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Q2 Holdings, Inc. (QTWO)

Q4 2022 Earnings Call

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CORPORATE PARTICIPANTS

Josh Yankovich
Director-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.

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

Terry Tillman
Analyst, Truist Securities, Inc.

Alexander Sklar
Analyst, Raymond James & Associates, Inc.

Robert Napoli
Analyst, William Blair & Co. LLC

Charles Nabhan
Analyst, Stephens, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, everyone. My name is Lisa and I will be your conference operator today. At this time, I would like to welcome everyone to the Q2 Holdings' Fourth Quarter and Full Year 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. [Operator Instructions] Thank you.

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

Josh Yankovich

Director-Investor Relations, Q2 Holdings, Inc.

Thank you, operator. Good morning, everyone, and thank you for joining us for our fourth quarter and full year 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 these 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 Annual Report on Form 10-K filed today and subsequent filings, and the press release distributed this afternoon regarding the financial results we will discuss today.

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

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

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

Thanks, Josh. I'll start today's call by sharing our fourth quarter and full year results and highlights from across the business. I'll then hand the call over to Jonathan to give you more insights into the Emerging Businesses organization he oversees. David will then discuss our financial results in more detail as well as guidance for the first quarter and full year, before I conclude with a look ahead to 2023.

In the fourth quarter, we generated non-GAAP revenue of $146.7 million, up 11% year-over-year and up 1% sequentially. We generated adjusted EBITDA of $8.4 million, representing 6% of non-GAAP revenue. As mentioned in our press release, we had a mutual termination of a contract in the quarter with an international alternative finance customer, impacting revenue by $3.1 million and adjusted EBITDA by $3.9 million. David will further discuss the impact that this had on our financial results, but I want to emphasize that this outcome will positively contribute to margin expansion in 2023. Outside of this impact, I'm pleased with the strong financial results from the quarter.

With that, let me start by looking back at 2022. Rising interest rates, high inflation and other global influences created a complex operating environment that impacted communities, our customers and Q2. Even in the face of an uncertain economy, we executed well across the company, and our performance demonstrates the resiliency of our business model and while we believe we're positioned to deliver attractive growth with meaningful profitability expansion going forward.

First, we have a mature, differentiated product portfolio that allows us to capture technology spend on both the deposit and lending sides of the financial institutions' balance sheet. We believe this gives us a substantial addressable market and positions us to weather cyclical changes in the banking industry, like in the current rising rate environment where financial institutions are prioritizing deposit growth and managing fluctuations in loan demand.

Second, the bulk of our revenue comes from our digital banking contracts, which are largely subscription-based, higher margin and have an average length of over five years. So, in spite of recent headwinds within transactional revenue and slowing discretionary spend from some of our customers, the vast majority of our revenue is resilient, higher margin and predictable, and the demand for our solutions remains strong.

For the full year, we added 14 Tier 1 and five enterprise customers across the portfolio, exiting the year with more than 1,400 customers, and over 40% of the top hundred largest US banks and credit unions are utilizing at least one of our solutions. And when you look at our bookings performance in the past two quarters alone, it's clear to

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us that the financial institutions are continuing to prioritize digital transformation, a key reason we believe our subscription revenue growth will accelerate in 2023.

And finally, we've been able to quickly adapt to the changing economic environment and position ourselves to drive increased profitability. In the third quarter of 2022, we began to moderate our hiring, more effectively leverage our global workforce and rationalize certain business units, all to drive focus on our core strengths and highest return investment opportunities. In doing so, we delivered record free cash flow in the fourth quarter, and we believe we can deliver meaningful improvements to adjusted EBITDA and cash flow in 2023 and beyond.

Before I dive into the fourth quarter in more depth, I want to share a few key highlights from the full year. First, we supported customers through record levels of digital engagement in 2022, with more than 4.6 billion logins to our digital banking platform and our relationship pricing solutions were utilized to manage over $1 trillion in loans and $500 billion in deposits.

We also provided record system availability and security for our customers and continued to deliver meaningful product innovation throughout the year, with various aspects of our portfolio recognized as best-in-class by the likes of IDC, Aite-Novarica and Javelin. On the Emerging Businesses side, we gained substantial traction with customers and partners for Q2 Innovation Studio, our award-winning software development kit and partner ecosystem. Consequently, it's now consistently cited as a key driver and differentiator in both net new and expansion opportunities. And the Helix embedded finance team successfully navigated through a complex fintech backdrop, signing customers in new verticals, securing key renewals with some of our largest customers and supporting the launch of significant client programs.

And finally, as I alluded to a moment ago, we had solid sales execution throughout the year across our product portfolio. And our bookings performance improved with every quarter, culminating in a record-setting fourth quarter that I'll dive into now. Our sales performance was strong in Q4, both in terms of volume and breadth. We added the highest number of new customers in the quarter since before the pandemic. And in terms of booking value, it was the largest sales quarter in company history.

On the digital banking side specifically, we had a number of key wins, including a net new Tier 1 and the addition of several Tier 2 and 3 customers. I was particularly pleased with our performance in the Tier 2 space, which has historically been the sweet spot of the business. In fact, our largest booking from the quarter came from a Tier 2 bank that contracted for our end-to-end digital banking suite to serve its entire customer base, including retail and commercial.

I highlight this deal because the ability to serve both retail and commercial customers from a single platform continues to create a competitive differentiation for us. Because of the breadth of products included, this deal more closely resembles the bookings impact of a Tier 1 customer and is an example of how we've been able to grow the average sales price of our digital banking deals by over 80% within the last five years.

