Corrected Transcript

07-Nov-2022

Q2 Holdings, Inc. (QTWO)

Q3 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.

Joseph Vafi
Analyst, Canaccord Genuity LLC

Charles Nabhan
Analyst, Stephens, Inc.

Chase Donovan
Analyst, Raymond James & Associates, Inc.

Pete J. Heckmann
Analyst, D. A. Davidson & Co.

Jeffrey Parker Lane
Analyst, Stifel, Nicolaus & Co., Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Kelly Anne, I'll be your conference operator today. At this time, I'd like to welcome everyone to the Q2 Holdings' Third Quarter 2022 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.

I would now like to turn the call over to Mr. Josh Yankovich, Investor Relations. Please go ahead, sir.

Josh Yankovich
Head-Investor Relations, Q2 Holdings, Inc.

Thank you, operator. Good afternoon, everyone, and thank you for joining us for the third 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 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, 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 on our Form 8-K filed with the SEC this 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 sharing our third 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. From there, I'll discuss how we're adapting to current market influences before handing it off to David to walk through our financial results and outlook in more detail.

In the third quarter, we generated non-GAAP revenue of $144.9 million, up 14% year-over-year and 3% sequentially. We also added over 700,000 users to our digital banking platform, a year-over-year increase of 9% that brings us to approximately 20.9 million total registered users. We delivered strong sales execution in the third quarter, highlighted by a digital banking enterprise deal and five Tier 1 wins with both new and existing customers.

Our emerging businesses also had solid activity in the quarter. We signed a new Helix customer that opens a new vertical for us and launched key client programs. We're seeing Innovation Studio, our award winning SDK and partner ecosystem, continue to play an important role in our digital banking sales success.

And finally, we announced the acquisition of Sensibill in early October, a leading customer data platform designed to unlock actionable insights to help financial institutions and fintechs better serve their customers.

With that, let me unpack our sales highlights in more detail. I'll start with digital banking where we signed three Tier 1 deals and landed an enterprise win with a top 50 US bank. Q2 who participated in a highly competitive selection process to win this marquee enterprise deal. And the bank will now use the Q2 platform for their commercial and small business clients. It's worth noting that this is the largest deal we've signed in the last three years. And our proven ability to expand enterprise relationships beyond the initial bookings is one of the many reasons we're excited for the long-term potential of this partnership.

One of the Tier 1 wins from the quarter was with a $6 billion bank that will also utilize both our retail and commercial solutions. This bank was looking for a technology partner that's not only a best-in-class commercial provider, but one that could also support their acquisition road map. They selected Q2 because of our differentiated commercial offering, our speed of innovation and our track record of helping acquisitive customers grow.

We also saw significant cross-sell activity in the quarter. First, an existing Tier 1 credit union customer purchased our retail solutions to add to their Q2 commercial offerings, effectively building out their full digital banking suite on Q2's platform. Similarly, we also expanded our relationship with a top-50 US credit union that added our commercial banking solution to their existing retail banking suite and extended their contractual terms as part of the deal.

Digital lending also had a solid quarter, including a Tier 1 win with an agricultural lender looking to implement a new commercial loan pricing tool to better assess the risk and profitability of their commercial relationships. This win represents our second Tier 1 deal in the agricultural lending space this year. So, we're encouraged by our growing traction and credibility in this promising vertical.

We also landed a cross-sell deal with a large Tier 1 bank that began utilizing our loan pricing solution last year. The success of that initial launch led them to expand their use of our loan pricing platform. This deal demonstrates the multiple expansion opportunities we see with our loan pricing capabilities. In this case, the customer added licenses, enabling more of their lending staff to utilize our solution, and they added a new product module, both of which meaningfully grow the size of this partnership beyond the initial booking.

Overall, I'm pleased with our sales performance across digital banking and lending in the quarter. We believe our digital banking platform is well-positioned competitively across retail and commercial as highlighted by the deals we discussed. And on the digital lending side, we're executing meaningful net new and expansion wins.

We're seeing Q2 Catalyst, our end-to-end commercial solution set, resonating with customers and prospects for its ability to help them manage commercial relationships through the digital channel, from pricing to relationship, to onboarding new commercial clients, to serving and growing those relationships over time.

