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inContact, Inc.

First Quarter 2015 Conference Call

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Mark Schappel, *Benchmark*

PRESENTATION

Operator:

Good day everyone and welcome to the inContact Inc First Quarter 2015 Earnings Conference Call. At this time all participants are in a listen-only mode. Later there will be an opportunity to ask questions during a Q&A session. Please note, today's call is being recorded and I will be standing by should you need any assistance.

It is now my pleasure to turn the conference over to Greg Ayers, CFO at inContact. Please go ahead sir.

Gregory Ayers:

Thank you and good afternoon. This is Greg Ayers, CFO of inContact. Welcome to our Q1 2015 conference call. I will begin the call with some prepared remarks and I will then turn the call over to CEO Paul Jarman, to review our first quarter results. Finally, I will provide additional detail on our financial results for the quarter 2015 before opening it up for Q&A. For access to our news release and other information about inContact, please visit our website at www.incontact.com.

The purpose of today's call is to provide you with information regarding our first quarter 2015 results. Some of our discussion and responses to your questions may contain forward-looking statements, which are subject to risks, uncertainties, and assumptions. Should any of these risks or uncertainties materialize or should our assumptions prove to be incorrect, actual Company results could differ materially from these forward-looking statements. These risks, uncertainties and assumptions, as well as other information on potential risk factors that could affect our financial results are included in our filings with the SEC including our most recent report on Form 10-K, particularly under the heading Risk Factors.

During the call, we may offer incremental metrics to provide additional insight into our business or quarterly results. Please be advised this detail may be one time and may or may not be provided in the future.

Now I'll turn the call over to Paul Jarman.

Paul Jarman:

Thank you, Greg. Today I'm pleased to report an excellent start for the year with very strong revenues plus solid bookings growth which allows us to raise our revenue guidance for the year. As the leading provider for enterprise contact centers, moving to the cloud, we are driving disruption for all competitors including legacy premise players as well as for other cloud vendors with less mature offerings.

In Q1 we achieved record bookings in estimated annual contract value which posted 27% year-over-year growth. The estimated annual contract value of these bookings is the highest of any first quarter. We achieved a new milestone with the largest number of contracts in our history. We closed 115 total contracts, including 66 new logo customers and 49 expansion deals. With many of the contracts clustered around three key industries, retail, finance and healthcare. Also during the quarter, we continue to win majority of the deals against our primary competitors.

We had a very strong revenue quarter. Software revenue increased 62% year-over-year to $32.5 million for Q1 and combined software and software-related network connectivity revenue increased by 43% to $49.2 million.

I would like to note the strength of same store sales which increased by 3.7% during this quarter. Additionally, I would like to call out our 400 basis point improvement in consolidated cash gross margin over Q1 of 2014. This point to the leverage, we are achieving in our model as we drive higher revenues.

Now I’d like to give you some insight on some of our new customers in Q1 that are moving to inContact to power their customer service operations. As I mentioned earlier, we added a number of new customers in retail, finance and healthcare. These are massive industries in the midst of digital and competitive transformation that is driving the need for new customer service technology.

There are three enterprise deals I’d like to highlight today. The first is a business process outsourcer who supports multiple retail clients. This BPO is transitioning over 175 agents from premise to the cloud. They chose inContact’s enterprise grade cloud solution in order to customize their services and scale up or down seasonally based on the needs of different clients. Working with BPOs is a prime opportunity for us because of their high growth model. They need a solution that can adapt as they win new clients and quickly add new campaigns. We share in their success and growth with our proven scalability and agile solution that easily adjusts to the flow of BPOs business.

Another interesting win is a major cruise line that is moving 350 agents across more than five contact centers to the cloud. This travel leader is leaving behind a patchwork of legacy systems that has kept them from delivering industry leading service experiences. They will implement the InContact multi-channel cloud platforms including our patented Personal Connection Outbound Solution. Personal Connection enables agents to proactively connect with existing travel customers and improve upsell and new sells conversion rates.

Finally, an example that is very encouraging for our business and a great proof point for our acquisition of Optivity. This quarter, a healthcare company that has been a longstanding Optivity WFO customer are likely to move their contact center, ACDIVR engine from an older premise system to the inContact cloud. This is a great example of the hundreds of opportunities we have before us as we continue cross selling into the Optivity customer base.