Additionally, nearly all of our digital banking deals from the quarter included or were driven by our commercial functionality. Commercial banking inherently presents complex needs that require dynamic solutions. And our use of investments in our modern commercial offerings have positioned us ahead of the curve, especially in this macro environment where financial institutions are looking to grow their deposit base, drive fee-based income and serve clients more cost effectively through their commercial portfolios.

Shifting to the lending side, we signed several deals across loan origination and relationship pricing, including two Tier 1 and two enterprise clients. As usual, these deals came from a mix of net new cross-sell and expansion

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wins. Although loan origination volumes are slowing, our relationship pricing tool supports several critical use cases for commercial bankers beyond just pricing new loans.

Today, our clients use our relationship pricing products to reprice and optimize their existing loan portfolios and even to price their treasury and deposit services. So, even in a rising rate environment where lending volumes may be pressured and financial institutions are prioritizing growth in other areas such as deposits, we believe we're well-positioned to generate continued demand based on our differentiated solution sets.

Our Emerging Businesses also had a solid quarter. Rounding out a strong year, we are excited about the investments we've made to bridge valuable partnerships between financial institutions and the technology ecosystem surrounding them. And we're pleased to see this side of the business continue to scale.

So now, I'll hand the call over to Jonathan to talk through these highlights in more detail.

Jonathan Price

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

Thanks, Matt. I'm extremely proud of the impact our Emerging Businesses had in the fourth quarter and then 2022 overall. I'll start with Q2 Innovation Studio highlights before shifting to Helix, our embedded finance business.

At a high level, Q2 Innovation Studio is our award-winning software development kit and comprehensive partner ecosystem that allows customers and third parties to easily develop and integrate within our digital banking platform. In doing so, it helps our customers deliver new innovation quickly, drive deeper engagement to differentiation and add new fee-generating products to their digital offerings. 2022 was the first full year in market for Q2 Innovation Studio and its early traction leads us to believe that it will be a key contributor to our growth and improved profitability going forward.

First, Q2 Innovation Studio has proven to be a considerable differentiator for our digital banking platform, playing a vital role in our land-and-expand strategy. In 2022, it was cited as a key driver of over 80% of our net new digital banking wins. We also saw substantial adoption with existing customers. In the fourth quarter alone, we had over 20 existing financial institution customers adopt Q2 Innovation Studio, and we exited the year with over two-thirds of our digital banking customer base leveraging it.

Second, we believe Q2 Innovation Studio helps drive engagement and stickiness with our customers. Our large partner ecosystem enables financial institutions to add a vast array of unique digital solutions to their platform that embeds them more deeply into the financial journeys of their consumer and business customers. The more solutions customers add, the more integral our digital banking platform becomes for them and their account holders. And as hundreds of our customers and their millions of end users increasingly leverage this partner ecosystem, we believe Q2 Innovation Studio has the long-term potential to positively impact our overall churn rate.

And finally, by opening up our platform to customers, development partners and third-party technology providers, Q2 Innovation Studio creates an ecosystem in which all participants can drive meaningful product innovation across our digital banking platform. As of the end of 2022, we have more than 1,000 external developers coding to Q2's digital banking platform, more developers than our entire engineering organization.

During the fourth quarter, we added another 12 technology partners, meaning we now offer more than 100 pre-integrated solutions through Q2 Innovation Studio. And we're starting to see much deeper utilization. Since its launch, customers signed more than 400 partner applications from Q2 Innovation Studio for their digital banking

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environments. And as our customers continue to adopt and utilize these new solutions, we participate in a usage-driven revenue share, which we expect to drive higher margin revenue for the business over the long-term.

We built a strong foundation in 2022. We now have a robust best-in-class partner ecosystem. A vast majority of our digital banking customers have Q2 Innovation Studio in place and they are increasingly deploying these third-party technology applications to their account holders. And as we've increased our focus on profitability, this new model is evolving how we innovate, giving us a powerful way to deliver product innovation cost effectively through the digital banking platform. So, in 2023, we expect to see more of Q2 Innovation Studio's long-term potential begin to materialize for our business.

Now I'll move over to Helix, our embedded finance business that enables fintechs and brands to offer banking products to their customers directly. We began 2022 by launching the Helix brand in February. And over the course of the year, the launch proved successful in driving awareness of the platform, establishing product differentiation in the market and meaningfully growing our pipeline. But 2022 wasn't without its complexity. The changing economy and shifting market expectations drove many fintechs and brands to rapidly reprioritize their strategies away from growth and towards driving profitability which, in turn, created uncertainty in the demand environment.

In spite of a challenging backdrop, we executed well across the business, and there are several key aspects of our model that we believe position us for success in this new paradigm. First, our go-to-market strategy is focused on large, established companies and not just fintechs, but major brands in verticals like insurance, wealth management and retail. As a result, our customer and revenue base are primarily comprised of large organizations that have been committed to their embedded finance strategies and are relatively more insulated from cyclical changes in market conditions.

And throughout the year, we secured strategic long-term renewals with our largest customers. One of the wins in the fourth quarter was with an existing Helix client that was acquired by a much larger brand. And after owning the business for a few months, the acquiring company decided that Helix was the right embedded finance provider to support the strategic line of business through a new phase of growth, and they signed a multi-year renewal. Securing long-term renewals is critical for a few reasons, especially in this climate. It demonstrates the client's commitment to their Helix-powered programs in spite of economic conditions, and it gives us the opportunity to continue growing with them.