In fact, every one of the enterprise and Tier 1 customers I just discussed is leveraging at least one of our Q2 Catalyst solutions to enhance their commercial strategy. And we believe its ability to help our customers digitize the critical relationships across loans and deposits is highly differentiated in the market.

In summary, our sales execution across digital banking and lending remains strong. Our product portfolio is resonating. We saw our win rate improve. We are executing meaningful net new and expansion opportunities, and our pipeline suggests that demand for digital transformation remains strong.

Now, I'll hand it over to Jonathan to walk through our emerging businesses highlights from the quarter.

Jonathan Price

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

Thanks, Matt. I'll start with Helix, where we signed net new and cross deals and launched key programs in the quarter. First, we signed a digital life insurance company that offers a unique savings account with competitive benefits. As our first partnership within the insurance vertical, this deal showcases yet another opportunity for us to partner with innovative companies, no matter their industry, seeking to provide compelling alternatives to traditional offerings through embedded finance.

We also had multiple clients launch the Helix-powered programs in the quarter. One of these program launches was with Mana, an online gaming company, looking to offer personalized banking services to their users, including checking accounts and debit cards. As we've discussed in the past, program launches with our Helix clients are significant events as this business model is designed to generate incremental usage-based revenue, driven by user growth and adoption. So with Mana's partnerships in the gaming space, unique distribution model and engaged user base, we're excited to help unlock the potential of this program as it scales.

Another development in the quarter was with an existing customer that expanded their relationship with us, adding an incremental program, supported by a new issuer processor and bank of record, an initiative they determined only Helix could support. Not only does this program generate additional revenue for us, it also demonstrates how Helix can help clients leverage multi-bank environments or deployment models as they seek out greater optionality, risk mitigation and business continuity.

I'm also pleased to report that Q2 Innovation Studio continues to help us secure wins across the business. Consistently cited as a differentiator by prospects, Innovation Studio has now shifted beyond that. It's become an integral component in nearly every digital banking deal we signed, and its impact is two pronged. Not only have the number of deals citing Innovation Studio increased, but we're also seeing an uptick in our digital banking win rate overall, which we believe is correlated to the value that the financial institutions see with Q2 Innovation Studio.

Furthermore, from our growing pool of customers who've adopted Innovation Studio, now over 60% of our digital banking customer base, more of them are integrating with multiple partners at once, contributing to more immediate value for the financial institutions, their customers and Q2. And as of early November, we've hit the milestone of 100 partners signed with Q2 Innovation Studio, providing high-quality solutions that our customers can deliver to their account holders with speed and highlighting the ecosystem's value for innovative companies looking to amplify their go to market strategies.

Finally, as Matt mentioned, we recently announced the acquisition of Sensibill, whose machine learning platform captures and categorizes granular spending data that can help small businesses and consumer account holders better understand and manage their finances. We believe the addition of Sensibill will complement the capabilities of Q2 Catalyst, strengthening an already differentiated commercial offering and will enhance our comprehensive data portfolio.

Sensibill's mission to make financial wellness attainable for all aligns seamlessly with our mission, and we're excited for the benefits in terms of both talent and technology that this addition will bring to the business. Because of Q2's strong business model and balance sheet, we're able to capitalize on opportunistic acquisitions like Sensibill.

And with that, I'll hand it back over to Matt to discuss the current macro backdrop.

Matthew P. Flake

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

Thanks, Jonathan. I'm pleased with the sales execution from the quarter, and my conversations with our customers indicate that digital transformation remains a top strategic priority for financial institutions of all sizes. As we noted on our last earnings call, we have continued to monitor the challenging macroeconomic environment and we are seeing some larger financial institutions slow certain discretionary spending due to ongoing macroeconomic uncertainty. For example, in the third quarter, several key customers began to defer discretionary services projects with us. We have also observed shifting market dynamics in Europe, which has faced a particularly challenging sales environment.