We continue to feel our growth through expansion of our partner channel. Many of these partners undertake very extensive reviews, including a detailed RFP in deep diligence into our existing customers. Partners select inContact because of the superior nature of our technology and the piece of mind and knowing we have a proven solution that can help them achieve their growth objectives. Last week cloud UC leader RingCentral selected inContact to power their latest offering, RingCentral Contact Center. As they continue their dramatic growth in the cloud UC market, RingCentral realized that a growing percent of their 300,000 customers were seeking a solution for both their unified communications and their contact center. This OEM partnership with inContact is a timely way for them to address this need and differentiate their overall solutions portfolio.

RingCentral has been an inContact customer since 2011 with 500 agents on our system. This new partnership is a great advantage for us because it opens up a rich distribution channel and puts more sales power behind our solution and it expands our market reach, especially in the small to mid-size contact centers, locking up this distribution channel helps to block out smaller competitors and is a strong wedge against the larger players. We are the only successful OEM provider in this space powering three major OEM partnerships with Verizon, Unify and now RingCentral. These leading partners are selling our solution under their brand. They choose inContact after an intensive evaluation with other contact center offerings. With our diversified channel strategy and investment in our partners' success, we are capitalizing on the best possible avenues to accelerated growth.

The key to attracting and retaining both partners and customers is the ongoing commitment to innovation. We have a strong market-driven roadmap to enhance our platform and to introduce new products. In Q1 we set a new record in the number of expansion deals with existing customers this quarter. This includes expansions with new divisions or business units as well as the addition of new products. One area of innovation that is helping us win is out integration and our relationship with salesforce. inContact's Agent for Salesforce provides a seamless experience for the contact center agent. The interface is embedded on the Salesforce desktop so that agents have all the customer data needed while delivering a great experience for the consumer. We have over 65 customers of all sizes and industries who are using the inContact Agent for Salesforce. This month we are beginning the rollout of inContact's 2015 spring release. More details about this release will come in a few weeks but as a preview there are many enhancements that will improve customer and agent experience including updates to Personal Connection Outbound Solution and other highlights including new WFO features, new reporting options plus new APIs and developer resources to fuel our growing ecosystem of developers on the inContact cloud platform. Our innovative cloud solutions and over 10 years' experience in the multi-tenant cloud positions us as the number one enterprise choice for cloud contact center software.

We recently accomplished an important company milestone by closing $115 million of new financing. This financing has significantly improved our balance sheet, but more importantly it provides us further strategic growth and investment, in key technologies, in partnerships and in go-to-market activities.

In summary, during the first quarter we added key new partners and we had excellent growth in software revenue and strong bookings. Because of this we have high confidence for the rest of 2015.

Now Greg will provide more detailed information about the Q1 financial results as well as updated revenue guidance.

Gregory Ayers:

Thank you, Paul. We achieved strong results in the first quarter and now I will provide more details about the financial performance. The financial results I will discuss are presented on both a GAAP and a non-GAAP basis, however all revenue figures are GAAP. Please refer to the press release for non-GAAP amounts.

At this point I would also like to remind everyone of the Safe Harbor statement made at the beginning of our call.

First, let's look at the Software segment which includes all revenue related to the delivery of our software application and associated professional services. For Q1 2015 I'm happy to report that Software segment revenue increased to $32.5 million, a 62% increase over last year's $20 million. Excluding the Optivity contribution, our Software segment revenues grew 39% year-over-year. In Q1 we did not recognize any guaranteed revenues from our partnership with Unify compared to the $1.6 million of such revenues in Q1 2014.

The three key drivers of our recurring Software revenue are customer retention, existing customer utilization and new contracts. Our Software revenue retention rate for the quarter remained above 93%, a level we are very pleased with. Remember, unlike some of the other companies in the space, we measure retention as a percentage of revenues, not the number of customer accounts, and we exclude upsells from this calculation.

The second driver of quarterly Software revenue growth is the variable utilization of Software Services by existing customers. This metric fluctuates due to seasonality, macro economic conditions and customer service activities, as well as the revenue generated from the sales of additional services to existing customers. It's similar in concept to same store sales as used in the retail industry and it excludes attrition and new customer revenues. For the March quarter we experienced a 3.7% sequential increase in utilization, which is more than double the historical average of 1.6% for first quarters.

