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Q2 Holdings, Inc. (QTWO)

Q3 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Macy and I will be your conference operator today. At this time, I would like to welcome everyone to the Q2 Holdings Third Quarter 2021 Financial Results Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions] Thank you.

I would now like to turn the call over to Josh Yankovich, Investor Relations. Sir, you may begin.

Josh Yankovich

Investor Relations Manager, Q2 Holdings, Inc.

Thank you, operator. Good morning, everyone, and thank you for joining us for our third quarter 2021 conference call. With me on the call today is Matt Flake, our CEO; David Mehok, our CFO; and Jonathan Price, our Executive Vice President of Emerging Businesses, Corporate and Business Development.

A quick reminder that we'll be hosting our virtual Investor Day on December 14, 2021. Registration is now open and there will be a live webcast and replay available on the Investor Relations section of our website following the event.

This call contains forward-looking statements that are subject to significant risks and uncertainties, including statements regarding our expectations for the future operating and financial performance of Q2 Holdings. Actual

results may differ materially from those contemplated by these forward-looking statements, and we can give no assurance that such expectations or any of our forward-looking statements will prove to be correct.

Important factors that could cause actual results to differ materially from those reflected in the forward-looking statements are included in our periodic reports filed with the SEC, including our most recent quarterly report on Form 10-Q and subsequent filings, and the press release distributed yesterday afternoon regarding the financial results we will discuss today.

Forward-looking statements that we make on this call are based on assumptions only as of the date discussed. Investors should not assume that these statements will remain operative at a later time and we undertake no obligation to update any such forward-looking statements discussed in this call.

Also, unless otherwise stated, all financial measures discussed on this call will be on a non-GAAP basis. A discussion of why we use non-GAAP financial measures and a reconciliation of the non-GAAP measures to the most comparable GAAP measures is included in our press release, which may be found on the Investor Relations section of our website and in our Form 8-K filed with the SEC yesterday afternoon.

Let me now turn the call over to Matt.

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

Thanks, Josh. I'll start today's call by sharing our third quarter results and highlights from across the business. I'll then hand the call over to Jonathan to give you more insights into the Emerging Businesses organization he oversees. Given the long-term strategic importance of banking-as-a-service and Q2 Innovation Studio, he is joining today's call to provide updates and share his perspective. David will then discuss our financial results in more detail, as well as guidance for the fourth quarter and full year.

In the third quarter, we generated non-GAAP revenue of \$127.3 million, up 22% year-over-year and 3% sequentially. We also added close to 400,000 users, a year-over-year increase of 12% that brings us to approximately 19.2 million total registered users on our digital banking platform.

Throughout the year, I've shared our optimism that the financial services industry would continue to recover from the impacts of the pandemic as the year progressed, leading to gradual improvement in the buying environment in the back half of 2021. And in the third quarter, we saw strong sequential and year-over-year bookings growth that we believe is consistent with our optimism. Net new bookings were up 88% compared to the third quarter a year ago and we had a strong quarter of both renewal and cross-sell activity as well.

I've also shared the general sentiment from our customers that in spite of creating short-term uncertainty, complexity and competing priorities, the pandemic is ultimately serving as a catalyst for them to digitally transform their businesses. Consistent with that sentiment, we have started to see more financial institutions evaluate multiple aspects of our solution set like digital banking and lending at the same time as they look to unify their customer experience across the digital channel. We also are observing this digital acceleration with non-traditional providers, as evidenced by several key lending and banking-as-a-service wins with fintechs, brands and Alt-FIs in the quarter.

So with that, I'd like to take some time to discuss a few sales highlights that we believe illustrate this improvement in customers' buying behavior and our favorable position in the marketplace. I'll start with digital banking, where we signed a broad mix of strategic customers, including three new Tier 1 financial institutions. The first was a top

10 credit union that signed for our commercial banking suite. This was a highly competitive deal where our end-to-end commercial solution set was a key driver of their selection from onboarding to digital banking to risk management.

The second Tier 1 win was with a bank that selected us for retail digital banking. The Q2 Innovation Studio played a big role in this win in a scenario where many of our competitors were evaluated. And the third Tier 1 digital banking deal was with a bank that selected our full digital banking platform, including retail, small business and commercial, while also adding our account opening solution Q2 SMART and risk management products.

We're pleased to see Tier 1 activity increase on the digital banking side. And I think the fact that we saw standalone retail and commercial deals along with the full digital banking platform win speaks to our differentiation in this segment.

We had several significant wins in the Tier 2 and 3 spaces as well, both net new and cross-sale. We had a meaningful expansion win with a Tier 2 credit union that purchased our commercial banking suite in 2019 and has now decided to adopt a broad set of retail solutions from us as well, including digital banking, risk management and account opening. We have more than 450 digital banking customers, many of which start with one aspect of the digital banking platform like retail or commercial. Wins like these continue to highlight the expansion opportunity we have within our existing customer base. In this example, we also extended the duration of the existing relationship and added substantial incremental revenue.

And over the past several quarters, I've discussed the growing trend of financial institutions bundling more and more of our solutions as part of their initial agreement with us, whether it's digital banking, risk management, lending, or retail and commercial onboarding. Highlighting this trend, we signed a Tier 2 bank in what we would consider a full digital transformation win as they purchased our digital banking and loan origination platforms concurrently, simultaneously running the evaluation, due diligence and executing an agreement for both solutions.

Going deeper into the digital lending activity in the quarter, we continued to sign new deals and expand existing relationships. We are seeing compelling wins with our loan origination solution. In addition to the digital transformation deal I mentioned earlier, we signed an agricultural lender that will use our solution to modernize their borrower experience and simplify their internal operations.

I believe these wins demonstrate the flexibility of our loan origination solution, which enables us to compete for a broad set of digital lending opportunities from traditional financial institutions looking to modernize their lending up experiences to alternative finance companies operating within specialty markets.

