Guidance Software, Inc.

Fourth Quarter and Full-Year 2015 Earnings Conference Call

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CONFERENCE CALL PARTICIPANTS

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PRESENTATION

Operator:

Greetings and welcome to the Guidance Software Fourth Quarter and Full-Year 2015 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.

As a reminder, this conference is being recorded. I would now like to turn the conference over to your host, Mr. Lasse Glassen of Addo Communications. Thank you; you may begin.

Lasse Glassen:

Good afternoon and welcome to Guidance Software's Fourth Quarter and Full-Year 2015 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 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 those factors. The forward statements made in today's conference call are based on information available as of today, February 11, 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 the 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 available via webcast on Guidance Software's Investor Relations website. A replay will also be available on the site.

With that, I'd now like to turn the call over to Patrick Dennis. Patrick?

Patrick Dennis:

Thank you, Lasse, and thanks everyone for joining us today for Guidance Software's Fourth Quarter and Full-Year 2015 Earnings Conference Call. On today's call, I will provide an overview of our financial performance for the fourth quarter and full-year, and provide an update on the progress we are making to achieve growth. Following my remarks, Barry will take us through the fourth quarter financial results in more detail. After that, we will open the call for questions and answers.

I'm pleased to report that Guidance finished the year strong. The faster product velocity and growth and security products resulted in both revenue and non-GAAP EPS exceeding the high end of our guidance range for the quarter and full-year. The Security Products sales growth we produced in the first half of 2015 resumed in the fourth quarter with a particularly strong performance by EMEA Team. We delivered revenue ahead of our expectations and consensus for the quarter, and surpassed our performance on a sequential quarter basis as well.

Fourth quarter revenues were $27.6 million compared to $26.8 million in the third quarter, and for the full-year we generated revenues of $107 million. As expected, we ended the year with Endpoint Security being our largest line of business. License revenue and Endpoint Security grew by 24% year-over-year. We also tripled the number of incident response engagements in the year.

We should also remind everyone that we are still the leading provider of forensic security software to incident response service providers, including Mandiant. There is nothing more important than our customers. Here are some of the key security wins and customer highlights from Q4. EMEA finished the year strong with three key wins that included Thales, a leading aerospace company based in France with annual revenues exceeding €13 billion. They added additional Endpoint Security licenses to their UK deployment. I think this illustrates the opportunity for Guidance to continue to sell follow-on business after an initial purchase.

Lufthansa, the largest airline company in Europe with annual revenue of €30 billion also purchased Endpoint Security for their corporate office in Germany. They found the new capabilities in Endpoint Security 5.10 to be more compelling than the competition.

Aramco, one of the world's largest oil and gas companies based in Saudi Arabia, with annual revenues exceeding $375 billion, purchased Endpoint Security for their corporate headquarters in Saudi Arabia.

We've made a focused investment in the Middle East which we expect to be a fast-growing market for security.

I should also highlight the progress our EMEA Team made in cultivating the channel as part of our overall go-to-market strategy. In Q4, the channel brought more incremental deals to the region than in any prior quarter. The most important point is the details came from Italy, Belgium, the Netherlands, and parts of France where we have no direct field coverage. This is proof that the aggregate sales capacity in EMEA is increasing as our channel matures.

We also beat the competition at Juniper Networks, a multinational corporation headquartered in Sunnyvale, California with annual revenue of $4.6 billion; and at T-Mobile, the third-largest wireless network in the United States.

It's not just about new wins. I recently met with Viacom, a longtime customer who is really happy with the increase software release velocity and our tentativeness to their needs. They employ some of the most creative people in the world and they all use Macs. Viacom was particularly happy about our increased commitment to Mac users like them.

I first met with Viacom last summer. They mentioned that they needed a few improvements and that they'd been waiting a long time for them. This is one of the visits that made me commit to investing in the existing platform and all the customers that use it. It's an example of how small improvements can be very meaningful to great customers. Viacom continues to be committed to this relationship.

I believe this is also why we saw increased renewal rates in the quarter, as other customers committed to our software. Our global go-to-market model will follow the leadership and best practices established by our EMEA Team. Our new North American leaders are already implementing these practices. The global channels organization continues to mature channels around the world like we have in EMEA. With these changes, I expect material improvements in the North American (inaudible).

Globally, we witnessed spending shifts from prevention companies, like Tanium and Bit9 Carbon Black, to Guidance Software in a rapid detection and response solutions. The customers above and many others chose our software because we offer value across all stages of the cyber kill chain at an unsurpassed level of depth and visibility. Our software sees and removes problems other software simply can't.

