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Q2 Holdings, Inc. (QTWO)

Q2 2022 Earnings Call

CORPORATE PARTICIPANTS

Josh Yankovich

Head-Investor Relations, Q2 Holdings, Inc.

Matthew P. Flake

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

Jonathan Price

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

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

OTHER PARTICIPANTS

Andrew G. Schmidt

Analyst, Citigroup Global Markets, Inc.

Alexander Sklar

Analyst, Raymond James & Associates, Inc.

Peter J. Heckmann

Analyst, D.A. Davidson & Co.

Jeffrey Parker Lane

Analyst, Stifel, Nicolaus & Co., Inc.

Matthew David VanVliet

Analyst, BTIG LLC

Robert Dee

Analyst, Truist Securities, Inc.

Adib Choudhury

Analyst, William Blair & Co. LLC

Charles Nabhan

Analyst, Stephens, Inc.

Joe Vruwink

Analyst, Robert W. Baird & Co., Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Audra, and I will be your conference operator today. At this time, I would like to welcome everyone to the Q2 Holdings Second Quarter 2022 Financial Results Conference Call. This conference is being recorded. 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]

I would now like to turn the call over to Josh Yankovich, Head of [ph] Investor Relations (00:00:36).

Josh Yankovich

Head-Investor Relations, Q2 Holdings, Inc.

Thank you, operator. Good morning, everyone, and thank you for joining us for our second quarter 2022 conference call. With me on the call today are Matt Flake, our CEO; David Mehok, our CFO; and Jonathan Price, our Executive Vice President of Emerging Businesses, Corporate and Business Development.

This call contains forward-looking statements that are subject to significant risks and uncertainties, including with respect to 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 for 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, copies of which may be found on the Investor Relations section of our website, including our quarterly report on Form 10-Q to be filed this week 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 our Form 8-K filed with the SEC yesterday afternoon.

Let me now turn the call over to Matt.

Matthew P. Flake

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

Thanks, Josh. I'll start today's call by reviewing our second quarter results and highlights from across the business. I'll then hand it over to Jonathan to provide more insights into our Emerging Businesses activity. David will then discuss our financial results and second half outlook in more detail.

In the second quarter, we generated non-GAAP revenue of \$140.5 million, up 13% year-over-year and 5% sequentially. We also added approximately 500,000 users to our digital banking platform, a year-over-year increase of 7%. That brings us to approximately 20.2 million total registered users.

During the second quarter, we signed a mix of Tier 1 and 2 institutions across digital banking and lending, including one of the largest digital banking deals we've ever signed. In our Emerging Businesses, the quarter was highlighted by the announcement of Q2 Innovation Studio's partnership with Rocket Mortgage, continued execution and adding new financial institutions and partners to the ecosystem and signing a large lending customer within Helix, all of which Jonathan will unpack shortly.

And finally, we recently released our second annual ESG report, which outlines our ongoing focus to create a lasting impact on the financial services industry and in our communities. We're proud of the progress that's reflected in the report.

With that, I'd like to provide some additional commentary on our sales activity from the quarter. I'll start with digital banking, where we landed several net new customers, including one of our 10 largest digital banking deals in company history. This particular win is with a bank that's chosen to acquire customers exclusively through the digital channel with no brick-and-mortar branch network.

Given the importance of digital to this bank's strategy, they conducted a broad and rigorous vendor evaluation. In the end, they selected us for a comprehensive suite of retail solutions, including our full digital acquisition suite, retail digital banking and several ancillary digital banking products.

They also cited Q2 Innovation Studio as a key driver of their decision for its ability to generate non-interest revenue, drive primacy and expand their digital offerings. Even more important than the specific features and functions that drove their decision was how our overall portfolio aligned to this bank's vision.

While they're currently prioritizing their retail strategy, their ability to seamlessly expand into small business and commercial, as well as lending and other areas, helps set us apart and creates strong expansion potential with this customer over time.

Another important win in the quarter was with a Tier 1 bank, and their story provides a great example of why we believe it was important to launch Q2 Catalyst, our end-to-end solution set of commercial banking and lending capabilities. Commercial user expectations have changed rapidly, partly due to the pandemic-driven acceleration to online and mobile banking.

Just like consumers, commercial users expect their banking relationship to be personalized, convenient, and primarily digital. Meanwhile, these commercial relationships are becoming increasingly valuable to financial institutions of all sizes. And as a result, we're seeing banks and credit unions accelerate their investment in commercial banking and lending technology to help them compete, differentiate and ultimately more effectively serve and expand commercial client relationships.

In this deal, the bank expressed to us that their legacy commercial banking solution was no longer keeping them competitive in their market. So, they launched an initiative to invest in modernizing their commercial experience, starting with a new digital banking partner. The bank selected Q2 for commercial and small business digital banking along with business account opening to improve their ability to win and onboard commercial customers digitally.

And while our commercial digital banking solutions have been recognized as best-in-class on their own, I believe our Catalyst vision and combined set of tools to help banks like this connect the entire commercial banking journey is a key differentiator for Q2.

Moving to digital lending, we saw net new and expansion wins across our lending solutions. One of several deals from the quarter was with a Tier 1 bank in Australia. While they're headquartered there, they have a substantial international footprint and we originally began our partnership with their Canadian business. Our early success with this client in North America is ultimately what led to an opportunity with their primary business in Australia, resulting in the largest loan origination deal we've ever done. In addition to these highlights from our digital banking and lending teams, our Emerging Businesses continued to build on their strong momentum.

