

Q2 Holdings, Inc. NYSE:QTWO

FQ2 2024 Earnings Call Transcripts

Wednesday, July 31, 2024 9:00 PM GMT
S&P Global Market Intelligence Estimates

	-FQ1 2024-			-FQ2 2024-	-FY 2024-	-FY 2025-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.28	NA	NA	0.32	1.44	NA
Revenue (mm)	163.38	NA	NA	170.99	689.77	NA

Currency: USD
Consensus as of Aug-01-2024 3:53 AM GMT

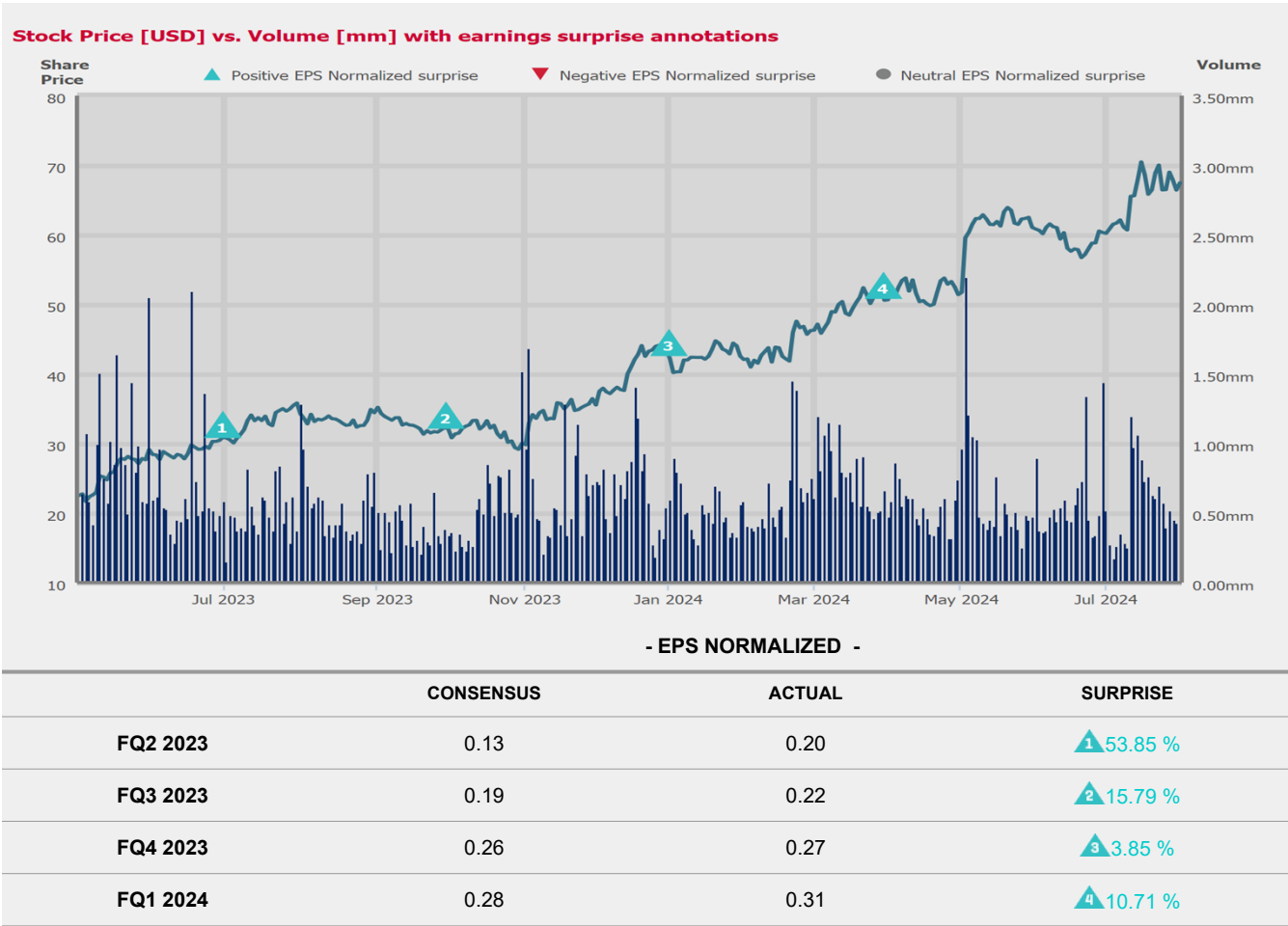


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Call Participants

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Presentation

Operator

Good afternoon. My name is Alex, and I will be your conference operator today. At this time, I would like to welcome everyone to the Q2 Holdings Second Quarter 2024 Financial Results Conference Call. [Operator Instructions] Thank you.

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

Josh Yankovich *Investor Contact*

Thank you, operator. Good afternoon, everyone, and thank you for joining us for our second quarter 2024 conference call. With me on the call today are Matt Flake, our CEO; David Mehok, our CFO; Jonathan Price, our Executive Vice President of Strategy and Emerging Businesses; and Kirk Coleman, our President, who will join us for the Q&A portion of the call.

This call contains forward-looking statements that are subject to significant risks and uncertainties, including, among other things, with respect to our expectations for the future operating and financial performance of Q2 Holdings and for the financial services industry. 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 for the second quarter of 2024 and subsequent filings and the press release distributed this afternoon regarding the financial results we will discuss today.

Forward-looking statements that we make on this call are based on assumptions only as of the date discussed. Investors should not assume that these statements will remain operative at a later time, and we undertake no obligation to update any such forward-looking statements discussed in this call. Also, unless otherwise stated, all financial measures discussed on this call will be on a non-GAAP basis. A discussion of why we use non-GAAP financial measures and a reconciliation of the non-GAAP measures to the most comparable GAAP measures is included in our press release, which may be found on the Investor Relations section of our website and in our Form 8-K filed today with the SEC.