Throughout 2015 it became increasingly clear that our growth is linked to the performance of the security business. We identified a trend beginning in Q3 and during Q4 that customer security spending was shifting to rapid detection and response technology like ours. This was confirmed by Gartner in their January security report.

Existing Guidance customers have started to realize that our leading forensic security software is vital. The product's strategy over the course of these same two quarters started to align with the emerging customer demand, beginning with Endpoint Security release 5.10, which included support for IOCs and the world's best remediation capability. We closed more new business than any prior quarter and had a higher level of customer satisfaction.

The combination of customer spending and emerging technology trends defined what we are now calling our Forensic Security Suite. This is a suite of three Security products built on top of the world's only 360-degree Visibility Endpoint Software. Product one is EnCase Endpoint Investigator, which brings the leading forensic and Internet response software to commercial enterprises for internal investigations; product two is EnCase Endpoint Security, which adds anomaly detection and world-class malware remediation for all the endpoints in an enterprise; products three is our recently announced EnForce Risk Manger, the only purpose built product in the world focused on finding, classifying, and remediating sensitive data throughout the enterprise to reduce the information attack surface area. These three products are only offered by Guidance Software and are fully aligned with customer security spending priorities for 2016.

Also aligned with customer spending priorities is our recently announced cloud initiative. Our largest customers continue to ask for the equivalent level of security robustness in their public cloud environments that they experience on-premise. Guidance is committed to meeting our customers' needs for public cloud computing and cloud-native applications.

Our first announcement is a demonstration of our EnCase Endpoint Security Solution being hosted on an Amazon public cloud. The future growth of endpoints will come from two categories: Internet of paying (phon) devices and cloud-hosted virtual machines. We have every intention on capturing the available market share for these high-growth categories of endpoints.

I'm excited about the growth opportunity in 2016. I think this announcement of our Q4 momentum is a great way to start the year. We have demonstrated increased product delivery in velocity; we're growing in our key line of business; and have a robust product strategy to attack top spending categories. The Sales Teams around the world have never been so confident about their ability to compete and win security business. I am confident we will grow our Forensic Security revenue throughout the year.

Now I' like to turn the call over to Barry to cover the financials in more detail and share his thoughts on the fourth quarter and full-year. Barry?

Barry Plaga:

Thank you, Patrick. I will now discuss our fourth quarter 2015 performance. Our fourth quarter revenues were $27.6 million compared to $26.8 million in the third quarter of 2015 and $28.2 million in the prior-year period. Q4 revenues exceeded both our guided range and Wall Street consensus. Total product revenues were $8.8 million compared to $7.8 million in the third quarter, and sequentially from Q3, Q4's enterprise software revenue grew 73% with North America and EMEA Endpoint Security driving that performance.

In our North America Enterprise Software business, 75% of bookings went through the channel in Q4 versus 70% in Q3, and a mere 25% back in Q1 of this year, indicating that as we progress through the year in 2015 our channel continued to expand.

During Q4, Forensic Software and Appliances were down 12% year-over-year, with that decrease primarily driven by Appliance revenues.

Gross margin on Total Product revenue for Q4 was 74% compared to 68% in Q3 2015 and 75% in the prior-year period. The sequential increase in product gross margin was due to a higher sales mix of Enterprise Software, in particular Endpoint Securities.

Services revenues were $8.8 million compared to $9 million in Q3 2015 and $8.7 million in the year-ago period. Professional Services revenues continue to be driven by an increase in incident response services which has led to some gains in our Services gross margins. Gross margin on Services was 37% in the fourth quarter compared to 38% in the third quarter and 33% in the year-ago period.

SMS revenues, or Maintenance revenues, which represent a recurring revenue stream, were $10 million compared to $10 million in Q3 2015 and $10.3 million in the prior-year period. Renewal rates, as Patrick mentioned, continue to be strong and we saw improvements in our renewal rates when we began releasing new features on a more rapid cycle. Gross margin on Maintenance revenues was 94%, in line with historical periods.

Total operating expenses for the fourth quarter were $20.5 million as compared to $19 million in the third quarter and $18.7 million in the prior-year period. The increase in operating expenses was primarily a result of investments in our sales and marketing capacity and increasing our product development capabilities to develop new products more rapidly. We will continue to manage expenses closely and at the same time make appropriate investments in these areas.

Moving on to specific expense line items, research and develop expenses were 18% of revenues, flat as compared to Q3 2015 and up from 17% in the prior-year period. Selling and marketing expenses were 36% of revenue as compared to 33% in Q3 2015 and 31% in the prior-year period. G&A was 15% of revenues, flat as compared to Q3 2015 and 14% in the prior-year period.

