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GUID - Q3 2015 Guidance Software Inc Earnings Call

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PRESENTATION

Operator

Greetings and welcome to Guidance Software Third Quarter 2015 Earnings Conference Call. At this time participants are in a listen-only mode. The question and answer session will follow with formal presentation. As a reminder this conference is being recorded.

I would now like to turn the conference over to your host Mr. Rasmus Van der Colff, Vice President of Finance and Chief Accounting Officer. Thank you sir, you may be --

Rasmus Van der Colff - *Guidance Software Inc. - VP Finance and CAO*

Good afternoon and welcome to Guidance Software's third quarter 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 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 the information available as of today, November 4, 2015, 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 Web site.

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



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

Patrick Dennis - *Guidance Software Inc. - President and CEO*

Thank you Rasmus and thanks everyone for joining us today for Guidance Software's third quarter 2015 earnings conference call. On today's call I will provide an overview of our third quarter financial performance and provide an update on the progress we are making to transform this business for long-term sustainable growth. Following my remarks, Barry will take us through the third quarter financial results in more detail along with our updated outlook for the remainder of 2015.

After that we will open the call for questions and answers. Overall our performance in the third quarter was mixed. We were pleased that we exceeded our non-GAAP earnings guidance for the quarter. On the other hand the revenue shortfall is unfortunate. That said, this quarter we had a solid performance from our federal business and shifting software functionality and we made meaningful progress on our overall business transformation.

I want to make it clear that we continue to focus on improving company-wide execution. We could have executed more crisply in our training business which would have addressed a portion of the shortfall. We offer no excuse for that. We can and we will do better. The remainder of the shortfall is attributed to our channel distribution strategy. Specifically the channel transition impacted commercial product revenue in Q3. We have every confidence that this is the right strategy for the company and that it will lead to increased sales capacity and transaction volume as it continues to gain traction.

We have already seen the pipeline start to build, increased average selling prices and increased average deal size. We understand that we need to do better and we need to continue to take corrective actions. We felt that it was prudent to incorporate these lessons learned into our full-year guidance which Barry will discuss in a moment in more detail.

I would like to turn and comment on the progress we've made in transforming the business, building on the momentum from the first half. I can assure you there are initiatives and actions already underway that are focused on the future of the company and that will ultimately drive growth. For example, we continue to make progress on our go-to-market transformation in both sales and marketing. We have also demonstrated improvement in our time to market with new software releases.

Continuing to enhance the way that we engage with our customers and innovate is at the core of driving growth in the future. With each new software release, we deliver more value to our customers and make our products easier for the channel to solve.

I will share some insights about the go to market and time to market progress we have made as part of our overall transformation in a minute. I should note that we continue to leverage our strong operational command of the business to manage our costs and rebalance funds to growth areas. We believe we have the right strategy and we are taking the right steps to ensure long-term sustainable growth in this business.

I cannot think of a better way to evidence the go-to-market progress than the body of work Michael Harris, our CMO, and our marketing team released earlier today. In case you haven't seen the press release, we unveiled our company's new corporate brand identity and logo which reflects our current market focus. This new branding will also support all of our global sales efforts. While the Guidance brand has long been associated with the forensic and digital investigations business, our customers around the world are also facing significant challenges related to cyber risk, legal risk and the protection of personally identifiable information.

With our strategic expansion into endpoint security, and other areas of risk management, our new brand better positions us to succeed in all of our key markets and with our key partners.

If you have not had a chance to see the new brand materials, I'd like to invite you to visit our Web site, GuidanceSoftware.com where the new campaign is prominently displayed. An important part of the brand identity is the new Guidance logo which represents the company's mission of providing expert guidance to our customers and solving for many types of information risk.

Our new Guidance tagline from beginning to endpoint reflects the strength of the company's heritage in digital investigations and the value of broader solution set for our customers. Given our continued transformation, I believe it is the right time to launch a new brand identity that's compelling to our customers and competitive in the marketplace.

A brand identity this strong isn't possible without leading solutions that bring real value to our customers. We demonstrated our commitment to improving time-to-market for software releases by shipping Version 5.9 of our endpoint security product during Q3.