We have also published additional materials related to today's results on our Investor Relations website.

Let me now turn the call over to Matt.

Matthew P. Flake *CEO & Chairman of the Board*

Thanks, Josh. I'll start today's call by sharing our second quarter results and highlights from across the business. I'll then hand it over to Jonathan to provide more insights into our strategy and emerging businesses. David will then discuss our financial results and guidance in more detail.

In the second quarter, we generated strong financial results that exceeded the high end of our guidance. We generated non-GAAP revenue of \$172.9 million, up 12% year-over-year. We saw continued strength in subscription revenue, which was up 17% year-over-year, and we had another quarter of solid improvement on profitability with adjusted EBITDA of \$29.9 million or 17% of revenue, and we delivered free cash flow of \$28.8 million.

In addition to the strong financial performance, we continued to deliver good sales results in the quarter. We saw a balance of Tier 1, 2 and 3 sales activity, which was highlighted by 6 Tier 1 deals, including an enterprise win. On the net new digital banking side, we're pleased with how we performed in the quarter, where factors like our single platform, strength in commercial and Q2 Innovation Studio continue to differentiate us in the market.

One of our Tier 1 wins in the quarter exemplified all 3 of those differentiators. The \$6 billion [indiscernible] will use Q2's platform to replace multiple incumbent solutions and consolidate to our single platform for retail, small business and commercial. And they have plans to use Q2 Innovation Studio as a means to deliver more innovation to their customers.

In addition to the digital banking wins, we also won a meaningful net new relationship pricing deal in the quarter with the Tier 1 bank that purchased our relationship pricing platform to support both commercial loan and treasury pricing across our institution.

On the expansion side, we had several noteworthy wins in the quarter with a couple I wanted to highlight specifically. The first came by way of an M&A transaction. We recently had a Tier 2 customer announced a strategic merger. During the quarter, our current customer put the Q2 platform hedge to optimally price their treasury services. At the same time, they expanded their original loan pricing agreement to make our solutions available to more of their commercial lending staff.

This is a customer which 7 years into their Q2 relationship is still aggressively expanding its usage of our relationship pricing solutions. And given our coverage with enterprise institutions in this space, we believe we have a substantial overall expansion opportunity here.

It's also a great example of another relationship pricing customer utilizing our solutions not just for lending, demonstrating the broad application of our relationship pricing solutions, especially in a more challenging lending climate.

In summary, we're pleased with another quarter of well-rounded sales performance. With several consecutive quarters of strong sales activity, we believe it's clear that banks and credit unions are continuing to prioritize technology investments that the demand environment remains strong. And we continue to view the strength and diversity of our customer base as an asset to Q2. We are 58% of the Forbes top 100 banks from the recent rankings and 42% of their top credit unions. Our quality customer base serves to insulate our business and position us well in terms of expansion opportunity and in the event that M&A picks back up in the space.

Another major highlight from the quarter was our annual customer conference, Connect, which builds our momentum heading into the second half. At Connect, we shared our strategic product road map and innovation priorities with customers and prospects, [indiscernible] in consumer banking so that they can better compete [for] acquire and retain deposits.

With Q2 Engage, we are bringing all of our consumer capabilities under one solution, umbrella and merit. In doing so, we'll enhance our consumer value proposition, make it easier for financial institutions to see all they can do with us on the consumer side, and ultimately drive further differentiation with our consumer digital banking and surrounding solutions.

Another key thing that customers were eager to hear about was the practical application of artificial intelligence and more specifically, generative AI across Q2 Solutions. We shared a holistic AI product strategy at the conference, which includes plans to implement our Andi Copilot within banker-facing products across our portfolio. One example we announced is the addition of Andi to our Centrix products for risk and fraud management.

The bankers can interface with Andi to improve the risk reviews, streamlined disputes and enroll account holders in check fraud protections. We also shared a demo of our Andi Copilot early adopter program, which we are actively developing through a beta process with our customers.

The next generation of Andi Copilot is being designed to combine our deep knowledge of the banking industry with advanced large language model capabilities to tackle a range of new, high-value use cases for our customers.

While this program is still in the developmental and early adopter stage, the response from Connect only made it clearer customers are ready to partner with us to help them navigate the next wave of AI in banking.

And last but not least, it was a banner year for Q2 Innovation Studio at Connect. We had more fintech partners attend and take part in key components of the conference than ever. And for the first time, we had customers share their success stories on the main stage, giving their peers inspiration for new ways to leverage Innovation Studio, which Jonathan will discuss in a moment.

It's apparent that many customers want to leverage technology from the broader market and the breadth and maturity of our partner ecosystem are significant differentiators for us, and we're excited to continue expanding.

In conclusion, Connect '24 was our highest in person attended and most successful conference yet. It reinforced for us that our customers are deeply engaged. They plan to continue investing in technology and they're cautiously optimistic about the prospect of moderately lower interest rates. The buzz around Connect has contributed to the momentum we're bringing into the back half of the year with existing customers, prospects and fintech partners.

With that, let me hand the call over to Jonathan to cover a few key highlights from our emerging businesses.

Jonathan A. Price
Executive Vice President of Strategy & Emerging Businesses

Thanks, Matt. I'll start with Q2 Innovation Studio, which, as Matt mentioned, played a vital role in the success of our biggest customer event of the year. Connect reinforced what a critical role our partner ecosystem plays in helping our customers drive more and better innovation faster.