On the loan pricing front, one key win was a large expansion deal with an existing global enterprise client. In this case, the customer had purchased our loan pricing platform several quarters ago. During the third quarter, the bank purchased incremental functionality in order to broaden their use of our solutions, meaningfully growing the revenue associated with this relationship. This is a great example of our ability to expand our footprint with existing digital lending customers, whether it's cross-selling additional functionality, as was the case here, extending into new business lines or into new geographies supported by the financial institution.

So, clearly, I'm encouraged by the sales performance from the quarter, and recent acknowledgment from industry analysts has further validated our product portfolio and our vision. We were recognized by IDC for the openness of our technology in partnership with one of our customers, Visions Federal Credit Union. Visions was one of the first customers to adopt the Q2 Innovation Studio, which they've used to substantially accelerate their ability to deliver innovation to their members. And we were recently named a top vendor in Aite-Novarica Group's annual

digital banking and cash management vendor reports, where they mentioned our expanded view of digital banking to orchestrate the end-to-end experience from acquisition to customer management as unique in the space.

Recognition like this is important. Customers look for validation from firms like IDC and Aite-Novarica Group when they are evaluating new partners, and we view being increasingly recognized for the breadth and strength of our portfolio as another driver of the market's belief in our product strategy. When you couple that validation with the improving buying environment, I believe we are well-positioned to build on the sales success we saw in the third quarter.

Thanks. And with that, I'll pass the call to Jonathan to talk more about banking-as-a-service and Q2 Innovation Studio.

Jonathan Price

Executive Vice President-Emerging Businesses, Corporate & Business Development, Q2 Holdings, Inc.

Thanks, Matt. Over the past several quarters, we've discussed the digital transformation of financial services, and this transformation applies not only to traditional financial institutions looking to refresh their technology, but also to non-traditional players as well, fintech companies and brands that are looking to provide banking services directly to their customers. To do so, they have to find ways to partner with financial institutions, both for the regulatory infrastructure and the expertise they provide. Likewise, many financial institutions are beginning to recognize that partnerships with fintechs and best-in-class digital solutions can be a driver of their ability to grow and differentiate in their highly competitive markets.

We believe this convergence could play a significant role in helping to shape the financial services space over the years to come. And whether through banking-as-a-service where our technology enables fintechs or brands to partner with financial institutions to launch their own banking products, or Q2 Innovation Studio, which allows financial institutions to easily embed cutting-edge fintech solutions into their own digital offerings, we believe we're in a unique position to facilitate these emerging partnerships and business models.

And demonstrating our traction with these solutions, we generated strong momentum with both banking-as-a-service and Q2 Innovation Studio during the third quarter. On the BaaS side, we signed multiple net new deals, extended a key existing relationship and supported a launch event with one of our strategic clients. This client is one of the largest US fintechs and has now launched multiple products, including traditional savings accounts and certificates of deposit powered by our BaaS platform. This is an example of the type of growth opportunity we associate with large BaaS partnerships.

As adoption increases among our clients and customers, we have the opportunity over time to earn meaningful incremental revenue to the initial deal. This launch also represents an early entry into business account functionality for our BaaS platform, which will expand our solution set and we believe will represent a competitive advantage for us in the banking-as-a-service space over time.

Turning to Q2 Innovation Studio, we are beginning to see this program serve as a differentiator for our digital banking platform, both with net new prospects and existing customers. In the third quarter, we signed several new partners to the Innovation Studio ecosystem and added many of our financial institution customers to the program. As Matt mentioned earlier, in Q3, we closed the digital banking opportunity with a Tier 1 customer, which cited our Innovation Studio as a key reason for selecting Q2. This situation underscores the growing strategic importance of a more open platform in today's market and the differentiation the Q2 Innovation Studio can deliver to both prospects and our existing customers.

Our customers are able to leverage Q2 Innovation Studio to accelerate their pace of innovation. It provides them the ability to extend their platform, deliver new functionality and embed fintech and other third-party products into their digital channels with launch timelines that can be much faster than traditional delivery models.

Combined, we believe, Q2 BaaS and Q2 Innovation Studio will add new layers of value to our business and, over time, will play a strategic role in expanding our TAM. In order to capitalize on that opportunity, we expect to continue making investments in these areas of the business. And by enabling this bidirectional partnership between traditional financial institutions and this emerging ecosystem, we believe Q2 is in a highly differentiated position to facilitate this convergence and help to power the next generation of financial services.

And with that, I'll pass it to David.

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

Thanks, Jonathan, and good morning, everyone. Following a couple of quarters of improved deal-related activity, we're encouraged by the strong bookings performance we saw in Q3. We delivered solid revenue growth that exceeded the high end of our guidance based on delivered revenue, as well as organic growth within existing customers as we benefited from increasing adoption of our solutions from customers that see the value in the wide range of solutions we offer.

Our ability to continue delivering revenue effectively and finding efficiencies in operations, even as we continue to make important investments in our solutions, resulted in EBITDA, which also exceeded the high end of our guidance. I'll begin by reviewing our results for the third quarter of 2021 in more detail and conclude with updated guidance for the fourth quarter and full year.

Total non-GAAP revenue for the third quarter was \$127.3 million, an increase of 22% year-over-year and up 3% sequentially. Both the year-over-year and sequential increase in revenue was largely the result of growth in subscription revenue driven by new customer go-lives and organic user growth. In addition, the sequential increase was also due to growth in services revenue associated with implementations as well as premier services.

Transactional revenue represented 14% of total revenue for the quarter, consistent with both the prior year period and previous quarter. Transactional revenue dollars in total declined slightly sequentially, largely from a decline in traditional bill pay revenue for the quarter, partially offset by growth in BaaS-related transactional revenue.