As planned, Version 5.9 significantly improves performance to help our customers detect much faster and reduces their overall total cost of ownership. To be very clear, our customers are getting faster performance, new capabilities at a lower total cost all delivered through a point release. This is real value.

I'd also like to share some specific examples of customers who selected Guidance Software products and solutions during the third quarter. In Q3 we closed an important competitive win back with Staples, a Fortune 500 provider of office supplies and business technology products with close to 2000 retail stores and 44,000 employees. Staples will be deploying EnCase Discovery to effectively manage their electronically stored documents and litigation, arbitration and internal regulatory investigations. Simply put, Staples selected us because of our proven track record in this very competitive market.

Let's move to Louisiana State University, the largest public university system in Louisiana with more than 35,000 students and 13,000 full-time employees. They selected EnCase to allow their internal investigators to search, collect, preserve and analyze data from servers and workstations anywhere on their network.

How about the University of Irvine Health, a nationally recognized university-based health services leader with more than 4800 employees who also selected EnCase Enterprise for their internal investigations. These last two examples also illustrate that the digital investigation market is not isolated to law enforcement and military applications. Digital investigations have become a mainstream activity in many commercial businesses already. It also seemed appropriate to highlight how strong our digital investigation business is on a day where we are clearly evolving the brand.

Guidance wouldn't be here today without our digital investigations customers. We continue to have success here and we are very grateful for it. While we cannot disclose specific federal, military or agencies by name, we closed several new large accounts that added to or enhanced their use of EnCase Solutions for e-discovery and incident response. I feel confident in saying our government business is healthy.

Consistent with last quarter, we remain committed to delivering new software value every quarter to help our customers keep up with the pace of change. We plan to release EnCase 5.10 later this month further enhancing our competitive offering in endpoint data security. EnCase 5.10 will add capabilities that our customers have been asking for. For instance, new support for open standard IOC's like YARA, improved surgical remediation, Windows 10 support, Mac OSX support and an integration with Splunk. All of this positions Guidance Software to drive revenue aligned to market demand. I'm excited to see our new software aligned with our new brand, channel ready, customer focused and ready to sell.

I've said before, but our strong operational foundation has offered the support necessary to execute the go-to-market and time to market transformations. This quarter was no exception.

Barry and the finance and operations teams that he leads continue to rebalance our investments to meet these needs. Now, before I turn the call over to Barry, I have to say, after six months at Guidance, I am confident that we understand how to drive this company's performance. I believe that we have made tremendous progress towards an overall business transformation and there is certainly more to do.

Execution issues will happen and I will act on them immediately. However, I will not lose sight of delivering long-term sustainable growth for this business and for our shareholders.

Now I would like to turn the call over to Barry to cover the financials in more detail and share his thoughts on the third quarter. Barry?



Barry Plaga - *Guidance Software Inc. - CFO*

Thank you Patrick. I will now discuss our third quarter 2015 performance and also provide an update on our guidance for the full year. Our third quarter revenues were \$26.8 million compared to \$27.8 million in the prior year period. Product revenues totaled \$7.8 million compared to \$9.5 million in the third quarter of 2014. Enterprise software was lower year-over-year and made up most of the year-over-year decline and from a vertical perspective the decline in enterprise software revenue was primarily in the commercial vertical. During Q3 forensic software was flat and forensic appliances were down slightly.

Gross margin on product revenue was 68% in the third quarter versus 74% in the prior year due to a higher mix of appliances sold in the current year's quarter. Services revenue increased to \$9 million up from \$8.2 million in the year ago period with the increase primarily driven by continued growth in our PS business especially around incident response.

As the shift in our services offerings moved more toward incident response solutions, we should see improved revenue growth and higher gross margins. For example, during Q3 gross margin on services increased ten points to 38% from 28% in the prior year. SMS revenues, which represent our recurring revenue stream were \$10 million compared to \$10.2 million in the prior year period.