We have roughly 200 partners in attendance this year, who comprise the majority of our exhibit hall and we're deeply embedded in the event's contest alongside Q2's product team. As Matt mentioned, we also invited several customers on to our keynote stage to present some of the compelling business outcomes they're driving through creative use of Q2 Innovation Studio.

Take, for example, a \$13 billion bank in Texas that shared their experience at Connect. They're a long-term Tier 1 customer that uses the Q2 platform for retail, small business and commercial. In total, they watched 10 fintech partners via Innovation Studio with more in their near-term road map. And in particular, they're focused on driving growth into business segment, where they launched 3 SMB payment solutions in 1 year, far more quickly than would have been possible in a conventional delivery model.

The bank has used these services to drive a meaningful increase in revenue-generating business activity. For example, they've had 10,000 businesses enroll in an invoicing and payment service from our partner Autobooks and used it to drive 15,000 merchant credit card transactions.

And more than these aggregate results, the quality and speed of the partners is enabling the bank to compete for valuable new commercial clients in their markets. On the stage, this bank shared a story about winning our commercial prospect with \$35 million in deposits. This prospect needed a modern international wire solution urgently. So the bank worked with Q2 and PayRex, one of our Innovation Studio partners to deploy their solution in time to secure the deal, feeding out one of the national money center banks with which they were competing head-to-head. And this is just one of multiple commercial deals where they've used this ecosystem to differentiate and win.

On stage, their executive speaker concluded their session by saying, "We would never be able to execute this strategy without Q2 Innovation Studio." And these are just a few examples of the business outcomes financial institutions can drive. At Connect, we heard from financial institutions using it to reduce call volumes, grow deposits, create meaningful operating efficiencies and drive noninterest income.

On the main stage, one customer shared with their peers that in 2023, they estimated that they offset 50% of their digital banking spend through cost savings and revenue share by leveraging this model. This kind of potential is why Q2 Innovation Studio is helping us differentiate on the net new side, where it's been consistently cited as a key driver in almost all of our net new wins over the past several quarters.

And we're continuing to see growth in customer adoption and usage with now over 80% of our digital banking platform customers using it. And we expect the activity and stories from Connect to further accelerate adoption.

On the U.S. front, we had a solid quarter of activity in the fintech and brand space, highlighted by 2 net new wins and a major customer renewal. This strategic renewal was a great story. The customer in question is a major brand and top 10 Helix customer that has put forth an aggressive strategy to grow deposits and accounts in 2025 in order to fund the growing lending business.

Historically, they've relied on the Helix score as the system of record for business checking and savings capabilities, an essential component of their offering that enables them to gather and benefit from customer deposits. In the renewal, they signed a long-term multiyear Helix extension and grew the bookings value of their relationship, recommitting to Helix as their platform of choice that they enter this next phase of growth.

This win provides a tremendous example of a brand that's investing in growing their BaaS strategy and doing so with Helix for its proven ability to operate effectively at scale.

With that, I'll hand it over to David to discuss our financials.

David J. Mehok
CFO & Principal Accounting Officer

Thanks, Jonathan. Our revenue and adjusted EBITDA results, above the high end of our guidance, we continue to see strength in subscription-based bookings, which is reflected in our ARR growth, and we delivered a significant increase in our free cash flow generation. I will now discuss our financial results in more detail and conclude with our updated guidance for our third quarter and full year 2024.

Revenue for the second quarter was \$172.9 million, an increase of 12% year-over-year and up 4% sequentially. Our total revenue growth was primarily from subscription-based revenues, which grew 17% year-over-year and 4% sequentially. The year-over-year and sequential growth was primarily driven by expansion sales with existing customers in addition to revenue from new customer go-lives.

As we mentioned previously, revenue generated from expansion opportunities, which consist of cross-sold solutions and improved financials on contract renewals, almost always have a quicker time to revenue compared to net new wins.

In the first half of the year, our revenue contribution from existing customers drove the majority of the subscription revenue overperformance we've observed. We continue to see a year-over-year decline in our services and other revenues, predominantly from our professional services revenues, which are more discretionary in nature. Based on the trends we're observing and our emphasis on targeting higher-margin growth opportunities, we would expect the level of decline of services in the first half of the year to continue for the foreseeable future.

Total annualized recurring revenue or total ARR grew to \$783 million, up 15% year-over-year from \$681.2 million at the end of the second quarter of 2023. Our subscription ARR grew to \$633.9 million, up 19% year-over-year from \$533.2 million in the prior year period. Our year-over-year subscription ARR growth was driven primarily from net new customer wins as well as expansion bookings with existing customers. Our total ARR growth was negatively impacted by a continued decline in professional services-based revenue.

Our earnings backlog of approximately \$2 billion, increased by \$38 million sequentially or 2% and a record \$426 million year-over-year representing 28% growth. The year-over-year and sequential increases were primarily generated from net new as well as additional solutions sold to existing customers and continued strength in renewals, where customers are adding new solutions and extending contract durations.

In addition, our year-over-year growth was positively by strong net new bookings performance over the last 12 months. As we mentioned previously, the sequential change in backlog may fluctuate quarter-to-quarter based on the number of renewal opportunities available within that quarter.

Gross margins were 55.7% for the second quarter up from 54.2% in the prior year period and from 54.9% in the previous quarter. The year-to-year increase in gross margin was driven by an increasing mix of higher-margin subscription-based revenues and increased efficiencies within our delivery and support functions.

Total operating expenses for the second quarter were \$73.8 million or 42.7% of revenue compared to \$72.9 million or 47.1% of revenue in the second quarter of 2023 and \$72.8 million or 44% of revenue in the previous quarter. The year-over-year decline in operating expenses as a percent of revenue came primarily from improved scaling of sales and marketing expenses relative to revenue. We also saw a year-over-year reduction in research and development expenses as a percent of revenue as we were able to drive efficiencies while accelerating innovation through our partner ecosystem. The sequential improvement in operating expenses as a percent of revenue was also driven by efficiencies within R&D as well as G&A.