The third and final driver of our Q1 Software revenue growth is revenue from new customers, that is contracts not yet included in the same store sales metric. We closed 115 new contracts in the quarter, 66 from new customers and 49 upsells to existing accounts.

As Paul noted, we set a new record for bookings and estimated annual contract value in any March quarter in our history. We estimate that the expected future value of these contracts will be approximately 27% higher than the estimated annual contract value of bookings in Q1 of 2014.

A quick reminder on how inContact calculates bookings: unlike certain other players in the space, bookings are an estimate of the annual contract value of new Software as a Service sales. It does not reflect the full value of a multi-year contract or any estimated Network Connectivity revenues, nor does it include any perpetual license software revenues generated by Optivity. This conservative approach to the bookings calculation accurately reflects the true Software revenue run rate that will be added to the business.

In Q1 2015 Software segment gross margin was 57.8% compared to 58.8% a year ago. Software gross margin excluding non-cash charges was 72.3% compared to 72.4% a year ago. Software gross margin was impacted during the quarter due to the absence of guaranteed Software revenue from Unify.

Our second segment is Network Connectivity which includes all communications services provided to our software customers as well as to legacy telco clients. Network Connectivity segment revenue for Q1 2015 was $18.9 million, an 11% increase over the $17 million in Q1 of last year. Gross margin for the Network Connectivity segment was 37.4% in Q1, up 100 basis points from 36.4% in Q1 of 2014. Operating margin for this segment was a robust 27.4 in Q1, flat to Q1 of 2014.

Network Connectivity revenue growth rates are lower than the growth rate for Software revenues. There are two reasons for this trend. First telecom based channel partners routinely provide the network connectivity services themselves. The second factor is the growth of our WFO software business which does not generate additional telecom revenue.

Consolidated revenue for Q1 increased to $51.3 million, a 39% increase from last year's $37.1 million. GAAP consolidated gross margin was 50% in Q1 2015 compared to 49% in Q1 of last year. On a cash basis, consolidated gross margin increased to 60% versus 56% last year.

Total operating expenses were $31.2 million in Q1, a 61% increase from Q1 2014 levels of $19.4 million. Sales and marketing expenditures rose 54% while the rate of growth in R&D spending was 77%, essentially the same as it was in Q4 of last year. For the first quarter, G&A spending was 62% above the levels in the corresponding period a year ago.

Operating loss for Q1 was $5.4 million, more than 3X the $1.4 million loss registered in Q1 of last year. The increase in the operating expenses is principally due to the addition of personnel, related to inContact organic growth, as well as the inclusion of Optivity's operations which were not present in Q1 of 2014.

On a non-GAAP basis, the operating loss for Q1 was $1.4 million compared to $227,000 in Q1 of 2014. The increase in non-GAAP operating loss is principally attributable to the $1.6 million stepdown in guaranteed Software revenue from Unify. We still expect to approach breakeven on a non-GAAP operating basis by the fourth quarter of this year.

Adjusted EBITDA, a non-GAAP measure, is an important metric in our operating results, due to the significant amount of depreciation and amortization resulting from the acquisitions of software, customer bases and network technology, as well as the amortization of capitalized software development costs and stock-based comp.

Adjusted EBITDA was $2.6 million for Q1, flat from Q1 from last year. This was our 13th consecutive quarter with positive Adjusted EBITDA.

As Paul mentioned, on March 30th we completed the sale of $115 million of 2.5% 7-year convertible notes. These notes are convertible at a price of $14.23 per share. At quarter end we had $117 million in cash and cash equivalents and access to an additional $15 million under our line of credit. The offering bolsters the confidence of our channel partners they have in our financial strength and will enable us to be opportunistic in assessing technologies that could enhance our service offerings.

Because of our strong first quarter, we are increasing our guidance for 2015. We anticipate consolidated revenues to be between $209 million and $213 million for the full year. We expect total Software revenues to be between $132 million and $136 million for the full year. This would represent 31 to 35% growth for Software revenues. We have reaffirmed our previously established expectations for Adjusted EBITDA of between $9 million and $10 million. On a GAAP basis, we anticipate a net loss of $0.37 to $0.42 per share in 2015. On a non-GAAP basis, we expect a net loss of $0.15 to $0.20 per share for the full year.