As such, we will prioritize profitable growth and focus our go-to-market efforts in regions with more favorable demand environments, but continue to provide outstanding support to our customers in Europe. Considering all these dynamics and our increased focus on profitability, we are revising revenue and EBITDA guidance for the remainder of the year, which David will discuss in more detail shortly. Taking a longer term view, I remain confident about the opportunity in front of us.

The fundamentals of this business haven't changed. We are competing well. We are extending and expanding customer relationships, and our pipeline suggests the demand for digital transformation solutions remains strong. Given these strengths, we expect subscription revenue growth, the vast majority of our revenue base, to accelerate in 2023. And with emphasis on cost management, we expect to drive expanding EBITDA margins in 2023 as well.

With that, I'll hand it over to David to discuss our financials and guidance in more detail.

David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

Thanks, Matt. Our revenue for the third quarter came in below our guidance range, predominantly driven by pressure on our transactional and lower margin services revenue streams. However, we also saw an acceleration in our higher margin subscription revenue. Despite total revenue coming in below our guidance, our adjusted EBITDA results exceeded the high end of our guidance due to proactive cost management and a more favorable revenue mix. Additionally, our ARR, backlog and user growth continue to give us confidence in the continued acceleration of higher margin subscription revenue.

I'll begin by reviewing our results for the quarter and conclude with updated guidance for the fourth quarter and full year of 2022. Total non-GAAP revenue for the third quarter was $144.9 million, an increase of 14% year-over-year and 3% sequentially. Year-over-year increase for the quarter was primarily driven by an increase in subscription revenue resulting from customer go-lives, specifically within our digital banking business, where we had more go-lives take place in the third quarter than during the entire first half of the year.

Our sequential growth was the result of solid organic growth and the contribution of go-lives, which resulted in the highest number of users added in the quarter in two years. Transactional revenue represented 11% of total revenue for the quarter, down from 14% in the prior-year period and 13% in the previous quarter. The year-over-year and sequential decline in transactional revenue was largely driven by a decline in transactional volumes within our digital banking and Helix businesses.

Usage-based revenue in our Helix business declined from prior quarters and some of our customers observed elevated transactional volumes during the spring tax season. This, combined with the continued year-over-year contraction of our bill pay business, is putting greater-than-expected downward pressure on transactional revenue.

Services and other revenue was 15% of total revenue for the quarter, down from 16% in the previous quarter. Services revenue was below expected levels due to a decline in customer spending on professional services and consulting, which was concentrated to some of our larger customers. These types of projects are generally more discretionary in nature.

Annualized recurring revenue or ARR grew to $633.7 million, an 18% year-over-year and 3% sequential increase. Year-over-year growth was primarily from net new and cross-sell bookings within our digital banking and lending businesses. The sequential growth was also driven by the booking success in the quarter, partially offset by the decline in usage-based transactional revenue.

While ARR can have limitations as a key performance indicator, we believe it serves as a better barometer for net new and cross-sell 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 increase of approximately $22 million. The year-over-year and sequential increase in backlog was largely the result of net new and renewal bookings. Gross margin for the third quarter was 52.1%, up from 51.9% in the third quarter of 2021 and 51.3% in the previous quarter.

The year-over-year and sequential improvement in gross margin was attributable to an increased mix of higher margin subscription revenue resulting from go-lives during the quarter. The sequential gross margin improvement was also the result of improved efficiency of resources delivering and supporting our solutions.

Total operating expenses for the third quarter were $69.8 million or 48.2% of revenue compared to $62.4 million or 49.1% of revenue in the third quarter of 2021 and $67.4 million or 48% of revenue in the second quarter of 2022.

Year-over-year percent of revenue decrease was predominantly driven by improved R&D cost scaling, in addition to a reduction in recruiting expenses and spending with third-party contractors. The slight sequential increase in operating expenses as a percent of revenue was driven by an increase in head count concentrated within R&D and sales and marketing.

Adjusted EBITDA was $10.8 million, up from $7.3 million in the third quarter of 2021 and $9.7 million in the previous quarter. Our adjusted EBITDA over-performance relative to our third quarter guidance was attributable to a more favorable mix of higher gross margin revenue and effective cost scaling. We ended the quarter with cash, cash equivalents and investments of $395.7 million, down slightly from $399.3 million at the end of the second quarter.

