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CCSI.OQ - Q1 2023 Consensus Cloud Solutions Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to Consensus Q1 2023 Earnings Call. My name is Paul, and I will be the operator assisting you today. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. (Operator Instructions.] On this call from Consensus will be Scott Turicchi, CEO; John Nebergall, COO; Jim Malone, CFO; and Adam Varon, Senior Vice President of Finance. I will now turn the call over to Adam Varon, Senior Vice President of Finance at Consensus. Thank you. You may begin.

Adam Varon - *Consensus Cloud Solutions, Inc. - SVP of Finance*

Good afternoon, and welcome to the Consensus investor call to discuss our Q1 2023 financial results, other key information and reaffirmation of our 2023 guidance. Joining me today are Scott Turicchi, CEO, John Nebergall, COO and Jim Malone, CFO. The earnings call will begin with Scott providing opening remarks. John will give an update on operational progress since our year-end investor call, and then Jim will discuss Q1 2023 results and 2023 guidance. After we finish our prepared remarks, we will conduct a Q&A session. At that time, the operator will instruct you on the procedures for asking a question.

Before we begin our prepared remarks, allow me to direct you to the safe harbor language on Slide 2. As you know, this call and the webcast will include forward-looking statements. Such statements may involve risks and uncertainties that would cause actual results to differ materially from the anticipated results. Some of those risks and uncertainties include, but are not limited to, the risk factors outlined on Slide 3 that we have disclosed in our 10-K SEC filing as well as a summary of those risk factors that we have included as part of the slide show for the webcast. We refer you to discussions in those documents regarding safe harbor language as well as forward-looking statements.

Now let me turn the call over to Scott.

R. Scott Turicchi - *Consensus Cloud Solutions, Inc. - CEO & Director*

Thank you, Adam. I'd like to provide a brief overview of the quarter before handing the call over to John and Jim for details on our operations and our Q1 financial results. Q1 2023 was a record first fiscal quarter with revenues of $91.5 million and an all-time record for our fax volumes. Our revenue was in line with our expectations, representing approximately 24% of our annual expected revenue at the midpoint of our guidance for the year and consistent with our disclosure during the Q4 call. The corporate channel experienced 6.2% growth consistent with the organic performance in Q4 of 2022. Despite this growth, we continue to see slow decision-making by our largest prospects and slow implementation by those under contract. This is driven by uncertainty in the economy and labor shortages that exist, especially in the health care space. As we have stated before, we believe that this will continue throughout 2023, and our previously released guidance has taken that into account. The price changes for SoHo are coming to an end of this current quarter and continue to perform within our modeled expectations.

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As you know, during the quarter, we had to file both an amended 10-Q for Q3 2022 as well as the delayed 2022 10-K. The amended 10-Q, delays in filing and additional audit work had an incremental cost of $2.3 million more than in Q1 of 2022 and had an impact on our EBITDA margin of 2.5 percentage points. In addition, as we noted in the Q4 call, our labor costs are up about $3.3 million due to an additional 70 employees more in the current quarter, most of whom were hired in 2022 and annual merit increases that took place on January 1 of this year. This is approximately 25% of the $12 million increase that we noted in our Q4 call. This had an impact on our EBITDA margin of 3.6 percentage points. As our revenue grows sequentially throughout the year and the audit costs do not repeat, we will see an expansion of our EBITDA margin. As we stated last quarter, we are judicious in our incremental hiring and are looking for ways to lower our nonemployee costs.

The sales and marketing realignment has taken place, and we are starting to see some of the benefits of the new structure. John will give you additional details in his portion of the presentation. I am pleased to report that the VA has begun the rollout of the EC fax service. Two facilities were deployed post the close of the quarter, and there is now a road map for the next several months. We will generate a de minimis amount of revenue in Q2 and see the rollout ramping in future quarters as more facilities are brought online. There are now more than 20 agencies interested in the service. Ten prospects have already been provided to demo and are in active discussions with Cognizant and ourselves. It is still early, and we do not expect any of these new agency opportunities to produce revenue in 2023 but are encouraged by the widespread interest in the solution.

