Guidance Software, Inc.

Second Quarter 2016 Earnings Call

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C O R P O R A T E P A R T I C I P A N T S

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

Patrick Dennis, *President and Chief Executive Officer*

Barry Plaga, *Chief Operating and Financial Officer*

C O N F E R E N C E C A L L P A R T I C I P A N T S

Zach Cummins, *B. Riley & Co.*

Michael Kim, *Imperial Capital, LLC*

Hendi Susanto, *Gabelli & Company*

P R E S E N T A T I O N

Operator:

Greetings, and welcome to Guidance Software Second Quarter 2016 Earnings Conference Call. At this time all participants are in 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, Rasmus Van Der Colff. Thank you. You may begin.

Rasmus Van Der Colff:

Good afternoon and welcome to Guidance Software's second quarter 2016's earnings conference call. With me today are Guidance Software's President and CEO, Patrick Dennis; and our COO and CFO, Barry Plaga.

We would like to remind everyone that during today's conference call, we will make certain forward-looking statements regarding the future operations, opportunities and financial performance of Guidance Software within the meaning of the Safe Harbor provision of the Private Securities Litigation Reform Act of 1995. These statements involve a high degree of known and unknown risks and uncertainties that could cause actual results to differ materially from those to be discussed. Please also refer to the risk factors and other disclosures contained in the Company's most recent reports on Forms 10-K, 10-Q and 8-K filed with the SEC for a more detailed discussion of these factors.

The forward-looking statements made in today's conference call are based on information available as of today, August 02, 2016, and Guidance Software assumes no obligation to update such statements to reflect events or circumstances after today's date.

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

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

Patrick Dennis:

Thank you, Rasmus, and thank you everyone for joining Guidance Software's Second Quarter 2016 Earnings conference call. On today's call I will discuss highlights from our financial performance for the second quarter and provide details demonstrating that our pivot towards cyber security is taking hold and our transformational efforts are stabilizing. Following my remarks, Barry will take us through the second quarter financial results in more detail. After that, we will open the call for questions-and-answers.

Total revenues were $27.6 million, up slightly on a year-over-year basis and up 7% sequentially. Total product revenue was up 16% year-on-year and up 29% sequentially. As a result we are now deployed on more than 33 million Endpoints around the world. Our Forensic Security Suite made up 75% of product revenue, up from 60% in Q1 and 39% a year ago. This was driven by the sale of our EnCase Endpoint Security product, which grew 40% year-on-year and over 100% sequentially.

In addition to revenue growth the EDR average selling prices increased more than 100% year-on-year and sequentially. The increase in forensic security software sales also resulted in a 240 basis point improvement in gross margin. The Company-wide transformation to pivot towards cyber security one year ago continues to gain momentum and improve results. We remain on-track to achieve our previously stated revenue guidance for the year.

These transformational efforts have also enabled us to take meaningful steps to improve the profitability of the Company. Through product revenue growth, targeted restructuring, expense controls and the resolution of some longstanding litigation, we expect to be EBITDA positive for the second half of the year. These efforts will result in one-time charges in Q2 and improved EPS for the remainder of the year. Barry will discuss these items in more detail and raise our full year EPS guidance. We continue to demonstrate strong operational command of the business and it's now resulting in persistent profitability improvements on an ongoing basis.

We have started to stabilize the operation during these transformational efforts. The Engineering Team completed eight product releases in Q2, more than ever before. The Forensic Security Suite was updated with EnCase Endpoint Security 5.13, EnCase Endpoint Investigator 8.1 and with the generally available release of the EnForce Risk Manager 11. EnForce is our first new platform product in 10 years. Additionally, we released the long anticipated EnCase Forensic 8.1 and three products from our Tableau division. We have consistently delivered on our commitment to increase product velocity over the last year. We are also pleased with a threefold increase in our net promoter score among existing customers over that same period.

Additionally, there's also been significant progress made in our go-to-market organization. We redefined our sales hiring profile to attack the cyber security enterprise software market as part of the restructuring in January. Today more than 80% of our field sales capacity is aligned to the new profile and results are improving. For example, in Q2 we sold our first license of EnForce Risk Manager. Over 80% of our transaction volume went through the channel. The number of deals over $250,000 doubled year-on-year and we transacted our first $1 million deal since 2012.