Operator, we are now ready to take questions.

Operator:

Certainly. At this time if you would like to ask a question, please press star, then one on your touch-tone phone. You may withdraw yourself from the question queue at any time by pressing the pound key. Again, star then one to ask a question.

Our first question comes from Katherine Egbert with Piper Jaffray. Please go ahead.

Katherine Egbert:

Thank you. Good afternoon. Can you talk about the RingCentral deal a bit more? Is that currently effective and does it have any impact on revenue this year?

Paul Jarman:

We are launching with them really here at end of May, first of June and it won't have impact in second or third quarter revenues. It could start to have a small impact in fourth, and then bookings would start to be impacted really starting a little bit in third, a little more in fourth and then obviously going into '16.

Katherine Egbert:

Is there an active pipeline there right now, Paul?

Paul Jarman:

There is. So when I say active pipeline, we've really launched this literally a week ago, maybe a week and a half, and we've already got nice lead flow in that's now turning to opportunities and we have sales teams now engaged together on those possibilities.

Katherine Egbert:

Okay. Great. Then you mentioned a competitive win rate and you specifically said you're displacing other cloud companies, which is new, I think, because usually it's just been the legacy vendors. Can you talk about that?

Paul Jarman:

Well there's really three things that we've seen. Number one is we most often displace legacy prem players and in that process we'll often compete with one or maybe two other cloud players which we would beat, or in some cases we'll displace an existing cloud player, but since that's such a small share of the market, that's not the norm.

Katherine Egbert:

Okay. Fair enough. Then a couple of quick things. There's a slowdown this quarter in the networking revenue growth while software is taking off. Is this the result of some of these OEM agreements?

Paul Jarman:

Really as Greg mentioned, it's really there's a couple of things to always think of in your model. One is that as we have carrier partners that we work with they sell telecom; we just sell software. Then secondly is as we sell more workforce optimization solutions that really doesn't bring any telecom with it, so as a percent you're going to see the software grow faster than the telecom and that will really be the two drivers and for what reason.

Katherine Egbert:

Great, and then last one. Greg, if I missed it, did you mention how much Optivity added in the quarter?

Gregory Ayers:

No, we didn't, and Katherine, to tell you the truth, we're not particularly focused on that. We really want to look at the whole rather than the parts. Obviously they are still in the process—we're still in the process of transitioning that business from being primarily perpetual, on-prem, immediate recognition to Software as a Service so we're really not focusing on the perpetual license recognition.

Katherine Egbert:

Okay. Fair enough. I will come back into the queue and let someone else ask a question. Nice job.

Paul Jarman:

Thank you.

Operator:

Thank you. We'll go next to Jeff Van Rhee with Craig-Hallum. Please go ahead.

Jeff Van Rhee:

Great. Thank you. Congratulations guys. It looks really nice here. A couple of questions for you. First, I guess just, Paul, along the lines of Ring but maybe a broader question on UC. To date, how many of the engagements that you were in pitching was the entire telephony infrastructure and UC up for sort of replacement? I guess I'm trying to get a sense of how many deals you've been seeing in the past where those two typically come together, and if you saw any difference in your win rates in deals where they were replacing both versus where they just wanted to call center.

Paul Jarman:

You bet. So the first thing I would say there is where we see the two today—I should say where we see those two together is often in the SMB. So in the smaller deals normally contact center deals anywhere from maybe 15 to 50 seats, that's where up front they're usually looking potentially for a combined UC and contact center offer. That's where it's most common, and that might be 20, 25% of those opportunities. Sometimes up in the larger 300, 400, 500 seat deals we'll see them ask for both. In most cases we overlay their existing system, but I would expect little by little over the next couple of years that that will become a little more common and it's not necessary for us to win the deal but it's something they're willing to do.

Jeff Van Rhee:

What should we expect in terms of additional partnerships as we look forward into this year?

Paul Jarman:

Jeff, we're going to keep adding partners. So you look at where those partners will come from, they're going to come from our referral partners, they're going to come from VARS, they're going to come from potential carriers, they're going to come from the UC space and those are the primary areas. But we feel we're really a perfect company to partner with, with the options we provide from referral to reseller to OEM and we have a leadership product they can be excited about. So we're going to keep driving direct sales and we're going to keep driving our partner relationships in the market.