Before handing the call over to John, I'd like to spend a moment to discuss our liquidity and capital allocation alternatives. We remain very liquid with more than $111 million of cash on our balance sheet and a $50 million undrawn line of credit that we put in place back in March of 2022. These funds are targeted to debt paydown, which cannot occur until the second anniversary of the spin, which would be October of this year and opportunistic stock repurchases. To that end, in the quarter, we were able to repurchase approximately 270,000 shares at an average cost of approximately $34 per share.

I'll now turn the call over to John.

John Nebergall - *Consensus Cloud Solutions, Inc. - COO*

Thank you, Scott. As you will recall in our last update, we announced a broad realignment of our go-to-market organization. This action was taken to build upon our sales and marketing foundation that we had established post spin with a focus on improving both efficiency and effectiveness of our revenue-generating efforts. As part of that initiative, we eliminated the revenue stream designations of enterprise, mid-market and SoHo, streamlining the organization into strategic sales and direct sales.

As a reassurance to the interested call audience, we will continue to report SoHo results consistent with your current models. However, operationally, we manage under the realigned structure. This past quarter, following an extensive search, we were able to secure new leadership for our direct sales team and are closing in on our targeted staffing level. The activities around implementation and normalizing operations under the new structure are progressing. In addition to the organizational changes, we have completed an extensive account reassignment project and initiated outreach to customers for introductions to their new consensus content. In concert with this, there have been a number of changes to the quota assignment and commission system designed to better motivate the sales team and drive top line performance. These improvements to the quota and commission are the result of a data-driven approach employed by our sales enablement team, and we will continue to further our data analysis program to identify opportunities for the business.

One more facet of the sales piece of the realignment is establishment of a new account development team. This group is making use of new analytics tools to target existing accounts for wallet expansion activities. While still fully developing their approach, this team has already contributed nicely to our pipeline building results for Q1. On the marketing front, we have merged the former corporate and web teams into a single marketing organization. The team has begun evaluating the business more holistically and identified several tools that will increase the efficiency and effectiveness of our marketing efforts. The team has also worked hard on ensuring our success at two major health care conferences, the HIMSS show in Chicago and ViVE and Nashville, which were both held only weeks apart. Those efforts resulting in the acquisition of hundreds of new leads and the ability to demonstrate clarity to thousands of new health care leaders were wildly successful for the company.

Surrounding the entire go-to-market restructuring is our IT infrastructure and the work to arrange all of the reporting, forecasting, billing and attribution changes in support of the new organization is an ongoing task. With the size and scope of the work needed to have this project

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completed, we expect that it will be an ongoing effort for the entire balance of 2023. On the next slide, we can walk through some of the key operating results for the quarter. Consistent with our commentary on the Q4 call, we continue to see delayed decision-making in the face of client-side staffing shortages and customer project backlogs caused largely by the current macroeconomic uncertainty. I would describe the sales outcome as flattish, up slightly sequentially from Q4 and down slightly year-over-year. While we have worked hard to mitigate the impact of our realignment on overall sales productivity, as you can tell from the earlier slide, there is a lot of activity around this, and there was certainly some loss of sales efficiency in Q1.

That said, there was a few items of note that are important to discuss. First, sales of fax was up both over Q1 of 2022 and sequentially over Q4. In addition, the advanced interoperability product again accounts for a significant portion of overall sales coming in at 30% of bookings. Also of note is that the upsell program we announced last year and a plan to accelerate through the realignment accounted for nearly $1 million of new bookings, expanding our revenue from existing accounts.

Finally, we did close two larger-sized jSign deals as the feature set is proving very competitive to the market incumbents. We remain pleased overall with the state of our pipeline. And while we continue to see slow prospect movement through the sales process, it remains strong and, in fact, continues to grow both with government agencies as well as our commercial prospects set.