Second, we have a demonstrated track record of helping our customers drive both revenue and profitability. And in 2022, in response to the shifting market dynamics I mentioned previously, we quickly launched new functionality designed to help customers drive more profitable and sustainable programs, including personalized admin capabilities to facilitate collaboration between our clients and their partner banks, granular card controls that drive user engagement and enhanced fraud prevention to curb fraud losses.

And finally, we believe our ability to support large client programs at scale will remain critical to the fintechs and brands we target. Through several significant client launches with some of the largest fintechs and brands in the United States, we now support over 13 million end users on the Helix platform.

In closing, 2022 was a year where we've renewed multiyear agreements with key Helix clients, our product differentiation in the market became clearer and the pipeline was strengthened. And while market challenges remain, I believe Helix is well-positioned to navigate this environment successfully in 2023.

Thank you. And with that, I'll hand the call over to David for a detailed look at our financial results.

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David Mehok

Chief Financial Officer, Q2 Holdings, Inc.

Thanks, Jonathan. Before I begin more detailed commentary on our financial results, let me first provide some clarification and quantification around the impact observed in the quarter from the contract termination Matt previously mentioned. The results of this termination were a reduction of $3.1 million in revenue related to the contract asset and outstanding receivables balance, in addition to approximately $700,000 of cost of sales expenses and $160,000 of operating expenses from previously deferred commissions. As a result, the net impact is a reduction to adjusted EBITDA of approximately $3.9 million for the quarter.

I will discuss our financial results and, where appropriate, note the impact to our results from this termination. We are also factoring in the positive impact this development will have on our margins in our 2023 outlook, given this engagement was dilutive to our overall margin profile. Focusing our efforts and resources on margin-accretive growth opportunities is an important aspect of our outlook as we look to optimize for profitable growth going forward.

Moving to our results, we're encouraged by the continued market demand for our solutions, our booking success and the efficiencies we're driving, which are positioning us to expand margins and generate more cash flow. Total non-GAAP revenue for the fourth quarter was $146.7 million, an increase of 11% year-over-year and up 1% sequentially. Total non-GAAP revenue for the full year was $566.3 million, up 13% from the prior year. The year-over-year and sequential increases for the quarter were primarily driven by an increase in subscription revenue associated with the deployment of new customers and continued organic growth from existing customers.

As I previously mentioned, the impact to revenue of the contract termination was $3.1 million. Our subscription revenue for the year was 73% of our total revenue, representing year-over-year growth of 14%. Based on the strength we have seen in our subscription-based bookings, we expect our subscription revenue growth will accelerate for the full year of 2023.

For the fourth quarter, services revenue was in line with our expectations entering the quarter. As we discussed previously, we're continuing to monitor professional services engagements associated with projects that are more discretionary in nature, some of which have been and could continue to be suppressed in the current macroeconomic environment.

Transactional revenue represented 11% of total revenue for the quarter, down from the prior-year period of 13% and consistent with the previous quarter. For the full year of 2022, transactional revenue represented 12% of total revenue, which is down from the prior year at 14%, due in part to a decline in revenue generated from our bill pay products. Based on the trends we're observing in our transactional business, our full year 2023 outlook anticipates the growth rate of our overall transactional revenue stream to be similar to what we observed in 2022.

We added approximately 200,000 users during the quarter, ending the year with over 21.1 million registered users, an increase of nearly 2 million users or 10% year-over-year. The sequential increase was largely driven by organic user growth. The year-over-year increase was attributable to organic user growth throughout the year and new customer go-lives largely concentrated in the second half of the year.

Looking to 2023, we anticipate an increasing mix of the number of customer go-lives on our commercial banking platform as a result of the strong bookings in the second half of 2022. As we discussed in the past, commercial go-lives carry a lower number of users compared to our retail go-lives, but also drive a higher revenue per user.

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Annualized recurring revenue, or ARR, grew to $655.2 million, up 14% year-over-year from $574.2 million at the end of 2021. Our ARR growth for the year was driven largely by new and cross-sell subscription-based bookings, partially offset by a decline in transactional revenue. In addition, we observed ARR growth resulting from increasing subscription run rates associated with existing customers. ARR was also up 3% sequentially from the third quarter, primarily due to booking strength observed in the fourth quarter.

Our ending backlog of approximately $1.5 billion increased by $104 million sequentially or 7% and equated to a 6% increase year-over-year. The sequential increase was driven by our strongest bookings quarter of the year across both net new and renewals. The year-over-year increase in backlog was primarily attributable to net new bookings.

As a reminder, the biggest driver of changes in backlog are net new bookings and renewals. Renewals are subject to seasonality as well as the number of opportunities in target. As a result, whilst possible we could see a sequential decline in backlog in any given quarter due to less renewal opportunities being available, we believe we will deliver year-over-year backlog growth for the full year of 2023.

Our trailing 12-month net revenue retention rate for 2022 was 110%, down from 119% in 2021. Our net revenue retention rate is calculated by taking the total revenue growth in the calendar year compared to the prior year for any customers that were implemented on any of our solutions in that prior year. The most significant drivers of change in our net revenue retention rate each year had been the number of new customers in the prior year and the timing of implementations of those new customers. As we previously discussed, given the reduced number of go-lives we had take place in 2021, particularly in the back half of the year, we anticipated that our rates would come down in late 2022.

Our revenue churn for 2022 was 6.3%, up from 5.4% in 2021. The increase in revenue churn was concentrated within our nonfinancial institution customers, including the contract termination during the quarter which added roughly 50 basis points to our total revenue churn. This was partially offset by a reduction in the year-over-year churn associated with our digital banking customers.