The revenue performance was consistent across geographies. North America, (inaudible) and EMEA all had product revenue growth on a year-on-year and sequential basis. In Q2, we closed several notable enterprise software deals with major corporations and Government agencies. Airbus Helicopters, a €6 billion aerospace company selected Guidance for Endpoint Security over several major EDR competitors, due to the strong IoC identification and remediation capabilities included in version 5.13. The European Commission also chose Endpoint Security and Endpoint Investigator for their pan-European enterprise due to the proven scalability of EnCase and its ability to manage security and investigations across a multi-country environment. European Commission will now have approximately 75,000 endpoints deployed.

As mentioned earlier, our Federal business is improving, evidenced by a very large new 40,000 Endpoint deployment of EnCase Endpoint Security for a major Federal organization. Rogers Communications, one of the largest diversified communication and media companies in the world selected Endpoint Security to help protect their 60,000 deployed endpoints. Our new real-time monitoring capability, threat intelligence and SIEM integrations were key drivers in the decision by this customer to choose Guidance.

VIZIO, a multi-billion dollar consumer electronics brand was the first customer of our new EnForce Risk Manager product. VIZIO will be deploying our solution in their corporate offices to identify, isolate and remediate sensitive data and critical endpoints. VIZIO made the purchase after using the product in a proof-of-concept capacity. In our classic business we also had great wins like Delta Airlines, who selected Guidance for e-discovery. We beat the competition in this deal due to the strength of our data collection and workflow. In the customer's words "Guidance is the only Company positioned to provide Delta with a targeted e-discovery solution, which directly aligns to our needs."

In addition to these key customers, we closed new software deals with several other name brand companies including Scottrade, DuPont and Saber, which shows our product sales momentum is growing with the largest companies in the world. Since repositioning the Company around Forensic Security in the second half of 2015 we are now selling in excess of one million Endpoints every quarter. This opportunity will accelerate with the growth in cloud and IoT base endpoints, which is increasingly important to our customers.

It is no coincidence that building high quality products faster, sold to the right customers at the right price has led to product revenue growth. The Company has never been better positioned to capitalize on the Cyber Security market opportunity. We expect continued growth in EnCase EDR, Endpoint Investigator and EnForce Risk Manager sales because of our Forensic Security Suite, which is fully differentiated from our competition and has proven unique value in the marketplace.

Now I would like to turn the call over to Barry to share his thoughts on the second quarter financial results in more detail. Barry?

Barry Plaga:

Thank you, Patrick. My prepared remarks today will focus on our second quarter 2016 performance and restructuring efforts as well as an update on our outlook and guidance for the year.

Our second quarter revenues were $27.6 million, up slightly compared with the prior year period. Importantly this quarter represents our second sequential quarter of year-over-year revenue growth. The last time we achieved that was in Q3, 2012.

Total product revenues were $9.6 million compared to $8.3 million in the second quarter of 2015. The increase in product revenue was primarily driven by an increase in sales of our Security Software Suite of products, supported by our increased focus on pricing as well as our continued strong performance in our Forensic products. I'd like to touch upon both of these factors in more detail for a few moments.

In regards to pricing, as Patrick mentioned, we've experienced consistent ASP expansion since last year. Our average selling price in the second quarter for Endpoint Security was $114,000 per deal, up 128% year-over-year and up 100% on a sequential quarter basis. As a result, we doubled the amount of deals over $250,000 compared to the second quarter of 2015. We are extremely pleased with our progress in this area and look forward to delivering continued strong results in the coming quarters.

Importantly, more than half of our Endpoint Security revenue came from new customers in the second quarter, a testament to the achievements of our Sales Teams' customer acquisition efforts, our competitiveness and the success of our product upgrades. As a result, the high mix of our enterprise security revenue drove a 240 basis point gross margin improvement in the quarter. Gross margin on total product revenue for Q2 was 75% compared to 73% in the prior year period.

Services revenues were $8.2 million compared to $9.3 million in the year-ago period, as we were more focused on product revenue generation during the quarter. Gross margin on services was flat year-over-year at 35%. Maintenance revenues, which represent our recurring revenue stream were $9.7 million, down slightly compared to the prior year. Gross margin on maintenance revenues was 94%, in line with historical periods. Total gross margin increased to 70% in Q2, 2016 versus 67.6% in the prior year.