Non-GAAP net loss for the fourth quarter was $1.3 million or $0.05 per share as compared to a net loss of $883,000 or $0.03 per share in the third quarter of 2015, and a non-GAAP income of $863,000 or $0.03 per share in the fourth quarter of 2014.

Turning to the balance sheet and some related metrics, cash and cash equivalents as of December 31, 2015 totaled $19 million as compared to $18 million as of September 30 and $18.4 million as of December 31 of the prior year. Cash flow from operations for the fourth quarter was $1.4 million compared to cash used in operations of $2.6 million in Q3 2015 and cash flow from operations of $3 million in Q4 of 2014.

Before wrapping up, I'd like to mention that we have a busy first quarter of investor marketing activity. We hope to see many of you next month at the Piper Jaffrey Security Symposium in New York followed after that by the 28th Annual ROTH Conference in Orange County.

With that, let me talk the call back over to Patrick for final remarks. Patrick?

Patrick Dennis:

Thank you, Barry. Two more items before we move to Q&A. First, in light of recent uncertainties, we will not be offering 2016 guidance at this time. Second, today we and the Shareholders were all notified by our former CTO and Chairman that he has proposed a slate of Directors to be considered at the next Annual Meeting. The Board will review and consider the proposals. In the meantime, the Company issued a press release on this matter today. Please refer to it for details on the matter. This action will not distract the Company and its people from continuing to serve our customers with the focus and dedication that we've demonstrated in Q4.

Now, before we take questions, let me close by saying I have every single confidence in our current Board of Directors, Management Team, and all of the hard-working people at Guidance as we continue to drive value for all of our Shareholders.

Operator, can we please open the call for questions?

Operator:

At this time we'll be conducting the 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 please while we poll for questions.

Our first question comes from Kevin Liu with B. Riley and Company. Please state your question.

Kevin Liu:

Just starting with the strong performance in the fourth quarter, could you just talk a little bit about the factors that drove the upside there? Was it dependent upon any large deals that it closed? Was it more so a function of budget? Just any color you could provide would be helpful.

Patrick Dennis:

Yes, thanks, Kevin. How are you doing? You know, we saw a lot of wins in Security, as we outlined on the call, and I think we have noticed this shift in spending priorities towards our rapid detection and response solutions, which we also mentioned. You know, at first we didn't know if that was a shift that we were observing ourselves or if it was a market shift, so it was encouraging Gartner release that report who indicated they think as much as 66% of the spending will shift to that category by 2020. So, I think we've seen some early indications that that's in fact how well this market is performing, and we saw some of that performance in the quarter.

Barry, did you have any feelings about how we performed there?

Barry Plaga:

Yes. I think overall the average deal size was pretty strong in Q4, especially in Endpoint Security, and if we look at kind of the factors, with the budget flush, etc., I would say I didn't really see that in this quarter. It was more or less a lot of deals that had been in the pipeline throughout the year came to close in the fourth quarter. So, closed out strong and I was pretty happy with the results there.

Patrick Dennis:

You know, and last point we'd make—I know we said it in the script, but I'd like to draw some additional attention to it. This approach that we've been using of really integrating customer feedback into the development cycle is paying off. You know, the take rate that we saw on 5.10 was truly substantial. So we're really happy with the product velocity that we talked about on the call a few times today and the results of that recent release.

Kevin Liu:

Got it. Just in terms of the decision to not offer up 2016 guidance at this point, could you just talk a little bit about the factors behind that? You know, certainly everyone's kind of faced with some of the macro uncertainty that's out there, but at the same time, if you were to take a look at your pipeline and the progress you've made over the course of the year, I mean what's preventing you from having that visibility to provide guidance?

Patrick Dennis:

Yes. I mean, certainly we're facing the uncertainty that others have faced. I think we have some unique uncertainties that I referenced towards the end of the call and I think we have a really good track record of being transparent with all of you about where we are and how we're performing. You shouldn't take our suggestion as to a lack of guidance at this time as an indication that we've made a policy change in that regard; rather, you should take it as a prudent assessment of these current conditions and how we feel about the business at this moment.

Kevin Liu:

Considering some of the filings that came out this morning, on your website looks like the Board has recently formed an M&A Committee. Was that in response to anything specific that you guys had forthcoming, or if you could just talk a little bit about why that committee was formed, that'd be helpful.