Gross margins were 51.5% for the fourth quarter and 51.6% for the full year. The contract termination negatively impacted gross margins by approximately 150 basis points for the fourth quarter and 30 basis points for the full year. This impact was partially offset by a reduced mix of lower margin pass-through revenue and the benefits from continued productivity improvements in areas of expense reduction.

Total operating expenses for the fourth quarter were $72.7 million or 49.5% of revenue, compared to $61.5 million or 46.5% of revenue in the fourth quarter of 2021, and $69.8 million or 48.2% of revenue in the third quarter of 2022. The fourth quarter year-over-year increase in operating expenses as a percent of revenue was driven primarily by the onboarding of additional employees concentrated within R&D as well as sales and marketing during the first half of the year.

In addition, we saw an increase in marketing events and travel compared to the prior-year period, as in-person events became more prevalent coming off of COVID restrictions in the prior year. The increase in operating expenses as a percent of revenue from the previous quarter was partially driven by employee expenses associated with the acquisition of Sensibill, which took place on October 3. We ended the year with 2,249 employees, up from 2,028 at the end of 2021, with the vast majority of hiring taking place in the first half of the year. As a result of our proactive cost measures, we observed a net reduction in head count for the final five months of the year.

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Total adjusted EBITDA was $8.4 million for the fourth quarter and $36.9 million for the full year. The contract termination negatively impacted adjusted EBITDA by $3.9 million for the fourth quarter and full year 2022. The year-over-year and sequential change in adjusted EBITDA saw a meaningful benefit from the effective utilization of our global workforce, reduced hiring activity and lower contractor expenses, as well as reduced facilities expenses. We ended the year with cash, cash equivalents and investments of $433.4 million, up from $395.7 million at the end of the third quarter.

Our CapEx spend as a percentage of revenue for the full year was approximately 2%, a reduction from the 4% observed in the prior year as we had lower infrastructure and facilities expenses. We generated cash flow from operations in the fourth quarter of $43.9 million. The strength in operating cash flow was primarily attributable to good working capital management and favorable seasonality. We also generated free cash flow of $38.4 million during the quarter. For the full year, we generated cash flow from operations of $36.6 million and free cash flow for the full year of $6.5 million. We believe this record performance and continued focus on higher profitability will translate into continued improvement in our cash flow conversion for the full year of 2023.

Let me wrap up by sharing our first quarter and full year guidance. We forecast first quarter non-GAAP revenue in the range of $149 million to $152 million and full-year non-GAAP revenue in the range of $632 million to $640 million, representing year-over-year growth of 12% to 13%. With the strength in subscription-based bookings in 2022, we anticipate our revenue for the full year of 2023 will have an increased mix of this higher margin revenue stream. We forecast first quarter adjusted EBITDA of $10 million to $12.5 million and full year 2023 adjusted EBITDA of $62 million to $66 million, representing approximately 10% of non-GAAP revenue for the year.

Looking ahead, I believe we're well-positioned to deliver profitable growth towards our goal of being a Rule of 30 company in late 2024, which we define as a combination of total non-GAAP revenue growth and adjusted EBITDA margin. In summary, for the fourth quarter, we delivered solid revenue results and generated record operating and free cash flow for the full year, resulting in a strong balance sheet entering 2023. We feel confident in our ability to show meaningful adjusted EBITDA expansion in the years to come.

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

Matthew P. Flake

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

Thanks, David. In closing, we ended the year with our best bookings quarter in company history and entered 2023 with a robust pipeline, suggesting that financial institutions continue to prioritize technology spend and our differentiated product portfolio is resonating with the market. We are hyper-focused on delivering the best customer experience and we believe the investments we've made in prior years have positioned us favorably to continue delivering best-in-class innovation for our customers and capitalize on the substantial market opportunity ahead of us. We plan to continue managing the business with an increased emphasis on improving profitability, while maintaining a strong top line growth profile with a goal to become a Rule of 30 company in late 2024.

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

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QUESTION AND ANSWER SECTION

Operator: Thank you, sir. [Operator Instructions] We will take our first question from Andrew Schmidt, Citi.

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

Q

Hey, Matt, David, Jonathan. Thanks for taking my questions. Good evening. I want to start off with the 2023 revenue outlook. Maybe help just bridge the outlook versus last quarter. Just curious if there's any differences, particularly in subscription revenues versus transactional and other. Help us just reconcile and bridge as a starting point, that'd be helpful. Thank you.

David Mehok
Chief Financial Officer, Q2 Holdings, Inc.

A

Hey, Andrew. Good evening. Yeah, happy to do that. There's a few key items that have changed over the course of the last three months since we talked and provided that high level outlook for 2023, the first of which is that contract termination that we discussed, there's over $4 million impacts to 2023. So you have to take that into account as you look at what the outlook was previously relative to the guidance that we provided.

We also take into accounts all the information that we've acquired over the course of the last three months in regards to the discretionary spending environment for services, the transactional business, which incorporates the Helix business as well, and we're certainly monitoring that space. And that space has changed over the course of the last three months and we're incorporating all that we know today into that guidance.

And the M&A environment is the final one that I had referenced. We had talked about the fact that there's an elongated cycle for approvals and what we've seen over the course of the last few months is it's really slowed down dramatically in terms of the number of transactions. In fact, January alone, there was only six transactions – six M&A transactions for financial institutions, which is the lowest January since 2009. So that reduction in activity is certainly something that is going to impact and has been factored into our guidance for 2023.