In the SoHo business, there are only a few months of annual plans to adjust for the price increase we enacted last June, and the customer base overall is holding very solidly within our modeled expectations for churn, with churn for the quarter coming in at a six basis point improvement from Q4's results. This past April, we had our first two successful deployments of the EC fax solution for the VA with additional sites planned in the coming months. It's still early times here, and we haven't yet gotten to a predictable cadence for us to confidently forecast the base. We look forward to working towards some normalization on that front. But until that time, it will remain somewhat lumpy and difficult to accurately anticipate the EC fax contribution in the coming months.

The first production instance of clarity has been accepted by the customer, and the rollout timing is dependent on availability of client-side resources. We have also had very successful demonstrations of the Clarity technology at both HIMSS and ViVE and interest in AI-powered solutions generally is reaching a high level. In the meantime, we have active POCs in process with additional customers and are actively engaged in a number of discussions with pipeline prospects. The product team is working on several fronts from security to new products and infrastructure improvement. Our High Trust annual certification is underway, and we will be introducing jSign as a new addition to our HITRUST certified product set.

Progress continues to be made on Harmony, and we are code complete with a production version of fax-to-direct, a feature that allows faxed documents to be delivered as direct secure messages across the DirectTrust network. This allows providers to use either a recipient's fax number or their direct address to securely deliver vital health care information.

As announced in the last call, the product team is introducing the new discipline of product marketing, creating a more effective bridge between the engineering work that creates products and the commercialization process. We have successfully recruited a strong leader for the team and are beginning the work of establishing this vital function for the business. As we talked about on the last slide, there is an important systems component to our realignment that the product engineering team is building as part of our larger Genesis initiative, including sales force and consolidation of our billing systems to generate better and more insightful reporting for the sales enablement team to use as a key component of their data-driven approach.

Finally, the engineering team is working on several system improvements that will support our upmarket move in Japan. There have been several large prospects in Japan who have expressed interest in a corporate version of our product, which has historically not been available in the Japanese market. We anticipate beginning upmarket activities there in Q3.

In summary, we have made some great progress on our realignment initiative, and while there is certainly more work to do, we're pleased with what's been accomplished. We continue to see slow decision-making in our prospect pipeline. However, the dialogue remains active. Sales results for the quarter are consistent with our expectations given the macroeconomic environment and progress in our efforts to upsell within the base as well as seeing jSign getting traction are encouraging. The VA rollout has begun. Our first clarity production installation will commence once

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client-side resources become available, and the SoHo-based churn has been holding within expectations. Finally, the product development team is focused on security, Harmony development and infrastructure support of the go-to-market realignment.

Now let me turn the discussion over to Jim Malone, our CFO. Jim?

James C. Malone - *Consensus Cloud Solutions, Inc. - CFO & Principal Accounting Officer*

Thank you, John, and good afternoon, everyone. Let's start with our corporate business results. Q1 2023 corporate revenue was $49.4 million, an increase of $2.9 million or 6.2% over the prior year comparable period. On a constant dollar basis, corporate revenue was 6.4%. ARPA difference is due to a greater portion of paid debts coming from SMB customers and an acceleration of SoHo migration to corporate. Monthly churn was 1.4%, down from 2% for the prior year, supporting our last 12 months revenue retention of approximately 102%, consistent with our expectation.

Moving to SoHo results. Q1 revenue was in line with expectations of $42 million, a decrease of approximately $0.8 million or a negative 1.8% over the prior year comparable period. On a constant dollar basis, SoHo revenue was $0.4 million or 0.7% negative. ARPA of $15.10 increased to $1.22 or 9% year-over-year. Monthly churn was 3.8%, up from 3.5% over the prior period and in line with expectations.

The year-over-year revenue decrease was due to lower pay debts, partially offset by higher ARPA related to price increases. The price increase further enhanced the contribution to SoHo fixed revenue.