Patrick Dennis:

Yes. I made a substantial increase in the amount of corporate development activities since the day I arrived. The Board and I have had those types of discussions as it relates to all the opportunities that would be presented to Guidance since my arrival. We felt that it was appropriate time for us to establish that committee and we talked about it at the last Board meeting. The timing as it relates to today is coincidental at best. We've been focused on making sure we explore all those opportunities for several quarters now, and as you know, since you attend most of these calls, I've said that we're going to be thoughtful and prudent, and we'd demonstrate some operational performance and then we'd begin to consider those things and felt like this was a good time for us to make sure we had a Board-level pool to discuss those items.

I was particularly happy with Max Carnecchia's decision to help us Chair that committee. I think it'll be really helpful for the Company. But timing was coincidental.

Kevin Liu:

Got it. Just one last one before I hop off; you guys have announced some new products and also just getting out updated versions of your products faster. How do you expect new solutions like that recently announced data risk offering to contribute to revenues over the course of this year?

Patrick Dennis:

Yes. We haven't broken it out yet, so let me just give you some color on the size of that market. You know, we started to see customer shifts in the end of the year. This was really a customer-driven product in the sense that customers had asked us to reshape some of our current capabilities and offered service engagements that would allow their software to do these things. That was our first indication that there could be a product opportunity here.

Over the course of those months we explored that opportunity with Gartner and with IDC. IDC has sized that market at roughly $800 million, and you've probably seen that in our most recent investor material. So we made a decision to try to capture a portion of that opportunity that could be as much as $20 million to $40 million. When we're not breaking out, certainly a portion of that that we're planning to capture this year, we are incredibly excited about the fact that we have delivered this product first-to-market with a purpose-built piece of software to address this opportunity and the concerns that customers have across the EU as more privacy regulations go into place.

So we're really excited about kind of the incentives just around the need for this type of software and really happy with the high-quality velocity coming out of the Engineering Team to get it to market first. So, future's bright there.

Kevin Liu:

All right. Well, I appreciate you taking the questions and congrats on a strong quarter.

Patrick Dennis:

Thanks, Kevin.

Operator:

Our next question comes from Michael Kim with Imperial Capital. Please state your question.

Michael Kim:

Hi. Good afternoon, guys. You called out a number of nice transactions in the EMEA region for Security. Just kind of—if you can expand on if that's a function of higher spending priority in EMEA versus North America or more a function of the maturity of the channel and the distribution capability.

Patrick Dennis:

Now, that's a really good question. I mean certainly we were satisfied with the improvements in the channel in EMEA as we called them amount. I also just have to recognize the incredible execution from the EMEA Sales Team. I think that it was sales execution in that geography that really served us well. That isn't to say that we didn't execute well in other geographies, as I gave you a couple of examples of North American wins as well. But I think the EMEA Team has done a nice job finding some best practices that we can leverage around the rest of the world, and most specifically in North America, as we referenced.

Michael Kim:

For a lot of those larger scale wins for Security, were those typically in head-to-head evals versus comps? I presume that your win rate was—I don't't' know if you can comment on that.

Patrick Dennis:

Yes, I'm not going to comment on the win rates specifically. I do remain convinces, as I've said in past calls, that right now in Security, what really matters is the order of the spending, so high priority items come first. I don't think that it's necessarily a scenario where you win or lose every transaction; rather it's a scenario where you're winning a transaction at that point in time. I mentioned we saw this shift towards rapid detection response a few times on this call, but Piper Jaffray reported their IT spending report for the end of the year, and security remained in position one for the fourth consecutive year. But more important to my business, the number one category inside of security was endpoint.

So there are some factors suggesting that spending priorities are shifting towards what we are referring to is our Forensic Security Suite of products and I don't believe that that's coincidental with the Q4 performance.

Michael Kim:

Got it. Then just specific to the new cloud house, the solution that you recently had come out (phon). You know, can you talk about what the phased approach means over the course of the year; and then I guess at some point would you start to begin breaking out some of the key metrics, like billings and duration and like that?

Patrick Dennis:

Yes. It's a good question. You know, as we described in the call, we know that there are more and more workloads being deployed on public clouds. It's probably not a surprise that Phase 1 involved us using our technology with Amazon's public cloud. We thought that was a good place to start. What we're really focused on doing now is making sure that the high-quality software that we deliver on-premise can also help customers protect workloads in their public clouds. We decided in Phase 1 we would demonstrate that capability, which is why I referenced the fact that it's in a demo capacity right now—and by the way, that has the secondary benefit of allowing us to enable the channel to do demos, so there's a go-to-market benefit in Phase 1.