And the one thing that's really important, and I tried to emphasize this in the call, is that we absolutely feel good about our subscription revenue heading into 2023. We think that growth rate is going to accelerate in 2023. And the growth rate for subscription is roughly going to be about 2x that of services and transactional combined.

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

Q

Got it. No, that's super helpful. Thank you, David. Appreciate the comments on sort of Rule of 30. Maybe you could just talk a little bit about – obviously, there's various ways to get there, just you're still little ways out, but just maybe some preliminary thoughts on how you get there.

And then obviously, a lot has changed over the past few years. But historically, investors thought of company's sort of Rule of 40 and interest rate and other dynamics have changed. But is that still the right thought process longer term when we think about just the long term algo for the company? Or is it adjusted just based on what we've seen over the last four years? Thanks a lot, guys.

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

Thanks, Andrew. Yeah, absolutely. That is still a long-term objective of ours. And all we were doing was laying out there one step towards that direction in this Rule of 30 towards the back end or towards the end of 2024. And we certainly feel like we have the ability through the combination of the profitability objectives that we've set out since actually in August that are manifesting themselves in the P&L late in 2022 and into 2023. We're going to continue to see acceleration in EBITDA, which you can tell from our guidance. And we're optimizing that combination of growth and EBITDA profile going forward to where this Rule of 30 that we referenced is just a step in the direction of getting to Rule of 40, which we ultimately believe we'll be at.

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

Awesome. Thank you very much, Matt. Appreciate the comments.

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

Thanks, Andrew.

Operator: Up next, we'll take a question from Joe Vruwink, Baird.

Joe Vruwink Q
Analyst, Robert W. Baird & Co., Inc.

Great. Hi, everyone. I guess I'll start just looking at kind of the sequencing of EBITDA as you think about FY 2023. I think out of 1Q, if you're looking at a pretty nice step-up in incremental margin, are there certain things that you can maybe speak to or is this really having kind of knowledge of this optimized cost structure exiting the second half of the year? And so, as we start to run rate some of those improvements in savings, it drives you to the higher step-up in the second half?

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

Yeah. Thanks, Joe. I mean, one of the things we really tried to articulate was that we've been very proactive in terms of the measures we've taken from a cost standpoint. We started this in the late summer, early fall. We're seeing the benefits of it now in terms of the P&L. It's coming from both COGS as well as OpEx. There's a mix component to the business as well. I talked about subscription revenue accelerating into next year.

As you know, subscription revenue also has the highest margin profile of any of the revenue streams that we have. We're doing a lot of work in terms of optimizing our workforce, in terms of making sure that as we add resources and as we backfill resources, we're trying to find ways to be more efficient in terms of how we deliver and utilize global resources more effectively. We've proven we can do that over the last couple of quarters. We're going to carry that into 2023. And then we're reducing our facilities footprint, which is also giving us some cost favorability as we head into 2023.

And finally, we certainly think that we have the ability to continue to optimize pricing and packaging, which is basically how we're marketing and going to market with our products and how we're extracting value out of those products as we're selling them.

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Joe Vruwink
Analyst, Robert W. Baird & Co., Inc.
Q

Okay. That's great. And then I guess this goes back to kind of the Rule of 30 and ultimately Rule of 40, but the normalized revenue assumption within that framework. And on the call today, you spoke about a lot of the inputs that traditionally gotten you to kind of the 20% rate of growth. You were talking about cross-selling across the suite, talking about organic user growth. Obviously, churn is a consideration. But I guess how do you think about some of those inputs and where would you put the construct today if you kind of revisit each of those variables?

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

Yeah. Thanks, Joe. And the way that I would look at it is, look, the world has changed a lot in the last 18 months, for sure. And one of the things that we're trying to take into consideration is, are those changes. First and foremost, some of the things that have happened in terms of discretionary spending and transactional revenue. But at the same time, the move to digital transformation on behalf of our financial institutions is remaining strong. That's where we're focusing our efforts and resources. We're making sure that we're dedicating those resources to the areas that are generating the highest return.

So, as you've seen some changes relative to what we communicated 18 months ago in terms of the growth profile, we've also made some changes proactively in terms of our cost profile. And as you referenced, that Rule of 30 that we're marching towards towards the end of 2024 is optimizing the combination of those two things.

Joe Vruwink
Analyst, Robert W. Baird & Co., Inc.
Q

Great. Thank you very much.

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

Thanks, Joe.

Operator: We'll go to Terry Tillman, Truist Securities.

Terry Tillman
Analyst, Truist Securities, Inc.
Q

Yeah. Hi. Can you hear me okay?

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

Yeah. We've got you, Terry.

Terry Tillman
Analyst, Truist Securities, Inc.
Q

Hey, Matt, David and Jonathan. Thanks for taking my questions. I guess the first question, and sorry to put you on the spot, Matt, but I'm going to put you on the spot. During this earnings season, which continues apace, I haven't heard companies talking about a record selling quarter. So I mean, it's pretty notable. And so what I'm curious about whether it's kind of top of the funnel or just kind of demand gen in general. And I know that you've got kind

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of this unique dynamic around deposits and loans and just a broadening platform. But how do you feel about bookings activity qualitatively as we're heading into 2023 here? And just can you keep up the vibrancy on the new bookings side? And then I had a follow-up for David.