As Matt mentioned in the second quarter, we hosted our annual client conference, Connect, which impacted sales and marketing expenses for the quarter by approximately \$1.5 million. Total adjusted EBITDA was a record \$29.9 million, up 69% from \$17.6 million in the prior year period, and up 18% from \$25.2 million in the previous quarter.

We ended the quarter with cash, cash equivalents and investments of \$372 million, up from \$338 million at the end of the previous quarter. We generated cash flow from operations in the second quarter of \$36 million, driven by improved profitability and continued effective working capital management.

For the quarter, we also generated free cash flow of \$28.8 million which is up meaningfully year-over-year from the \$3.7 million of free cash flow in the second quarter of 2023 and \$6 million in the previous quarter. This was driven by improved profitability and favorable working capital dynamics during the second quarter, some of which were timing related and may not persist at the same level in the third quarter. We still expect free cash flow as a percentage of adjusted EBITDA to be over 60% for the full year of 2024 with a target of continued expansion thereafter.

Also, you may have seen in [indiscernible] this afternoon in light of our strong financial performance over the past couple of years, including the significant enhancement of our balance sheet, we opened a revolving credit line to provide us with additional flexibility to strategically deploy capital over the long term to optimize our customer experience and shareholder returns. We have not drawn down on the revolver and our current plan remains to retire the remaining convert debt maturing in late 2025 and mid-2026, using existing cash from our balance sheet and free cash flow generation over that period of time.

Let me wrap up by sharing our third quarter and full year 2024 guidance. We forecast third quarter non-GAAP revenue in the range of \$171.5 million to \$174.5 million, and full year non-GAAP revenue in the range of \$688.5 million to \$692.5 million, representing year-over-year growth of 10% to 11% for the full year.

We continue to be optimistic about the demand environment, and we've seen stronger expansion based bookings this year than initially planned, which has accelerated subscription revenue growth for the full year of 2024. As a result, we now believe our subscription growth will be at least 15% for the year. This increased subscription revenue growth has given us even more conviction in our ability to deliver on our previously disclosed 3-year annual average subscription revenue growth target of 14%. And given this year's outperformance, we anticipate our subscription revenue growth rate in 2025 to be approximately 15%. We forecast third quarter adjusted EBITDA of \$27.5 million to \$29.5 million, and full year 2024 adjusted EBITDA of \$116.5 million to \$119.5 million, representing approximately 17% of non-GAAP revenue for the year.

In summary, our strong financial results for the second quarter and the upward revision of our full year guidance reflects our sustained focus on driving improved revenue mix, operational improvements and overarching profitable growth initiatives. Our subscription revenue growth and adjusted EBITDA margin for the second quarter put us well over the Rule of 30 on a subscription revenue growth basis, and we remain well positioned to achieve our previously communicated Rule of 30 target on a total revenue basis in the back half of this year.

We plan to continue to execute against our longer-term financial targets, encompassing strong subscription revenue growth, continued profitability expansion and cash flow conversion aligned with improving shareholder value.

With that, I'll turn the call back over to Matt for his closing remarks.

Matthew P. Flake
CEO & Chairman of the Board

Thanks, David. In closing, we had a great second quarter defined by continued strong sales success and financial performance. On the sales front, we continue to see a strong demand environment. We've put together several consecutive quarters of solid execution, both in terms of net new and expansion activity, demonstrating our competitive differentiation and a range of opportunities.

On the financial side, our better-than-expected results in subscription revenue, adjusted EBIT (sic) [adjusted EBITDA] and cash flow demonstrate our continued progress towards the long-term financial targets we shared at the beginning of this year.

As we enter the second half of the year, we feel good about the strength of our product, the continued positive demand environment and our growth and profitability profile. And we believe the strength of our customer base positions us favorably in the current economic environment.

With that, thank you, and I'll hand it over to the operator for questions.

Question and Answer

Operator

[Operator Instructions] And your first question comes from the line of Alex Sklar.

Alexander James Sklar

Raymond James & Associates, Inc., Research Division

David, starting with you. Just in terms of your comments about the 15% early look at 2025 subscription growth. We've now had 3 straight quarters of really nice subscription ARR growth that's [indiscernible] at that level. I appreciate there are still more -- a couple of more quarters this year to go. But can you just frame some of the puts and takes of why you kind of shift that 15% for next year as things stand today?

David J. Mehok

CFO & Principal Accounting Officer

Yes. Sure, Alex. And first, let me level set on the ARR. Yes, 3 straight quarters of it. If you look at the last 5 quarters and aggregate that, we're averaging about 17% and certainly that's the subscription growth rate that you saw this quarter in Q2.

We do sort of see a barbell approach to this. We're seeing some of the subscription strength in ARR manifest itself right now based upon the quick time to revenue around the expansion opportunities. And the other side of that barbell is, we had a lot of large deals in Q4 of last year and Q1 of this year. Those deals have a longer time to implementation. So they're not going to be going live until mid next year. And when you think about the impact that, that has on our subscription growth rate, you don't get a full year of that until 2026.

So we're certainly seeing the benefit of some of that ARR growth, the subs ARR growth that you referenced. Today, we're going to see some of that as well. Next year, but it really starts to stack up, and you're going to see the benefit of that as we exit next year. So hopefully, that helps bridge the gap between what you're seeing from an ARR standpoint on subs versus what we're seeing right now and then what we gave rough guidance for, for next year.