But this too was a decision that we made jointly with our customers. Some of our largest retail customers, in fact, had said to me, "We're using your software in public cloud environments today. We know, Patrick, you're passionate about it. Is there a way where we can work more closely together on these types of solutions?" So we decided to launch an internal project which we refer to as cumulus. You're seeing Phase 1 now. Future phases will further demonstrate the ability to use our software products for these high growth endpoint categories like cloud virtual machines. It does not necessarily represent a need, by the way, to move to a SaaS model. It offers customers an opportunity to use our software deployed on-premise or to accelerate the deployment of our software in the cloud. So, for example, a software deployment in the cloud, it takes minutes, which is an improvement over most off-premise software installations. So, yes, Phase 1 is really exciting. Our customers are excited and we're excited, and we can't wait to share more with you as it develops.

Michael Kim:

Well, great. We look forward to the following phases and the rollout.

Patrick Dennis:

Thank you.

Operator:

Our next question comes from Mark Jordan with Noble Financial. Please state your question.

Mark Jordan:

Thank you. Gentlemen, while not wanting to give guidance relative to—I guess relative to earnings, would you be willing to share what your goals or objectives would be for cash generation and/or the preservation of the current cash balance?

Barry Plaga:

Yes. Hey, thanks, Mark. Good question and important question. As you know, over the last six to eight quarters we've been very focused on managing our cash balance and reducing any kind of cash burn. This year we had a negative EBITDA, less than $400,000 for the year, so more or less managing cash with our investments appropriately. So we measure on a monthly basis or even more often. (Inaudible) and I team together we look at cash projections and what the investments we can make relative to our sales and marketing capacity, as well as our R&D development capacity.

So we balance those three things on a regular basis, get Patrick's buy-in in terms of when we can pull the trigger on making further investments and when we should hold back. So, we're very focused on driving the Company towards profitability and we're going to do that around the potential growth model that allows us to leverage our sales and marketing expense to its fullest extent.

Mark Jordan:

All right. While also just looking at 2016, do you think that the sort of general pattern of revenues on a quarterly basis that was exhibited in 2015 would be reasonable to—would be the guide for 2016?

Barry Plaga:

Yes, we saw some pretty typical seasonality throughout 2015, so I would say we did have a less than what we hoped for Q3. So I think that would probably be stronger seasonally wise in terms of weighing (phon) those quarters. But for the most part, I would follow kind of the last couple of years have been very similar in the seasonality.

Mark Jordan:

Okay. Final question for me; currency—your pricing in Europe with the strength of the dollar, have you maintained prices or what has been your marketing strategy with regards to marketing in Europe with the strong dollar?

Patrick Dennis:

Maybe I'll make some broad pricing comments and then I'll let Barry make some comments about currency in general. In previous calls we had announced probably fairly modestly that we had been instituting some, what I will call market price corrections. So we did two of those last year, the last of which was announced in roughly the November timeframe and then deployed in the December timeframe. Those are changes that we're making to better align our pricing to market and the value that we think customers are getting from our software globally, and we'll continue to do that assessment through a Pricing Committee that we have here at the Company that meets and looks at that data on a monthly basis. So we're very focused on that to make sure that we can compete effectively in all markets.

Barry, do you have any feelings about the more international nature of that question as it relates to currency?

Barry Plaga:

Yes. In terms of currency, our euro pricelist and our pounds pricelist are great in the UK, so as those prices were adjusted, as Patrick talked about, we didn't see any pushback relative to the strong dollar and those prices. So, they were pretty current in terms of equivalency, so I think that was part of it. So, overall, really no negative impact at all.

Mark Jordan:

Thank you.

Operator:

Our next question comes from Hendi Susanto with Gabelli & Company. Please state your question.

Hendi Susanto:

Good evening, Patrick and Barry.

Patrick Dennis:

Hey, Hendi.

Barry Plaga:

Hey, Hendi.

Hendi Susanto:

Could you share some sales dynamic in your core eDiscovery products? Specifically do you still see eDiscovery as a growth area in 2016 in light of the current microenvironment and possibly a shift more towards security spending?

Patrick Dennis:

Yes. So, the comments I'd make around eDiscovery, as we've made around the last few quarters is the growth in that market, broadly speaking, is more modest than the growth in the security market and that's why we've been very particular about our focus on the Forensic Security opportunity. I would also like to point out that there are some capabilities inside of our EnForce Risk Manager product that we believe will be very attractive to some of our traditional eDiscovery customers as they try to manage down the overall amount of risk profile of information and enterprise.

So, we remain committed to our eDiscovery customers and bringing capabilities to them that they think—that they ask for and that they will use. We bring some of those to market through the actual eDiscovery products and we bring some of those to market other ways. But if we look further into the years, to give you an example, later this year we're going to be expanding the number of information sources and connectors in what will be our 5.13 release and that's an example where we're creating a connector suite that really helps cloudify our eDiscovery capability, again, as an example as both our commitment to the cloud and people's move to the cloud, and to our eDiscovery customers.