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

A

Yeah. Thanks, Terry. If you look at the last two quarters, Q3 and Q4, you began to see the momentum on the digital banking side. And I think what that is, is a couple of things. It's coming out of the pandemic. The pressures on the legacy systems that didn't have the feature functionality that were required really raised attention to the age of the technology, to the leadership of the financial institutions we're dealing with. And they have seen more executive engagement in these opportunities than I've ever seen. And so it culminates in a record Q4 with, just that bread and butter of this business, that Tier 2, Tier 3, those deals we signed – more deals they signed in the pandemic in a long time in the quarter, a lot of good volume, had a nice Tier 1 in there. So that activity is strong.

The pressure around deposits has put a focus on this as well. Every deal had commercial banking in it. And so commercial banking for us drives a higher ARPU, drives a higher ASP, it's a better long-term customer because of the integration and the depth you have with them and it's very difficult to switch off the system. And so, whether it's a bank or a credit union, we really are pushing those products. And so the demand environment on the deposit side of the house is as strong as I've seen in a long time. And those of you that know the business know that it takes 9 to 12 months to come to revenue. So you're going to look at some of this in the back half of late third, fourth quarter of 2023, and then most of it – you'll get most of it in 2024. So, very encouraged by that activity.

Obviously, on the lending side of the house, it's slowed somewhat, but you still have customers that need technology to originate and service loans. And then – so there's going to be pressure on the lending side of the business, I think, for the first half of the year. But on the PrecisionLender, the pricing and relationship tool, we had so much success with that at the end of the year, but that's beginning – what we're going to see is the delivery of that product into the existing customers and then the expansion will begin to happen like we saw a couple of expansion deals in this quarter.

So, feel really good about the demand environment on the digital banking side. And I feel like the products we have on the lending side are unique enough to where we're able to drive, we're able to kind of weather this rapidly rising interest rate environment to where we can differentiate ourself, and the pricing and relation tool is very valuable in that. So we're encouraged by the pipeline and excited about the way things look moving forward. So I appreciate the question. And you had one for David, I think.

Terry Tillman
Analyst, Truist Securities, Inc.

Q

I did, yeah. So, David, it sounds like – I mean, yeah, it's a very fluid kind of macro situation. So it sounds like some moving parts as it relates to discretionary services and then Helix transactional revenue and then the M&A environment. Could you – so a two-part question. Could you stock-rank what of those three items has changed the most since the last update? And then on the subscription revenue, to get to your Rule of 40 as you exit 2024, is it kind of at that same rate that it accelerates in 2023 or does it accelerate further? Thank you.

David Mehok
Chief Financial Officer, Q2 Holdings, Inc.

A

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Yeah. Sure, Terry. And to sort of do the stack ranking, I would say, all of them have changed to an extent over the course of the last four months. The biggest impact, quite frankly, to the guide was that contract termination. As I said, that was a greater than $4 million impact to FY 2023.

Sort of looking out, what's changed there, I would say the Helix environment and the fintech environment has certainly changed. And I would probably stack rank that at the top. The other transactional revenue, which is predominantly bill pay, I would say, is sort of next. M&A is going to be relatively small in terms of the impact that it has on our revenue in year-end 2023. So I would say that's next.

And then finally, we actually did right-size for the most part that discretionary spending impacts heading into Q4. And I think I mentioned that on the call. What came in Q4 was relatively aligned with what we expected, but we're just making sure that we're factoring that into the guide fully based upon what we know today.

Is there something else, Terry?

Terry Tillman
Analyst, Truist Securities, Inc. Q

Yeah. I mean, unfortunately, I asked a two-parter on the second question, so that's terrible of me. But yeah, so David, it was just related to your aspirational goal of the Rule of 30, kind of progressing towards that by the end of 2024. Would you say that subscription revenue accelerates further from where it ends up shaking out in 2023 or it's about the same level? Because I'm asking that because I'm definitely getting questions about the booking strength, and maybe if there's like a multiyear kind of acceleration or just whatever it accelerates to in 2023, it stays at that level in 2024. Thank you.

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

Yeah. Thanks, Terry. There's a lot of variables in place for us to get to that Rule of 30 in late 2024. So we're not going to get to the point of parsing out exactly where it's going to come from. Certainly, booking strength in our subscription-based business is going to result in accelerated subscription revenue at some point in the future. But we're not going to start to look at those individual variables and start to say exactly how much is going to come from which for 2024 yet. We certainly want to focus on delivering and executing on 2023 relative to the guidance and some of the commentary that we provided on that. Thanks.

Terry Tillman
Analyst, Truist Securities, Inc. Q

Thank you.

Operator: Next up from Raymond James, it's Alex Sklar.

Alexander Sklar
Analyst, Raymond James & Associates, Inc. Q

Thanks. Matt, I wanted to follow up on your answer to Terry's first question. Every deal you said having commercial banking in it. What can you tell us now about your pipeline composition in terms of commercial banking opportunities where it seems like you have high win rates versus kind of retail banking or other solutions?

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

A

Alex, so the pipe from an RFP perspective, it's up quarter-over-quarter, year-over-year. Total opportunities created, those were up quarter-over-quarter, year-over-year, big year-over-year. Demos were up, I think, 21% year-over-year. So the activity on the digital banking side is obviously increasing.

And I don't have the stat on it, but there's a lot of commercial activity. I would think you'd see those – 70%, 80% of those have commercial banking related to them. I just want to make sure you understand the reason for that is because that's where a lot of those deposits are. And what's happening is, is the retention of those deposits for those commercial customers is critical, and our technology is one of the tools. I literally had banks reach out to me and say, we're telling them to hold on until we do the conversion because we're going to upgrade the technology and it's going to be a better experience.