Gross margin on maintenance revenues was 94% compared to 95% in the prior year period. For the third quarter in a row our average enterprise deal sizes increased year-over-year. During the quarter we added 97 new customers of our enterprise products. We continue to emphasize a two-prong strategy focused on landing new enterprise customers and at the same time maximizing up-sell and cross-sell opportunities within our installed customer base which has resulted in higher deal sizes. Meanwhile we are transitioning existing customers, many of who were sold direct to the channel and this takes a few quarters to complete. Total operating expenses for the third quarter were \$19 million as compared to \$19.2 million in the prior year period. We will continue to manage expenses closely and at the same time make appropriate investments in our sales capacity and in extending our marketing capabilities.

Moving on to specific expense line items, research and development expenses were 18% of revenues compared to 17% in the prior year. Selling and marketing expenses were 33% of revenues versus 34% in the prior year and G&A was 15% of revenues versus 13% in the prior year.

Non-GAAP net loss for the third quarter was \$900,000 or \$0.03 per share as compared to a non-GAAP net loss of \$200,000 or \$0.01 per share in the third quarter of 2014. Turning to the balance sheet and some related metrics, cash and cash equivalence as of September 30, 2015 totaled \$18 million as compared to \$15.6 million as of September 30, 2014.

Cash used in operations was \$2.6 million as compared to \$3 million in the prior year period. Now, I would like to turn and discuss our forward-looking guidance. Given the Q3 shortfall, we are taking a cautious stance on Q4. We are lowering our product revenue expectations for the balance of the year. This results in a fourth quarter revenue range of \$25.6 to \$26.6 million and a non-GAAP loss range of \$0.12 to \$0.08 per share.

As such, revenue for the full year is expected to be \$105 to \$106 million and non-GAAP pretax EPS for the year is expected to be a loss of \$0.26 to a loss of \$0.22 for diluted share. As I sit here today, I continue to see momentum building our business. For the first time at Guidance I am surrounded by a world class enterprise software management team and for the first time I see clarity in our product roadmap, I see a big shift in our corporate branding and our product messaging and I see a change in our corporate culture which knows it has to act with a sense of urgency. We are investing heavily in our talent and in our products and this will benefit the company and its shareholders in the years to come.

In closing, we hope to see many of you later this month at the ROTH Technology Corporate Access Day in New York, the Southwest Ideas Conference in Dallas or the Imperial Capital Security Investor Conference in New York in early December. That concludes our prepared remarks and we will now open up the call to your questions. Operator?

QUESTIONS AND ANSWERS

Operator

Thank you. We will now be conducting a question and answer session. (Operator instructions). One moment please while we poll for questions. Our first question comes from the line of Mark Schappel at Benchmark. Please proceed with your question.

Mark Schappel - The Benchmark Company - Analyst

-- and thanks for taking my question. Patrick, I was wondering if you could just review, again, the issues that you ran into with respect to your channel distribution strategy, the new strategy that you put in place?

Patrick Dennis - Guidance Software Inc. - President and CEO

Yeah. Hey Mark, how are you? Good to hear from you. So, you know, as we mentioned before in prior calls, the channel strategy is not one that's unknown in the software business, there's a set of steps that companies have to take to successfully activate the channel. Some of those steps we took earlier in the year so for those on the call that may not remember, we made the appropriate policy changes in Q1 so that there's not any friction with the sales force. By Q2 we stood up a significant amount of the distribution necessary both here in North America and in Europe and we're moving into the phase where we need to actually transact through the channel for a period of time in conjunction with the direct sales force and then overtime increasingly with them producing opportunities and closing opportunities on their own. So, now to specifically answer your question, here's what I saw that I liked during the quarter and here are the few places I think we could have, the channel, helped us out a little bit more.

So, on the positive side, we saw quoting activity up, pipeline up, average sale price up, average deal size up. On the downside we didn't see enough transaction volume closed to offset the revenue we would have needed to hit the plan.

So, very specifically, we've taken a lot of the right steps to get the channel strategy lined up and I've said before, that there's a portion of, period of, time where it's going to take to get the traction ramped. I think we're in that space right now but there are certainly early indications that we're on the right path here and that's why I made some remarks in the opening statements around my confidence that this is the right thing for us to do.