Alexander James Sklar

Raymond James & Associates, Inc., Research Division

Yes, I know it's a great color. So some of it is already benefiting now. Maybe just one more follow-up for you. Just in terms of gross margin, and I know you don't always split out the subscription gross margin, you called out really good expansion activity. You called out really good renewals as a positive over the last few quarters here. I know there's been a lot of work behind the scenes on the underlying infrastructure side. Can you just help frame where you think subscription gross margins kind of are today or could get to over the medium term relative to what you report on the blended number?

David J. Mehok

CFO & Principal Accounting Officer

Yes. And Alex, we've talked about this before. I think the target that we put out there around getting to 60 points of gross margin over the few years, through 2026 being the last one that we talked about, is still well within our cross hairs, if you will. We're doing a lot of things in regards to the way that we operate both in terms of implementation as well as in terms of support.

And that cost structure continues to improve. And we have plans in place to continue to drive efficiencies there over the coming years. And then the bigger driver of this, as you can imagine, is the subs that we just talked about. The mix up to subscription specifically is certainly benefiting the overall gross margin profile of the business. And to your question specifically on sort of what subs has the opportunity to get to. We've talked about this more. But when we go through a renewal process, and that implementation revenue rolls off, we're typically around 70 points of gross margin. So that's a good indicator of where we are from a sub standpoint, right now overall.

But obviously, we blend in those professional services, you blend in the implementation services and some of the transactional. That does put an overall drag on the gross margin profile. But -- we feel good about the progress that we've made around efficiencies. We feel good about the progress we've made on pricing and the mix to subs and feel like we're still on track for continuing to expand our gross margins going forward.

Alexander James Sklar

Raymond James & Associates, Inc., Research Division

Congrats on the quarter.

Operator

Your next question comes from the line of Andrew Schmidt.

Unknown Analyst

This is David Wilczynski on for Andrew Schmidt. Well, you have exposure to a range of FI sizes with some legacy providers mentioning a shifting focus towards smaller FIs. Have you seen an impact on win rates, the lower end recently? And there's also been a rollout of competing digital banking products lately, wondering if this has an impact either?

Matthew P. Flake

CEO & Chairman of the Board

Yes, we -- this quarter, we had a lot of success in the Tier 2 and the Tier 3 win rates where they historically been, if not a little better, as you work your way up the line. But we don't really focus on the size of the bank as much as the approach and the attitude the bank has towards technology taking a long-term view. We want banks that want to be in this for a long time and credit unions as well because they're the ones that are going to do the acquisitions, they're going to continue to grow.

So we don't really favor a certain asset side we more in favor of a management team or an ownership group that wants to use technology as a weapon and not as a shield. So no -- there's no change there. As far as other competitors, I haven't seen any newer competitors jump into the space that I know of. Every deal is a dogfight you got to go win it, but like I said, our win rates are where they've been historically, and we continue to do really well. So there will be new players coming in, and we'll be prepared for them. We still have a broad set of products and we solve a lot of problems with our single platform that a lot of other vendors can't address.

Unknown Analyst

And I know you've historically benefited from end market consolidation trends, typically landing on the acquiring consolidation to return to historical norms following the election? And is there any impact to the longer-term targets in the case of continued slower trends?

Matthew P. Flake

CEO & Chairman of the Board

That's hard to predict what's going to happen. Each administration will probably have a different view on acquisitions. So I'll probably just wait to see what happens with the election with that. But I think we're obviously doing really well. If you look at the numbers in the quarter and the win rates we're having. And so M&A would be -- if the historical trends kept up would be a tailwind for us if they picked up.

So -- it's just hard to predict what's going to have on that. I'm not really in a position to pontificate on who's going to win and what the results are going to be. So we'll know next quarter pretty soon around the earnings call.

Operator

Your next question comes from the line of Charles Nabhan.

Charles Joseph Nabhan

Stephens Inc., Research Division

Pretty high profile failure in the BaaS space this quarter, along with some increased scrutiny and comments from the Fed around the overall industry. So I was wondering if you could just comment on those 2 things. First, does that failure create opportunity for Helix? And then secondly, any thoughts you might have on the recent Fed announcement around BaaS.

Jonathan A. Price

Executive Vice President of Strategy & Emerging Businesses

Yes. Thanks, Chuck. It's Jonathan. I'll take both of these. When you think first about the vendor that you're mentioning, it certainly has created some noise in the space. I think we definitely see opportunity on the back of that. But what I'd say is we're going to be remaining very disciplined about the prospects that we look at and the opportunity set in front of us because as you look at some of

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the names of customers that have been mentioned publicly, it's not just small fintechs, it's a range of different brands and fintechs that have been impacted over the -- and that are around that situation.

So we're being really prudent about that. We're going to be careful and thoughtful about what type of customer makes sense for us. We mentioned one earlier this year that was conversion off one of those platforms. They've since gone live and been very successful on Helix. So we feel good about the opportunity set coming out of it. And I would just say like when you think about both our position as a vendor and the sponsor banks that are playing in the space. It is such a big differentiator actually being the core and that source of truth that the regulators can go in and do an audit the right way and be able to have both the bank, the fintech and all the related parties sort of comply and abide by a traditional regulatory process.

So that is a big differentiator for us. And when I look at our bank partners on Helix, they kind of view this in general as building a moat around their business because there was so much momentum around the space and everyone kind of wanted into it. And now people are seeing the pain that some of these FIs had to go through over the last 5 years to be ready for the vast space. And so we feel like it's not just us as a vendor that's differentiated, but our bank partners that are really experienced in this space.