Cash flow generated from operations for the third quarter was $6.1 million, which benefited from effective working capital management. We generated negative free cash flow in the quarter of $3.9 million. Based on enhanced profitability projections and normal seasonality, we expect fourth quarter cash flow from operations and free cash flow to be positive.

As Jonathan mentioned, we believe our cash position and projected future cash flow generation affords us the ability to evaluate capital deployment opportunities while continuing to ensure we're in a position to service our convertible debt balance, the vast majority of which does not come to maturity until late 2025 and 2026.

Let me wrap up by sharing our fourth quarter guidance and updated full year guidance. We forecast fourth quarter non-GAAP revenue in the range of $148.4 million to $150.4 million. We're updating our full year non-GAAP revenue guidance to the range of $568 million to $570 million, representing year-over-year growth of 13% to 14%. This guidance incorporates our revised revenue expectations, taking into account the impact we're seeing to discretionary services and transactional revenue.

We forecast fourth quarter adjusted EBITDA of $10.5 million to $12.5 million and we're updating our full year 2022 adjusted EBITDA guidance to the range of $39 million to $41 million, representing approximately 7% of non-GAAP revenue for the year. Despite the revenue headwinds we're observing, we're still able to produce meaningful adjusted EBITDA driven by a more favorable revenue mix and proactive cost management.

Also incorporated into our guidance is the impact of Sensibill, which we acquired in October. We expect Sensibill to generate low-single digit millions in revenue and low-single digit millions in adjusted EBITDA loss for the full year of 2023 with an immaterial impact to Q4 of 2022.

As we continue to go through our 2023 planning process, I want to share our preliminary view on our expectations based on the trends we're seeing and the proactive measures we're taking. We continue to believe our subscription revenue will show an accelerated growth rate for the full year 2023 as a result of the booking success we've observed year-to-date, our sales pipeline and the strength of leading indicators like ARR. However, we believe that subscription revenue growth will be partially offset by reduced expectations for our transactional and services revenue as well as our reduced expectations for Europe.

Based on what we're seeing in the second half of this year in transactional and services revenue, we anticipate our total revenue growth rate in 2023 will be relatively flat to the full year growth rate implied in our revised 2022 guidance. Despite this reduced total revenue outlook, we do expect an acceleration of subscription revenue growth and expanded adjusted EBITDA margins for the full year 2023.

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 closing, I want to emphasize the strength of our execution from the quarter. We had the strongest bookings quarter of the year, signed new customers across all lines of business and had meaningful wins in digital banking, digital lending and Helix, including five Tier 1 deals and the enterprise win, the latter being our single largest since 2019.

While we believe the recent sales execution and the state of our pipeline signal a positive demand environment, we continue to monitor the changing economic backdrop and its impact to our customers and are focused on profitable growth and driving adjusted EBITDA margin expansion.

In long term, I remain extremely confident in the future of this business. Our financial model is strong, our product portfolio is highly differentiated and financial institutions continue to prioritize digital transformation across their businesses. Thanks.

And with that, I'll hand it over to the operator for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] We'll hear first today from Andrew Schmidt with Citi.

Andrew G. Schmidt
Analyst, Citigroup Global Markets, Inc.

Q

Hey, guys. Good evening. Thanks for taking my questions. I want to start up on the discretionary spend piece. If you could just kind of talk about what types of discretionary spend are being deferred? And then just by my math, I think between discretionary spend and transactional revenues may be about $8 million headwind in the fourth quarter. Just curious how to think about that layering in on a quarterly basis going forward? Thanks a lot, guys.

Matthew P. Flake
President, Chief Executive Officer & Director, Q2 Holdings, Inc.

A

Yeah, Andrew, thanks for asking that question. So, the types of discretionary spend that we're seeing impacted, I want to be clear, they're not implementation decisions. It's more around staff augmentation, like back office automation things, efficiency projects, where you could have a customer that is doing things to automate a process where there is a human involved, but there is a double cost for that period of time. And so, what we're seeing is they're backing off of those types of agreements. It could be rebranding exercises, some readiness consulting type projects that has impacted the discretionary spend. And I think this kind of comes with when you have – we have 190 customers that are more than $5 billion and more than 100 that are over $10 billion, you start to get into some of those services projects. But that's what we're seeing on the discretionary spend side.