Was that clear?

Mark Schappel - The Benchmark Company - Analyst

Yeah, that's fine, thank you. So, next question here on the federal side of your business. Obviously September is a big federal quarter for you guys. Could you go ahead and maybe just give us a little color on what you saw in that vertical?

Patrick Dennis - Guidance Software Inc. - President and CEO

Yeah, so let me back up and say, you know one of the reasons why we mentioned the federal business is in prior years we had often gotten questions about the government business and headed into Q3 I had said, I think we should all suspend disbelief on whether or not the government business was going to share up for us and we should see how the quarter turned out. I think I would describe the quarter as solid and as I made a comment in the opening remarks, the business is healthy. As you know, we've wanted to manage the mix of government business as part of the overall portfolio to a percentage that we were comfortable with. I think we did that well and appropriately and we have some lessons learned from the government business here in North America that we're going to leverage around the rest of the world. So we saw some -- have good lessons that we could carry to other places to get better performance. I think we got the mix to the right percentage in the portfolio and we saw our execution head on all of the right cylinders for Q3.



I always ask Barry to make some comments since he has a better sense of the history than I do here with the government business.

Barry Plaga - *Guidance Software Inc. - CFO*

Yeah, Mark, as you may recall we have a pretty long established channel with the federal sector and so that was not impacted by our channel issues as it wasn't the enterprise commercial market. What I like, what I saw, in Q3 and even year-to-date, the nine months through for the federal business is a really good balance of enterprise product bookings were strong, our enterprise services bookings were very strong and you saw that kind of through the growth in our services business during the quarter, year-over-year and it was strong across both the forensic and Tableau appliance business so it's -- I think it's back on track and it's gaining some momentum.

Mark Schappel - *The Benchmark Company - Analyst*

Okay, and then just finally, in the past you've given some metrics around your cyber security business as far as the growth rates in the quarter and percentage of total revenue. I was wondering if you could update us with those?

Patrick Dennis - *Guidance Software Inc. - President and CEO*

So, you know, a couple of points there. You know, I think we -- when it comes to cyber and we think about the channel a bit, we're counting a lot on the channel to help us accelerate cyber; say a little less satisfied with this quarter in that regard then maybe quarters prior. But, again, I see some early indications including pipeline sale prices and deal sizes like was mentioned before on the cyber side that make me optimistic. I'd also say that we continue to see demand in our services business around cyber so we saw growth in the services business. I think we're going to continue to see some growth, or return to growth in the software business this week; get this channel execution model headed in the right direction.

Mark Schappel - *The Benchmark Company - Analyst*

That's all for me, thanks.

Barry Plaga - *Guidance Software Inc. - CFO*

Thanks Mike.

Patrick Dennis - *Guidance Software Inc. - President and CEO*

Thanks Mike.

Operator

Our next question comes from the line of Hendi Susanto at Gabelli & Company. Please proceed with your question.

Hendi Susanto - *Gabelli & Co. - Analyst*

Good evening.



Barry Plaga - *Guidance Software Inc. - CFO*

Hi Hendi.

Patrick Dennis - *Guidance Software Inc. - President and CEO*

Hi Hendi, how are you?

Hendi Susanto - *Gabelli & Co. - Analyst*

Hi, I saw the latest investor presentation and then you presented like a lot of new information. One of them is the opportunity and the endpoint detection and response market where you highlighted that the company has the potential to grow the top-line at the market rate of 30% to 40% KEGR. How do you plan to achieve that and what should we expect in the endpoint detection and response going forward?

Patrick Dennis - *Guidance Software Inc. - President and CEO*

Yes so that's a great question Hendi. So, you know, the point that we made around the growth rate in that market is that, one, it's a high growth market so it's rational for us to allocate resources there. Two, to compete in that market we need to scale a sales force so that they can compete effectively. To do that we're going to create a channel model that allows us to increase the aggregate selling capacity and also allows us to compete in the channel for the business, vis-?-vis the competition. The third thing that we're going to do is deploy increasing software functionality in each software release. We delivered 5.9, we're on schedule for 5.10. We've queued up 5.12 and 5.13 all that increase the software functionality that cyber customers are looking for so they can offset the challenges that they face in that fast moving market and we're confident between the increased velocity and software delivery and the standing up of a more robust channel model, we're going to be able to activate ourselves and get access to that opportunity.