So, now, I want to hand the call over to Jonathan to provide some detail on Innovation Studio and Helix.

Jonathan Price

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

Thanks, Matt. I'll start with Q2 Innovation Studio, where we've more than quadrupled the size of our fintech ecosystem since launching just a year ago. We're very pleased with the growth and success we've seen with Q2 Innovation Studio over the first year. It's consistently cited as a key differentiator in net new digital banking wins, and we continue to see rapid adoption from existing customers and fintech partners alike.

More than 80 fintechs and over 250 banks and credit unions, representing more than 50% of our digital banking customer base, leverage the Innovation Studio today. And in our Investor Day presentation in December, we talked about how we believe this business will expand our total addressable market over time by bringing in technology partners that allow us to extend our platform and address opportunities outside of our current solution set.

During the quarter, we finalized an agreement with Rocket Mortgage, the single largest mortgage provider in the country. In adding their solution to Q2 Innovation Studio will provide our bank and credit union customers with the option to embed Rocket Mortgage into the digital banking platform to offer to their account holders.

This gives customers fast, easy access to a best-in-class digital mortgage solution that can help them enhance an existing mortgage lending practice or launch a new one altogether. And for Rocket Mortgage, this is a valuable opportunity to expand and diversify their go-to-market strategy by adding a large turnkey distribution channel. We are excited to add a market leading brand like Rocket to our ecosystem and believe this partnership will help Q2 and our customers provide an additional best-in-class digital lending experience and an additional opportunity to generate non-interest fee income.

In Helix on the net new side, our most notable win in the quarter was with a large lending company that represents our first major deal in this vertical. We are seeing alternative lenders increasingly look for ways to improve engagement and better monetize their existing customer bases. And our Helix platform enables them to build differentiated experiences that drive new sources of revenue into their business models. As we continue to expand into new industries, we believe wins like this should help our sales efforts in these verticals moving forward.

Another notable deal during the quarter was a progressive community bank seeking to launch a digital-only brand alongside their traditional business. This financial institution evaluated several options and determined that Helix was the right product fit for their strategy. We believe that over time, an increasing number of traditional financial institutions could start to pursue digital strategies to focus on their target market and differentiate themselves, which would open another segment of the market.

Overall, I'm pleased with our Emerging Businesses activity from the quarter, including the impact that Innovation Studio has had on the business just a year in. Across Emerging Businesses, we're continuing to sign strategic deals, launch new programs and drive adoption. And with partnership additions like Rocket Mortgage, we believe Innovation Studio is becoming a differentiated ecosystem in which our customers, partners and Q2 all can benefit.

Thank you. And with that, I'd like to pass the call over to David to discuss our financials.

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

Thanks, Jonathan. In the second quarter, we continued our focus on operational execution across the business. Revenue results came in towards the high end of our guidance range and adjusted EBITDA results exceeded the high end of our guidance range.

I'll begin by reviewing our results for the quarter and conclude with updated guidance for the third quarter and full year 2022.

Total non-GAAP revenue for the second quarter was \$140.5 million, an increase of 13% year-over-year and 5% sequentially. The year-over-year and sequential growth for the quarter was primarily driven by an increase in subscription revenue resulting from customer go-lives as well as organic growth.

Service-based pass-through revenue associated with our Helix business also contributed to the year-over-year and sequential revenue growth observed in the quarter. As expected, the sequential growth was also driven by seasonal increases in usage-based revenue attributed to Helix customers that was related to tax season.

Transactional revenue represented 13% of total revenue for the quarter, down from 14% in the prior-year period and consistent with the previous quarter. Transactional revenue dollars in total had a sequential increase driven by our Helix business, which offset a decline in traditional bill pay.

Annualized recurring revenue, or ARR, grew to \$615.5 million, up 17% year-over-year and 4% sequentially. The year-over-year and sequential growth was primarily from net new and cross sale bookings. In addition, the sequential growth in the quarter also benefited from increased usage-based revenue from our Helix solutions.

While ARR can have limitations as a key performance indicator, we believe it serves as a better barometer for net new and cross sale bookings, given that our backlog metric can be inordinately impacted by the seasonality of renewal activity.

We ended the quarter with approximately \$1.4 billion in backlog, an 8% increase year-over-year, and a sequential decline of approximately \$19 million. The year-over-year increase in backlog was largely the result of net new bookings over the past four quarters in addition to renewal opportunities, which were concentrated in the fourth quarter of 2021.

As we previously mentioned, in some quarters, we will have fewer renewal opportunities, which will impact sequential backlog growth. As expected, the number of in-target renewal opportunities remained lower in the second quarter, but we continue to deliver net new and cross sale bookings, as evidenced in the sequential dollar growth of our ending ARR balance. We expect renewal opportunities will remain low in the third quarter before increasing in the fourth quarter, which is in line with the seasonality we've observed historically.

Gross margin for the second quarter was 51.3%, down from 51.9% in the second quarter of 2021, and roughly in line with 51.4% from the previous quarter. The year-over-year decline in gross margin was attributable to direct costs associated with third-party products included in our solutions, an increase in the mix of pass-through revenue, and incremental delivery resources. The sequential decline in gross margin was also driven by an increased mix of lower margin pass-through revenue associated with some of our Helix customers.