David Mehok
Chief Financial Officer, Q2 Holdings, Inc.

A

Yeah. And just to take down – I think, Andrew, your question was taking them to 2023, the way that we're viewing this is based upon what we know today is we're expecting that we're going to see continued pressure on those discretionary services. So, we're extrapolating what we're seeing today into 2023 based upon that high level outlook that I provided. And then, on the transactional side, that's a combination of both the continued bill pay pressure, which we've seen, and again, that's been much more significant than we thought coming into the year, combined with Helix, which is very transactional based. As you know, over the course of the last year, we've migrated those contracts to be from license to much more transactional based. As a result, when the number of transaction start to go down and the user acquisition starts to go down with some of our customers, we see pressure on our transactional revenue. So, those two things combined are what we're referring to when we talk about the pressure on transactional heading to 2023.

Andrew G. Schmidt
Analyst, Citigroup Global Markets, Inc.

Q

Thanks, Matt and David. That's super helpful. And then, I guess, on the margin side in 2023, I think, previously adjusted EBITDA, [indiscernible] (00:24:44) the expectation was 300 to 400 basis points. And just trying to understand kind of the moving parts with mix for next year and the focus on efficiency, is that still the right way to think about margin expansion or is there a little bit more just given the nature of revenues and the focus on efficiency? Any comments on just how to think about margin expansion as a starting point would be helpful. Thanks a lot.

David Mehok
Chief Financial Officer, Q2 Holdings, Inc.

A

Yeah, Andrew, qualitatively, you're spot on. I mean, those are going to be some of the key drivers. The mix of revenue, which we see improving towards higher profit revenue streams in 2023 relative to what we originally expected as well as very prudent cost management, those two things combined are going to result in the EBITDA expansion we referenced. We're not going to quantify that at this point. So, don't want to get into too much detail. That's something that we're working on diligently right now. We're right in the middle of the planning process. So, we'll give you a lot more color in detail on what that EBITDA profile looks like in February.

Andrew G. Schmidt
Analyst, Citigroup Global Markets, Inc.

Q

Perfect. Thank you very much, guys. Appreciate the comments.

David Mehok
Chief Financial Officer, Q2 Holdings, Inc.

A

Thanks.

Matthew P. Flake
President, Chief Executive Officer & Director, Q2 Holdings, Inc.

A

Thanks, Andrew.

Operator: We'll hear next to Joseph Vafi with Canaccord.

Joseph Vafi
Analyst, Canaccord Genuity LLC

Q

Hey, guys. Good afternoon. Thanks for taking the questions. Just one more on the transactional side. If you take a look into where that's coming from, is it less business transactions or is it a kind of a trickle in on less retail or individual transactions? Just trying to get a feel for kind of where, perhaps, in the model there may be a little bit more weakness right now?

David Mehok
Chief Financial Officer, Q2 Holdings, Inc.

A

Yeah. Joe, this is a consumer retail driven phenomenon for us based upon what we're seeing. This is not a commercial driven issue.

Joseph Vafi
Analyst, Canaccord Genuity LLC

Q

Got it. And then, on the Helix and the life insurance win, maybe you could kind of delve a little bit more into the use case there given they're not a bank, they're a financial institution, a little bit different. But just to get a feel for that value proposition and how it works outside of the bank.

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

A

Yeah. Hey, Joe. So, what they're looking to do really is very similar to other embedded finance clients and prospects we see, which is get more engaged with their customers and figure out new ways to work with them, to monetize them. And so, in this example, they're going to be launching an embedded savings program with them. Obviously, the rate environment's changed, so the ability to do that right now is attractive. And so, there was nothing specific about being a life insurance business that's unique to that model. It's more just what we're seeing across the different verticals where there are opportunities we're looking at, where they want to engage with clients around financial services in a deeper way than, just in this case, their core insurance business.