Hendi Susanto - *Gabelli & Co. - Analyst*

And then would you be able to share some kind of preview of what major function of this will come with the new EnCase platform?

Patrick Dennis - *Guidance Software Inc. - President and CEO*

So in -- so we talked about 5.10, I'll give you the highlight reel, I'm not going to give you the specific delivery examples for our roadmap. We talked about increasing support for operating systems including Windows 10 and OSX. We talked about the (unintelligible) 26:10 support, we talked about the Splunk integration. As we move forward into 5.12 we're going to work a little bit more around threat reputation lookup, native black and white listing and then we have some customer satisfaction fixes that I think will help people get some more value out of the software.

By the time we get to 5.13 I think there's going to be some integration with SIEM platforms. It's going to need to be done based upon the release schedule for those other products that are in our ecosystem. We also have some additional remediation bits that we'd like to add there and some more dashboard functionality to make the software easy to use so that kind of gives you a flavor between now and Q2 of next year.

Hendi Susanto - *Gabelli & Co. - Analyst*

Okay, that's very helpful. And then would you be able to refresh our memory in terms of how many channel partners you have at the moment and where would you like it to be in the near term?

Patrick Dennis - *Guidance Software Inc. - President and CEO*

I don't have an exact number Hendi but it's in the hundreds around the globe and, you know, our focus is really on the top 20% of those. There's specific ones in every region and they're different in our different product lines but in the enterprise side, you know, the numbers are in the hundreds and it's the usual -- you know, you get 80% of them returned out of 20% of the participants. So, Hendi you know we're also always concerned with quality so that's, for instance, why we picked Westcon and distribution, we think they're world class in (inaudible), etc., so we'll also continue to make sure we focus on high quality partners.

Hendi Susanto - *Gabelli & Co. - Analyst*

And one more, in the -- in your latest investor presentation, you highlighted that in e-discovery, guidance share is around 7%. So how should we feel in terms of like winning more market share in the near-term? Is it realistic to expect more in 2016?

Patrick Dennis - *Guidance Software Inc. - President and CEO*

So, you know, I'm not going to make too many forward-looking statements about 2016, I think we have some time for us to get that model settled out. What I've said in the investor presentation, other meetings, has been, you know, we understand the growth rate in that market. The model that is in the investor presentation is a constant share model. I think that's a conservative view and we'd like to outperform constant share and at the same time I think I've also made it clear that we want to make sure we access the opportunity around cyber security and also I've alluded to the fact that we think that there's a side of the e-discovery market that's beginning to emerge and focus on personally identifiable information and as that segment of the market starts to shape up and form, it's going to take a portion of the e-discovery market and a portion of what's known as the information governance market and as we enter the new year, we're starting to think that that's going to take shape as a standalone market.

Hendi Susanto - *Gabelli & Co. - Analyst*

Thank you.

Patrick Dennis - *Guidance Software Inc. - President and CEO*

You bet.

Operator

Our next question comes from the line of Michael Kim of Imperial Capital. Please proceed with your question.

Michael Kim - *Imperial Capital - Analyst*

Hi, good afternoon guys. Just going back to the cyber security part of the business and the specific endpoint, some of the larger security vendors have announced some fairly large platforms or earnings solutions and curious kind of where you see your endpoint product fitting within that ecosystem and if enterprises are starting to sort of evaluate or reevaluate their endpoint strategy and where budgets could start to shift?