Total operating expenses for the second quarter were \$67.4 million or 48% of revenue compared to \$57.9 million or 46.6% of revenue in the second quarter of 2021, and \$65.7 million or 48.9% of revenue in the first quarter of 2022. The year-over-year percent of revenue increase was predominantly driven by increased head count concentrated within R&D and sales and marketing, travel-related expenses and marketing programs and events.

The sequential decline in operating expenses as a percent of revenue was driven by lower expenses associated with reduced payroll taxes following our Q1 annual bonus payout and annual equity vesting, lower benefit expenses and an increase in capitalized software impacting R&D.

Adjusted EBITDA was \$9.7 million, down from \$9.9 million in the second quarter of 2021, and up from \$8.1 million in the previous quarter. Our adjusted EBITDA results, which exceeded the high end of our guidance, were driven partially by lower benefits expenses resulting from reduced claims activity for healthcare. In addition, we've continued to rationalize facilities to align with our flexible working environment.

Given the macroeconomic backdrop and uncertainty, we intend to continue to proactively seek out efficiencies in the business and prioritize investments in a manner which we believe will allow us to drive long-term value to the business.

We ended the quarter with cash, cash equivalents and investments of \$399.3 million, down from \$413.7 million at the end of the first quarter. Cash used in operations for the second quarter was \$9.8 million, driven largely by an increase in accounts receivables associated with the timing of some large annual invoices for some of our bigger customers.

We generated negative free cash flow in the quarter of \$16.2 million. The normalization of working capital timing in the second half of the year is expected to result in positive cash flow from operations and free cash flow over this period.

Let me wrap up by sharing our third quarter guidance and reiterating our previously provided full year guidance. We forecast third quarter non-GAAP revenue in the range of \$145.8 million to \$147.8 million. We are reiterating our full year non-GAAP revenue guide to the range of \$577.5 million to \$581.5 million, representing year-over-year growth of 15% to 16%.

We forecast third quarter adjusted EBITDA of \$6.2 million to \$8.2 million, and reiterating our full year 2022 adjusted EBITDA guidance of \$41.4 million to \$44.4 million, representing 7% to 8% of non-GAAP revenue for the year.

As a reminder, the customers associated with bookings in the back half of 2021 are scheduled to be implemented in the back half of this year. As we've seen historically, large installations can bring some near-term expense pressure, which is reflected in our third quarter adjusted EBITDA guidance. Once those customers are installed and begin revenue recognition, we expect to see revenue and EBITDA acceleration exiting the year, which is reflected in our full year guidance.

In summary, we delivered better-than-expected adjusted EBITDA results for the second quarter and reiterated our full year guidance for both revenue and adjusted EBITDA. Looking ahead, we will be closely monitoring the impacts of the broader macroeconomic conditions on our customers, while placing an emphasis on prudent cost management to optimize the long-term value of the business and help drive EBITDA accretion as we exit the year.

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

Matthew P. Flake

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

Thanks, David. In conclusion, the first half of the year was highlighted by broad-based product adoption in our digital banking and lending solutions, as well as the announcement of key programs and partnerships for our Emerging Businesses, allowing us to engage in strategic verticals we haven't previously served.

While we're excited about what's going on inside the business, we are also monitoring the potentially challenging macroeconomic environment and the impact it may have on our customers and our operations. As we begin planning for the year ahead, we will continue to closely monitor market conditions and proactively adjust as conditions warrant, while prioritizing long-term value for our stakeholders.

With the durability of our business model, we believe we're well-positioned to weather a potentially tougher climate ahead and that financial institutions have a lot of reasons to continue to prioritize the digital transformation with a proven partner like Q2.

Thank you. And with that, I'll turn it over to the operator for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And we'll take our first question from Andrew Schmidt at Citi.

Andrew G. Schmidt

Analyst, Citigroup Global Markets, Inc.

Hey, guys. Good morning, and thanks for taking my questions here. So, I wanted...

Matthew P. Flake

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

Good morning, Andrew.

Jonathan Price

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

Hey, good morning, Andrew.

Andrew G. Schmidt

Analyst, Citigroup Global Markets, Inc.

Hey. Good morning, guys. Wanted to ask about the direction of ARR growth as we head into the back half, obviously, as it relates to the pipeline and deal execution and fourth quarter is a big quarter. But if you talk about

just the direction with respect for ARR kind of exiting – in the back half and exiting the year and how that might influence your confidence in achieving the acceleration in revenue growth that you outlined for 2023, a frame work there, any thoughts there would be helpful. Thanks a lot.

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

A

Hey, Andrew. Sure. Happy to go over that with you. And as you know, ARR is something that we began disclosing last year. We hope you found it as a useful metric. And as we go through the end of this year, one of the things that we are absolutely anticipating is: one, a lot of that activity that we saw in the second half of last year in regards to bookings strength as well as the first quarter and second quarter of this year is, we see that second half of last year manifest itself in go-lives in the second half of this year. So, Q3 is actually going to be the largest go-live quarter that we've had in a while, in fact, more than the entire first half of this year.

So, as a result, what you'll see is that revenue ramp in Q4, because you have a full quarter of those go-lives in Q4. The ARR number that you'll see going through the year, we expect that to continue to grow sequentially as we get to Q3 and Q4. So, you can model that out effectively.

Now, one thing that we are monitoring closely is M&A. We talked a lot about how encouraged we are by the activity there. If you look over the last 18 months, over 150 of those opportunities have involved a Q2 customer, and we're on the winning side of that. Our customers are on the winning side of that in over 90% of them. But the regulatory approval process has been longer than we've anticipated with dozens of these are now hung up in the approval process, and most of them are the larger opportunities that have more revenue attached to them. So, it's something that we are going to continue to monitor closely as we go through the next six months.

