it's -- realize it's from a small base right now as we grow that business. That's an encouraging number in spite of being down overall year-over-year.



Mark Schappel - *The Benchmark Company - Analyst*

So, moving off of just some of housekeeping items, I know it's very early yet here, Barry, and -- but still I feel I have to ask. You mentioned some of the headwinds with the forensics side of the business, and that's been kind of a problem child for some time now. Also the old case central business. Is it fair to assume that these -- that you're looking at all options regarding these particular business units, including potential sales? Or divestitures?

Barry Plaga - *Guidance Software, Inc. - CFO and Interim CEO*

We don't really talk about those items, but the management team and the Board discusses the results of all of our business unit operations. And we do evaluate that on a regular basis.

On the forensics side, although the revenues were not excellent this year, it is in the fourth year of Version 7. And we need the new product cycle, and V-8 will reinvigorate that. I'd like to note that our law enforcement, and our site licenses in forensics that we have around the world, renewed at almost 100% clip. So, satisfaction in the use of product is still very wide, very deep in terms of law enforcement agencies, consulting agencies around the globe.

And it is one of the areas that generates a lot of cash for us, because it's more mature. Main in stream plus this product revenue is very strong for us.

Mark Schappel - *The Benchmark Company - Analyst*

Okay. That's all for me. Thank you.

Barry Plaga - *Guidance Software, Inc. - CFO and Interim CEO*

Thanks, Mark.

Operator

Sarkis Sherbetchyan, B. Riley & Co.

Sarkis Sherbetchyan - *B. Riley & Co. - Analyst*

Thanks for taking my question. So just to kind of go back onto the weakness in federal, given that you have guided conservatively from last quarter's call, maybe if you can give us some more color on the weakness that you are seeing?

Barry Plaga - *Guidance Software, Inc. - CFO and Interim CEO*

I think it's -- I think it's -- when I talked about on the call, our -- the headwind, I think we've pretty well-penetrated the federal space with our eDiscovery product. And as we look at cyber, you're going to say, oh, okay, why aren't they buying cyber now? I think it's an execution issue in that group, and we're not getting in front of the right customers at the right level.

So we've taken some actions again, and actually reappointed the person who was very successful running that group a couple of years ago. We sent him off to do other things. But we do feel that that's a valuable piece of our business; it will grow again. It has very good potential for us with our new products, especially in the Cybersecurity area where we are not that fully penetrated yet. And I'm confident he is going to lead that group back to success.

But in Q3 in particular, Sarkis, the pipeline and the close rate, the pipeline was pretty good and the close rate was pretty poor in our Q3 federal business. And we expected it to be much better, based on where deals were, et cetera. So some of those lift into the next year. And the problem with federal is you never know you're going to get those early in the year or is it all going to have to wait till September again when they redo budget?

Sarkis Sherbetchyan - *B. Riley & Co. - Analyst*

Okay. That color is helpful. And then just kind of transitioning into the forensics piece of the business. Was that kind of attributable to customers knowing that the new products were to be released soon? Or -- I mean, you kind of did mention there was some execution. But to just kind of get a little bit more flavor around that.

Barry Plaga - *Guidance Software, Inc. - CFO and Interim CEO*

Yes, we try to be very careful about how we talk about futures with customers, because we don't want to freeze them in a particular quarter or time period. I think that -- I don't think any of that occurred in Q3; I doubt any of it will occur in Q4. The risky timeframe is the middle of the year around the release with the quarter right before it. We may have to do better incentives, better demand generations in that time period, to kind of offset that potential.

But for the most part, it really shouldn't freeze a customer. Because when they purchase the software, it's 90 to 120 days before they implement it. And it's -- V-8 is right around the corner. They'll tend to implement that when it comes out, if they get it on the SMS and update schedule that they pay for separately.

So, it shouldn't have an impact. I think it's far less impactful than it used to be in the old days. When we released Version 7 of EnCase, a lot of that forensic customers were not on SMS contracts; they were paying for upgrades. And that did freeze some people buying V-6 in anticipation of V-7. But we don't have that situation now. We fixed that with the last version. And I think that's going to work out fine as we go through the middle of next year.

Sarkis Sherbetchyan - *B. Riley & Co. - Analyst*

Okay. That's helpful. And then did I hear correctly that Professional Services in Q3 was about \$4.2 million for sales?

Barry Plaga - *Guidance Software, Inc. - CFO and Interim CEO*

Professional Services, yes, \$4.2 million.

Sarkis Sherbetchyan - *B. Riley & Co. - Analyst*

Okay. How did training perform in Q3 relative to your expectations?

Barry Plaga - *Guidance Software, Inc. - CFO and Interim CEO*

Training was right around \$2.3 million, which was flat with Q2. So they were -- I think our original forecast was \$2.3 million to \$2.4 million, and they came in at \$2.3 million. Summer months, people on vacation, don't like to go to five-day training classes. But in Q3, training will -- or Q4, training will perform very well.



And just to take a minute and talk about services, services is kind of flat quarter-to-quarter from Q2 to Q3; flat with last year. But one thing we changed at the beginning of this year is the way we incentivized our sales force with respect to selling services. And we had a record number of bookings in terms of dollars during Q3. A lot of it came in the mid-to-late Q3, but none of that get delivered.