Jeff Van Rhee:

Okay. Then could you just—in the past you've commented on win rates. Curious if you've seen any shift there with respect to win rates, and then also where are we with sales headcount and expectations?

Paul Jarman:

You bet. So first quarter, very similar to the fourth quarter. Solid, above the 60% in the win rates, and in the sales side we've really stopped giving the exact quota bearing number because we have a much more dynamic sales process now between direct sales people, channel people, sales engineers, lead gen people, so it's not a great proxy for our sales growth. But I'll just tell you that we are adding to our direct sales team at the right proportion of our expected growth targets.

Jeff Van Rhee:

Got it. I guess last one from me then, as you look at your pipeline going forward here, could you just give us a little color commentary? Breadth, depth, just give us a little more incremental color about what you're seeing there. Maybe sequential growth, anything that gives us a sense of kind of what's happening there and how that's morphing. Thanks.

Paul Jarman:

Yes. So first of all, we see opportunities across the board. We see strong mid-market interest. We also see strong enterprise interest. We have good pipelines across our direct sales teams, our channels. We're getting some of these channel players in smoother and smoother cadence with us as we go. So as I said earlier in my presentation, based on the first quarter we feel very confident for the year and that really is obviously revenue and then the kind of new deals we're going to win through the year as well.

Jeff Van Rhee:

Got it. Great. Thank you.

Operator:

Thank you. We'll go next to Mike Latimore with Northland Capital Markets. Please go ahead.

Mike Latimore:

Yes. Thanks a lot. Excellent quarter there. Greg, just to clarify, did you say that the software growth ex Optivity and normalizing for Unify was 39%? Is that what you said?

Gregory Ayers:

No. We did not normalize for Unify. We included that stepdown in the 39%.

Mike Latimore:

Got it. Okay, that's great. Then can you just remind what percent of your business came through resellers and what percent came through Verizon in the quarter?

Gregory Ayers:

So generally, Mike, we give statistics around direct versus all channel, and it was about 40% for the channel for this quarter, which is right in line with what it has been historically.

Mike Latimore:

And Verizon was roughly, what? Half of that or something?

Paul Jarman:

Yes, it's a percent of that. We really can't give individual numbers, but, you know, just know that it just stays very consistent between—typically channel is between about 40 and 50 and 40 and 55, and then direct sales is the rest.

Mike Latimore:

Okay. Got it. Then you had a strong utilization or usage pattern in the first quarter here. Does that—do you expect kind of normal patterns to follow this year? Or do you kind of expect maybe a little reversal at some point?

Gregory Ayers:

Yes, Mike, that's an excellent question that unfortunately only time will answer. So we looked into the significant step up and really it wasn't any single factor or a trend line. It was additional seats turned up. I think just through growth versus seasonality, so that would suggest that we would not see a significant step down, but to tell you the truth we don't have that much visibility. I mean those seats that got turned up incrementally could have been somewhat seasonal. So it was just clearly more seats by that population of customers that are in that same store sales metric, that it was really kind of a blend of both additional seats and some seasonality.

Mike Latimore:

Got it. Then just last question: how is pricing looking on the low end of the market? Are you seeing less discounting? More discounting, just generally in the low end?

Paul Jarman:

You know, we don't see a major change there as we look at our trends for pricing. They've really stayed very stable for almost a year and a half now and some of that is as you add more features you have more price power. Some of that is just not a lot of competitors in certain deals. But I haven't seen a big shift there that we've really seen, not up or down really.

Mike Latimore:

Okay. Great. Thanks very much.

Operator:

Thank you. As a reminder it is star, then one to ask a question, and the pound key to remove yourself from the queue.

We'll go next to Brian Schwartz with Oppenheimer. Please go ahead.

Koji Ikeda:

Hey guys. This is Koji Ikeda for Brian Schwartz. Congrats on the quarter and thank you for taking my questions. I was wondering if you could provide an update on the—I think Optivity brought about 50 VAR relationships to your platform. Can you give us a sense on if you're converting any of those VARs to exclusive inContact resellers or if any of those VARs that previously wasn't selling inContact has signed up as a reseller for you?