Research and development expenses were 22% of revenues; selling and marketing expenses were 41% of revenues; while G&A was 13% of revenue. Excluding the impact of one-time items, total expenses in Q2 were lower than expectation. One-time items in the quarter included $1.5 million in expenses related to the proxy contest. We also incurred approximately $900,000 in restructuring expenses related to employee, severance and lease write offs.

Lastly, we incurred a $2.3 million charge to settle the McCreight litigation related to a patent infringement lawsuit that has been ongoing for more than five years. As an offset to this settlement we settled a related indemnity lawsuit for $1.2 million which will be credited to our P&L upon receipt in Q3. Based on the economics of the case it made sense to settle both sides of the litigation for a net cost to Guidance of $1.1 million. Going forward we will save approximately $700,000 per year in legal expenses related to this matter. In total, we expect to realize annual savings of approximately $2.5 million to $3 million as a result of these restructuring efforts and the resolution of the legal matter.

For the quarter, non-GAAP net loss was $2.4 million or $0.08 per share as compared to a non-GAAP net loss of $1.3 million or $0.05 per share in the prior year.

Turning to the balance sheet and some related metrics, cash and cash equivalents as of June 30 totaled $13 million, as compared to $19 million as of December 31, 2015 and $21 million as of June 30, 2015. Cash used in operations for the second quarter was $6.5 million compared to $1.7 million in the prior year period.

Turning now to our forward-looking guidance; for the full year, we continue to anticipate that revenue will be in the range of $108 million to $112 million. In addition, as a result of the restructuring and cost reduction initiatives recently completed, we now expect to be EBITDA positive in the second half of 2016 and for the full year in 2017. We also expect improved earnings for the full year 2016 and are revising our non-GAAP EPS loss to a range of $0.21 to $ 0.25 per share from our previous range of a loss of $0.30 to $0.36 per share. With that, I'll now turn the call back over to Rasmus.

Rasmus Van Der Colff:

Thanks Barry. Before going to Q&A, I'd like to mention that the Company will be participating in several Investor Conferences later this month. We are scheduled to present at the Oppenheimer Conference in Boston on August 9, followed by the Canaccord Conference also in Boston the following day on August 10. We hope to see many of you there. With that Operator please open the call for questions.

Operator:

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

Our first question comes from Kevin Liu from B. Riley. Please proceed with your question.

Zach Cummins:

Hi, good afternoon. This is Zach Cummins on for Kevin today. I just want to start off with your EnForce Risk Manager product. It sounds like you are making good traction at this point. I was just wondering what does your pipeline looks like for the second half of 2016.

Patrick Dennis:

Hello, it's Patrick. Thanks for joining us today, give our best to Kevin. So the pipeline is looking robust. On previous calls we haven't shared specific pipeline metrics with all of you. What I will say is there is a robust number of closing transactions that are in play for the back half of the year. Those were generated in combination because of the buzz that we got around the product, given its uniqueness in the market, the work done at our Enfuse Conference this year and some targeted road shows that happened around the world. So pipeline's building. It's robust and we continue to see a large number of customers make request to go to demo when they see initial bits of the product and then demo requests quickly turning into quote requests.

Zach Cummins:

Great, that was really helpful. Then for your anticipated cost savings in the second half of 2016, can you provide more color on which specific line items that will be coming out of?

Patrick Dennis:

Sure. So it's a—a chunk of it's going to come out of professional services. We've done some work there on reducing the non-billable overhead. In addition we will see some savings out of G&A, which make up. It's kind of the two main buckets of where those cost savings come out of.

Zach Cummins:

Okay, thank you. Then I guess for the final question. Is it pretty safe to assume that—I remember on the Q1 earnings call you were remaining committed to providing new software updates and new products every quarter. Is it safe to say that's still your same initiative going forward?