And so to your second question, when we think about sort of evolution of the regulatory environment, that really comes down to where our banks play and how they play and own this business as a BaaS bank. And that's where, again, we feel like our partners are very aware of the regulatory environment and the pickup, in the focus by the regulators and are watching it closely, but really feel like, if anything, this will act as a way to weed out some of the players that are historically been playing in the space without really putting the rigor and discipline around building business around it. So they kind of view this as an opportunity for them just like we do as a vendor.

Charles Joseph Nabhan
Stephens Inc., Research Division

Got it. Okay. Appreciate that color. And as a follow-up, I know you said 60% free cash flow conversion for the year and that, that metric will come down in the third quarter. But -- could you comment on how we should think about the cadence for the back half of the year between the third and the fourth quarter for conversion? And then I guess on a related topic, were there any sort of transient or nonrecurring expenses associated with the conference this quarter that we should consider?

David J. Mehok
CFO & Principal Accounting Officer

Yes, I'll take the last one first, Chuck. Connect, the conference from last quarter was about \$1.5 million in terms of expenses that we incurred. The first question, which was around cash flow. So the seasonality of that, we do have some working capital things that normalize somewhat in Q3. So you'll see a dip and cash flow from operations as well as free cash flow in Q3, and then you'll see a seasonally strong Q4. Q4 is typically our strongest quarter of the year. And we don't anticipate that we're going to deviate from normal seasonality in that regard.

Operator

Your next question comes from the line of Terry Tillman.

Robert William Dee
Truist Securities, Inc., Research Division

This is Bobby Dee on for Terry. Where do you see demand generation and pipeline building most strongly between Tier 1s, Tier 2s, Tier 3s, et cetera, over the course of the back half of the year? And then I have one follow-up.

Matthew P. Flake
CEO & Chairman of the Board

Yes, Bobby Dee. I'd say it's -- it's strong in the Tier 2 space in particular and the Tier 1 is building back up. Remember, we won a lot of big deals. We fill -- had 6 Tier 1s in the quarter. But I think we should have a solid back half and that will include Tier 3, Tier 2s and Tier 1s. But the Tier 2 space on the banking and credit union side are pretty strong for us, especially those that are looking for commercial offerings to retain those deposits and grow them. And just -- it's tough to compete with us when with the breadth of products that we have right now. But I'd probably say that Tier 2 is the strongest. The Tier 1 is probably going to have a strong finish to the year.

Robert William Dee
Truist Securities, Inc., Research Division

Great. And then as a follow-up, we'd love to get an update on PrecisionLender, how is the demand for the product? And more specifically, how much back to base opportunity lies ahead for it?

Matthew P. Flake
CEO & Chairman of the Board

Well, I'll let Kirk chime in on kind of the premium treasury pricing and things like that. But we have seen kind of a consistency with PrecisionLender that we didn't see in '20 and '21. It started to pick up in late '22, I think. But you're really -- you're seeing -- we had a customer, has been a customer of us a long time, a top 10 North American financial institution. It did an expansion deal with us for premium treasury pricing. I like the pipeline, the way it looks for the back half of the year. It's -- there's a tremendous opportunity there because it's a very complex pricing market right now. So Kirk, do you want to add anything to that, you've been pretty involved in...

Kirk L. Coleman
President

So I think you nailed it, I mean, the -- it's never been as important right now that price your commercial relationships correctly, both to maximize the profitability, right? All of the banks are really watching their profitability carefully, but also to make sure they can retain those customers and that they're structuring these relationships and their deals well. We mentioned premium treasury pricing in the release, and we're seeing success with that. That's an important addition to our product offering. It really addresses 3 key revenue generators for banks: interest rate, fees, and services.

These are the most valuable customers at a bank, right, these big operating accounts in these commercial companies. And so we feel good about the demand there. Customers can buy premium treasury pricing on its own also that's different this year, and so we feel about the demand going forward.

Operator

The next question comes from the line of Matt VanVliet.

Matthew David VanVliet
BTIG, LLC, Research Division

We saw a pretty strong sequential growth in RPO here from first quarter to second quarter, which based on sort of the last several years. It was one of the first times you've had an actual sequential increase here.

So I guess the question is, is there something changing in the overall buying environment or the seasonality of the industry that you've sort of outmaneuvered here and outpaced? Or could we think about annual or I guess, throughout the year, bookings trends being a little more linear as you have a lot more expansion opportunities with such a large customer base?

David J. Mehok
CFO & Principal Accounting Officer

Matt, I don't think that it's anything that's necessarily [indiscernible] really solid execution on behalf of our teams across the organization because as I mentioned in the call, a lot of this is coming from what we call expansion. So expansion encompasses both cross-sell as well as renewals. And our ability to get more value out of renewals. And that includes everything from getting incremental term, to getting cross sales as well as getting better economic value per unit. They're doing a tremendous job, and this is probably about 6 straight quarters of doing this with every quarter getting a little bit better.

When you do that, as you know, the way backlog is calculated, if you can those things during a renewal, that's going to add significant backlog. And you saw that in Q2. You've seen it consistently over the last few quarters. I mean a year-over-year growth of \$426 million is a record, and that 28% is the highest rate we've seen in a long time.

And to your point sequentially, we're even up. And it's not anything unusual from a seasonal standpoint. It's just executing on our existing customer base and making sure that they're understanding the value and we're selling that value to them appropriately.

Matthew David VanVliet
BTIG, LLC, Research Division

And then as you look towards whether it's the second half pipeline or out into '25, how much if -- is there much of a difference in terms of contribution from existing customers on that expansion side versus net new customers? How do you balance that today versus where you've been maybe the last 6 to 10 quarters or so that as you look at it on a go basis?