Turning to backlog, we ended the quarter with approximately \$1.3 billion in total backlog, a 3% increase year-over-year and a sequential increase of \$15 million. The year-over-year and sequential increase in backlog was the result of bookings added through renewal opportunities in addition to the contribution of net new bookings.

Gross margin for the third quarter was 51.9%, down from 52.5% in the third quarter of 2020 and consistent with the second quarter of 2021. The year-over-year decline in gross margin was primarily attributable to expenses associated with implementation resources required to deliver and host new customer go-lives as we continue to make investments in implementation resources aligned with the net new bookings strength.

Total operating expenses in the third quarter were \$62.4 million or 49.1% of revenue compared to \$50 million or 47.8% of revenue in the third quarter of 2020 and \$57.9 million or 46.6% of revenue in the second quarter of 2021. The year-over-year increase in OpEx as a percent of revenue was largely related to R&D as we continued

to invest in differentiated innovation. This innovation includes investments we have made in our Emerging Businesses and our commercial banking and lending offerings that we believe will drive long-term value and growth. In addition, some of the increase in R&D was driven by incremental head count associated with the acquisition of ClickSWITCH which were concentrated in R&D.

The sequential increase in OpEx as a percent of revenue is largely the result of increases within sales and marketing driven by the first full quarter of expenses associated with Q2 Stadium naming rights as well as key demand generating resources and programs intended to position us for the market opportunity that lies ahead.

Adjusted EBITDA was \$7.3 million for the quarter, down from \$8.1 million in the third quarter of 2020 and \$9.9 million in the second quarter of 2021. The year-over-year and sequential decline was largely attributable to a slowdown in revenue growth as a result of fewer go-lives in the quarter, which was the direct result of the pandemic impact on demand in prior periods that we have previously discussed.

We ended the quarter with cash, cash equivalents and investments of \$394.6 million, down from \$411.3 million at the end of the second quarter 2021. Cash used in operations was \$14.4 million in the third quarter compared to cash flow generated from operations of \$11.5 million in the second quarter. The sequential decline was due in part to the final payout of our termination agreement with StoneCastle totaling approximately \$7.6 million. In addition, the timing of payroll resulted in the extra payroll run in the quarter, occurring the day prior to quarter close, also totaling approximately \$7.6 million. These two items also influenced our free cash flow in the quarter, resulting in a use of \$17.7 million. We expect that the normalization of these two items coupled with a more favorable seasonality of other working capital items should result in positive cash flow generated from operations in Q4.

Now, let me wrap up by sharing our fourth quarter and updated full year guidance. We forecast fourth quarter non-GAAP revenue in the range of \$131.3 million to \$132.8 million, representing year-over-year growth of 20% to 21%. And as a result, we are increasing our guidance for full year revenue to \$499.8 million to \$501.3 million, representing year-over-year growth of 23%. We forecast fourth quarter adjusted EBITDA of \$7.3 million to \$7.9 million. And as a result, we are increasing full year 2021 adjusted EBITDA guidance to \$34.4 million to \$35 million, representing 7% of non-GAAP revenue for the year.

In summary, we delivered better-than-anticipated results in the third quarter and we're increasing our full year guidance for both revenue and adjusted EBITDA. Based on the improving sales performance and customer response to our solutions we have observed as the year has progressed, we're increasingly confident in our ability to continue capitalizing on an improving buying environment in Q4 and into 2022.

With that, I'll turn it back over to Matt for some closing remarks.

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

Thanks, David. Before I hand the call over to the operator for your questions, I want to emphasize that I was pleased with the increase in bookings activity in the quarter. We've been optimistic about having a strong back half of the year and our bookings execution in the quarter was early evidence that this is materializing. We had a strong quarter of renewal and cross-sell activity and grew net new bookings substantially, both sequentially and year-over-year. We signed a broad mix of net new and expansion deals across our lines of business and market segments, which is a trend we expect to continue. And looking forward, we feel good about the pipeline and the opportunity ahead of us. We have a solution set that matches up with where the market is going, and we're seeing

validation among customers and industry analysts alike. With all of this considered, I believe we're extremely well-positioned to capitalize on the widespread digital transformation in financial services that is upon us.

With that, thank you for joining today. We look forward to sharing more about our evolving market, strategic vision and our perspective on the business in our virtual Investor Day on December 14.

I'll now turn it over to the operator for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Tom Roderick with Stifel.

Tom Michael Roderick

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Yeah. Hi, everybody. Thank you for taking my questions. Great to hear from you. Congratulations on the success in the quarter. Matt, let me throw the first one at you. I guess, if we could just go back 90 days, it seems like at that time you offered some mildly cautious comments on the timing and pace of some of these Tier 1 deals in the pipeline. And I guess, as we sit here today, it's pretty loud and clear. It seems like anyway that the business momentum has returned, three Tier 1 deals, a number of deals around new product solution sets. So, I want to ask kind of two questions on that. Number one, do I have that right? Is this really kind of the all clear signal that you're offering us? And if so, can you kind of comment on the momentum in the pipeline as well as the deals that you locked in and the big bookings strength that you saw just in the quarter that just passed?

And second question around that, if I do have that right, how should we think about how this all ripples through the model? I mean, I know it's too early to kind of issue formal guidance for 2022, but I'd love to hear any directional thoughts you might have as to how kind of this renewed momentum plays into the model. And I guess, more to the point, when should we all expect to see a little bit of renewed momentum or should I say acceleration in the top line as a function of when these bookings kind of ripple through the model of the P&L?

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

A

Yeah. Thanks, Tom. So, I'll take the first one and have David kind of talk about the model and how the bookings plays out. But extremely pleased with the quarter, obviously, to – whether it's the all clear sign or not, I'm not sure, but I will tell you that I think Q4 looks better than Q3 did. And I think the Q1 and 2022 are shaping up to be really much better than the past five quarters. The opportunities, whether it's on digital banking, digital lending, banking-as-a-service, digital acquisition, data products, corporate banking products, the breadth of the platform is really differentiating.