Joseph Vafi
Analyst, Canaccord Genuity LLC

Q

Got it. And then, just maybe just if I could ask one more kind of on the macro here. It's kind of early in the potential slowdown in the economy. Obviously, interest rates are higher. Some of the banks should be able to see some rising net interest margins over time. Matt, kind of how are discussions going on your types of deals with the banks as they're looking at this kind of potentially more uncertain economic outlook as we look into 2023? Thanks, guys.

Matthew P. Flake
President, Chief Executive Officer & Director, Q2 Holdings, Inc.

A

Yeah. Thanks, Joe. I mean, I think if you look at the quarter, the pipeline, the ARR growth, we had a phenomenal quarter. Digital transformations drove to top of the list. We signed the biggest deal we've signed since 2019 with the top-50 US bank for a commercial deal, we signed three Tier 1s, one retail, one commercial, and one was both of them. We had success on the lending side of the business. Jonathan just talked about the Helix win. So, the digital transformation is underway. We feel like we're well positioned to capitalize on that with the tools we have in the products and in the customer base.

The discretionary spending piece is really the piece where we're seeing the slowdown. And that's coming from, like I said earlier, the 190 customers above $5 billion in assets that are just being cautious. It's a complex environment out there and these guys are not risk-takers and they're going to make sure that there is a risk mitigation plan in place to make sure that they don't get themselves in trouble. And so, you'll begin to see they're preparing for charge-offs or losses there if they need to. But couple that with a tougher regulatory environment, they're just being cautious around those types of spend that they can control.

But other than that, the demand environment looks great. Our pipeline's up 50% year-over-year in the fourth quarter. So, there's a lot of positive trends in the pipe and the digital transformation – the need for digital transformations is as high as it's been in a long time.

Joseph Vafi
Analyst, Canaccord Genuity LLC

Q

Great. Thanks, guys. Thanks, Matt.

Matthew P. Flake
President, Chief Executive Officer & Director, Q2 Holdings, Inc.

A

Thank you, Joe.

David Mehok
Chief Financial Officer, Q2 Holdings, Inc.

A

Thanks, Joe.

Operator: We'll hear next today from Charles Nabhan with Stephens.

Charles Nabhan
Analyst, Stephens, Inc.

Q

Hi. Good afternoon, and thank you for taking my question. So, I wanted to get your comments on Europe. You're certainly not the first company to reference weakness in the area. And while I don't want to put words in your mouth, it almost sounded like you were referencing Europe as a potential area where you could pull back on some spend and focus some of your cost containment efforts. So, I guess with that, I was hoping you could just comment on how you think about the future in the region as well as what you're seeing there.

Matthew P. Flake
President, Chief Executive Officer & Director, Q2 Holdings, Inc.

A

Yeah, Chuck, I mean, for us, the demand environment's been tough since we've gotten into it with – in, I guess, January 2020, and before that it was cloud lending and then precision lender, it really slowed down and then it just continued to struggle with the economy and the war and the things that are going on. So, we made a decision to let go of some of the less profitable revenue and reduce the go-to-market expense. We're still focused on the customers we have there, supporting them in innovating on the product side. But it was a place where we made a decision to cut some cost out of the business.

But we're not giving up on it. We're just going to be a little patient on the demand side. The pandemic has taught us that we can do things remotely as well. So, it is a place where you got to make decisions like that in this environment. And so we've reduced our go-to-market expense there, and it's an opportunity for us to take care of customers and innovate. But it was an opportunity to find a way to save some money.

Charles Nabhan
Analyst, Stephens, Inc.

Q

Got it. And I know you've gotten a few questions on the margin guide, but if I look at what's implied by the midpoint for the fourth quarter, slightly below where we had previously expected despite the fact that third quarter came in a little higher than expected on EBITDA. So from that standpoint, I was curious, is that a function of lower transaction revenues going forward? Or how – could you maybe walk us through some of the puts and the takes and the drivers of that margin guide for the fourth quarter?

David Mehok
Chief Financial Officer, Q2 Holdings, Inc.

