



Guidance Software, Inc.

First Quarter 2017 Earnings Conference Call

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CORPORATE PARTICIPANTS

Rasmus Van Der Colff, *Vice President, Finance & Chief Accounting Officer*

Patrick Dennis, *President and Chief Executive Officer*

Barry Plaga, *Chief Financial Officer and Chief Operating Officer*

CONFERENCE CALL PARTICIPANTS

Kevin Liu, *B. Riley & Co.*

Brian Alger, *Roth Capital Partners*

Michael Kim, *Imperial Capital*

Hendi Susanto, *Gabelli & Company, Inc.*

PRESENTATION

Operator:

Good afternoon, everyone, and welcome to Guidance Software's First Quarter 2016 Earnings Result Conference Call. After comments by Management, we will go directly to a question-and-answer session. As a reminder, this call is being recorded.

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

Rasmus Van Der Colff:

Good afternoon and welcome to Guidance Software's First Quarter 2017 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 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 report on Forms 10-K, 10-Q, and 8-K filed with the SEC for a more detailed discussion of these factors.

The forward-looking statements made in today's conference call are based on information available as of today, May 2, 2017, 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 also in our supplemental slide presentation on our website.

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

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

Patrick Dennis:

Thank you, Rasmus, and thank you everyone for joining Guidance Software's first quarter 2017 earnings conference call. On today's call, we will discuss Q1 in detail and then take questions.

Q1 was a solid step towards achieving our 2017 objectives. The Company performed well across meaningful operating metrics. Revenue of \$26.8 million or 4% growth year-on-year; earnings per share of \$0.07 compared to negative \$0.08 in Q1 of 2016; a cash balance of \$17.8 million, up from \$12.6 million sequentially. Product revenue of \$8.9 million or 19% growth year-on-year; Forensic Security Suite bookings growth of 169% year-on-year. We added 1 million new end points and upgraded an additional 4 million, and the number of deals over \$250,000 doubled year-on-year.

The growth continues to be driven by our Security line of business. In total our Enterprise software business was up 90% year-on-year. I'd like to focus on the key wins from Q1 that contributed to this growth. We won new business at one of the world's leading global security and aerospace companies. This company selected Guidance to be the basis for their worldwide Enterprise investigations platform. A global billion-dollar IT services company with major operations throughout North America, Europe, and Asia, selected Guidance to help secure their critical infrastructure. Our Forensic Security Suite was selected to establish an enterprise investigation and security platform.

NTT Communications is the leading global provider of information and communications technology solutions within the NTT Group. This customer has about \$100 billion in revenue and over 10,000 Enterprise clients. NTT chose Guidance as their information investigation, search, and collection platform.

The quarter also included transactions with 15 financial services firms, including: Barclays, TD Bank, EcoBank, Amex, FIS, Visa, Cigna, The Hartford and several other major financial institutions in the U.S., Europe and even South Africa. Customers increasingly choose Guidance solutions because they see the value of the Forensic Security Suite of products and the universal agent platform technology.

Our strategy is delivering results: revenue, profitability, and cash are all trending as planned. With that, we remain focused on executing our 2017 plan and we reaffirm our full year guidance.

I will now turn the call over to Barry to cover the financial metrics in more detail, and then we will take questions. Barry?

Barry Plaga:

Thank you, Patrick. My prepared remarks today will focus on our first quarter performance. Our first quarter revenues were \$26.8 million, up from \$25.8 million in Q1 of the prior year. This quarter represents our fifth sequential quarter of year-over-year growth, a signal of the ongoing strength and momentum we are achieving through our focus on cybersecurity.

Total product revenues were \$8.9 million compared to \$7.5 million in the first quarter of 2016. We saw solid Enterprise software bookings in the first quarter. Our Endpoint Security average selling price was \$94,000, up 68% compared to the first quarter of 2016. Gross margin on product revenue in the first quarter was 80% compared to 74% in the prior year period. This improvement was attributable to the increase in the mix of software revenues.

Services revenues were \$7.8 million, down from \$8.5 million in the year-ago period. The decline includes a product mix shift away from eDiscovery, and Security software requires fewer related services. Gross margin on services overall was strong at 40%.

Maintenance revenues, which represent our recurring revenue stream, were \$10.1 million, up 3% compared to the prior-year period. Gross margin on maintenance revenues was 93%, in line with historical periods.

The increase in mix of our Enterprise Security revenue drove a two point overall gross margin improvement in the quarter to 73% versus 71% a year ago.

Research and Development expenses were 19% of revenues; Selling and Marketing expenses were 35% of revenues; and G&A was 8% of revenues. We also incurred approximately \$1.4 million in realignment expenses related mostly to the consolidation of certain of our facilities.