And one of the things in the script that we talked about was we signed our first transformation deal, which is the bank started off looking at digital banking and ended up moving to digital lending. We have a couple of those deals in the pipeline that I believe will materialize down the road, but I think those are opportunities that are very difficult to compete with us on. And I think that talk track is really growing within the customer base quite a bit.

So I think you're going to see this momentum continue into Q4 and hopefully into the first half of 2022. I'm a little leery to say all clear based on the world we're living in now. But I feel really good about what we just did in the quarter, what the team did. There's a lot of things [ph] within (00:24:32) execution and delivery, but the sales

organization really stepped up and that's cross-sell, net new, banking-as-a-service, lending and digital banking, so really pleased with that group. And we look forward to kind of getting the last five quarters behind us and continuing the momentum that we had coming into 2020. So David, do you want to talk about the model?

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

A

Yeah. Sure. Hey, Tom. And in regards to how this all plays out for model, as you can imagine, we're right in the middle of our 2022 planning process and there's some really important variables that we need to finalize, [ph] not the least (00:25:04) of which is our Q4 bookings number as well as refining our model for our transactional BaaS business. But if we were to say where we think the floor is right now for next year, we'd say that's about 15% to 16% of growth for next year on the revenue side.

But you cast the question in a way that I want to make sure that I elaborate on which is when do we start to see the momentum that we had in Q3 come back into the model. And if you think about how this revenue starts to manifest itself in the model and bookings start to manifest to revenue in the model, we think we could see an acceleration of about 300 points, in fact, in excess of 300 basis points in FY 2023 based upon the strength that we saw in Q3 and then assuming that we see that momentum continue in Q4 and into 2022.

Tom Michael Roderick

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Super – super helpful, David. Really quick follow-up for you just so I have it clear on that and that 15% to 16% floor is really helpful. As you consider some of these newer solutions Jonathan is talking about BaaS and if we think about, say, perhaps PrecisionLender, there are certainly some of these where there's perhaps a little bit of a transactional component or shorter revenue recognition cycle component that goes into it. When you look at the pipeline and how those newer solutions with different rev rec policies might sort of impact the model, how are you contemplating the impact of those in that kind of 15% to 16%? Is there really no assumption of those kind of clicking in 2022? Do you have some assumptions? Would love to just see, thematically here, how that might impact the model and how you're thinking about it in that floor you just laid out?

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

A

Yeah. And that's exactly why I said that was one of the key points that we're working on right now for our 2022 planning because the more data that we have around these vast programs in terms of the program launch relative to when we start to see the revenue really kick in from the launch of these programs and the incremental users and the incremental transactions, the more data we have, the more we can incorporate that into the model, the more intelligent model becomes. So, we want to refine that over the next few months for our 2022 planning so that we can give you a more defined answer.

So for both of those questions, your question overarching on what the trajectory looks like into next year, as well as how BaaS plays a part in that and how we model transactional, we're going to give you more color in the investor meeting in December as well as in our guidance that we'll give you formally in February. So we look forward to having that conversation with you. We'll certainly talk about 2022 as well as our long-term planning model, which will give you a little more color on 2023 as well.

Tom Michael Roderick

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Fantastic. I'll jump back in the queue. Thank you, gentlemen. That's great.

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

Thanks, Tom.

A

Operator: Your next question comes from the line of Terry Tillman with Truist Securities.

Terry Tillman

Analyst, Truist Securities, Inc.

Yeah. Good morning, everyone, and congrats on the new business bookings uptick. It's great to see and the commentary in 4Q as well. I think the operator said I could ask one question. I may have a lot of parts to the question, so just a heads up on that. But the first part of my multi-part question is on the Innovation Studio, Matt. Maybe as we're talking to investors and trying to kind of keep this simple and understandable, what exactly could be a couple of examples where Innovation Studio stood out in like that one Tier 1 transaction? I know the idea of open banking and that sort of thing, but like any kind of more color on a specific situation where, yes, this part of Innovation Studio what you're doing really was the tipping point for the deal?

Q

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

Yeah. Terry, I'm going to have Jonathan join us today, and he runs the business, so he deserves the credit for that, but I would say that, we have three really large customers in yesterday and today and the segments that we had with them, there was a slotted hour on Innovation Studio and it ended up being 2, 2.5 hour conversation on places that they can go with it because there are a lot of different ways they can use this to drive innovation and partnership with fintech. But let me have Jonathan kind of cover how he sees that playing out because he runs that business.

A

Jonathan Price

Executive Vice President-Emerging Businesses, Corporate & Business Development, Q2 Holdings, Inc.

Yeah. Thanks, Terry. So, to get into your question, when you think about the specific segments they're looking at, this is all really about how do they get the opportunity to engage more with their end users. And so we're trying to figure out where in the financial journey of a consumer, a small business or even a corporate end user of a bank or credit union has the opportunity to engage with these applications in a more tangible way inside the bank. So, think of areas like digital customer support. There's a lot of technology vendors out there that are solving for that inside the FI channel. We're bringing those partners into the platform by opening up through the SDK. Areas like payments and money movements, HR payroll, anywhere where they're basically adjacent to the financial journey and not a core product necessarily of the bank, how can we bring these best-in-class fintechs into their experience, so they can get that incremental engagement with the end user. And that's across – like I said, consumer and small business are the most frequent end user use cases we're seeing.

A

Terry Tillman

Analyst, Truist Securities, Inc.

And on that, Jonathan, would you all get like residuals – some of these are third-party tools. You're not in the HR payroll space, digital customer support, likewise. Would you make money through a reseller relationship? And then I just have one final question.

Q

Jonathan Price

Executive Vice President-Emerging Businesses, Corporate & Business Development, Q2 Holdings, Inc.