Andrew G. Schmidt

Analyst, Citigroup Global Markets, Inc.

Q

All right. So, the M&A environment, while you might be on the winning side, you could see some lumpiness if these deals come through and the conversion happens at some point, let's call it, next year, it sounds like, later this year or next year, that's the right way to think about it on the conversion front with M&A?

Matthew P. Flake

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

A

Yeah. Andrew, this is Matt. That is accurate. The other thing that gets held up in these opportunities, big or small, is if you're in the middle of waiting for approval or waiting for a conversion, it freezes your ability to buy new products, so that your cross-sell gets hit a little bit, too. But the bigger point is, is the hold up in these larger banks that we're waiting to get approval on so we can get the conversion and then get them up and running. And that obviously adds to organic growth to the business and gives us much more cross-sell opportunity as they become a bigger bank or a credit union.

Andrew G. Schmidt

Analyst, Citigroup Global Markets, Inc.

Q

Got it. That's helpful, Matt. Thanks for the clarification. If I could just sneak just one more in. The obvious question on the macro backdrop, just you had some comments about being cautious. So I just want to be a little bit clear. Are you seeing anything in the decision-making process or in the customer base that leads you to believe that there is a slowness in the decision-making process or the deal cycle is slowing, or is it just being proactive on your front just in case – being prudent in case a slowdown should [indiscernible] (00:23:21)? Just curious about that aspect. Thanks a lot.

Matthew P. Flake

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

A

Yeah. It is being prudent. I think if you look at the data, there is – in the first half of the year, demos were up, RFPs were up, the activity is up. I feel good about the sales pipeline. I feel good about the pipeline in the back half of the year. I think whether it's Tier 1 or Tier 2 or Tier 3, bank or credit union lending or digital banking, we have a lot of great opportunities out there.

The challenge with the macro environment is, if you talk with the CEOs of banks and credit unions, it's a pretty simple formula. Inflation stays up, rates continue to rise, if unemployment goes up, you're going to have charge-offs and charge-offs hit a bank or a credit union, the cost becomes something they have to manage on those. And so no matter how important digital transformation is, the profitability of the entity matters is obviously paramount.

So, those are the things that we're watching closely. But with that said, we're seeing – as I said, the demos were up, RFPs were up, the sales cycle year-over-year is actually -- the timeframe is down somewhat just on a – maybe a tactical piece. But quarter-over-quarter, which two or three deals a trend doesn't make, but we have a little bit of an elongated sales cycle in the second quarter, closed some of those deals already and we have more that are coming. But I don't want to say that we don't have an elongated sales cycle at this point yet, just – but it's something we're monitoring. And so, we're just trying to be prudent with the information we put out there. This is 18 years of doing this now and so, we've been through multiple cycles and our customers are not riverboat gamblers and they are going to be very – and that's why they have been able to sustain for more than 100 years in this world. So, we're just – we know them well and we're just paying attention to it and just want to make sure we're being prudent with our shareholders.

Andrew G. Schmidt

Analyst, Citigroup Global Markets, Inc.

Q

Got it. Thank you for the comments. Appreciate it, guys.

Matthew P. Flake

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

A

Thanks, Andrew.

Jonathan Price

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

A

Thanks, Andrew.

Operator: We'll go next to Alex Sklar at Raymond James.

Alexander Sklar

Analyst, Raymond James & Associates, Inc.

Q

Thanks. Maybe following up on that, Matt, just the idea or the kind of optimism coming out of the back half of the year, the pipeline was up I think 2x last quarter. In terms of later-stage opportunity, are you still seeing that kind of growth through the second quarter here?

Matthew P. Flake

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

A

Yes. Yeah, I think we're still seeing – and as I said, the pipeline continues to grow. Obviously, the first half of 2021 was not a great first half for anybody. So, the cards are great. If you look at it over the last four quarters, we continue to see an improvement in demos and RFPs and activity in the marketplace. Our products are resonating well, whether it's our retail products or commercial products or our lending products, digital acquisition, risk and fraud. All those are landing very well with our prospects and customers.

Alexander Sklar

Analyst, Raymond James & Associates, Inc.

Okay. Great. And then maybe a follow-up for Jonathan. Some Helix wins in the quarter. I'm curious, in terms of pipeline impact there on the macro as far as the consumer is concerned and the appetite from some of your existing customers that kind of continue marketing behind some of the products they've already booked.

Jonathan Price

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

Yeah. No, it's a great question. I would say, the one thing we've seen over the first half of this year from an existing customer perspective is a shift in the mindset towards the profitability of their program. So, it's not that they're not marketing. I think marketing events within our best clients will still be episodic and they will have big pushes throughout any year. But what they're really focused on in a more challenging consumer backdrop looking forward is how they're more profitable, which means they're driving engagement with their most active users, figuring out how to drive profitability overall as a program. So, again, it doesn't mean they're not going to spend on marketing as much. It just means that's less of a focus adding the next incremental user versus ensuring that the current basis is as engaged and profitable as possible.

And as far as demand and the outlook looking forward for Helix, the pipeline is strong. As we talked about in the script, the reality is that these wins are opening up new verticals for us, which is exciting because it gives us an anchor into some of these verticals and a referenceable opportunity to go and leverage. So, it's a different world with fintechs and brands as they evaluate this than the traditional financial institution. But the desire to embed financial services is there and the opportunities are exciting for us. So, we're just trying to keep our heads down and execute.