We are sitting on a really healthy backlog for our Services group for the first time going into Q4 and into next year, with some pretty big projects with some high-profile customers that use our software and need to augment their teams with ours in the short-term. So, I think Services is going to have a pretty good Q4. And going into next year, I think they're going to have continued momentum.

Because one of my frustrations over the last nine months, 12 months, has been we've been adding customers at an ever-increasing rate, which means the follow-on services should be building. And it hasn't been released through the floodgates yet, but we, based on the bookings we did in Q3, if we do that in Q4 and deliver, we're going to start seeing the fruits from that labor of meeting all those customers with a product.

Getting EnCase everywhere means more training revenue, more services revenue, and an increased -- it increases product revenue over time. Because 60% to 70% of our business product revenue comes from existing customers. So the bigger that base, the faster and more potential for that for growth.

Sarkis Sherbetchyan - *B. Riley & Co. - Analyst*

Okay. And then finally from me before I hop back in the queue, can you provide us with any updates on the opportunities you are seeing in the pipeline with regards to the point-of-sale solution that you guys had kind of talked about previously?

Barry Plaga - *Guidance Software, Inc. - CFO and Interim CEO*

Well, so far this year, we've done pretty well in the retail sector. I don't have the exact count in front of me, but we've gotten some good success there from -- it's funny. These retail chains that are visible to everybody, they are quite large, they have POS issues in general. So that's going to continue with that success.

We have some of the biggest retailers already as our customers. And the new ones really like the products. And I think the POS capability is something that helps get them over the fence to take care of their entire security profile.

Sarkis Sherbetchyan - *B. Riley & Co. - Analyst*

Thank you. I'll hop back in queue.

Barry Plaga - *Guidance Software, Inc. - CFO and Interim CEO*

All right. Thanks.

Operator

(Operator Instructions). Michael Kim, Imperial Capital.

Nate Cheng - *Imperial Capital - Analyst*

This is actually Nate Cheng calling for Michael Kim. Can you give us a little bit more detail, or anything else you can give us on the CEO succession plan? And like maybe a timeframe or anything?

Barry Plaga - *Guidance Software, Inc. - CFO and Interim CEO*

Yes. The Board is opening a search and I'm, of course, throwing my hat in the ring. And I've got a pretty good endorsement from Shawn, as you heard at the beginning of the call. We definitely want to get the best person for the role; I think I can fill those shoes. But we're going to -- we figure it's going to take three to six months to go through that process, especially given the timing of the year, November, with challenges around the holidays, with schedules, et cetera, and doing interviews. But we are going to go on a pretty strong mission to pull in the best candidates possible and evaluate them from there.

Nate Cheng - *Imperial Capital - Analyst*

Awesome. And it looks like the product gross margins were -- not unusually low but pretty low. Is that something you can expect going forward? Or can you give us a little more detail on what happened there?

Barry Plaga - *Guidance Software, Inc. - CFO and Interim CEO*

Sure. So overall product revenue margin was --

Nate Cheng - *Imperial Capital - Analyst*

Like 74%?

Barry Plaga - *Guidance Software, Inc. - CFO and Interim CEO*

Yes, 74%. And typically, we like to see it in the high-70s or low-80s. So this quarter, with some of our Enterprise business being down related to the federal sector, we had a higher mix of hardware revenue in our tableau line. And I mentioned that they had a really good quarter in Q3. They released some new products.

And as I said on our Company call earlier, that some of our customers in the federal sector were gobbling them up so quickly we couldn't keep up with the shipments, which is a really nice problem to have. And it shows we have really good attention with that federal sector in law enforcement with our forensic product, both software and hardware.

But the mix -- it's a mix issue on the gross margin line that takes that down to 74%. And that will improve in Q4. There should be a switch to a higher mix of software product revenue in the --.

Nate Cheng - *Imperial Capital - Analyst*

All right. So it should improve in Q4. And one more for me. You mentioned like a cost-cutting program. So there's some operating expense cutting. Can you give us more details? Is this an ongoing thing or --?

Barry Plaga - *Guidance Software, Inc. - CFO and Interim CEO*

I mean, this is something we did in January. So now you're seeing the year-over-year comps where expenses are much lower than they were in the prior year. So I think we cut about \$2 million in costs out of the system year-over-year. But that was done in the beginning of the year. So in Q4, we will see the same thing; but then in Q1, it will normalize to be comparable, so.

Nate Cheng - *Imperial Capital - Analyst*

All right. That's all for me. Thank you for taking my call.

Barry Plaga - *Guidance Software, Inc. - CFO and Interim CEO*

All right. Thanks.

Operator

Thank you. And I'm showing no further questions from our phone lines. I'd now like to turn the call back over to Rasmus van der Colff for any final remarks.

Rasmus van der Colff - *Guidance Software, Inc. - VP of Finance and CAO*

Great. Thank you, operator. I think that concludes our call for today. We'd just like to thank everybody for joining us.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone have a wonderful day.

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