A

Yeah, exactly. And we'll dive much deeper into the model at the Investor Day, Terry, but you kind of hit on it. We're striking rev share arrangements with these partners. And in many cases, through the marketplace model, we're sharing that revenue back with the financial institution to try and help drive a new non-interest related revenue stream for the FI. But, yeah, we're striking rev share relationships with these partners and trying to incentivize adoption within the FIs, but also make the channel attractive to these fintechs.

Terry Tillman

Analyst, Truist Securities, Inc.

Q

Okay. And my final part of my three-part question. And sorry, Matt and David, you guys are getting short shrift today since we have Jonathan performing, is on the BaaS business. I'm curious, Jonathan, there's been a lot of consolidation and some BaaS vendors that have been acquired or merged, et cetera. Are you seeing any kind of dislocation or disruption that's creating incremental opportunities for you all to get new design wins? So, just maybe what the competitive environment is like and kind of takeaway environment? Thank you.

Jonathan Price

Executive Vice President-Emerging Businesses, Corporate & Business Development, Q2 Holdings, Inc.

A

Yeah. We've certainly seen a lot of activity, whether it's consolidation, fundraising, new startups in the space. It's obviously very early in the – in early innings in the BaaS market and we think we're in a very differentiated position with our scale, our flexibility, our bank of record network. And so we're seeing it and we're watching it, but we're also going after a very targeted segment of the market that is the largest Tier 1 fintechs and brands. And so we really feel that there are very few players that can serve that market at scale. And that's how we're differentiating right now. And we think that as we move in, we talked about business account functionality and we continue to invest in this business in the roadmap, we think we're in a good position.

But you're right, a lot of consolidation is happening and some of that consolidation is happening between theoretical competitors in the market, which makes customers potentially leery of where to place their data, what programs to work with, et cetera. So it's interesting because it's probably too early to tell how much the consolidation could drive opportunities our way or churn within existing competitors, but we're clearly watching it and there's a lot of activity in the market.

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

A

Thanks, Terry.

Jonathan Price

Executive Vice President-Emerging Businesses, Corporate & Business Development, Q2 Holdings, Inc.

A

Thanks, Terry.

Operator: Your next question comes from the line of Sterling Auty with JPMorgan.

Sterling Auty

Analyst, JPMorgan Securities LLC

Q

Yeah. Thanks. Hi, guys. So for my question, I want to ask on kind of the supply side, in other words, on your sales and sales productivity and capacity. It's great to hear the increase or the more positive tone around bookings. Where are you in terms of capacity utilization within the sales force that you have today? And what are the hiring plans that you have that kind of support that improved demand environment that you're seeing out there?

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

A

Yeah. Thanks, Sterling. So from a planning perspective, as David said, we're putting our 2022 plan together, but we added – Mike Volanoski joined as Chief Revenue Officer, a lot of experience at big enterprise sales organizations. What he's really doing is structuring enterprise account teams that are going to go out and be able to get a lot more leverage out of an existing customer or a prospective customer.

So, I think where we are now is there's not going to be a big spend on the sales side. On the marketing side, I think there's going to be a little bit of an increase in investment to drive the messaging, the one Q2 messaging, more demand gen out there because we're really seeing that our messaging is resonating with folks, but I don't see a big increase in spend, David, keep me honest here. But right now our – what Mike's doing both to expand within existing customers as well as to go win the net new deals, I think you're going to see a lot of efficiency out of that.

I think we've also become pretty efficient in the pandemic, working in a remote environment where we're able to leverage more resources, whether it's our office of strategy, whether it's our premier services or our kind of our advisory consulting groups to where we're able to get far more people in front of a customer without having to get on airplanes. So we get more coverage that way. So, feel really good about the coverage model we have right now and also feel good about where Mike, our Chief Revenue Officer, is taking it into 2022 and beyond.

Sterling Auty

Analyst, JPMorgan Securities LLC

Q

Got it. Thank you.

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

A

Yeah. Just add on to that, I think as we look out to 2022, Matt hit it on head in terms of the sales organization, a lot of the spend that we see is going to be directed on top of funnel pipeline gen and that's going to be with marketing programs and there's going to be some tactical spend that increases as well. Naturally, like T&E, we're starting to see that ramp back up in the second half. We don't expect it to get back to pre-pandemic levels next year, but we certainly expect it to be more like we exit this year than where we exited last year.

Sterling Auty

Analyst, JPMorgan Securities LLC

Q

Understood. Thank you, guys.

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

A

Hey, thanks, Sterling.

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

A

Thanks, Sterling.

Operator: Your next question comes from Bob Napoli with William Blair.

Robert Napoli

Analyst, William Blair & Co. LLC

Q

Hi. Thank you and good morning. Appreciate all the information. Just a question on the model and I'm you'll get a lot more into this on December 14. But as you've changed the mix of the business quite a bit and broaden out the business, what is the right gross margin and EBITDA? And I mean, the timing to expand the margin and EBITDA is that extended since you have, well, it seems like incremental investment opportunities?

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

A

Yeah. Bob, I mean, you're right, we do have incremental investment opportunities and we want to make sure we take advantage of those opportunities. However, as we're looking out to 2025 and beyond, we certainly see a landscape in which we can expand our gross margins and our overall EBITDA margin substantially over a period of time. I think it's going to be really instructive to have those discussions with you in December because we'll be able to show you the shape of how we think that can happen over a period of time. It's not going to be linear, as you can imagine, but we're going to talk specifically about the opportunities that we see to drive efficiencies, while at the same time, making these important investments, many of which are happening now. But, yes, we do see the opportunity to expand those margins. We do see it over the course of the next three to four years, but we're not going to get into specifics quite yet. We'll provide that color in the December.