Patrick Dennis:

Yes, it's same initiative going forward. We've been doing that for several quarters now. I think just to give you a little bit of color around that, when we started the program we committed to doing software updates every quarter. But they really began focused on kind of enhancements and improvements for support for our clients. We moved into new feature function development along the way. So this quarter for instance we dropped digital forensic investigation timeline into the security product, which is a really big and brand new feature. So not only are we committed to doing it quarterly but we are also improving and enhancing the quality of each release that we ship. So we remain committed to it and on this call today we talked about how there were more products and releases shipped in Q2 than ever before. So really, really happy with the pipeline in product development and the velocity that the Development Team is working on and to do that and to have a threefold increase in customer satisfaction is pretty remarkable.

Zach Cummins:

All right. Great. Thank you for taking my questions.

Patrick Dennis:

Appreciate it.

Operator:

Our next question comes from Michael Kim from Imperial Capital.

Michael Kim:

Hi, good afternoon guys. With regards to that Endpoint product revenue growth, can you talk about how much of that was driven by expand (phon) orders with some existing or earlier customer adoptions and how much came from new customers?

Patrick Dennis:

Yes, I don't think we broke the number out specifically, but Michael, we had a large number of new logo wins that were substantial in size. So when I talk about the number of deals over $250,000 for instance, Included in that were in fact new logos. So we are not driving our Endpoint growth just on the expand boost (phon), we're actually capturing brand new logos at the same time, and by the way those brand new logos are contributing to some of these large deals.

Barry Plaga:

It was about two-thirds coming from new logos in that product line. So good expansion with a third and then two-thirds of the sales, so good mix.

Michael Kim:

Okay, great. Then not too long ago you talked about some opportunities for public cloud deployment, I believe you were doing some demo activities on AWS. Any commentary on how that's progressing with may be some of your public cloud enterprise customers or your hybrid cloud customers?

Patrick Dennis:

Yes great question. So to clarify—and this is less for you Michael than it is for everybody else on the phone. What we decided we were going to do is we were going to prove our technology worked on pubic clouds. We started with Amazon and that worked successfully. People and the customers are buying our Endpoint software to protect those public cloud endpoints or hybrid cloud endpoints, depending on their deployments. From our point of view and their point of view they are making a deployment decision around those.

So for instance there is a very large customer that we're working with right now who has shifted, much like many of other deals, tens of thousands of endpoints into Amazon and as part of their workload balancing moving from on-prem to off-prem, they will be moving our software off-prem along with it. So it does two things for us, that project; one is defends the installed base of endpoints that we have, that might be installed in the data center today and moving off-prem. Then second, it gives us the ability to expand on to public cloud-based endpoints which tend to be higher in quantity and more quickly. So yes, we're seeing some good traction and adoption there with our customers thinking of it as a deployment model.

Michael Kim:

Any early efforts on Azure as well?

Patrick Dennis:

That's the next one. So in order we will do AWS and then we will do Azure. The technical integration on Azure it turns out to be a little bit more challenging. Then as a bridge we're also—we did Amazon, we began with the commercial side. We will also quickly do a certification on the Government side of that cloud so that we can bring support for Amazon GovCloud to our Federal customers.

Michael Kim:

Great, and then lastly with the increase in larger, $250,000 deal sizes, was that driven by a global accounts program or are you seeing some good activity out of the channel through some of your distribution partners?

Patrick Dennis:

Another really good question. A little bit of both, so the Global Account program has been very successful for us already and I think it's likely when we look back at the year we're going to think that, that program did a really, really nice job. So if I think about this quarter specifically a large number of those were driven by some of our early global account activity and frankly the vigor that the new sales profiles, even at the account executive level brings to large opportunities. So in this quarter that was probably more biased to the new selling profile and the co-ordination happening between new Sales Management, new Sales Executives and the Sales Leadership Team.

At the same time we did see some more meaningful transactions brought to us, and through the channel. So we are seeing improved performance there as well. So I think if you actually broke out direct deal sizes and channel deal sizes you would actually see that both went up.

Michael Kim:

Great, terrific. Thank you very much.

Patrick Dennis:

Appreciate it.

Operator:

Once again ladies and gentlemen, if you do have a question please press star, one on your telephone keypad.

Our next question is from Hendi Susanto from Gabelli & Company.

Hendi Susanto:

Good afternoon, Patrick and Barry.

Patrick Dennis:

Hi, Hendi.

Barry Plaga:

Hey, Hendi. How are you?