A

Yeah. Sure, Chuck. I mean, the way to think about it is we're – and I think Andrew or somebody referenced earlier, it's about $8 million call-down for the quarter. And the mix of that is going to be predominantly – and when I say predominantly, of the various buckets, about 40% is going to be based upon those services that are discretionary in nature. You've got about another third of it coming from transactional and the rest of it is coming from predominantly Europe. So, those are the three buckets to think about. And then there's different margin profiles for each one of those, respectively. And those are the results of the implied EBITDA guidance that we referenced earlier in the call.

Charles Nabhan
Analyst, Stephens, Inc.

Q

Got it. And if I could sneak in one more, it sounds like you've done a pretty good job on cross-sell over the past few quarters. And in the past, you've alluded to that as incrementally beneficial to the overall margin. So I'm just curious, as we think about 2023, you're cutting back on costs in certain areas, but could we presumably see a bit of a lift off from a business mix shift towards cross-sell over the next year or two?

Matthew P. Flake
President, Chief Executive Officer & Director, Q2 Holdings, Inc.
A

Yeah. Chuck, I think that a safe bet. We're doubling down on our customers, getting in front of them as much as we can. We have a lot of solutions that can solve a lot of the problems in digital transformation. We've got a great relationship with our customers. Our NPS scores are high as they've been in a long time. And so, cross-selling products into these customers, it was the game plan before the macroeconomic conditions. And so, you're seeing us really run that play nicely and the customer success team is doing a great job of it.

Charles Nabhan
Analyst, Stephens, Inc.
Q

Got it. Thanks again.

Matthew P. Flake
President, Chief Executive Officer & Director, Q2 Holdings, Inc.
A

Thanks, Chuck.

Operator: We'll move next to Alex Sklar with Raymond James.

Chase Donovan
Analyst, Raymond James & Associates, Inc.
Q

Hi. This is Chase Donovan on for Alex. Thanks for taking the question. I know you'd called out 3Q as being a large implementation quarter. Can you talk about how the go-lives are trending and how that is providing confidence in the outlook? Thanks.

David Mehok
Chief Financial Officer, Q2 Holdings, Inc.
A

Yeah. Sure, Chase. Yeah. Q3 was significant in terms of our go-lives. We had more in Q3 than we did in the entire first half. And that's the benefit of the bookings that we predominantly drove in the second half of last year and, to a lesser extent, in Q1. So with a continued bookings momentum, and Matt referenced some of those wins that we had this quarter, we expect to see those manifest in go-lives late next year. I mean that the large enterprise opportunity that he referenced is one that's not going to go live until Q1 of 2024. So, great for the long-term prospects of the business, but you don't start to see some of those larger ones go live until later next year.

Chase Donovan
Analyst, Raymond James & Associates, Inc.
Q

Perfect. Thanks.

Matthew P. Flake
President, Chief Executive Officer & Director, Q2 Holdings, Inc.
A

Thank, Chase.

David Mehok
Chief Financial Officer, Q2 Holdings, Inc.

A

Thanks.

Operator: We'll move next to Pete Heckmann with D. A. Davidson.

Pete J. Heckmann
Analyst, D. A. Davidson & Co.

Q

Hi. Thanks for taking my questions. So just to be clear, when you think about transactional revenue and disaggregating it a little bit, is it are you seeing the actual declines in users, in accounts within some of your Helix relationships? Or is that something that you're more predicting? And then, on the bill pay side, is it both the dynamic of your large institutions contracting directly for bill pay with some of the larger bank tech companies as well as existing active digital banking users paying less bills through a bank aggregator's website.

Matthew P. Flake
President, Chief Executive Officer & Director, Q2 Holdings, Inc.

A

Yeah. Hey, Pete. I'll take the bill pay thing and let JP or David take the Helix. Really, what we're seeing on bill pay is the number of payments an individual makes reducing. So, you see the consolidation of people paying fewer cable companies or your cable company, maybe your cell phone company. So, I think for a while there, you were saying every refinance and every mortgage had a direct payment that was set up on it, so you started to lose [ph] those. So, you're just seeing (00:35:59) that the reduction in the number of payments people make through bill payment reduced – going down, plus you have P2P services that eliminate potentially paying landscapers or handymen around the shop. So, that's what you're seeing on the bill pay side largely. And do you want to take the Helix?