Robert Napoli

Analyst, William Blair & Co. LLC

Q

And the backlog – just related to the growth in the backlog, can you go over the numbers on the year-over-year and sequential growth? And is there any change in the timing of recognition in backlog over what you've had historically?

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

A

No. And you know what was great this quarter was when you look at the makeup of backlog in terms of how we added to backlog year-over-year, it came from all key buckets: cross-sell, renewals and new. We saw really good growth in net new bookings year-over-year, which Matt mentioned. All three quarters this year, we've seen really good year-over-year growth in cross-sell. And then, we had the best quarter of renewals this quarter that we've seen in a while. In fact, the quarter for Q3 in terms of renewals that added to backlog was greater than first half in its entirety.

So, it was a great mix for us to see all three of those areas of business deliver. And we certainly see – Q4 historically has been a really strong renewal quarter. We see that opportunity again this Q4. I mean, if we pull some of those renewals then from Q1, it can put some pressure on Q1 backlog, but we feel really good about how we're positioned for Q4.

Robert Napoli

Analyst, William Blair & Co. LLC

Q

Thank you.

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

A

Sure.

Operator: Your next question comes from the line of Andrew Schmidt with Citi.

Andrew G. Schmidt

Analyst, Citigroup Global Markets, Inc.

Hey, guys. Thank you for taking my questions here and good to see progress on the net new side. I want to dig in a little bit on the digital banking competitive environment. If you could talk a little about how the competitive environment is evolving and your current engagement? It seems like customers are demanding multiple solutions, getting a little bit more sophisticated, that seems like an advantage for you and other scale players. But just curious if you're seeing a difference on the competitive side in terms of capabilities, pricing, anything like that relative to what we would see pre-pandemic? Thanks.

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

Yeah. Thanks, Andrew. No, I mean, the competitive environment is largely the same. There's new names that have come to the surface with you guys. But in general, I would continue to say that as far as a full platform, whether you're looking for retail and commercial banking solutions, whether it's a bank or a credit union or both, we do very well in those scenarios. We won a standalone retail deal, a standalone commercial deal, and a combined retail, commercial, corporate banking solution in the quarter on three Tier 1s, so – in highly competitive deals.

So we continue to differentiate in all those categories. As I've said before, the retail digital banking space is pretty crowded. And so we're trying to be cautious in those deals. I think if you look at it from a win rate perspective, I think that they're holding steady to what they've been historically. I think there's a chance for our win rates to improve as we move forward into Q4 and 2022 based on the wins that we're having right now or what I'm seeing in the pipeline. But it's still a very competitive environment and we're doing very well in that environment.

Andrew G. Schmidt

Analyst, Citigroup Global Markets, Inc.

Got it. Appreciate the comments on that. And then maybe one for David. I thought organically 20%-plus in the quarter was pretty strong given the air pocket in net new. Maybe you could break that down in terms of contribution from organic user growth, transactions, maybe some small go-lives, et cetera? And then you put out a 15% to 16% floor for 2022. But if you're doing 20% in an environment where there's very, very limited level of sort of go-live activity, why is that 20% level not sustainable as we get into next year? Thanks.

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

Yeah. And I mean the biggest reason for that – I know we've been talking about this now for a few quarters, there's this air pocket concept. I mean, five quarters in a row where you've got COVID and pandemic impacted demand/bookings that ends up manifesting itself at some point in time and with our delivery model of 9 to 16 months in terms of the most complex at 16 months, we end up – what we're going to be seeing is those five quarters impact the 2022 revenue fairly significantly. And you see that right now at our Q4 guidance, right? Our Q4 guidance is 20% to 21% revenue growth, which is a drop off from where we've been year-to-date. We certainly expect that to continue in terms of going lower, obviously, with that 15% to 16% floor that I referenced.

But then we'll start to see the benefit of the Q3 bookings second half of next year. We talked about those three Tier 1s. Those Tier 1s, most of those had a go-live in the third quarter and maybe the fourth quarter of next year. So you start to see that revenue come on board late next year and you start to see that revenue acceleration as we exit FY 2022 and then see the real benefit of that in FY 2023.

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

Yeah. I would add, Andrew, that if you think about – David wasn't here at the time, but if you think about 2016, we had talked about a slowdown in decision-making and there were three quarters of an air pocket that we worked through and those worked through 2017. It's the same thing. Here, you just have a longer set of quarters that you had pressure on bookings, so that air pocket will work its way through 2022 and sets up for a really nice 2023.

Andrew G. Schmidt

Analyst, Citigroup Global Markets, Inc.

Got it. Makes a lot of sense. Appreciate the comments, guys. Thanks a lot.

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

Thank you.

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

Thank you.

Operator: Your next question comes from the line of Pete Heckmann with D.A. Davidson.

Peter J. Heckmann

Analyst, D.A. Davidson & Co.

Hey. Good morning. Thanks for taking my call. I wanted to follow-up a bit on PrecisionLender. It seems that in each of the last three quarters, the company has been announcing either new deals or expansion for loan pricing. And I'm curious do you think PrecisionLender is poised to meet or exceed kind of your original goals for \$30 million to \$35 million in revenue at the time of acquisition sometime – to get to that run rate sometime here in the next couple of quarters?

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

Yeah. I'll let David comment on the run rate side of it, but for me, PrecisionLender has really had a strong 2021 and they even had some enterprise deals that we were working that pushed into Q4 that we're working now. But the pipeline looks good. The activity looks good.

You see the partnership announcement that we had with BCG around them building a product around PrecisionLender. I feel very good about the pipeline where it is and I think that they are going to meet, if not exceed, the expectations that we had when we acquired the business. It's been – they had a rough go in 2020 because of the decision making at the enterprise level with these banks, but right now, it's coming out. I feel really good about the pipe for Q4 as well as for 2022.