Moving now to consolidated results for Q1. Revenue was $91.5 million, an increase of $2.2 million or 2.4% over Q1 2022. On a constant dollar basis, revenue increased $2.7 million or 3% year-over-year. Reported adjusted EBITDA of $44.2 million is a decrease of $4.4 million or 9%, delivering a 48.4% adjusted EBITDA margin, driven by planned employee-related expenses and professional fees in connection with the 2022 year-end audit.

Non-GAAP EPS of $1.10 was lower by $0.23 or 17.3% compared to comparable prior year period, driven by the adjusted EBITDA items mentioned and a negative $1 million noncash foreign exchange impact related to the intercompany balance revaluation, partially offset by higher revenues. We ended the quarter with $111 million in cash, which is more than sufficient to fund our operations and debt. We are reaffirming full year guidance, adjusted EBITA for revenue, adjusted EBITDA and adjusted non-GAAP EPS. The 2023 guidance ranges are as follows: revenue, $370 million to $390 million with $380 million at the midpoint. Adjusted non-GAAP EBITDA, $192 million to $206 million, with $199 million at the midpoint. Adjusted non-GAAP EPS, $4.93 to $5.20 and with $5.08 at the midpoint. Our Q1 non-GAAP tax rate and share count was 19.98% and 19.9 million shares within our 2023 guidance. We are planning to file our Q1 2023 10-Q on market close tomorrow, May 10.

This concludes my formal remarks. I will now turn the call back to the operator for a Q&A session. Thank you.

QUESTIONS AND ANSWERS

Operator

Thank you. We will now be conducting a question-and-answer session. In the interest of time, we ask that you please limit yourself to one question. (Operator Instructions.] We will also be taking questions today via e-mail. If you wish to e-mail through any questions, please e-mail your questions to investor@consensus.com, that's investor@onsensus.com. Please, one moment while we begin. And the first question from the line is coming from Ian Zaffino from Oppenheimer.

Ian Alton Zaffino - *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*

I joined a couple of minutes late, but glad to see this VA is now being implemented. How do we think about the ramp of the VA as it relates to the remainder of the year and then into 2024?

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R. Scott Turicchi - *Consensus Cloud Solutions, Inc. - CEO & Director*

Yes. Ian, this is Scott. I appreciate the question. So, the way the VA rollout works is there was an initial group of five facilities, of which two have launched, as was noted in our press release and our comments. The other three are to be launched over the next 60 to 90 days. Cognizant, the VA and ourselves are working then on a plan for the rollout beyond that time frame. And there's some different methods of doing it. But what has occurred to date is to go facility by facility with the goal of cutting over predominantly, if not exclusively, all of the modes by which that facility sends and receive faxes. So that would be the porting of telephone numbers for inbound that may be connected to servers, multifunction printers and devices converting over, of which there's a variety of underlying providers like Lexmark and HP, Rico, Cannon, etc. And then there's the outbound piece, which is the sending of documents via the service, which actually do not require a telephone number to effectuate that. So, the first five are going on essentially a full cutover basis. It is typical with our corporate clients that we actually -- if they are as sophisticated as the VA facilities are, we actually do it in phases. And so instead of trying to do everything all at once, particularly where we find there's a distribution of traffic, oftentimes say, a multifunction printer, a specific brand, they have a very small amount of the total traffic of that facility or that entity, we would phase that to be at the end to be cut over. So, let's say that's not currently what is going on. So what Cognizant, the VA and ourselves are working with the plan once we get through the first five to hopefully have a more streamlined approach that can accelerate the pace of rollout, certainly, at least of the outbound services for certain of the facilities and then phase in over time other elements on a facility-by-facility basis, but that's still very much under development with the VA.

So long answer to your question, which is you still got to stay tuned. I don't think the five facilities that we know are in this current phase. As I mentioned in my comments, they'll have a de minimis contribution to revenue in Q2. It will be somewhat slightly above de minimis in Q3 and its hopefully slightly greater than that in Q4. It's really as we get beyond the first five and start layering in the ramp beyond that and the mode by which that ramp occurs, that we'll be better able to answer the 24 question. But I don't think in any event, it's going to be terribly impactful for 2023 revenue.