So that's really what's driving that, as well as we have a lot of credit unions that are signing up for commercial banking because there's a lot of opportunity in the credit union space to take advantage of. They have a lot of small and midsize businesses that are hiding on the retail product. And so our ability to take our retail product and turn on commercial functionality on demand is highly differentiated. And so, that's one of the things that's driving a lot of that activity as well.

Alexander Sklar
Analyst, Raymond James & Associates, Inc.

Q

Okay. Thanks for that color. And then, David, you gave us a stat...

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

A

Yes.

Alexander Sklar
Analyst, Raymond James & Associates, Inc.

Q

...in the past, I think it was 70% gross margins on a subscription renewal. And we heard about the better mix for 2023 that's going to kind of benefit gross margin. But what can you tell us about kind of line of sight to gross margin improvement over the next year or two in terms of that stat or some of the other buckets that you have?

David Mehok
Chief Financial Officer, Q2 Holdings, Inc.

A

Yeah. We certainly do see that margin expansion [ph] part really want to (46:03) just to give a little context on that. I mean, one of the bigger drivers behind that is you have the mix of subscription revenue combined with the recurring revenue that we have associated with the implementation services. So, when you go through a renewal process, those implementation services roll off. Those are lower margins. So as a result, you get a margin uplift from that on top of the incremental users and incremental solutions that you've been adding, which are typically higher margin. So we do anticipate that to continue. As we renew customers, we get higher margins.

And then just broadly speaking, in terms of the gross margin profile going forward, we expect the EBITDA expansion that we provided in guidance to come both from OpEx scaling, so OpEx coming in lower as a percentage of revenue, combined with gross margin expansion. So you're going to see both of those line items deliver towards that EBITDA accretion.

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Alexander Sklar
Analyst, Raymond James & Associates, Inc.

Q

Okay. Great. Thank you.

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

A

Thanks.

Operator: The next question is Robert Napoli, William Blair.

Robert Napoli
Analyst, William Blair & Co. LLC

Q

Hi. Thank you for taking the question and good afternoon. A question, I guess, first on the contract termination and just maybe your overall lending business. Within your lending business, first of all, is there anything else that we should be aware of in the portfolio that could be like that? How do you get a reversal? How did this – what happened, I guess? And then just how that relates to – I know you made the acquisition. Was this in cloud lending? I know it's not part of PrecisionLender, but just any update on your overall lending business as well?

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

A

Yeah. Bob, so this is a deal that was a legacy contract we had before. And it was – looking at where we are now as we focus on becoming a profitable growth company, it just didn't fit into the direction we were going. Parted ways mutually. Like I said, it was a alternative finance international company. It wasn't really in our wheelhouse looking back on it now. And so we've moved on forward – moved on from it, both of us, on good terms. And so it's a business decision we had to make, the both of us had to make, and we moved on from it.

As far as the lending business goes, like I said earlier, you're going to see pressure on – when rates rise this fast, people are not asking for loans. There are workouts that are happening and that type of thing. You still have banks still because you still need to automate their origination process. They still need to automate their servicing process. But it is something that's going to slow down.

As far as the relationship pricing tool, PrecisionLender, as I said earlier, it's in demand. You're seeing it grow within existing customers. And getting people's attention on the lending side is kind of what the distraction is right now, but I feel good about the way that team is engaged in the opportunities that we have. And I think you'll see in the back half of the year a lot of momentum. But digital banking has carried the quarter obviously and has a lot of momentum going into 2023. I really like where the pipe is and the deal activity right now.

Robert Napoli
Analyst, William Blair & Co. LLC

Q

Thank you. And then...

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

A

I think you had a question for David.

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Robert Napoli
Analyst, William Blair & Co. LLC

Q

Yeah. A question for – I guess, it would probably be for Jonathan maybe. But on Helix, your BaaS, you were targeting $100 million in revenue, I believe, by 2026. I think that was the number you had given in the past. And I know that the fintechs in this environment may be slower growth. But just any update on is that still a reasonable target? What is a reasonable target for Helix BaaS and what are you seeing as far as opportunities in the embedded finance or BaaS area?

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

A

Yeah. We haven't – obviously, a lot's changed, as David said, in the last 18 months and that's certainly true within the Helix business. We haven't given a revised long-term view of it. But we certainly still feel very good about the opportunity set in front of us. What I'd say is the composition of the pipeline has changed. Right now, when you look at fintechs, as we've talked about, we're still focused on the bigger opportunities, but now the composition of the pipeline is really filled with conversion opportunities that are looking for a platform that can scale, that are looking for a better economic outcome from their vendors. And so we're just seeing a very different view of how the larger fintechs are behaving.

We're also seeing a lot of growth within our existing customers, as I talked about on the script. Really, really important, we continue to have a year that was characterized by meaningful multiyear renewals of these large Helix clients, and that drives a lot of growth in this business. And so, you marry those two things with our brand strategy and what we're seeing on the brand side, and I'd say what's changed there over the course of 2022, especially as we got into Q4, is we're much more focused now in the verticals where we think we can win.

If you rewind the clock six to nine months, I'd say we were pretty aggressive in going after a bunch of large opportunities across verticals. And we sort of learned where we're strong and where we can win and where our model works. And certainly in this environment, I think that's prudent for us to be very focused. And we're still bullish on the opportunity. It's just, as I mentioned, a lot's changed. And we're navigating through that environment, but still excited about what this business can do.

Robert Napoli
Analyst, William Blair & Co. LLC

Q

Thank you.