So what I would tell you about eDiscovery is it remains an area of focus, but perhaps the lens at which we look at those customers is a bit different than the lens that we have used in the past.

Hendi Susanto:

Okay. Then Patrick in your security space, how do you see the majority of your customer profiles, whether presence is uniformly distributed among different size of customers or whether certain size of customers have liked more sales traction?

Patrick Dennis:

Yes. It's a good question. I mean I think, Hendi, you've seen some of our investor relations material—and if there are others on the call who haven't, we share some case studies in that material that I think are informative. While there are verticals that tend to move to these technologies perhaps more quickly than others, if you look at our overall customer distribution, it's relatively even across many categories and sizes. So we're quite happy with the customer accounts that we have. We have a high penetration rate in both Fortune 100 and 500, and these days I don't think there's a company that doesn't worry about the digital risk problem. So I think if anything we have been limited in the past by our aggregate sales capacity which is why we deployed the channel strategy over the course of the last several quarters that's going to help us more fully and completely reach our customers.

Also, as we enter 2016 we performed a secondary go-to-market segmentation as part of the restructure for growth. One, we're putting some specific focus on our top accounts to increase our level of penetration there, as well as we're running a strategy with our inside sales force that I refer to as down and out, meaning in markets where we have high density of field personnel, the inside sales force is moving down market, and in markets that we don't have direct field personnel, the ISRs are actually moving out to those markets to help support the channel, which is our primary method of attack and distribution.

So, I think we have the world covered. Just the plan this year is to be very focused in areas where there's density and be smart about the deployment of those resources and then use a combination of the channel and inside sales resources to go out to rest of world.

Hendi Susanto:

Okay. Then, Patrick, is the Company shifting more towards channel partners or do general partners have a higher portion now? Should we expect changes in operating expense and operating margin profile?

Patrick Dennis:

Let me make some initial comments there and then Barry can give you his thoughts on the numbers. In this call I think it was important that Barry referenced the rate at which we've shifted to the channel. You know, it accelerated from 25% in North America in the beginning of the year, all the way to 75%, and we've said to you that that would happen over a period of quarters as we find an equilibrium. So I think as you start to think about that 75% number, it is directionally towards the equilibrium we expected. We figured that the channel equilibrium would settle in at somewhere between 75% and 90% of revenue, so we'll probably see that we're starting to find an equilibrium point there in terms of the percentage of sales that go through the channel.

Now, Barry, do you want to talk about kind of how the financials work for channel transactions?

Barry Plaga:

Yes. There's a couple parts to that, one is the impact on gross margins, which as revenues flow through the channel, it really doesn't impact so much gross margins as it does the top line. So we've managed our way pretty well through that in 2015. I think Q1 was the only year-over-year quarter where it's going to be a transitional kind of situation, but if you look at the investment, which I think is one part of your question, where we've been investing in sales and marketing, if you looked at our—the percent of revenues to sales and marketing in Q4, it ticked up. For 2016 versus 2015, it's going to be up slightly as a percentage of revenues because in the short-term we have to invest in the support system for the channel internally, as well as we've been continuing to invest in our field sales resources—not to the extent as our channel—and that'll level off over the next, I would say, four to six quarters, and then we should start seeing some pretty good leverage on the sales and marketing line.

Hendi Susanto:

Okay. Then Barry, what should our expectation on profitability and whether or not you will be able to achieve positive free cash flow in 2016?

Barry Plaga:

That's it's pretty close to a guidance question, Hendi, but as I mentioned earlier to one of the other questions, we're very focused on expense controls and cash management, but we at the same time want to invest in the growth opportunity in front of us. We've got two exciting markets that we're playing in now between Endpoint Security and Risk Management, and we want to make sure that we put the proper wood behind the arrow there to get—that'll deliver the results.

Patrick Dennis:

Hey, Hendi, let me add some color there because when you spend money on things like R&D you want to know that you're getting a result. So, I guess let me just hit on a couple of things. So in 5.12 we're going to deliver additional IOC enhancements; we're going to add more guard (phon); we're going to add sticks; we have additional integrations and updates for blue co and for virus total partners we've had for a long time.

Following that in 5.13, we have a big release that's focused on accelerating rapid detection and response. It gives deeper artifact coverage and it offers really major usability upgrades based on customer feedback and furthers our anomaly detection capabilities. At the same time that's going on, we're going to deliver Forensic 7.12, which has artifact improvement everybody's been looking for, Mac enhancements like the Viacom team is looking for, including OS X for El Cap team. Then we'll do a Q2 major release that's completely focused on customer-driven usability enhancements and it's going to marry the best interface that we've ever had with our forensic technology with the modern and robust performance that we've been able to capture recently along with product big (phon) integration so that we can help with child protection. In addition, the eDiscovery items I already covered.