For the quarter, non-GAAP net income was \$2.2 million or \$0.07 per diluted share as compared to a non-GAAP net loss of \$2.2 million or \$0.08 per share in the first quarter of last year.

Turning to the balance sheet and some related metrics, cash and cash equivalents as of March 31, 2017 totaled \$17.8 million, with no borrowings outstanding. This compares to \$12.6 million in cash as of December 31, which included \$3.5 million of borrowings outstanding. Cash flow from operations for the first quarter was \$8.7 million compared to \$2.3 million in the prior-year period.

We are reiterating our guidance for 2017 as follows: We expect our 2017 revenue to be in a range of \$112 million to \$118 million, with non-GAAP EBITDA in the range of \$9.0 million to \$11.8 million, or non-GAAP EBITDA margins of 8% to 10%. In addition, we expect, non-GAAP earnings per share in the range of \$0.28 to \$0.36 per share, a dramatic turnaround from a loss of \$0.05 for the full year 2016.

With that, I'll turn the call back over to Rasmus.

Rasmus Van Der Colff:

Thanks Barry. Before going to Q&A, I'd like to mention our upcoming ENFUSE Conference in Las Vegas during the week of May 22. We hope to see many of you there, as well as at the B. Riley Investor Conference in Santa Monica on May 25.

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'd 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. If at any time, you wish to remove your question from the queue, please press star, two. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment while we poll for question.

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

Kevin Liu:

Hi. Good afternoon. First question. Just given the strong product revenue growth you've seen over the past four quarters, I'm just curious as to how you're feeling about the pipeline now, then what you feel is driving that acceleration in the growth rate?

Patrick Dennis:

Hi Kevin, it's good to hear from you. We feel good about the pipeline. You know on these calls I've historically not reported on pipeline specific metrics but I gave you a sense of whether or not there are large transactions closing and we tend to give you a feeling for ASP expansion. So, I guess here's how I would characterize the pipeline. We reaffirmed our guidance so I think you get a sense of where we think the revenue is going to fall. We see strong signals around the Security Suite, there tends to continue to be a bit of mix shift here but if you look at the quarter all up and all in, the significant part of the business came out of the ENFUSE Security Suite and we saw great growth in our Enterprise business. Some of that expansion is associated with improved ASPs along with larger individual transactions and just some great momentum that we had coming out of Q4.

Kevin Liu:

Got it and given what you have in the pipeline and the current growth rate, can you talk a little bit about how you're thinking about when the right time to start reinvesting back into the sales organization is and whether you have expectations for ramping up head count there?

Patrick Dennis:

I think at this stage I still think there's room left for us to push on the yield. Again, we don't give a particular sales force metric, what I'll tell you is the team broadly speaking is doing a good job, you can see that in the results. We're starting to have a sales force that is getting to have tenure after effectively the re-engineering that we did over the last year. So, at this stage in the game I don't necessarily think that it's just about head count. I think that it's about us pushing on the yields a bit and if we start to see something super interesting, obviously, we'll take advantage of that opportunity. Make sure we communicate that to you folks in advance.

Kevin Liu:

All right. Just lastly from me. With coming in ENFUSE conference, wondering if you can preview and sort of significant product introductions or feature updates that you believe could help out and drive continued growth on the product side?

Patrick Dennis:

I think that it's going to be a really exciting ENFUSE conference and there might be things worth coming to see.

Kevin Liu:

All right, I guess short and sweet. Congrats on a good quarter.

Patrick Dennis:

Thanks.

Operator:

Our next question comes from Brian Alger from ROTH.

Brian Alger:

Hi, guys. Congrats on a good quarter. Good outlook as well. Just wondering, earlier this year we had a WikiLeaks (inaudible), some data coming out of our U.S. Government Agencies, basically implying that any electronic device would be hacked and used against people whether it's by our government or by bad actors. I'm curious if that is included in the Inpoint market share data that was done by Gartner or if that's just more traditional Enterprise hardware in points that were included?

Patrick Dennis:

It's a really important question and so this is effectively a comment that is more about the Gartner results than it is about our business. What I'll tell you is Gartner historically, and in this report, is better at reporting on traditional end points. That tends to be the focus of their scope. That said and Brian it's good to hear from you and you know this, but for others that might be on the phone, we do think that there's an opportunity for us to grow our business by selling Endpoint Security software onto an emerging class of Endpoints that we refer to as Edgepoints. We think those are the devices that tend to have sensors on them. They tend to have artificial intelligence and they tend to be fairly autonomous. The other point around those devices is they tend to exist on the edge of an unsecured network and if you think about the future where Teslas can drive themselves and Uber cars can drive themselves and there's drones, all those types of devices. We see those as endpoints and we think there's an opportunity for us to have some growth in that category.