Alexander Sklar

Analyst, Raymond James & Associates, Inc.

Okay. Great color. Thank you, all.

Matthew P. Flake

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

Thanks, Alex.

Jonathan Price

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

Thanks, Alex.

Operator: Our next question comes from Pete Heckmann at D.A. Davidson.

Peter J. Heckmann

Analyst, D.A. Davidson & Co.

Hey. Good morning. Thanks for taking my questions. Just kind of want to follow up and – and follow up you on these numbers, but we – certainly, with ARR, we've seen some nice growth here the last four quarters, kind of running high-teens to the low-20s. And certainly that's encouraging the – acknowledging some of the uncertainties for macro, but it certainly appears that based upon some of the activity you've seen, assuming that continues in the back half, is it fair to say that that's probability that we should get some revenue acceleration from this year's levels in 2023?

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

A

Yeah, Pete. One of the things that we're doing right now, and this is the case every year in August, is we're getting ready to kick off our FY 2023 planning process. And right now, the macroeconomic environment is changing rapidly. It's uncertain as everybody understands. So, we're going to be going through this process over the course of the coming months and making sure that we understand all these variables at a much more intelligent level, just based upon the inputs that we're getting, and then we'll be able to assess 2023 projections much better for you as we get towards the end of the year and into next year.

Peter J. Heckmann

Analyst, D.A. Davidson & Co.

Q

Okay. Okay. And then shifting over to the digital lending part of the business, nice job on the Australian Tier 1 bank this quarter, can you talk about – in the, I guess, three, four years you've owned this business, where really has the growth come from, and how much have you expanded that footprint either in number of institutions or in thinking a little bit about domestic versus international growth?

Matthew P. Flake

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

A

Yeah, thanks, Pete. I think if you think about the Cloud Lending acquisition which we made in the fourth quarter of 2018, the expansion has been a – multiple layers of expansion, right? So, the consumer, small business, leasing, all of those areas had grown, I think, at 25%, 30-plus percent. And then our – the other thing we've done with the tools is the product – is we made it part of our commercial banking solution, so business account opening, part of our Q2 Catalyst announcement, which is the on-boarding of customers. We've used that tool to expand that way. So, it's been a transformational transaction. And then once you put PrecisionLender into the lending side of the business, we now have the ability to price the relationship, onboard the customer and expand their utilization of the product within – whether it's for lending or deposits. So, it's transformed our business.

As far as the different segments in the world, obviously, we've talked about the struggles in Europe. Some of that has just been – whether it's the pandemic and now you have inflation, recession and you have the war that's going on over there and everything that's tied to that. Obviously, Australia has been a strong market for us and we're happy about the results that we've got out of there. But the lending solutions that we have continue to mature and grow. And we have – I would say that the team has been methodical and disciplined in how they build the products out and we feel like we're in a really good position to capitalize on the digital transformations happening on the lending side of the business as well.

Peter J. Heckmann

Analyst, D.A. Davidson & Co.

Q

All right. Thanks for the feedback.

Matthew P. Flake

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

Thanks, Pete.

A

Operator: We'll go next to Parker Lane at Stifel.

Jeffrey Parker Lane

Analyst, Stifel, Nicolaus & Co., Inc.

Yeah. Hi, guys. Thanks for taking the question. I thought the digital-only brand deal on the Helix side is pretty interesting in the quarter. Could you provide some context maybe on the scale of that opportunity in terms of how many banks are going down that direction, how large that opportunity could be, what you expect over the next few years? Thanks.

Q

Jonathan Price

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

Clearly you're talking about the Helix deal, Parker?

A

Jeffrey Parker Lane

Analyst, Stifel, Nicolaus & Co., Inc.

Yeah, correct. Just how many other banks are considering going with the digital-only brand presence.

Q

Jonathan Price

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

Yeah, it's interesting. We've seen more and more of it throughout 2022. I think what's interesting is, you have sort of this bifurcation between the executives of financial institutions and the sales organizations that are very focused on strategically growing the business, and a digital-only brand is a great vehicle for them to target certain demographics, whether it's millennials or the like, or even national strategy through the digital-only channel. But operationally, it's a different core than what they're used to with their traditional cores that power the financial institution that they're used to.

A

So, understanding the box that you're operating within from a core perspective is really the challenge that these banks have to overcome. And we like where Helix fits in that equation. And we're seeing all over the market the strategic value of a cloud-based core coming more and more to the forefront, whether it's in this use case or it's in the embedded finance use case that Helix is largely focused on with fintechs and brands. So, it's exciting. It's opening up a new market, and I think we're going to see more and more opportunities with regional community financial institutions launching these digital-only initiatives. It's just a question of making sure that the operational side of their house and the strategic side of their house are aligned on what the capabilities are in a digital-only scenario.

Jeffrey Parker Lane

Analyst, Stifel, Nicolaus & Co., Inc.

Got it. Very helpful. And then, David, could you provide some more color on the decline in traditional bill pay during the quarter, was that simply seasonality? And secondarily, how should we think about the impact of the transactional business in more uncertain economic times? Thanks.

