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VDSI - Q1 2018 VASCO Data Security International Inc Earnings Call

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Saliq Jamil Khan *Imperial Capital, LLC, Research Division - VP*

Zack Turcotte

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the VASCO Data Security First Quarter 2018 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded, Tuesday, May 8, 2018. I would now turn the conference over to Joe Maxa. Please go ahead, sir.

Joe Maxa - *VASCO Data Security International, Inc. - Director of IR*

Thank you, operator. Hello, everyone, and thank you for joining the VASCO Data Security First Quarter 2018 Earnings Conference Call. My name is Joe Maxa, and I'm the Director of Investor Relations. This call is being broadcast over the Internet and can be accessed on the Investor Relations section of VASCO's website at ir.vasco.com.

With me on the call today and speaking first will be Scott Clements, VASCO's Chief Executive Officer. Also on the call is Mark Hoyt, our Chief Financial Officer.

This afternoon, after market close, VASCO issued a press release announcing results for our first quarter 2018. To access a copy of the press release and other investor information, please visit our website. Following our prepared comments today, we will open the call for questions.

Please note that statements made during this conference call that relate to future plans, events or performance, including the guidance for full year 2018, are forward-looking statements. We have tried to identify these statements by using words such as beliefs, anticipates, plans, expects, projects and similar words, and these statements involve risks and uncertainties and are based on current expectations. Consequently, actual results could differ materially from the expectations expressed in these forward-looking statements. I direct your attention to today's press release and the company's filings with the U.S. Securities and Exchange Commission for discussion of such risks and uncertainties in this regard. Please note that certain financial measures that may be discussed on this call are expressed on a non-GAAP basis and have been adjusted from a related GAAP financial measure. We have provided an explanation and reconciliations of these non-GAAP financial measures to the most directly comparable GAAP financial measures in the earnings press release that can be found on the Investor Relations section of our website. In addition, please note that the date of this conference call is May 8, and any forward-looking statements and related assumptions are made as of this date. Except as expressly required by the federal securities laws, we undertake no obligation to update these statements as a result of new information or future events or for any other reason.

At this time, I will turn the call over to Scott.



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Scott M. Clements - *VASCO Data Security International, Inc. - CEO, President & Director*

Joe, thanks very much, and thank you for joining on the call everyone. I want to start by noting that we're on the eve of the most significant product introduction since VASCO's original authentication solution. Later this month, we will announce the details of our initial Trusted Identity Platform offerings and how they deliver a much needed and profoundly innovative approach to address the tens of billions of dollars that banks are losing to fraud annually.

The nature and sophistication of attacks against banks, especially in online and mobile channels have reached new heights and require a new approach. We've been an industry leader in stopping fraud for 2 decades, and with more than half of the top 100 global banks as customers, we have unparalleled insights into the challenges faced by financial institutions today. These challenges include more than 1,000 vendors selling security solutions to financial institutions for the bewildering variety of claims and undifferentiated value propositions. For them, vendor selection is a [dying cast]. Vendor approval can take more than a year. Implementations often take 6 months or longer. And the solutions are usually not designed to work together.

We are addressing these challenges with our new trusted identity solutions. Identity is at the core of our open platform strategy, and we are using API-based approach to ease implementation and orchestration of antifraud technologies, including customer-developed solutions. This will enable a unified solution approach with integration of artificial intelligence, machine learning and biometrics with administration through a single management interface.

We demonstrated some of the core elements of our Trusted Identity Platform at the recent RSA Conference. We've been implementing proof-of-concept for select customers, and we already have potential customers using the new developers sandbox.

I'm confident that the significant investments we're making in our trusted identity strategy will yield benefits for our customers in winning the battle against criminal hackers.

Now I'll discuss our first quarter results. Revenue grew 8% to \$45 million, driven by the doubling of our mobile security software and nearly 50% growth in our e-signature solutions. The growth was partially offset by the expected decline in hardware.

For the quarter, nonhardware, including software, subscriptions and other services accounted for 62% of revenue, positively affecting gross margin, which increased to 76%. We anticipate the mix of hardware and nonhardware will return gross margins to the 70% range for the balance of the year subject to normal variations.