Paul Jarman:

Yes, I'd be happy to do that. So first of all we brought about 50 over with the relationship with Optivity and we have signed a bunch of those VARs into reseller agreements that where they're now selling our full product portfolio versus just the Optivity pieces. We've done a lot of different trainings. We've been at their kick-offs. I don't think VARs will ever make them exclusive but what we are starting to see is good coordination and starting to see better movement with really the VARs that we're focusing on and starting to sell the whole process versus just the WFO piece.

So, yes, we've signed a bunch. We are training them and it's starting to have a small impact and growing impact in bookings.

Koji Ikeda:

Great. Thanks for that. Then I'm not sure if this question is for Paul or Greg, but correct me if I'm wrong. I think traditionally you usually have a step-up in cap ex every other year to accommodate expected capacity and 2014 was one of those years, but given your strong performance here and good growth in same store sales and the strong bookings commentary this quarter, are you going to have to adjust that step-up to be every year or is there going to be any change in cap ex then going forward?

Gregory Ayers:

Yes, Koji. So I answered this question last call with regard to investments in PP&E and they really come in three buckets of increasing importance. The first is just replacement of obsolete assets. The second is additional PP&E to support the growth. Then the third is really investments with regard to scale and leverage of the business and I think that the previous guidance I gave was probably between $7 million and $9 million in total for the year. We'll probably look to up that to $8 million to $10 million. So a little bit, just a million higher range than last time but nothing too large.

Koji Ikeda:

Great. Thanks for that. Congrats again on the quarter.

Gregory Ayers:

Thank you.

Paul Jarman:

Thank you.

Operator:

Thank you. We'll go next to Mark Schappel with Benchmark. Please go ahead.

Mark Schappel:

Hi. Good evening. Nice job on the quarter and thanks for taking my call. Paul, starting with you. When you brought on Optivity, when you brought that business on, a portion of their business were selling conventional software licenses and I was just wondering if you could discuss the progress you've been making or have made with respect to moving Optivity more to a subscription revenue model.

Paul Jarman:

You bet. So really there's two-fold there. One is we've trained the direct sales team, and two is we're out training their primary go-to-market which is the VARs on how to sell subscription and cloud. First of all, we've increased the percent of what we close to subscription versus premise, and we see some nice opportunities right now in the second and third quarters to win some really nice subscription business that would have a year ago been premise.

So really, a couple of things. One is our sales team from Optivity understands how to sell recurring now. Two is we've taught a lot of the VARs how to improve the way they reference it and sell it. Three is more and more customers are interested in that recurring model. So I would say it's been almost a year now since the acquisition and we're now starting to see that kind of step-up progress every quarter as a percent. We've not really given numbers there but I would say that '15 will be a great year for progress for us in that area.

Mark Schappel:

Okay. Great. Then finally, Paul, with respect to your international operations, which, granted, are still very small at this point, not too much commentary in the last couple of calls with respect to those. I was just wondering if you can give us an update on where you stand.

Paul Jarman:

So first of all, we actually closed a fair amount of opportunities that are international, but what they are are usually US firms with offshore contact centers. So we have a lot of opportunities where we're doing that today which, to handle that, obviously we have infrastructure in Europe, we have some infrastructure in Asia. We now have put support personnel in Europe and we have some support personnel in Asia. So that's the most busy part of our international process today is supporting multi-national companies.

Secondly, we do have partners in Europe. We do have deals that come from them and we are working on other partners that will be in Europe as well. So I think you'll just see a steady organic increase; it won't be a shock and awe kind of approach to Europe or to Asia, but building off our beachhead of contact centers already there through international clients, we'll start little by little adding partners who will represent us in these areas.

Mark Schappel:

Great. Thank you. That's all from me.

Operator:

Thank you. It appears we have no further questions at this time. I'll turn it back to our speakers for any final remarks.

Paul Jarman:

Well, thank you everybody for being on the call today. We're excited for our first quarter, for our achievements in the quarter and also we're excited for the leadership position we fill now and for what that means for inContact and our future opportunities in the market and as a company. So, thank you and have a great day.

Operator:

Thank you. This does conclude today's program. You may disconnect your lines at any time and have a great day.