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

A

Yeah. And on the Helix side, Pete, what I'd say there is, it's more that what we're seeing is existing customers shift the focus of their spend away from acquiring new customers towards making them more profitable. So, the impact on transactions there is more just relative to expectations, we're seeing fewer net user adds and there's an attach rates that comes with the number of users and, therefore, the resulting transaction. So, we're not seeing number of users decline. We're not seeing number of transactions decline. It's just the pace at which the user adds are coming in and what they're spending their dollars on, they're shifting towards the profitability of these programs. And that impacts our plan in terms of the flow through of that transactional revenue, if that makes sense.

Pete J. Heckmann
Analyst, D. A. Davidson & Co.

Q

Yeah. Okay. That's helpful. And then just one follow up on the M&A that you've seen within your customer base, decisions have been made so far, are they pretty consistent with your expectations over the last couple of quarters that you have felt pretty well-positioned to win on the consolidations amongst some of the banks and credit unions in your customer base?

Matthew P. Flake
President, Chief Executive Officer & Director, Q2 Holdings, Inc.

A

Yeah, absolutely. I mean, we're certainly seeing the benefits of those when they are getting approved, but that's a big but, right, and that's something that we talked about last call was that we're seeing delays in the regulatory approval process when they are going through the approval process. So, we're seeing the benefits as we have anticipated, generally speaking. And you're probably seeing this, Pete, we're seeing the slowdown as well in recent M&A activity, in general. We were seeing about 28 a month in the industry in Q1, that's down about 18 a month last quarter. So, we still expect to see some benefits later in next year regards to some of those that we talked about earlier in the year. But given the elongated regulatory process, it's just taking us longer to see the revenue associated with it.

Pete J. Heckmann
Analyst, D. A. Davidson & Co.

Q

Okay. I appreciate it.

David Mehok
Chief Financial Officer, Q2 Holdings, Inc.

A

Thanks.

Matthew P. Flake
President, Chief Executive Officer & Director, Q2 Holdings, Inc.

A

Thanks, Pete.

Operator: We'll hear now from Parker Lane with Stifel.

Jeffrey Parker Lane
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Yeah. Hi, guys. Thanks for taking the question. Curious, when you look at the downtick in discretionary spending and weaker transactional and services revenue, is that something you encountered from the start of the quarter or is that something that popped up later on towards the end of the quarter? Thanks.

David Mehok
Chief Financial Officer, Q2 Holdings, Inc.

A

Yeah. Parker, it really started towards the middle of the quarter and we immediately took proactive actions in regards to making sure that we were focusing on some areas of what we do control, and that's cost. And as we looked into Q4, we looked deal by deal at the pipeline and saw some of those opportunities start to push out or at least get delayed. We don't know how long those delays are going to be. And as a result, we've given you what we truly believe is the Q4 outlook for the revenue associated with that. And then we've extrapolated that into what we believe to be a reasonable growth rate on that discretionary business into 2023, incorporated into that high level outlook we provided.

Jeffrey Parker Lane
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Got it. And I know it's very early and we're not even in 2023 yet, but from your initial conversations with customers, is their expectation that the current conditions persist through all of 2023 or is there some hope that maybe we end up stabilizing midway through the year and maybe the back half of the year looks a little bit better?

Matthew P. Flake
President, Chief Executive Officer & Director, Q2 Holdings, Inc.

A

Parker, It's one of those things where I think there is so much going on right now that everybody is – trying to predict what's going to happen next summer is a little tough. So, I think, right now, people are just trying to focus on the information that's coming in and making the best decisions they can. I haven't had a lot of conversations. I think most people would argue that for the consumer, it's going to get tougher in the back out the 2023 not easier, based on what you're seeing with jobs and inflation and interest rates. But it's an environment that our customer base takes a step back and becomes pretty conservative. And that's what you see in the discretionary spending that's going on.

Jeffrey Parker Lane
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Got it. Appreciate it, guys. Thanks for taking the question.

Matthew P. Flake
President, Chief Executive Officer & Director, Q2 Holdings, Inc.

A

Yeah. Thanks, Parker.

Operator: And with that, that will conclude today's conference. We do thank you all for your participation and you may now disconnect.