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

A

Yeah. Just on – keep in mind that they were impacted, obviously, and we talked about this fairly extensively on numerous earnings calls that the PL business was impacted by the pandemic. So, the original business case was done without contemplating that impact. We do feel like with the momentum that Matt referenced, the strong pipeline that we've got in PL and all of the things that we see lining up over the course of the next few quarters that, that run rate could certainly be achieved within the next couple of quarters. In other words, if you take that quarterly revenue that we see coming from PL over the next couple of quarters and run rate that out, it would certainly be at or above those levels that you referenced.

Peter J. Heckmann

Analyst, D.A. Davidson & Co.

Q

Okay. Great. Thanks, David and Matt.

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

A

Thanks, Pete.

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

A

Thanks, Pete.

Operator: Your next question comes from the line of Alex Sklar with Raymond James.

Alexander Sklar

Analyst, Raymond James & Associates, Inc.

Q

Thanks. So Matt, I want to ask kind of just bigger picture in the post-pandemic trends and kind of as it relates to the strong bookings this quarter, but are you starting to see more urgency from the FIs to kind of modernize their digital banking capabilities in order to retain customers? Or is there some other commonality that kind of drove the bookings activity kind of across the finish line in what's normally a seasonally slower quarter? Thanks.

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

A

Yeah. Thanks, Alex. I think what you're seeing is our customers as we've talked about, their number one focus during the pandemic was their customers and how they were going to help them get out of the pandemic and survive, whether it's through PPP or whatever. So what you're having now is they're back and whether it's a sense of urgency or the criticality of digital as an experience moves forward, I am seeing far more executives involved in decision-making. There's a change in the reporting structure in a lot of these financial institutions where you have a Chief Digital Banking Officer, a Digital Officer now that's reporting directly to the CEO. And so it's moving to – the importance of it has become clear and the decision-making around it.

I think some of the decisions that were made in 2021 were just – they were just extending contracts with existing vendors, knowing that they were going to have to make a change, but they had to kind of sort out what was going to happen in the market with the pandemic. And so what you're seeing now is a lot of these decisions that were delayed in 2020 or 2021 are coming to fruition for us in the pipeline in Q4 and 2022. And so my optimism is that we're going to see this bookings momentum continue.

And I think, as I've said multiple times, we are extremely well-positioned with the breadth of our platform, our experience with the integrations, the type of customers we have, the number of times we've done this. And so I feel very good about how things look moving forward and I think we're aligning with our customers and our prospects on what they're trying to solve for.

And even Innovation Studio, we're having conversations with customers about revenue generating opportunities for them as opposed to just selling them more software where we just extract money from them. And those conversations are what banks and credit unions want to talk about right now, which is how can I generate revenue from this channel and how can I drive meaningful engagement and experiences and cross-sell and expand my relationship with my existing customers.

So we're in a very good position. We just have to continue to execute and focus on the customers' prospects and the culture and the employees of this company.

Alexander Sklar

Analyst, Raymond James & Associates, Inc.

Got it. Thanks. And then just one quick follow-up. We talked about the M&A activity amongst your customer base last quarter is kind of a potential driver of users. I'm just wondering if you've been able to get any more confidence around that potential for the coming year. Thanks.

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

Yeah. I mean, if you look at the numbers, year-to-date, I think we've had total in the customer base, 83 acquisitions or MOEs that have occurred in total and 78 of those have been where we have been the acquirer or the merger of equals. So 94% of those deals have gone our way. And then just on the digital banking side, year-to-date, I think we're 36 total acquisitions, 34 where we're the acquirer or the merger of equals.

So, for me, those numbers are phenomenal. They align with what we've said all along, which is we have – there's a law of attraction that occurs. The most strategic financial institutions want to partner with us. Those financial institutions are taking a long-term view on technology. They, therefore, are going to be the acquirers. They're going to grow in their regions. And so those numbers are very difficult to refute that, so feel really good about the mergers and acquisitions activities coming in our favor.

The only challenge right now is the Federal Reserve has got a backlog, and the delay around these mergers is that's another thing, it's probably not going to contribute much to 2022. You're looking at 9 to, in some cases, maybe even 12 months of approval of some of these acquisitions. But beyond that, I'll still take it. It is something we are going to get down the road when it comes on and it's growing our base and it grows our opportunity to expand with them. So the M&A activity continues to be extremely favorable for us and a tailwind.

Alexander Sklar

Analyst, Raymond James & Associates, Inc.

Got it. Thanks, Matt.

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

[ph] Hey, thank you, Alex (00:49:01).

Operator: Your next question is from Matt VanVliet with BTIG.

Matthew David VanVliet

Analyst, BTIG LLC

Q

Yeah. Thanks for taking my question, guys. Nice job on the quarter. I guess, when you look at a number of these new opportunities around digital banking, both from the Innovation Studio and some of the other acquisitions you made and then also on the lending side, it seems like you're finally seeing some strong success cross-selling and in one case, this quarter, even selling it all together, I guess, the bigger question following on one earlier as well, but what's the deal impact when you're able to sell multiples of these products over the top of digital banking? How much of an uplift to whether it's recurring revenue from a deal or total contract value, should we think about some of these adding in and then in the case of adding the lending components to digital banking, how frequently is that now being discussed in net new deals?

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

A

Yeah. Matt, so, if you work through the products and as we go through like the cross-sells that we have, the top products that we're selling to our customers now are data-driven or digital acquisitions or onboarding, whether it's a retail or commercial customer, risk management products, like things like Centrix and our fraud products, and then Innovation Studios is becoming a big part of the cross-sell. So, those all have very different uplifts and they can be, depending on the significance, can depend on the size or what the customer wants to do with it.

As far as digital banking and digital lending goes, we're not seeing price pressure on – when you sell digital banking, you've got a reduced digital lending because those are very different products that I think the customer and prospects understand require support in implementation. So, it's hard to put a number on it. But I think the real value here is on the net new side, you tell a story that's very difficult for somebody to compete with because the banks and credit unions don't want to go cobble together other vendors and other technology that's not integrated, built together, and they want to have one vendor to deal with to tie all of this together.