Hendi Susanto:

With regard to your full year revenue guidance and positive EBITDA guidance in the second half, how should we think about the spread between Q3 and Q4? Similarly how should we think the spread out of the second half expense saving of $2.5 million and $3 million between Q3 and Q4?

Barry Plaga:

Yes, so on the latter one on the expense savings, I'd say it's pretty well balanced between both Q3 and Q4, it's 50/50. To kind of clarify on that earlier question I think we will see about $300,000 to $400,000 per quarter in savings of cost of services, about $300,000 to $400,000 savings out of G&A, $300,000 to $400,000 out of R&D and then the balance out of sales and marketing. So that's kind of where the mix comes from. Then in terms of looking at the revenue seasonality between Q3 and Q4 we expect Q4 to be the strongest quarter of the year based on kind of the pipeline development, and the things we have in the hopper right now. So I would—I'd weight it a little heavier towards Q4 than Q3.

Hendi Susanto:

How about EBITDA? Barry.

Barry Plaga:

So EBITDA would be maybe slightly negative in Q3. It's a breakeven and then it would be positive in Q4.

Hendi Susanto:

Okay.

Barry Plaga:

But net-net the six months will be positive.

Hendi Susanto:

Then Patrick as you transform Guidance Software more towards security, any insight on how much e-discovery business is?

Patrick Dennis:

E-discovery business continues to be a hallmark and classic part of our business. It's performing as we would have expected vis-à-vis the plan, and on this call today for instance I shared one of the wins with Delta, where we did a nice job. So if it continues to be an important part of our business. Nonetheless as I've been clear with you all at the street level we are going to continue to press in the Cyber Security and we're going to continue to drive that Forensic Security Suite to be a larger percentage of revenue. So rather than breaking out the e-discovery line individually I think what you did focus on is this notion of Forensic Security versus classic revenue and we included some materials in our supplementary documents, which you can also get online and we will be providing into the future, so you could see how that mix has shifted.

So we continue to make product development efforts there and we continue to offer our customers a high level of service, and at the same time we just continue to see a much bigger opportunity as it relates to Cyber Security and so we're driving the Forensic Security Suite revenue to a much higher percentage in the mix.

Hendi Susanto:

Okay. One last question for me, so in the Cyber Security space you introduced new products. Any insight on sales of individual products versus a bundled set of products?

Patrick Dennis:

Sure, so I think the nature of the question is kind of philosophically how do we think about the Forensic Security Suite being sold as a suite versus the Forensic Security Suite being sold as individual products? Just again, to calibrate everybody, the Forensic Security Suite is made up of EnForce Risk Manager, our EnCase Endpoint Security and our EnCase Endpoint Investigator product. So those three products make up the suite. Customers can buy them individually or they can buy them as a suite. Somewhat by the nature of the fact that EnForce Risk Manager (inaudible) we haven't had a customer buy a full and complete suite yet.

Generally, what we see is a customer buy one or two products at a time, usually in two product sales. It's Endpoint Investigator and Endpoint Security at one time. So we see that for some number of deals and then we see a reasonable number of deals that our individual products, because the design principles are we want to have best-in-class products in each of those categories and then if you buy those products together you get even more value.

So if we look at EnCase Endpoint Security, our Endpoint Security product is competitive with Tanium and beats Tanium, it's competitive Carbon Black and it beats Carbon Black on a standalone basis, and we believe for instance we have the best real-time monitoring in that category, full stop.

We also believe we have the gold standard in investigative software, where in this particular case we're talking about our Endpoint Investigator technology. If a customer is looking for investigative technology they can buy the gold standard in Endpoint Investigator, if a customer is looking for top shelf Endpoint Detection and Response they can buy our EnCase Endpoint Security products. They are best-in-class individually and then they offer you even more value when you use them as suite.

Hendi Susanto:

Thank you and all the best for the second half.

Patrick Dennis:

Thank you.

Barry Plaga:

Bye Hendi.

Operator:

Ladies and gentlemen, we have reached the end of the question-and-answer session. I would like to turn the floor back to Management for closing remarks.

Rasmus Van Der Colff:

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

Patrick Dennis:

Thank you.

Operator

Thank you. This does conclude today's conference. Guidance Software thanks you for your time and your participation. You may disconnect your lines at this time and have a good evening.