So we have a big roadmap ahead of us of brand-new software that we're going to deliver to our customers and that's our focus right now: world-class software.

Hendi Susanto:

Okay. Then Patrick, with regard to the new data Risk Manager, I have several questions in terms of what—how should we think of new positioning and in competing. In guidance of software slide, it has a slide where it shows that it has like 20 million to 40 million total addressable markets beyond 2016. I'm wondering what is the niche market and if there are several players, then the pie you get is a portion of that and I do think that there the Risk Manager falls into Security Analytics where you have to compete with big players with comprehensive product portfolio. Then looking back, the last effort on Encase Analytics, I would say that it didn't reach (inaudible) success for the top line.

Patrick Dennis:

Yes. So let's take them in order. So you can take up your feedback on which quadrant the—this product belongs in with Gartner. They're fairly certain that it's going to be in a new category. That's a synthetic market created in between eDiscovery and information governance, which is why we tend to think of it that way. The great news on the competitive front is there's no other purpose-built product to solve this problem in the world today, which is why we're particularly happy about the opportunity for accretive new software license revenue that could go with this category, and we're even happier to see that IDC sized it at roughly $800 million. It remains to be seen whether it will be a niche market or it will be a growth oriented market given that it hasn't been deployed for long.

That said, the privacy standards that are being levied in the European Union certainly suggests that this is going to be a market that stays. So while we can't predict the future, we certainly can look at the reinforcing loop that's being driven by the regulatory environment and I think that that has made us very confident that this is a market that we want to play in.

You know, vis-à-vis Analytics, I will say that we built the Analytics capability using our old software development thoughts and we've deployed a much more modern approach to how we develop that software. The first release 5.09 brought significant enhancements to our Analytics product because we recognized some of the things that you brought up. So I'm more confident than ever that we're going to bring high-quality software to market now that we've resolved some of those challenges.

Hendi Susanto:

Okay. Then, Patrick, when companies release like a cloud platform product, usually it tries to differentiate whether it's a truly cloud software architecture, like Salesforce, or whether it's somewhat, let's call it, like the partial cloud platform. So could you talk about the software architectures of the new cloud platform so that we have a better idea on what it looks like?

Patrick Dennis:

Yes. What we want to give people the ability to do is to actually deploy the software in the cloud. So there's an emerging category of cloud applications which I referred to in the script called cloud native applications. Those are applications that were purpose-built for the cloud. So really right now our focus is getting people and ability to deploy the software anyplace they choose, whether it's on-premise or in the cloud. So I understand that the traditional thinking around cloud tends to be cloud means SaaS. I think of that in an entirely different way. Cloud is a deployment model option that customers want to be able to explore so that they can get the same level of security robustness on-prem or off-prem, as I articulated, and they can make decisions about where they're going to deploy applications, whether they're on-prem or off-prem based upon the cost points more to scalability requirements for those applications.

So for us this isn't a shift in the software architecture per se. It's a rethinking of offering customers deployment options that are better aligned to the market.

Hendi Susanto:

Then last question for me is in light of today's filing, how should Investors measure the success of your current Management Team in terms of growth (phon), milestones, and timeline?

Patrick Dennis:

You know, Hendi, I said when it comes to this issue there we're not going to talk about it on this call—and candidly, we're running out of time. So I'd be happy to cover those things in a more appropriate forum. I again reference you to the press release that we made earlier today for now.

Hendi Susanto:

Okay.

Operator:

Our next question comes from Mark Schappel with Benchmark. Please state your question.

Mark Schappel:

Hi. Good evening. Barry, I just want to make sure I heard you currently in the Q&A. Did you say that you expect sales and marketing expenses to be up as a percentage of total sales in the coming year?

Barry Plaga:

Yes. It should be, definitely. I think it was about 35%, just under 35% for 2015 on a non-GAAP basis and it should sneak up about 200 basis points to 36% to 37%. But we should see an offsetting increase in gross margins with (phon) the Product Software revenues, so I think we'll be better off bottom line wise.

Mark Schappel:

Okay. Great. Thank you. Then, Patrick, just building on an earlier question, I noticed on not only this call but the Q3 call that you're no longer referring to EnCase Cyber Security as a product or even a market, using different phrases like data risk, privacy protection. My first thought here was that this is just the Marketing Department kind of hijacking the Company with some new buzzwords, but as I start to think about this more and look a little bit deeper, I'm starting to believe there's a little bit more of a shift going on here than just a rebranding exercise. Maybe you could just let me know if I'm reading this correctly and expand on that?