Patrick Dennis - *Guidance Software Inc. - President and CEO*

First of all, hey Michael it's good to hear from you. So here's what we see that's probably interesting about endpoint, in prior calls we've talked about that market taking shape and that to a large extent it was useful that it became a market with a name, endpoint detection and response. We still saw a significant amount of variability product-to-product and that continues to be the case. And so what we've seen customers doing is using a combination of endpoint products to solve for the set of problems that they have in totality. So there was a point in time where I considered



our software to be competitive with other people's software. These days what I see is customers leveraging our software products for our best of breed capabilities and oftentimes using additional endpoint or additional security products in a complementary fashion.

So I think there's less argument over budget at the individual deal level and we see customers broadening their consumption of overall security solutions to reduce the aggregate risk profile.

Michael Kim - *Imperial Capital - Analyst*

Great and then when you think about the channel network or broadening that out through the distributors, you know, are you seeing a lot stronger uptake on the security resellers and how that's progressing?

Patrick Dennis - *Guidance Software Inc. - President and CEO*

I'd say we're seeing stronger uptake. I mean, we consciously bias our decision around our channel model to make sure that we could access that security opportunity that we've talked about so there's probably a bit of confirmation bias in there built into the decision around Westcon etc., but we certainly have seen a lot of interest in those products by the channel partners, you know, it's again one of the reasons why I think we're on the right path we just have to get to a place where there's full traction.

Michael Kim - *Imperial Capital - Analyst*

And sorry if I missed this but do you see an opportunity to leverage that into some of the federal opportunities that are emerging for new security solutions?

Patrick Dennis - *Guidance Software Inc. - President and CEO*

So I kind of think of the federal business as Barry described it. It's almost like a vertical market for us and so the channel model for our federal business and the channel model for our commercial business, they will have -- they will likely have some similarities and they'll have some differences. We're evaluating, you know, what the best channel model is for the federal business right now. If that question is, do we want to access the substantial government contracts that are in flight, sure we do, and we'll make sure that we're in a position to do that.

Michael Kim - *Imperial Capital - Analyst*

And do you have a dedicated federal sales leader now?

Patrick Dennis - *Guidance Software Inc. - President and CEO*

Yes we do, in fact this, since you asked, this quarter we made a decision not only to -- we had a dedicated federal sales leader. What we decided to do was actually consolidate all of our government assets in the field under that one leader so that he can be incredibly responsive to the needs of our government clients and he has kind of the full suite of resources there to do that. We also asked him to take many of his lessons learned on how to be successful working in that space overseas. So, we added a fair amount of resource so we can do the best job possible there, right, and you know we feel that way since we started that process in the sales force broadly at the beginning of the year and now we're doing it in an even more focused way around the government and we think we're going to see some additional results as we bring those lessons learned overseas.

Michael Kim - *Imperial Capital - Analyst*

Great, terrific, look forward to the rollout.



Patrick Dennis - *Guidance Software Inc. - President and CEO*

Thank you.

Operator

Our next question comes from the line of Mark Jordan of Noble Financial. Please proceed with your question.

Mark Jordan - *Nobel Financial - Analyst*

Good afternoon gentlemen. Question in the fourth quarter given the guidance that you have, what realignment expense levels or needs do you have that should flow the P&L in Q4?

Barry Plaga - *Guidance Software Inc. - CFO*

I'm actually looking at those to be pretty immaterial Mark; to be near zero. So, not anticipating any expense in that category in Q4.

Mark Jordan - *Nobel Financial - Analyst*

I mean, if you -- historically if you looked at the company's selling efforts, you had direct sales force and then grew an in-house sales force. As you've transitioned to a channel oriented distribution, what in-house capabilities will you maintain to support the channel?

Barry Plaga - *Guidance Software Inc. - CFO*

Yeah, I've had a similar question on prior calls so my strategy here hasn't changed. I believe in the history of all companies that sell software, you generally begin with the direct sales force and then decide that you want to use the channel or you begin with a channel sales force and then you decide that you want to add direct resources.

Where we are in our lifecycle is we're starting to stand up this channel and make it a bigger portion of the business. As such, when you start to see the take rate and the close rate in the channel stand up on its own, you can start to take the direct sales resources that you have and begin to reinvest them in focused large accounts.