Adjusted EBITDA in the quarter totaled \$6.1 million and we generated \$9.7 million in cash from operations. Mark will provide additional details on the first quarter during his financial review.

Our cash balance at the end of the quarter was \$166 million. We're focused on utilizing our cash to drive shareholder value by actively pursuing strategic acquisitions and by investing in our next-generation Trusted Identity Platform-based solutions such as adaptive authentication.

Some noteworthy highlights for the first quarter include the continued rampant growth of our differentiated e-signature solutions, strong global demand for our mobile security software solutions within the financial services industry and the launch of our orchestration, SDK, for DIGIPASS for Apps. This SDK enables our customers to more simply and rapidly integrate biometrics and other security features into their mobile applications and is a key element for the mobile side of our upcoming Trusted Identity Platform.

We remain pleased with our progress and the performance of our business. Our growing pipeline of opportunities gives us confidence that 2018 will be a year of solid growth.

I'll now turn the call over to Mark Hoyt, our Chief Financial Officer, to provide details about the quarter. I'll then come back to comment on our outlook before opening the call for questions. Mark?

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Mark Stephen Hoyt - VASCO Data Security International, Inc. - CFO, Executive VP & Treasurer

Thanks, Scott. As a reminder, we adopted ASC 606 on January 1, 2018. We included in the press release issued today, a table with a summary of the effect of this new accounting standard on our Q1 results.

Total revenue for the first quarter of 2018 grew 8% year-over-year to \$45.4 million. Product and license revenue grew 6% to \$33.5 million, and services and other revenue grew 15% to \$11.9 million. This quarter, we are providing additional revenue metrics by products and services categories, which can also be found in today's press release.

Software licenses and subscription revenue increased more than 50% to \$19 million, driven by strength in our mobile security and e-signature solutions, which included 2 large global banking e-signature contracts.

Maintenance, support and other revenue increased 9% to \$8 million. Hardware revenue declined 20% year-over-year to \$17.5 million. Let me remind everyone that in the fourth quarter of 2017, we benefited from several million dollars of product that was originally scheduled to ship in Q1. We expect more favorable hardware results for the balance of 2018.

Gross margin for the first quarter of 2018 was 76% as compared to 71% for the first quarter of 2017. The increase in gross margin percentage is primarily attributed to an increase in software and subscription licenses and a decrease in hardware revenue.

Operating expenses for the first quarter of 2018 were \$33 million, an increase of 12% from \$30 million reported last year and a decrease of 5% from \$35 million reported in Q4 2017.

The year-over-year increase of expenses reflects investments to improve our operating infrastructure, along with sales and marketing growth investments.

Adjusted EBITDA or adjusted earnings before interest, taxes, depreciation, amortization and long-term incentive compensation was \$6.1 million, an increase from \$4.2 million for the first quarter of 2017. Adjusted EBITDA margin was 13.5% as compared to 10.1% for the first quarter of last year.

GAAP diluted earnings per share was \$0.04 for the first quarter of 2018, compared to \$0.01 for the first quarter of 2017. Non-GAAP diluted earnings per share, which excludes long-term incentive compensation, amortization of purchased intangible assets and the impact of tax adjustments was \$0.12 for the first quarter of 2018, compared to \$0.08 for the first quarter of last year.

Now moving to the balance sheet. As of March 31, our net cash balance, including short-term investments in commercial paper, was \$166 million, an increase of \$8 million or 5% from \$158 million at the end of last year and an increase of \$20 million from the prior-year period.

VASCO has no outstanding long-term debt. Deferred revenue, which includes short-term and long-term components, was \$37.2 million as of March 31, 2018, and included a negative impact of \$5.5 million from the adoption of ASC 606. Deferred revenue as of December 31, 2017, was \$40.3 million.

Our geographic revenue mix continues to shift with increasing contributions from the Americas region. This is largely due to the strong growth we're seeing from our e-signature solutions. For the first quarter of 2018, 35% of our revenue came from the Americas, 40% was from EMEA and 25% from Asia Pac, compared to 29%, 44% and 27%, respectively in the first quarter of 2017. I will now turn the meeting back to Scott.