Brian Alger:

That's exactly where I wanted to go with this. We seem to be seeing some pretty steady growth here and it's great to see the triple digit movement that we have in the Forensic security but I guess if we're going to see a step function or real jump, don't we need to see a new type adoption or a new type of implementation of Inpoint security for (inaudible) accelerate to a different point.

Patrick Dennis:

So, I think if I were in your—so first of all yes, so if I were in your shoes, I would look for us to do something around mobile. I think that's an important segment that's not yet fully and completely served. I think you should expect us to continue to do things in and around Cloud. Whether that's viewed as an endpoint or viewed as a repository for information that needs to be protected, that's an important segment for growth and then you should expect us to message and bring product out in a leadership position around this Edgepoint opportunity. We think to fully access that opportunity you need a combination of agent based, which we're known for, agent list which we've been using in our thread assessment for the last several quarters and perhaps even embedded technologies. We think some combination of those three will help the Company reach the maximum portion of the addressable market.

Brian Alger:

Great. That's insightful and I appreciate it. Looking forward to the ENFUSE down in Vegas guys. Keep up the good work.

Patrick Dennis:

Thank you.

Operator:

Our next question comes from Michael Kim from Imperial Capital.

Michael Kim:

Hey, good afternoon, guys.

Barry Plaga:

Hey Michael.

Patrick Dennis:

Hey Michael.

Michael Kim:

Just on Endpoint Security. I think you mentioned you added another million new Endpoints but I was curious about the 4 million upgraded Endpoints and if that's driving some of the ASP extension. How we should think about the contribution as you upgrade your (inaudible) installed base?

Patrick Dennis:

You know Michael, you know this, again, for others on the phone that may not have as deep a familiarity with the Company. Historically there had been some pricing challenges and one of the reasons we started to talk to you all about the upgraded Endpoints is—and I think what you should hear from us on that is that's the, Company being able to go through the install base and perhaps get clients that were on less favorable contracts onto more favorable contracts as they see additional value in our newer software products.

So, we've been releasing software recorder, it gives us a great way to go back and talk to customers who have owned the software for a long time about the new value that they can get. Often times, those conversations lead to a note expansion in addition to confirming or renewing their SMS so I think we're getting pretty good at that. Over time we'll see if 4 million Endpoints is a trend or not but I think it gives you kind of a good sense of how we've been able to roll back through the customer base and cross sell and up sell based on new capabilities that we have in the Forensic Security Suite.

Michael Kim:

Great and then just switching over to the multi product sale side. Was that a contributor to some of the large yield activity and I'm not sure if I caught this but did you see any million dollar transactions close in the quarter or pretty close to that:

Patrick Dennis:

We had a couple of substantial transactions that kind of eeked their way close to that bar. What I would tell you is—you asked this question quarter in and quarter out. Typically, I'd said that there tended to be one product or perhaps two products sold. I think we're starting to shift into more of the norm where kind of the core Enterprise software trends actions include two products. It continues to include Endpoint Investigator and something like Endpoint Security or one of the other products in the Suite.

Michael Kim:

Great. Thanks very much.

Patrick Dennis:

Thank you.

Operator:

If you'd like to ask a question, please press star, one.

Our next question comes from Hendi Susanto with Cabelli & Company.

Hendi Susanto:

Good afternoon Patrick and Barry.

Patrick Dennis:

Hi Hendi.

Barry Plaga:

Hi Hendi.

Hendi Susanto:

First question is for both of you. What are your assumptions of service and maintenance revenue in your annual guidance, specifically, would you be able to share some insight whether the year-over-year service revenue decline is unique to Q1 or whether that trend may continue further more?

Barry Plaga:

Let me take maintenance first because that's the positive one—we're forecasting that to be up 4% to 5% year-over-year. So, we're on target for there. On services with our kind of exit or de-emphasise on E-Discovery, we're definitely seeing an impact on our E-Discovery services business but that's part of the plan and so overall those services will probably be down somewhere between 5% to 10% depending on the line item. That's the one headwind we're suffering through this year as we kind of really drive a majority of our business towards the Forensic Security Suite.

Hendi Susanto:

Then do you expect that to bottom exiting 2017, Barry?

Barry Plaga:

Yes. I think for the most part, it will. It will flatten out from there.

Hendi Susanto:

Okay. Then if I look at your operating margin—your Q1 operating margin is 8.3% which is above the annual operating margin guidance of 6% to 8%. I'm wondering what your annual operating margin guidance is conservative. I don't see how operating margin in Q2, Q3 or Q4, like lower than Q1.