So we'll continue to do that as we see traction inside the channel and we start to see the channel increase, you would think of geo-rep yield, so as geo-rep yields increase and the velocity through the channel increases we'll reinvest direct sales capacity in our largest accounts to increase share volume.

Mark Jordan - *Nobel Financial - Analyst*

Okay, and given the -- normally the fourth quarter has a -- you know, on the commercial side at least a budget flush. Is the -- the applied guidance relatively flat product sales Q4 versus Q3. Is that flat versus a seasonal uptick just a function of the dislocations of this transition you're going through or is there another cause for not having that more normal seasonal uptick?



Patrick Dennis - *Guidance Software Inc. - President and CEO*

I think you hit the nail on the head. I think Barry's word was cautious. You know, we know we are confident that the channel strategy is the right strategy. We know what steps we need to take to make sure that the channel is activated. The question that we've always had is the rate at which it will activate and the speed at which we'll get the traction. So, given what we saw in Q3 we're simply trying to be prudent for Q4. There's nothing that we -- nothing else that we haven't shared with you.

Mark Jordan - *Nobel Financial - Analyst*

Okay, thank you very much.

Operator

Our next question comes from the line of Sarkis Sherbetchyan, of B. Riley & Company.

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

Thanks for taking my questions. Given the implied guidance for Q4, with respect to the loss in Q4, why is it greater than in Q1 on higher revenues?

Barry Plaga - *Guidance Software Inc. - CFO*

So we've -- if you go back nine months we did have a lower operating cost model. We had quite a few openings in certain critical areas and I talked in my remarks about our seasoned software management team now that we have on board; most of those were not onboard in Q1 so there was -- and they hadn't built out their teams yet and so that transition has happened and I'd say our kind of Q4 expense run rate is going to be close to what it is going forward for a while. So, there is an uptick in Q4 also to commission plans, etc., as reps start to hit their annual quotas.

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

Got it so the Q3 kind of expense level is a good baseline to work with going forward?

Barry Plaga - *Guidance Software Inc. - CFO*

Nah, I think our Q4 which, you know, should be, you know, \$1.5 to \$2 million higher at the high end of that revenue range. So the expenses in Q3 were a little lower than we anticipated due to lower sales commissions due to kind of the revenue shortfall so that should come back a bit in Q4 and expenses will be higher.

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

Okay, understood. And when do you think you can get back to profitability?

Patrick Dennis - *Guidance Software Inc. - President and CEO*

We've said in previous calls that some of that answer is dictated by the level of investment in the markets that we're competing in. So, we continue to have a strategy where we want to grow the business, as I mentioned earlier, in a sustainable way into the future and based upon the investment that we're seeing in the security business right now I think for a period of time we're going to need to continue to reinvest in the business so that we can be effective in competing for those dollars in that market.



I don't think that that is a position that is materially different from any of the people whom we compete with in those markets so that will be the plan and as we start to see our level of success change and where the market dynamics change, we'll reevaluate that position.

In the meantime, I think once again through Q3 we've demonstrated we have a strong operational command of the business. Barry, Rasmus and that team do a great job of making sure that we handle the financial assets that we have as prudently as we can.

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

Understood and I think with respect to some of the shortfall for Q3 in the prepared remarks you also mentioned some portion attributable to the training business, is there a level that you can quantify that at?

Patrick Dennis - *Guidance Software Inc. - President and CEO*

Sure, 40% to 50%. So I've made remarks in previous calls that we're going to be very transparent with this community. That's our fault, we had an execution failure on our side. We're taking the right corrective action on that particular issue. It probably made up 40% to 50% of that shortfall. And, again, I don't offer any excuse for that, that's on us. So, we'll get it sorted out.

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

All right, that's all for me, thank you.

Operator

There are no further questions in the audio portion of this conference. I would now like to turn the conference back over to Rasmus Van der Colff for closing remarks.

Rasmus Van der Colff - *Guidance Software Inc. - VP Finance and CAO*

Great, thank you operator. That concludes our call for today and I'd like to thank everybody for joining us and we look forward to speaking next quarter. Thank you.

Operator

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

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