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

A

Thanks, Bob.

Operator: And next up is Charles Nabhan, Stephens.

Charles Nabhan
Analyst, Stephens, Inc.

Q

Hi. Good afternoon and thank you for taking my question. Two-part question. First, if we think about the expected acceleration in subscription growth, could you give us a sense for how much of it is coming from cross-sell versus user growth versus new logos? And secondly, as you come up on these big renewals, could you comment on the

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pricing environment and any impact, positive or negative, the pricing of those deals might have in your ability to cross-sell into those new – add new products into those new contracts?

David Mehok
Chief Financial Officer, Q2 Holdings, Inc.

A

Hey, Chuck. Sure. So, on the subscription breakdown, it's really coming from both cost and net new, and it's relatively evenly split. We're seeing a lot of good momentum in both. And really it varies by quarter. Second half of the year, we really saw some good momentum with subscription and that's going to carry forward into next year. So there's really an equal driver coming from each one of those areas. And on the pricing standpoint, you're asking about the pricing environment that we're seeing?

Charles Nabhan
Analyst, Stephens, Inc.

Q

Yes.

David Mehok
Chief Financial Officer, Q2 Holdings, Inc.

A

Yeah. Yeah. So a few things that I just – I mentioned there, and I don't know, Matt may have a couple of points. One is that we're seeing some very high win rates right now. The second half of the year, our win rate was at 50%. So we feel really good about how we're positioned, particularly when you look at the composition of the deals where we're playing and where we're winning. As these deals continue to increase in breadth, we continue to see a higher win rate.

So the screening process that we're going through in terms of the deals that we participate is certainly an important variable in all that. In fact, when you look at the bookings that we won on net new deals for FY 2022, the average deal size was up 34% year-over-year from 2021. So that's – there's a few contributions there, one is the contribution of more products and breadth; and two is the contribution of commercial being a bigger part. So we're definitely feeling like we're really well-positioned to effectively screen the deals, win our share, and the win rates that we saw on the second half of 50% certainly exhibit that.

Charles Nabhan
Analyst, Stephens, Inc.

Q

Got it. And just as a follow-up, I wanted to drill in...

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

A

Hey, Chuck. Thanks. Yeah. Go ahead.

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

A

Go ahead.

Charles Nabhan
Analyst, Stephens, Inc.

Q

Oh, sorry. I wanted to drill in – as my follow up, I wanted to drill into the revenue mix within Helix and specifically get a sense for how much of that Helix revenue is transaction-driven versus subscription or user-related.

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

A

Yeah. So the way I would think of it is roughly 30% of the revenue would be what I would call analogous to subscription revenue, where it's either the platform fee, the actual subscription fee, or what we call excess user fees. Then you have a bucket that I would broadly call transactional revenue, and that includes everything from interchange revenue, deposit float to the extent there's any revenue share on a deposit program, and then pass-through fees. And pass-through we've talked about, David's talked about a lot, in terms of how that impacts the Helix business from a margin perspective, but that includes things like fraud monitoring and other control solutions to help us manage, navigate fraud disputes and the like. And so that makes up the balance of it. So it's a much more transactional business inherently than the digital banking or digital lending business.

Charles Nabhan
Analyst, Stephens, Inc.

Q

Got it. I appreciate the call. Thank you.

Operator: [ph] William MacNamara (55:06) from BTIG is next.

Q

Hi. Thanks for taking my question. In terms of thinking of margin improvements and things of that nature, you talked a little bit about the head count increasing slightly compared to last year, but just kind of wanted to know how you're thinking about head count going into 2023.

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

A

Sure. And one data point that I think is important to note is when you look at the proactive actions that we said we took starting late summer, that included all the areas that I referenced, whether it's some areas of contractor spend, third-party spend, facilities footprint and head count. Our head count was actually down from a net standpoint from the end of August through the end of December.

Now, as we look forward into FY 2023, there's certainly some areas where we feel it's really important for us to add some head count. And that's going to be in areas that typically touch the customer as well as the product. So the customer and the product are the areas where we're going to invest. We're also going to find more efficient ways of doing that though. And that was my point on global resources. We can add heads net on an overall basis and still have our overall cost profile not move too much.

So those are the things that we're looking at is how do we reduce the cost per head, one; and then two, make sure we're really efficient with the heads that we have. And then three, we will be adding heads in specific areas that touch the customer and the product.

Q

Okay. Great. Thanks. And then in terms of thinking about the churn rate that you disclosed, I guess, just is there any more color you can add to that in terms of deals maybe you guys are walking away from if it just doesn't fit your criteria or things of that nature?

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

A

Yeah. I mentioned that in the pricing question, which is we're doing a really good job of screening opportunities now and making sure that the deals that we're going after are those that are going to yield the highest return, and that's going to be based upon the scope of the opportunity. Is the customer really looking to transform digitally? Do we have opportunities to continue to expand with them as they grow? And we've done a really good job over the course of the last year, as is evidenced by that 34% increase that I referenced.

So we feel really good about how we're screening deals now for existing customers. We're going to continue to grow with them as well. And we're going to find if there's opportunities for us to continue to expand with an existing customer that uses that through their or inorganic opportunities or by expanding the products that they have with us, we're certainly going to capitalize on that.

Q

All right. Thank you.

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

A

Thanks.

Operator: And ladies and gentlemen, that does conclude our question-and-answer session as well as the Q2 Holdings' fourth quarter and full year-end 2022 financial results call. At this time, you may disconnect. Goodbye.

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