Barry Plaga:

Well definitely not in the back half for sure. So, I agree with you there Hendi. You know we did have some delayed spending in Q1, we came in under our expense plan so that helped out the operating margin in Q1. I think everybody would agree we want to have the right level of resources in the Company so we will continue to kind of push that in the right direction but maintain that target of 8%. I wouldn't say it's conservative but we're pretty mindful of our expense run rate and whenever we can push something off, we do.

Hendi Susanto:

That is helpful. One question for Patrick. Patrick now that guidance of where the shares—the Endpoint Security ASP, how should we analyze and then look into that.

Patrick Dennis:

I think you should think of it in phases so Hendi you've been with us for a really long time so when we first started to talk about ASPs, frankly they were pretty modest. We went through a period where they nearly doubled, if not went a bit higher than that. Following the doubling we up a little bit from there and I think what you're going to see is that you're going to see that average selling price increase primarily driven through deal size, no longer just through the changes that we've made to the actual structural part of the pricing. So, we should expect it to flatten out a little bit from here on out and we should expect that expansion that we see in that ASP line has to do with overall increases in deal size. Does that make sense?

Hendi Susanto:

Yes, yes. One last question for me, Patrick. In the area of security analytics, your EnForce Risk Manager, can you give us some update on the sales direction, how many customers you have had? Any data point it may be helpful for us.

Patrick Dennis:

We continue to work with customers that are trying to solve for among other things, the rules and regulations around GDPR and so as you might imagine, organizations are wrestling with their own policies on how to comply and therefore a lot of the risk manager work is right now with clients trying to determine how they can use software to deploy their policies in an automated way. We continue to see interest there. I think many of you are starting to try to sort out when you're going to start to see that revenue really flow through the P&L. I think most of you have said you expect that kind in the back half of the year and that's probably pretty rational.

Hendi Susanto:

Thank you.

Patrick Dennis:

Yes. Thanks.

Operator:

Our next question is a follow-up from Michael Kim with Imperial Capital.

Michael Kim:

Just one more follow-up question on strategic partnerships. I think you mentioned or you announced that a couple of partners have kCura and Lastline—kind of curious how some of those integrations might turn into co-marketing opportunities or where you might be able to leverage your customer base?

Patrick Dennis:

Great question. Michael thanks for coming back on for that one because I think that's really important. We probably don't have time for all of them so why don't I kind of speak to what we're doing in security with our partnerships broadly rather than the specifics. For instance, around Lastline and then I want to talk about kCura for a second. I think that's meaningful and important.

At the top level, we believe that customers are investing in several security products in an effort to fully and completely protect the operation. However, if you look at most customers, they're not necessarily getting all the value from any one of those products because many of them work, frankly, as individual tools. As you start to see us shape our next generation security software, which again is a plug, might be something you could come see at ENFUSE. I think you're going to see us take on almost a role based use of the software. So, we're going to expect that there's personas in the software and as such we want people to stay in our software day in and day out to solve security problems. So, these partnerships in the security eco system are about bringing more information into our security products so that a security professional can be more effective. They're also about getting a customer, frankly, better return on the investment that they're making in software products.

So, one of the integrations in our security products and I'm most excited about is Splunk. We have a great integration with Splunk that brings more value to Splunk and more value to us. So, the core strategy in security is, let's make deep relationships and important partnerships with people that in and around on the security apparatus to drive up customer value and keep people in our software more often. I don't want people to think our Endpoint Security software is a tool anymore, I think our Endpoint Security software specifically in newer versions is going to be the kind of software people really use to investigate and resolve security incidence every day and for us to do that made deep partnerships and deep integrations with other people that are not in the security field. So that's a trend you should expect to continue.

A bit different from that is the partnership with kCura which is all about two leaders coming together to bring best in class, end-to-end solution to market. The relationship with kCura takes advantage of the leading hosted review platform and the world's best search and collect technology. We've built a deep integration between our software and kCura's relativity product that actually allows customers to import information right into relativity spaces with the Meta data map from our evidence files right into their catalogue. So, for us that's all about reducing friction for customers that are interested in new discovery. Actually, that integration is shipping as an update to the existing product, so our existing customers get that value along with anybody that also owns relativity products. The relationship between the two organizations has never been better. The CEO of kCura and I have said that this is going to be a deep and meaningful partnership in the marketplace and with our customers and it's going really, really well.

Michael Kim:

Great. We'll look forward to it and thanks for the follow-up.

Patrick Dennis:

Thank you.

Operator:

Ladies and gentlemen, we've reached the end of our question-and-answer session. I'd like to turn the call back over to Rasmus Van Der Colff for closing remarks.

Rasmus Van Der Colff:

Great. Thank you, Operator. That concludes our call for today, and I'd like to thank everybody for joining us.

Operator:

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