So the differentiation is going to lead to what I believe is, as I said earlier, probably better win rates than we've seen in the past. It's going to be a huge expansion opportunity for us within the business. And it just kind of leads to this optimism we have going into 2022 as these banks have kind of feel confident that their customers are healthy and going to continue to do well and that they're going to begin to invest in technology because they've seen the efficiency and the opportunity to go drive, whether it's revenue or better engagement with their customers. So, David, I don't know if you can provide more color on it, but?

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

A

Yeah. I mean, it's interesting because if you take the baseline of just a retail digital banking deal and then you say, hey, what's that's expanding either over time with an existing customer or for a given opportunity. And you add commercial in there, you add risk management, you add account onboarding, you add digital lending solutions, it becomes a multiple of that original deal. It's not just a 50%, 60%, 70%. We're talking about multiples of the original deals. So you see significant amounts of opportunity on top of that original digital banking retail deal that I referenced earlier if you use that as a baseline.

The other thing that's important to add and you referenced this and Jonathan's here in the room is, we also layer in there a much different economic model with the transactional nature of the Innovation Studio. And that's one

that that we feel is going to be really rich and creates this flywheel approach going forward that we're really excited about quite frankly.

So you have the traditional subscription-based model. And again, as you start adding on more and more of these products, it becomes a significant incremental revenue stream relative to the deal – digital banking retail deal and then you have different economic model, and it's transactional in nature when you have the Innovation Studio component to it.

Matthew David VanVliet

Analyst, BTIG LLC

Q

Very helpful. I guess, on a quick follow-up on something you mentioned earlier that a number of these deals now you're sort of extending the duration as you add on products. But as we look back to the last air pocket you mentioned in kind of the 2016-2017 timeframe, we're now getting to the point where I presume those – the original contracts on that sort of average five-year term are coming up for renewal. Should we expect the cycle of renewals to be at an elevated level for the next four to six quarters here, or is there anything that over the last couple of years, you've sort of kicked that can down the road and it's a little smoother on the renewal cycle here on a go-forward basis?

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

A

No, actually, last year, we saw an outsized amount of renewals occur, and a lot of that was market driven. As we talked about last year, we saw a lot of customers reach out to us proactively to renew with us given the uncertainty with the pandemic. We also had programs that we ran the Q2 CARES program as an example to incent customers to renew with us and give them some economic relief. So that resulted in an outsized year last year, and that not only included what was in target, but it also included bringing in some out of target renewals.

But now when I bring this to short-term, I mentioned this earlier, we do see typically Q4 as a big renewal quarter, and this year will probably be no exception, and you typically then see a dip in Q1. So just for modeling purposes, understand that as you're thinking about how backlog starts to play out over the next couple of quarters, but I would not expect next year to be an outsized year in terms of renewals because we pulled so much back into FY 2020.

Matthew David VanVliet

Analyst, BTIG LLC

Q

All right. Great. Thank you for all the color.

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

A

Thanks, Matt.

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

A

Thanks, Matt.

Operator: Your next question comes from the line of James Faucette with Morgan Stanley.

Q

Hey, guys. It's [ph] Jonathan (00:55:13) on for James. Appreciate you taking our questions. Want to build on Andrew's question from earlier. As the new bookings environment improves for you, it's presumably also improving for competitors. Can you talk through how you're thinking about potential customer churn, perhaps the pricing environment, given the renewal expectations for Q4?

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

A

Yeah. Sure, [ph] Jonathan (00:55:36). I mean, right now, we're really comfortable with our position with our customers. We're seeing churn rates that are aligned with what we said entering the year, which was sort of a 5% to 6% range. So we feel good about how we're entering 2022. We obviously have an account-by-account buildup of what customers are up for renewal next year and the relationships with all of our customers and those specifically up for renewal in 2022 are generally good. We feel like what we provided you earlier in regards to a churn rate is still an accurate reflection of what we're seeing.

Q

Got it. That's helpful. And a quick follow-up on M&A, you talked about M&A to customer base, but I want to touch on Q2's potential for M&A. How are you thinking about that strategy going forward? And how are you thinking about valuations in the current environment? Do you still think you can be opportunistic with capital deployment?

Jonathan Price

Executive Vice President-Emerging Businesses, Corporate & Business Development, Q2 Holdings, Inc.

A

Yeah. [ph] Jonathan (00:56:31), it's Jonathan on our side. I can take that. I mean, we are always looking at M&A. Candidly, the pipe is as robust as it's ever been, but the reality is the valuation backdrop is challenging from a buyer's perspective. And so we've got to be disciplined in the quality of the assets. It's clear that a lot of people are in market trying to take advantage of that valuation backdrop. So obviously, we're looking and we're always interested. But at the end of the day, we got to be prudent from a valuation standpoint and we've got to find the right strategic fit and marrying those two things together in the last – throughout 2021, outside of the ClickSWITCH deal, has obviously not been something that we found. But there's lots of opportunity out there and we're always going to be looking. It's just a question of those two things coming together.

Q

Helpful color. Thanks, guys.

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

A

Thanks, [ph] Jonathan (00:57:17).

Operator: There are no further questions at this time. I will now turn the call back over to the speakers for closing remarks.

Matthew P. Flake

Chief Executive Officer, President & Director, Q2 Holdings, Inc.

Thanks, everybody, for joining us today. We look forward to diving deeper into the business and the future of the business on December 14 at our virtual Investor Day conference. If you need any information, please reach out to Josh. Thank you very much. Excited about the quarter we had and look forward to a strong finish to the year and a really strong 2022. So thank you very much and have a great day.

Operator: This concludes today's conference call. You may now disconnect.

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