Q

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

Yeah. Parker, it's something that we're monitoring really closely. The bill pay business was certainly something that was below what we expected, and that's for the first half in total. So, we're going to continue to monitor that in the second half and obviously, as we enter into next year, it's going to be something that's going to be a key variable as we work through that planning process that I talked about earlier in regards to FY 2023.

Jeffrey Parker Lane

Analyst, Stifel, Nicolaus & Co., Inc.

Got it. Well, thanks again, guys.

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

Thanks.

Operator: Our next question comes from [ph] William McNamara (00:34:15) at BTIG.

Matthew David VanVliet

Analyst, BTIG LLC

Yeah. Hi, this is Matt VanVliet. So, I guess looking at some of the digital-only banks that you announced on the digital lending side, maybe different than Parker's question. When you're looking at those banks, is there any difference in terms of pricing out the solutions or the number of total users expected or maybe even just the build of those deals coming through than a normal brick-and-mortar-related digital banking deployment and how you're thinking about some of those opportunities coming through the pipeline?

Matthew P. Flake

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

Yeah, Matt, it's a good question. I think when you think about a startup bank and there hadn't been many for a while, but a long time ago, we used to do them. You have to – it's a partnership where you go in – we've got to evaluate who the ownership is and the structure of them. And then there's – it's a multi-tiered kind of a year – you give them time to grow. You can't charge them too much at the beginning. We're both betting on this together a little bit. And so, it can – if you get the right group, it can be a great deal for both of us. And so, it is a different construct than when you go to an existing bank that has 50,000 users or a credit union, 50,000 members, and they're signed on, you're going to convert them over and you have a minimum that's tied to that.

So, it does have some different dynamics to it. But one of the things about these de novo banks, if you think about it is, we're on both sides of the balance sheet, we have the technology to be able to offer them everything from pricing a relationship to on-boarding the relationship because they have to onboard every single new customer as opposed to an existing financial institution that has – already have the customer base. So, we have a lot of tools [ph] to (00:36:08) digital acquisition and on-boarding that make it kind of a no-brainer to go with us on the digital side.

Matthew David VanVliet

Analyst, BTIG LLC

Okay. Very helpful. And then as you look at the large deployments, both from the second half of last year and maybe more importantly, some of the Tier 1s you've signed earlier this year, do you feel like there's any concerns

that they might sort of drag along the process or extend out the project timelines, given the macro uncertainty, or do you feel like they're all pretty well staged in and to your point on second half of 2022 getting some of those late 2021 deals into the revenue stream? Thanks.

Matthew P. Flake

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

A

Yeah, I know – I – the one that we signed last year and [ph] all but net – (00:36:57) the net new to us go-lives are on track. I would reiterate what David's comment was. We have dozens of customers that's skewed to the larger side that are on the M&A front that are just being held up by the regulatory environment. They're just not [ph] – there's not improving them (00:37:10) right now. And so, those delays extend out. And that's one of the things that we're monitoring closely. But as far as the net new side, you signed it last year, you signed it this year, we're on track, the delivery team's doing an amazing job of delivering in Q3 and Q4. We've got some big go-lives, but no delays there.

Matthew David VanVliet

Analyst, BTIG LLC

Q

All right. Great. Thanks for taking the questions.

Matthew P. Flake

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

A

Thanks, Matt.

Operator: And we'll go next to Terry Tillman at Truist.

Robert Dee

Analyst, Truist Securities, Inc.

Q

Great. Thanks for taking the questions. This is Robert Dee on for Terry. Just starting off, you're talking about being prudent on expenses. How is actual employee head count trending? And are you seeing more stable retention now, or still the great resignation with difficulty in keeping top talent still highly prevalent? Thanks.

Matthew P. Flake

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

A

Yeah, Robert, I would say that we've put a lot of time and energy into our culture and the sustainability of this in our employees. If you look at our attrition rates, our voluntary attrition rates, they're 5 points below whatever you're seeing in the software industry right now. And so, I think you're seeing a stabilization of employees and you're also seeing a – the wage inflation has flattened out somewhat. So, really happy with the retention that we have of our employees and also the engagement of our employees around our mission. So, feel good about that right now.

Robert Dee

Analyst, Truist Securities, Inc.

Q

That's great to here. And then just one follow-up, if I may, more on the macro front. How would you compare and contrast demand across Tier 1 banks, Tier 2 banks, and then the fintechs you serve? Thanks.

Matthew P. Flake

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

A

Yeah. The concerns are similar on the Tier 1s and the Tier 2s. Keep in mind we have quite a few enterprise customers as well through PrecisionLender. Rates going up, creates a more complex lending environment. And so, PrecisionLender is a tool that should come into play there. But the sentiment between Tier 1s and Tier 2s is similar to what I said earlier, which is what's going to happen with inflation, what's going to happen with rates, unemployment, and how are those going to ripple through the business, whether it's having to write off loans, how you have to adjust that. And so, they're just being prudent with their decision making.

Robert Dee

Analyst, Truist Securities, Inc.

Okay, great. Appreciate the color. Thank you.

Matthew P. Flake

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

Thanks, Robert. Appreciate it. Have a good day.

Operator: We'll go next to James Faucette at Morgan Stanley.

Hi. It's [ph] Michael on (00:39:46) for James. Thanks for taking my question. Maybe just help me unpack the Rocket Mortgage process in general. I imagine that process was highly competitive. So just help me understand, like how you were able to win that deal relative to others.