Scott M. Clements - VASCO Data Security International, Inc. - CEO, President & Director

Thanks a lot, Mark. 2018 is an important year for VASCO. As I noted, we'll be launching our next-generation Trusted Identity Platform, which builds upon our success with e-signature and mobile security offerings. We continue to strengthen our technology capabilities and build a performance-oriented culture with a focus on driving value for our shareholders by accelerating the profitable growth of our company. For full



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year 2018, we are reaffirming our guidance as follows: Revenues expected to be in the range of \$197 million to \$207 million and adjusted EBITDA is expected to be in the range of \$21 million to \$25 million.

With that, thanks for listening, and Mark and I will be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question today comes from the line of Zack Turcotte from Dougherty & Company.

Zack Turcotte

Zack Turcotte on for Catharine Trebnick. Couple things about e-SignLive. First, if you could just speak on the recent DocuSign IPO and what this means for your company and how the stock's reacted to that as well?

Scott M. Clements - VASCO Data Security International, Inc. - CEO, President & Director

I'm sorry, Zack, what was the last part of your question?

Zack Turcotte

Sorry, again, can you hear me?

Scott M. Clements - VASCO Data Security International, Inc. - CEO, President & Director

Yes. I can hear you. I just couldn't hear the last 3 to 4 words.

Zack Turcotte

Okay, yes, I was just trying to say if you could speak on the recent DocuSign IPO. How that impacts your company and how it's -- how the stock's reacted as well?

Scott M. Clements - VASCO Data Security International, Inc. - CEO, President & Director

Well, I think, just thinking about the DocuSign IPO, I think from our point of view, it's a good thing. It really, I think, validates the entire e-signature industry. We generally are (inaudible) top 3 providers of e-signature, and so I think that every positive reaction to DocuSign IPO is indicative of the view that there is significant growth opportunity remaining in this space. And we intend to fully participate in that as we have and as we did again in the first quarter. As far what contribution that is really making to our stock price, I guess, I'll leave that up to you guys to figure that one out.

Zack Turcotte

Got it. And beyond that, I wonder if you have any sort of update on the progress with going international with e-SignLive. If there is any more business there, and if you're leading into a lot more deals with e-SignLive now that -- with this 30% growth rate that we're seeing quarter after quarter?

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Scott M. Clements - VASCO Data Security International, Inc. - CEO, President & Director

I think for international, there we do continue to see a building pipeline of opportunities. We have booked a number of orders internationally. We do expect that to continue. I think we -- as we see more and more clarity with regard to the ADAS regulation in Europe and how banks are going to respond to that, I think the interest level continues to grow. It's still a relatively small part of the global e-signature revenue that we have. But it certainly is headed in the right direction. We've made some changes to our sales model this year and the way in which we take e-SignLive to market through our broader sales channel. And so we do expect that to have an impact as we go through the next 3 quarters of this year. I think the -- there is a lot of growth opportunity that remains in North America for e-signature, and I would say, in general, the other regions of the world are behind the U.S. in adoption, and so we think there is a real driver of sustained growth for e-signature outside the U.S. as well.

Operator

Our next question today comes from the line of Saliq Khan from Imperial Capital.

Saliq Jamil Khan - Imperial Capital, LLC, Research Division - VP

Guys, just a few questions. First one is, in what sectors are you guys experiencing a higher adoption rate for software and services? And then could you highlight where you guys see longer term for hardware as well?

Scott M. Clements - VASCO Data Security International, Inc. - CEO, President & Director

Yes. I think, as you know, Saliq, our business is really driven fundamentally or predominantly by banking and financial services. That continues to be the case, and I think much of the growth that we're seeing, particularly outside of e-signature, is really continuing to be driven by banking on a global basis. E-signature is a little more of a horizontal play. We do a significant amount of business with banks. 2 of the big orders we booked in the first quarter for e-signature were in the banking vertical. We do see significant opportunity in other regulated areas, insurance for example. Medical is another one where we see opportunities in e-signature and in really any circumstance where there is a more complex contracting process that people -- that has to take place either online or in -- either online or in the circumstance where people just want to do things digitally instead on paper. And of course, that's a very broad statement and that reflects I think the breadth of the opportunity for e-signature.