David J. Mehok

CFO & Principal Accounting Officer

Yes. I don't think the mix changes too much from what we've seen in the last couple of quarters. I mean, we're continuing to do really well on the net new side of things, but we're seeing great opportunities with expansion, not only with our long-standing customers, but with some of these wins that we had early last year, and we fully anticipate that some of the wins that we've had late last year and early this year, we're going to have some expansion opportunities with them a year from now.

So I think the mix is going to remain somewhat similar. I do think that the first half of this year, and I said this on the call, that the amount that we're getting from expansion is more than we anticipated. And that's why you're seeing the incremental subs growth this year.

And again, if you take a look at this year compared to next year, in aggregate, entering this year, we said that we were going to see 13% floor of subs growth. We're now up to 15%, that's a 200 basis point increase, obviously.

And when you look at the 2 years in aggregate, we're executing better than we had anticipated in terms of driving subs growth, and we thought we would be able to when we entered this year. So we feel really good about where we stand right now. And that mix component that you asked about, I would say, the first half is a good indicator of what we're going to look like going forward.

Operator

Your next question comes from the line of Parker Lane.

Jeffrey Parker Lane

Stifel, Nicolaus & Company, Incorporated, Research Division

Matt, earlier you talked about being pleased with net new performance. I was wondering at this stage of the digital transformation in the industry you play in, is there any particular common themes you're seeing with the net new wins out there? Are there 2 to 3 main pain points? Or is it a variety of different outcomes that you're looking to achieve there?

Matthew P. Flake

CEO & Chairman of the Board

Yes, Parker, I think it's -- we've covered this before, but after the pandemic, you drove so much more utilization of the products. And the products that weren't updated didn't build features, there wasn't a lot of investment in R&D. It's just difficult for them to stay on those products.

And that's driving the demand environment plus the importance of having a commercial banking solution that's competitive that you can retain and grow your deposits, those most profitable and stickiest deposits they have. So the theme we've had continues, and I think you're going to continue to see that as we move forward.

And there's too many things that list on our earnings call that are differentiators for us. But we've put a lot in the innovation over the last 20 years, but in particular, over the last 10 into our commercial banking products, getting better with getting deeper functionality for larger corporates. We're hearing stories of our product being the Wells Fargo, CEO product in the marketplace, the Chase product, the Bank of America product, so they're taking customers away from them. That news travels pretty fast. We take good care of our customers, and we have a culture where people wake up every day and we want to help our customers win. So that combination, I think, is working for us. And if I look at the pipeline as long as we continue to do those things, I think we continue to see the success we've had.

Jeffrey Parker Lane

Stifel, Nicolaus & Company, Incorporated, Research Division

Got it. And David, a quick one for you. Services is clearly an area that you're facing some headwinds. Is there any potential time line for that to sort of bottom out or normalize relative to the challenges you faced in the last 18 months or so?

David J. Mehok

CFO & Principal Accounting Officer

Yes, Parker, I used the term foreseeable future for a reason. I mean, based on what we know today, we expect the rate of decline that you saw in that first half to continue. These contracts, about 2/3 of them, 70% of them are annual in nature. So we've got pretty good visibility over the course of the next 12 months. And what we've seen dry up is the net new I mean every year, if you go back 4 or 5 years, there's a certain amount of net new we were executing on -- that's no longer the case that's dried up fairly considerably and the existing customers have pulled back on some of the work that they're doing.

If you think about a couple of things in particular that have really gotten reduced. One is what we'll call vanity projects, right? Think about that as rebranding as an example, the website, the logo. They need our help to do those kinds of things. Those are discretionary in nature. They're not happening.

M&A, another one. You've heard out there, you've seen out there from an industry standpoint, M&A isn't at the same level as it was 2 years ago. If that picks up at some point in time, could there would then be a lag effect, and we could start to see that services pick up thereafter, but we're not seeing it yet.

So we don't anticipate, as I said, for the foreseeable future, that change. And then the final big ones is, as you know, we have a very large customer that we've talked about for a while that was acquired. And that services component of it, which was the vast majority of that revenue continues to bleed off. It's happening gradually over time. We're working with the acquiring entity, and we're trying to make sure that we make this experience as seamless as possible for them, but that continues to be a headwind as well from a services standpoint for us.

Operator

Your next question comes from the line of Adam Hotchkiss.

Adam R. Hotchkiss

Goldman Sachs Group, Inc., Research Division

Matt, I just wanted to dig a little bit more on the AI team. What are you hearing from financial institutions, [indiscernible] around their desire to adopt AI and GenAI, and what has historically been a risk of our space? And then how do you think about sort of your internal efforts like Andi Copilot versus how some of your fintech partners are using AI in Q2 Innovation Studio. Just any incremental color around that would be useful.

Matthew P. Flake

CEO & Chairman of the Board

Yes. Kirk, why don't you [indiscernible].

Kirk L. Coleman

President

Sure. So I would -- Connect in other meetings we've had with customers and say there's a lot of interest in AI, but they're taking a very measured approach in terms of how they think about it. But as you mentioned, they're very risk-averse. We look at it through a lens of being responsible, ethical and practical and they like that stance because they want to know that we understand how they have to answer to their internal risk committees and to their regulators when they think about doing new solutions.

So what that means is we're not doing black boxes. We're focusing on how can we embed efficiencies and new products that they might be already using. And then with that Andi Copilot, not really focusing on how do we make bankers more efficient by giving them assistance and advice in the right context and at the right time.

And so a lot of this also has to do with getting the right type of AI for the right situation because if we use GenAI as an example, that might be a great tool, but it's not appropriate for every single use case that a bank might be trying the [indiscernible]. So -- what we've found with our banks is that they're interested, they're accepting, they trust us as a partner. We have also an advantage from having a huge amount of data which makes a very big difference.