Jonathan Price

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

Yeah. Thanks for the question. No, I mean, look, it's a long time in the making and it's a great brand for us. But, we really won there on the back of the differentiation of our software development kit and the platform and the openness and the ability and ease to work with it. This was the process where both sides saw the strategic benefits, and for us, all of the Innovation Studio thesis is around how do we bring optionality for our banks and credit unions to drive adjacent or relevant products into their client base, and Rocket's a great brand for that, especially in the backdrop that we're operating within. And they did a lot of diligence, and they talked to our existing partners, they referenced call – referenced calls were done with existing partners, prospect partners to understand what it's like to work with us, how easy it is. And, really pleased with the deal and the opportunity and the early adopter universe of banks and credit unions that we're already talking to. And again, I think it's timely from the standpoint of – in a rising rate environment, in a world where a lot of the regional community banks have big refinance portfolios, that's an area of home lending that's going to be challenged over the foreseeable future. And so, the opportunity to pivot that into – or sidecar that into a another business where it's fee income, the management of the paper and the process is all done by a best-in-class digital provider that has a brand like Rocket I think is going to be exciting. So, we're really pleased with that one. And we have many others. We signed north of 15 partners again in the quarter, and so we're just continuing to build an ecosystem and give these banks and credit unions access to more innovation.

Great. Thanks, Jonathan. And then maybe on backlog, can you help me sort of decompose the backlog composition geographically? So, how much do APAC and Europe comprise? And have you seen any elongation of sales cycles in Europe, specifically like we've seen from some other SaaS names?

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

Yeah, just quickly on the breakdown. So, there's very little that – of the backlog mix that comes from Europe, quite honestly. And then, in regards to the timeline of deals and decision making, I mean, I think Matt covered it pretty extensively. It's certainly something that we're monitoring closely, but they have not come out of – some of the delayed decision and/or macroeconomic pressures that they've been dealing with for the last couple of years. So, it's certainly an area of the world that we're going to continue to closely look at.

Great. Thanks very much.

Matthew P. Flake

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

Thanks.

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

Thanks.

Operator: We'll go next to Bob Napoli at William Blair.

Adib Choudhury

Analyst, William Blair & Co. LLC

Hi. Good morning, guys. This is Adib Choudhury on for Bob Napoli. Thanks for taking our questions. Just wanted to ask on the competitive environment, if you guys are seeing any shifts in competitive intensity when you're in the market for digital banking deals. And I guess to tail that, sounds like Innovation Studio is the key reason for why your customers are choosing to partner with Q2. Is this starting to move the needle in terms of win rates? Thanks.

Matthew P. Flake

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

So, the competitive environment remains – as I've said over the last several quarters, retail digital banking is a competitive environment, especially as you work down the tiers, Tier 2, Tier 3, the credit union side in particular, a lot of solutions out there. We continue to fare well in those markets. Our win rates in Tier 2 and Tier 1 are similar to what they've been historically. And then Tier 3, we've never really given win rates there. There's just lot more volume down there and I don't have any indication there of any problems. We're a little more selective in that area as well, so--. And then, Innovation Studio, the breadth of our products, Q2 Catalyst, all those things are differentiators for us when you talk to the people that select the products.

Adib Choudhury

Analyst, William Blair & Co. LLC

Great. Thanks for that color. And then just as a follow-up on capital allocation and M&A, could you talk about your current appetite given some of the compressed valuations in the market? It feels like corporate development might be opening up a little bit. So, I guess what types of assets or capabilities would you guys be most interested then?

Jonathan Price

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

A

Yeah. So, from a market backdrop perspective, I can tell you that the second quarter was probably one of the quietest we've seen in the last several years in terms of inbound activity, where we get calls around opportunities and assets in the market. So, while we certainly expect in the back half of the year to start seeing what you referenced in terms of the market opening up and more corporate development activity and opportunities, we didn't see it yet in the second quarter. And I think it's largely because of the lag between what's happened in the public markets and how that slowly translates into private sellers. And so, we do expect that will happen, though.

And as far as where we're going to be focused, I wouldn't say that anything's changed. I do think that we have the benefit now of Q2 Innovation Studio and some of our other partner and new product launches across the portfolio that give us more and more insight into end-markets and the assets within those and how they perform in the hands of our customers. So, I think that's interesting. But as far as areas of interest across digital wealth, digital insurance, risk and compliance, the segments we talked about in the past continue to be interesting. I just think we have a much different lens into it now and new and – more new segments are opening up and piquing our interest. We just have to see what comes to market and what makes sense.

Adib Choudhury

Analyst, William Blair & Co. LLC

Q

Great. Thanks very much.

Jonathan Price

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

A

Thank you.

Operator: We'll go next to Charles Nabhan at Stephens.

Charles Nabhan

Analyst, Stephens, Inc.

Q

Good morning and thank you for taking my question. I appreciate the color on the gross margin for the quarter, but I was wondering if you could walk us through some of the puts and the takes for the second half of the year, specifically in terms of how we should think about cadence as well as any headwinds and tailwinds you anticipate.

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

A

Yeah. Sure, Chuck. And I do think that in the second half, our gross margin profile will improve slightly from the first half profile. And one of the pressures that you see in Q3 is, very specifically, when we have these large implementations, you typically do see some pressure on gross margins. So because we have such a high concentration of implementations in Q3, you have a lot of those implementation resources and customer support resources that are hired that are – and on the implementation side no longer capitalized that end up hitting the

P&L. So, you do see some short-term pressure, but obviously it gives us a nice long-term lift after winning these opportunities. So, that pressure exists during Q3, you end up seeing an uptick in Q4.