Saliq Jamil Khan - Imperial Capital, LLC, Research Division - VP

Okay. If you take a look at the recent RSA event that took place, when you kind of walked away from that, did you guys walk with from -- walk away with some ideas in regards to what can you do to continue to develop or evolve your product before you can create a niche for yourself in the marketplace? And what idea you guys walked away from in regards to interesting technologies that you could really fold into your current business?

Scott M. Clements - VASCO Data Security International, Inc. - CEO, President & Director

You said with respect to RSA, Saliq?

Saliq Jamil Khan - Imperial Capital, LLC, Research Division - VP

Yes.



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Scott M. Clements - VASCO Data Security International, Inc. - CEO, President & Director

Yes, yes. So I think -- I don't think there was anything that was from our point of view really new or different that we saw out of RSA, but I think there was a confirmation of the directions that we're headed. At RSA, we did demonstrate a prerelease version of our Trusted Identity adaptive authentication platform. And then, we also demonstrated an onboarding application with e-signature, working with Mitek for identity document scanning. And so there was a lot of interest I think in both of those areas. And I think we spent a lot of time and effort on the Trusted Identity strategy. I think we continue to get good confirmation from our customer set at RSA and elsewhere that we are on the right track. We have discussions underway with a significant number of our largest customers who are interested in our adaptive authentication capabilities and ultimately also in our onboarding -- digital onboarding capabilities. Both of those appear to be areas of rich opportunity that will -- it won't have a big impact I don't think on 2018, but I think we will see some events that occur through the balance of 2018 that validate those product directions. And I think as we do that we are really moving into the identity verification stage more fully. So the history of VASCO is that we really have predominantly worked with already verified identities -- authenticating already verified identities. There is a significant opportunity and expansion opportunity for VASCO to be more involved in the actual verification of the identity upfront. So that is -- when we talk about onboarding and related elements of our strategy, that's really what we're talking about.

Saliq Jamil Khan - Imperial Capital, LLC, Research Division - VP

Scott, just one last question, which is you guys have ramped up your sales and marketing, and how do I think about that going forward? You need to hire more sales people, you need to pay them better? What can you do from a strategy perspective in that regards?

Scott M. Clements - VASCO Data Security International, Inc. - CEO, President & Director

Yes, I think we have significantly ramped up our sales and marketing activities, and it's really both sales and marketing over the last 1.5 years or 2 years. I think the marketing piece is really important for us. I think the company was significantly underinvested in marketing in the past. And so as our solution portfolio becomes broader and more sophisticated, the marketing component of sales and marketing really becomes critical in terms of lead generation and helping our salespeople to communicate our value proposition into the marketplace. We have added a number of salespeople over the last couple of years as well. What I would expect going forward is -- Saliq, is that the sales expenses would generally grow kind of with revenue from here. I wouldn't expect there to be sales and marketing expenses growing a lot faster than revenue as has been the case over the last year. So as we move into 2019 and we think about our operating expenses in sales and marketing, in G&A, in particular, we're working to leverage -- get some leverage on the P&L around those areas.

Operator

(Operator Instructions) And our next question comes from the line of Matthew Galinko from Sidoti.

Matthew Evan Galinko - Sidoti & Company, LLC - Research Analyst

Can you -- so in terms of the orchestration SDK, is that a revenue generator component or is that a differentiator that you think will sort of draw people into the DPA ecosystem or just kind of walk me through how that influences the business?

Scott M. Clements - VASCO Data Security International, Inc. - CEO, President & Director

Yes. I think there's 2 ways that it really provides benefit. One is that it makes it easier to use our product. And so customers can adapt our product, integrate it with their applications -- their mobile applications and do it more rapidly. And then the secondary knock-on effect is the ability -- as we add additional capabilities and components, new biometrics, things like that, it will be much easier for those customers to adapt those, in this case, new biometric modalities, in a way that is much less complicated than it would have been for them in the past. So it really helps us in terms



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of the ease of using our product. That's a differentiation capability for us and then also ultimately reduces time to revenue and reduces the effort that a customer has to undertake to use our product.