Ian Alton Zaffino - *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*

Okay. And then on the margin side, how are you thinking about margins, I guess, as we kind of enter a recession or the slowdown we're seeing margins were down year-over-year. How do you intend to, I guess, hit that margin target of the 82% to 83%? And what type of offsets can you do on the cost front?

R. Scott Turicchi - *Consensus Cloud Solutions, Inc. - CEO & Director*

Well, we focus first on the EBITDA margin. That's the $50 to $55. And actually, if you look at Q1, we had these unfortunate as rather large expenses related to the 10-QA filing and the delayed 10-K filing of about $2.3 million versus what we spent in Q1 of 2022. That's 2.5 points in margin right there. So those expenses certainly will not reoccur, our audit and other professional services go down always dramatically in Q2 and Q3, and we start to ramp in Q4 as we look to the next audit cycle. So, we're kind of in the range. Having said that, there is, as I said in my prepared remarks, there is about $12 million of increase year-over-year in compensation expense related primarily to our employees. We have about 70 more employees in Q1 of 2023 versus Q1 of 2022, although essentially flat with where we were at year-end, but we do have merit raises that took effect in January of this year. So that's been fully budgeted, and we saw basically a full quarter's effect of that with an increase of non-GAAP compensation expense of about $3.3 million. So that I do expect to persist throughout the year. And then as our revenue grows, we should see the margin continue to expand off of what I'll call the pro forma margin of about 50% to 51% when I back out the excess accounting and legal fees associated with the audit.

So, we're very -- as I mentioned in the last earnings call, given that our budget contemplates at the beginning or the middle of this year a recession, we're very judicious on incremental costs, particularly as it relates to additional hires. We do still continue to hire, but we are not hiring anywhere near the pace we did in 2022. And when we look outside of the employee costs, which are about 56% of our total cash cost structure, we look for areas where we can either eliminate cost or trim some costs. So, there will be puts and takes, I think, as we go through the balance of the year where we probably will pick up some incremental savings in these non-compensation, nonemployee-related expenses.

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Operator

Thank you. (Operator Instructions.] The next question is coming from John Tanwanteng from CJS Securities.

Unidentified Analyst

It's Pete Lucas for Jon. You answered a lot of the questions in the prepared remarks, I do appreciate that. I guess just going back to -- you talked about the delayed decision-making impacting sales. Can you kind of break that down in terms of how it's affecting health care budgets? And specifically, are there any reasons why IT departments are getting stuck or hung up? And then also how it relates to the nonhealthcare corporate end markets such as legal and financial, are they seeing similar headwinds to health care?

John Nebergall - *Consensus Cloud Solutions, Inc. - COO*

Yes. Thank you for the question. I appreciate that. I think what you've got in health care is a lot of pressure on health care IT organizations to stay staffed. And we started to see that as we came out of the pandemic. But I think that part of it accelerated beginning about middle of last year. We started to see the roots of it, I think we talked about it on a couple of these calls now. And health care, in particular, was pretty hard hit with the ability to find some of these technical resources they need to run their IT projects. So, you can imagine if you're a large health system, you have any number of IT projects, and now you have a dwindling number of staff to help with the implementation. And while certainly the kind of implementation that we perform at these kinds of facilities is a relatively light touch, it still does require interaction and work with the internal project teams on the client side.

So, where we're seeing a fairly large impact in our ability to drive revenue is in those particular areas. I think secondarily, what we're also seeing is some caution. And the caution, I would say, is not limited to just healthcare around making the decision to pull the trigger on purchasing. So, while we're still working through and working with these clients and having engaged conversations, the question is, is this something that I'm going to pull the trigger on right now? Can it wait a month? And it's not a matter of, in our minds, if, it's a matter of when. And I think that like much of everybody else that is looking at the economy right now, it's trying to decide at what point whatever it is, this recession, whatever form this recession takes, when does it hit? What does it look like and how effective am I going to be? And I think those questions are keeping the market slowed to be able to feel comfortable moving into new kinds of technology.