We also believe that there's going to be, as we exit this year, less of a mix of the pass-through as a total mix of the overall business. So, if you remember, we talked about that pass-through business being higher, some of it related to tax season activity. So, as we get into Q4, the gross margins are pressured as much based upon that lack of mix. So, those are a couple of the key variables to keep in mind as we get into Q3 and then exit the year in Q4. But I would I would expect, from a modeling standpoint, you'll see increases in Q4 relative to Q3.

Charles Nabhan

Analyst, Stephens, Inc.

Q

Got it. And I know you're not going to give specific guidance for 2023, but you did reiterate the 60% long-term target. So, just curious if you could kind of give us a little color around that tailwinds and catalysts over the medium to long term, specifically, if you're – you see a mix shift more towards cross-sell and – cross-sell activity, which has the higher incremental gross margin.

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

A

Yeah. Long term, if you think about some of the drivers we talked about: one, we have opportunities to mix up in our business towards higher profit margin in areas – Innovation Studio is a great example of that. Jonathan's talked about laying the groundwork and the partners that we've signed up and the ecosystem that we're creating. As that becomes a more meaningful part of our business three, four, five years down the road, that's a very high margin business.

And the Helix business is going to continue to mix up away from pass-through towards higher margin transactional business over the course of the next three to five years. That's going to help the overall business. And that obviously is a business that's going to grow at a premium to what we have overall. And then we're going to have opportunities from a scale standpoint in things like utilizing global resources in a more effective manner that are just going to help our labor mix and our overall cost structure when you think about our gross margins.

Charles Nabhan

Analyst, Stephens, Inc.

Q

Got it. I appreciate the color. Thank you.

Jonathan Price

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

A

Thanks, Chuck.

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

A

Thanks, Chuck.

Operator: And we'll move next to Joe Vruwink at Baird.

Joe Vruwink

Analyst, Robert W. Baird & Co., Inc.

Q

Great. Hi, everyone. When you step back and look at the broader landscape over the past two years now and new system decisions that are getting made, do you think the level of activity has skewed proportionately more towards retail offerings? And given some of the comments like the Tier 1 win, changing commercial expectations, maybe the industry is readying to shift back around and focusing on commercial. And if that is happening, I guess this dovetails a little bit with the competitive landscape question, [ph] is that type of shifts (00:49:20) something where Q2 actually stands out better by comparison?

Matthew P. Flake

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

A

Yeah. Joe, I think if I understand your question correctly, the difference has been credit unions have largely been focused on consumer forever. And over the years, we have built a practice with credit unions of helping them build their small business capability out, as well as some of them beginning to move into larger mid-sized business offerings. For commercial banks, which in 2004, when we started the business, we were – we built a platform – single platform for them to have retail, small business and commercial customers on the platform. So, we're 18 years into building that product. But our commercial banking investment that we began to really make in 2012 and 2013 before we went public, and one of the reasons we went public in 2014, was to fuel and fund those offerings.

And so, as you look forward – commercial banking has always been the cornerstone of small and mid – of Tier 1 and Tier 2 and Tier 3 banks. The difference now is the need to be able to offer commercial banking solutions digitally. And that's where, whether it's a mobile phone or a tablet or a desktop, we have a significant lead in user experience, in breadth of product as far as deposit and lending side of the house, pricing, relationship, the Q2 Catalyst product, over anybody in the space. We have to continue to build out offerings for large corporates which is where the legacy players have the product set there, but they don't have it in a modern technology form.

And so, our position in the marketplace right now, our investment in Q2 Catalyst, is highly differentiated. When we sit down with a bank above a couple of billion that has larger commercial customers, they are blown away by our offerings and there's not many people that can come close to us without cobbling together solutions they don't own or they're partnering with people. So, our differentiation in the commercial space, I anticipate it will continue to grow. We're going to continue to invest in those areas. And so, I think whether it's a community bank or a credit union, we're in a very good position there because all the things that come with that are the experience in the conversion, advisory services, well, how you use these tools that we've built over years and years of teams that work here. So, highly differentiated for us in the marketplace, we anticipate that will continue to be a differentiator for us in 2023 and beyond.

Joe Vruwink

Analyst, Robert W. Baird & Co., Inc.

Q

Yeah. And I guess where I was going with the question, I think your commercial product stands up really well. When you look into the pipeline, are you seeing proportionately more opportunities in the commercial than might have been the case over recent years, so if you're kind of matching a strong product with a stronger market opportunity?

Matthew P. Flake

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

A

Yes. Yeah, that is true as well. If you think about it, the consumer space – not consumer, well, retail digital banking [ph] outside (00:52:34) is crowded, but the consumer space is crowded as well. Whether – Jonathan started the business [indiscernible] (00:52:39) we have several customers that jumped into the space and have

millions of retail accounts and debit cards that are out there. And so, you see credit unions and banks shifting to have more commercial focus because of their cost of capital, their advantages of being in the market, their ability to offer wires and ACH and that type of stuff. So, I think you're going to continue to see the pipeline skew towards more commercial offerings, and we're well-positioned for that.

Joe Vruwink

Analyst, Robert W. Baird & Co., Inc.

Okay. Great. Thank you.

Matthew P. Flake

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

Thanks, Joe. Appreciate it.

Operator: And that does conclude the question-and-answer session and today's conference call. We thank you for your participation. You may now disconnect.

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