Matthew Evan Galinko - *Sidoti & Company, LLC - Research Analyst*

Got you. Okay. And can you say in terms of feedback that you've garnered over the last, I guess, months since it has been, maybe, live. Or I don't know if it's been a product rollout, but do you have any feedback, do you have any sense or feel for adoption of it so far? How quickly existing customers are taking to it?

Scott M. Clements - *VASCO Data Security International, Inc. - CEO, President & Director*

This is on the mobile SDK or the Trusted Identity offering?

Mark Stephen Hoyt - *VASCO Data Security International, Inc. - CFO, Executive VP & Treasurer*

For SDK.

Scott M. Clements - *VASCO Data Security International, Inc. - CEO, President & Director*

SDK. No, I don't think so. We just released it here not too long ago. And I think like any -- this is like just about any software business. So if you have a software product and you kind of standstill with it, then you're falling behind. You're losing your competitive position and your ability to sustain or grow market share. And so we have to continually improve these products either by adding features or by making them easier to use or easier to implement. And so I view this as sort of an ongoing process that we have in our software businesses to maintain our competitiveness, respond to what's happening in the marketplace. In this case, what's happening is that there are an increasing number of biometric approaches that institutions can use to authenticate the customers. And what's happening is that bank will start with one type of a biometric modality, but later on, they may want to add another one or they may -- may want to switch to another one because it has fewer false positives, fewer false negatives, it's easier to use for the consumer with a better user experience. And so our -- this really I think helps our ability over time to sustain our relevance and our position with our core customers and really demonstrate to them that we are being responsive to the way their business challenges are evolving.

Matthew Evan Galinko - *Sidoti & Company, LLC - Research Analyst*

Got it. All right. One last one from me on the e-signature business, how is demand skewing in terms of premise deployment versus a SaaS deployment?

Scott M. Clements - *VASCO Data Security International, Inc. - CEO, President & Director*

Yes, that's a great question. I wish it was skewing a little faster towards SaaS than it is. I think the good news is, we have the ability with our product to deploy in either approach. We can do it as a subscription service or we can do it as an on-premise implementation. I think financial institutions, banks in general, have lagged other verticals in moving toward the cloud deployment of services and technologies. We believe that's changing. We -- and I do believe that as we go over the next couple of years, we are going to see an increasing shift from on-premise to more cloud-based approaches. That's a bet that we've made with our Trusted Identity Platform as well. We've made that a cloud-first strategy because we think that, that is going to be the place where there is the greatest growth opportunity is in the cloud. And there has been a number of studies out there that have reflected this that banks are really realizing that moving to the cloud doesn't negatively impact security. In fact, it's probably more secure. And given the financial pressure that a lot of institutions are under in terms of competition, regulations, things like that, the need to reduce their IT costs and infrastructure costs is also going to drive them more toward the cloud. So I think these are the same things that have driven other vertical markets to adopt the cloud more aggressively. Banks have been a little slower about it, for good reason. I think they had to wait until the



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time was right and there was the right level of confidence. The European banking commission, in fact, just announced some rules and regulations for banks wanting to move to the cloud. So they created a framework now for what are the things that European banks have to think about if they want to deploy cloud implementations of products like ours. And that's good, not necessarily from the point that they've added regulation, but certainly from the point of view that there is a framework the institutions understand and that they know they can follow and be responsible as they transition to the cloud.

Operator

(Operator Instructions) And there are currently no further questions on the phone lines at this moment.

Scott M. Clements - VASCO Data Security International, Inc. - CEO, President & Director

All right. Last call, any last questions from anyone? I'm happy to answer them.

Operator

(Operator Instructions) And there are still no questions on the phone lines at this moment, sir.

Scott M. Clements - VASCO Data Security International, Inc. - CEO, President & Director

All right. Very good. Thank you, operator, for giving it one last shot there. Again, I want to thank all of you for joining the call today. We are very excited about the direction of the company. We're working hard to continue to improve our business and deliver on our commitments. And we're going to keep doing that. Thanks, everybody.

Operator

Ladies and gentlemen, that does conclude the conference call for today. We thank you for your participation, and ask you please disconnect your lines.

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