In the Andi Copilot, we're using also proprietary technology that we have that both reads and categorize data from documents from documents, from everything like a handwritten loan application all the way up to really complex financials, able to categorize that and make it useful for commercial bankers, which is kind of what that product that -- we're in beta with really focuses on, which is kind of reducing the workload, really some of the highest paid people in the bank, the commercial bankers. So we like the uptake and the interest that we have there. We like the collaboration we're getting from our customers. But as you mentioned, they continue to be kind of measured in terms of their -- how they assess the risk there.

Matthew P. Flake
CEO & Chairman of the Board

The last thing I'll mention on this front is that we, of course, are using it internally as well in terms of helping us drive efficiencies across our different teams, and that have things that we're in production with and using kind of our own teams, but all the ways that we're experimenting with that. So it's kind of a range of possibilities. I think we'll be talking about this for a while as that evolves.

And our Innovation Studio, our partners is just another great extension. It's just a really wonderful innovation story in terms of giving our customers a lot of different kinds of capabilities across more than 160 fintech partners in Innovation Studio, and we see a lot of opportunity there as well.

Adam R. Hotchkiss
Goldman Sachs Group, Inc., Research Division

Got it. That's incredibly useful. And then, David, I just wanted to follow up an earlier question. I appreciate the color on how the high-teens subscription ARR growth we've seen likely take some time to flow through the model. But how should we think about that within the context of the 14% 3-year subscription CAGR you've mentioned? Should we really be viewing that as more of a floor at this point? Or I guess, how do you think about the range of outcomes given your longer-term visibility into revenue and some of the strength recently?

David J. Mehok
CFO & Principal Accounting Officer

Yes. I mean we obviously feel good about the strength, right? We talked specifically about some of the drivers this year in terms of the incremental subscription revenue growth that we're seeing. And next year, maintaining that sort of 15% level, which we feel very good about as well.

We're not going to get into sort of the 3-year guide at this point in time. There's just a lot of things that we want to make sure that we're fully assessing particularly demand over the course of the next couple of quarters and heading into FY '25. So we'll revisit that when it's appropriate, but don't want to speculate yet on '25 and then changing that target from the numbers that we provided previously.

Operator

Your next question comes from the line of Dan Perlin.

Daniel Rock Perlin
RBC Capital Markets, Research Division

So I just wanted to revisit this expansion-based subscription being stronger than expected. It sounds like it clearly surprised you and is an incredibly important part to kind of the growth motion going forward. So I guess the first thing is just -- is it a function of like the internal team that had pivoted to kind of push in this direction? Or is it like the demand in the end market that seems to surprise you guys and like clients are pulling you in this direction?

Were there incremental product launches that may be tilted in this direction? I'm just trying to make sure I leave the call understanding exactly what's driving that because it sounds like it's going to probably be with you guys for a while and is important for the future growth.

David J. Mehok
CFO & Principal Accounting Officer

Yes. I think it's a little bit of all the above, Dan. So I'll touch on the first one, which is the execution one, which is the first example that you gave. The teams are incented more so than they were a few years ago. They had the tools available, more so than they did a few years ago. To go through a renewal process and be able to extract better economics.

And quite frankly, it's better aligning the value that we're driving. And over a 5-year contract, we're adding a lot of incremental features and a lot of incremental value to the solution. When we go through a renewal process, we're making sure that the teams do a good job of articulating that, showing that value to the customers and obviously, having nothing reflected in pricing.

Then you asked about products as well. Yes, part of it is market-driven in products, our Centrix products in risk and fraud are seeing great traction. And as you can imagine, from an industry-based standpoint, risk and fraud is top of mind for a lot of our financial

institution customers. And that is another example of a product that's very quick time to revenue, particularly as they're expanding their existing Centrix footprint.

So it's a combination of all of the above. It's -- the team is doing a great job of executing. It's having the right product set based upon where the market is going. And we do feel like we have the ability to continue and the teams are very focused on executing them.

Daniel Rock Perlin

RBC Capital Markets, Research Division

That's awesome. The other question is just around the guidance. If I did the numbers right, it looks like obviously, the 3Q number looks very similar in terms of kind of growth trajectory, what you just posted. But 4Q, I think it stepped down a little bit to 10% at the midpoint. And so I'm just wondering -- is that just a difficult comp? Is it conservatism? Are you seeing something in there? Is it maybe the commentary on professional services that kind of fall off a little bit harder. So anything around that would be helpful.

Matthew P. Flake

CEO & Chairman of the Board

Yes, sure, Dave. I'll sort of walk through it from a sequential standpoint, maybe that will help then obviously, we can bridge that to year-over-year if you still desire.

But if you look at it sequentially, the guide for Q3 represents sort of 1% to plus 1%. So roughly flat quarter-over-quarter. The reason why it's roughly flat is we do have seasonality of the Helix business. The Helix business is very focused on tax season in terms of revenue peaks. So obviously, we've exited tax season Q2 to Q3 is normally a seasonal decline.

The second one, are those professional services. So we talked about one customer specifically, FRB. We've also talked about, just broadly speaking, we're seeing pressure in that services business. And we know what's sort of going to be rolling off over the next 3 months. So that's what's embedded in the sequential minus 1% to plus 1% for Q3.

And then Q4, the embedded guide there is up 2% to 5%.

So good momentum into Q4 and actually from the Q3 baseline. So we feel like right now, we're giving you a good line of sight into what we see for the rest of the year based upon that guide. And it does have some seasonality to it. And that seasonality is pressured in Q3, and then we do see a ramp in Q4.

Operator

That will be all for our Q&A session. Ladies and gentlemen, that concludes today's call. Thank you all for joining. You may now disconnect.

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