Patrick Dennis:

Yes, sure. How are you doing, Mark, by the way?

Mark Schappel:

Hi.

Patrick Dennis:

Yes. We want to access the total security opportunity that we can address and so there are several parts to that, right. One, well-defined market inside of the security segment is Endpoint. You know, and I mentioned just a few seconds ago, that's a high priority spending category validated by third-parties. We offer our product there today that we think is really quite capable and I just laid out a roadmap that says that we're dedicated to delivering in that market on a very repeated basis.

At the same time, we believe that there are some changes in the security market, vis-à-vis incident response, which I also talked about on the call. We believe that there are more incidents than most people hear about because there's not really a clear reason why you'd report them and therefore our Endpoint Investigator technology is our reimagining of the best forensic software in the world being brought to commercial enterprises in a way that allows them to do incident response in a more complete and comprehensive way. So we're excited about that capability, again, as a security capability that leverages all the great work that we've done in the past around forensics.

You know, and then finally, we think that the EnForce Risk Manager product really tackles this notion of attacks surface area, which you hear many security companies talk about, in a much more robust way. If by all estimation there's going to be 30 billion to 50 billion devices by 2020, we think that trying to manage attack surface area in device count is kind of silly. The better way to do it is to actually look for the information that's spread across the enterprise and make some very, very specific decisions as to whether that information belongs where it is or it doesn't, and if it doesn't belong there, remove it, both so you reduce your liability as it relates to things like eDiscovery, but also to make it more difficult for an attacker to find it.

So what you should read into this is a very, very specific strategy at attacking well understood and known segments of the security marketplace and accessing the emerging trends and security that we referenced on this call, like the shift to rapid detection and response, and that's why we categorized the suite of products, the Forensic Security Suite. We think that it has capabilities offered by no other company in the world and it gives us a chance to access not only the endpoint detection response market, but many other aspects of the broader cyber security market.

Mark Schappel:

Good. Thanks. Then the announcement earlier this month on the new Data Risk Privacy and Protection Solution, when will that product be generally available?

Patrick Dennis:

Yes, great question. We're doing what we're referring to as (inaudible) inside the Company right now and are working with some clients on it, and then we said that we'll be releasing that product next quarter for revenue.

Mark Schappel:

Okay. Thank you. That's all.

Patrick Dennis:

Yes.

Operator:

We have time for one final question. Our last question comes from John Zaro with Bourgeon Capital. Please state your question.

John Zaro, III:

Hi, guys.

Barry Plaga:

Hey, John.

Patrick Dennis:

Hi. How are you?

John Zaro, III:

Good. Quick, just more just on the question of the whole guidance issue—and I'm not trying to press you guys on it. More of a—is it given the circumstance that happened today you don't want to talk about guidance or is it more just because you don't know what's going on with the economy per se that you don't want to talk about it?

Patrick Dennis:

You know, John. There are certainly others that have said they have concerns with the macroeconomic environment. I think we had some unique circumstances which you referenced. It's just my view at this time that it's not the right time for us to do guidance. I will say the Board and I made that decision and I hope that you get a sense of how confident we are in the business from the performance that we had in Q4 and today's call. So, we just felt that it wasn't right given the current set of circumstances and the Board and I'll make a decision on when we talk about guidance.

Again, as I mentioned earlier on this call, don't consider that a statement of policy, rather, a statement of circumstance.

John Zaro, III:

Okay. So there is a chance that sometime over the next quarter or even the next quarter release that you'd be starting to provide guidance again?

Patrick Dennis:

What I've always committed to you all as Shareholders is that there'll be a constant stream of communication, and if and when we find a time where it's better for all of us to do that, we will.

John Zaro, III:

Okay, because as you would expect, in sort of a time like this where you're seeing other people talking about all of a sudden they saw their business change in the last four or five weeks, I think that's probably why people are more interested in it than what are prior Management Team's issues might be with that, just as a heads up.

Patrick Dennis:

Yes. Well, thanks for that.

John Zaro, III:

Anyway, fantastic job. Terrific, really terrific.

Patrick Dennis:

Thank you.

John Zaro, III:

Appreciate it. Great day to have it come out as well too. Congratulations.

Patrick Dennis:

Thanks, John.

Barry Plaga:

Thanks, John.

Operator:

Mr. Dennis, there are no further questions at this time. Would you like to make any closing remarks?

Patrick Dennis:

Yes. Thank you for joining us today. We look forward to speaking with you all soon. We'll be in touch. Thank you.

Operator:

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