R. Scott Turicchi - *Consensus Cloud Solutions, Inc. - CEO & Director*

Before Paul, we go to the next question, we've got a few questions that have come by e-mail. These are pretty quick answers. One is the question came is our -- is anything for the VA contract or our Japanese expansion revenues that John mentioned, included in our guidance? The answer -- or well, I would say, our budget, the answer to that is no. Obviously, our guidance is a wide range. So, the expansion of the range, particularly to the upside, you could argue part of the way to achieve an outperformance would be contributions from the VA contract of Japan. But as I noted earlier, I don't expect the VA contract this year to be a major contributor, and I would say the same is true of Japan, but they're not in our budget.

And then the other question regarding cost is exclusive of the audit costs, which I assume is the $2.3 million that I referenced in the prepared remarks, however SG&A and R&D come in relative to our expectations pretty much in line. Little bit heavy on some employee costs by maybe $200,000, $300,000. But in the aggregate, both SG&A and R&D were in line exclusive of the $2.3 million of professional fees that I referenced earlier.

Let's go back to live questions and then we'll come back to another question by e-mail.

Operator

[Operator Instructions.]

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R. Scott Turicchi - *Consensus Cloud Solutions, Inc. - CEO & Director*

Well, I'll take this opportunity, Paul, then to go to the next question by e-mail. And the question is, some of you may have seen that we put out a press release a few days ago regarding our relationship with AWS and the ISV opportunity. I think it was a pretty detailed release. But John, why don't you give some additional color, I think that the questioner would like some additional color on that relationship.

John Nebergall - *Consensus Cloud Solutions, Inc. - COO*

Absolutely. I think that so much of what we've been able to gain over the last two or three years has been part of our growth in the channel area. The channel program is something that the organization has developed probably beginning in 2017 or 2018. And when you think of AWS as a channel, what you're really looking at is the large customers that very often use AWS as their platform as they look for technology solutions. AWS becomes a great source for them to be able to not only direct them to quality vendors, like ourselves, but also understand that those vendors because they use AWS have a high degree of compatibility with the environment that they are already working in.

Now I know as we have spoken with not only AWS but the customers that we have had through the introductions through AWS, that the entire ecosystem there is very interested in making sure that you have solutions that can interact simply with each other and that are accustomed to the same platform. So, I think that as we look at that relationship, we look at the relationship we have with Verizon and Salesforce, those kinds of relationships continue to be important drivers for us. And those kinds of introductions are very helpful for us as far as how we advance our ability to sell into a variety of markets and be able to drive the top line.

Operator

There were no other questions from the dial-in audience. At this time, I'd now like to hand the call back to Scott Turicchi for closing remarks.

R. Scott Turicchi - *Consensus Cloud Solutions, Inc. - CEO & Director*

Great. Thank you, Paul. Thank you all for participating today in our Q1 earnings call. We have a release that will come out that will reference additional conferences that we'll be at over the coming weeks. My recollection is correct, it'll be Adam and I at the High-Yield conference of Goldman Sachs coming up and then virtually at a Needham conference, which is being held in New York, but our participation will be virtual. As both of those will be entertaining one-on-ones and in some cases, we'll also have a public presentation. So, stay tuned for the webcast links for that. In terms of the next regularly scheduled call, we'll look to report Q2 earnings probably the week of, I believe it's August 8 or August 9, I can't remember exactly which that Monday is, but it will be some time that week. We'll obviously put out a notice well in advance to alert us to the times in a way to participate. Thank you.

Operator

Thank you. This does conclude today's call. You may disconnect your lines at this time and have a wonderful day. Thank you for your participation.

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