Full Reviewed Transcription

Temenos Group

Q2 2023 Results Conference Call and Live Webcast

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COMPANY REPRESENTATIVES

Andreas Andreades, Chief Executive Officer

Panagiotis Spiliopoulos, Chief Financial Officer

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PRESENTATION

Operator

Ladies and Gentlemen, welcome to the Temenos Q2 2023 Results Conference Call and Live Webcast. I am Moira, the Chorus Call operator. I would like to remind you that all participants will be in listen-only mode and the Conference is being recorded. The presentation will be followed by a Q&A session. You can register for questions at any time by pressing * and 1 on your telephone. For operator assistance, please press * and 0. The Conference must not be recorded for publication or broadcast.

At this time, it's my pleasure to hand over to Andreas Andreades, CEO. Please go ahead, Sir.

Andreas Andreades

Thank you, operator. Good afternoon, and welcome to our Q2 results call. I will first talk through our performance, the market environment and some of the highlights from the quarter before handing over to Takis to run through the financials. As in previous quarters, I will not be going slide-by-slide, but will instead focus my commentary on a few key areas.

Now in terms of performance, we continued the momentum from Q1 to deliver a strong second quarter. I was particularly pleased with our ARR which, as you know, is our key performance metric as we transition the business to a recurring revenue model. ARR grew 14% in Q2 and has now grown 14% for the first half as well, setting us up well for the second half of the year.

The growth in ARR was driven by strong subscription licenses, including the uplift on the shift of renewals from term to subscription as well as benefiting from the stickiness of our mission-critical software, which leads to industry-best-in-class churn rates. We had our highest ever quarterly SaaS ACV of 20 million Dollars as well as a strong cash quarter, which Takis will talk about in more detail, shortly. We are well on track to deliver the growth plan we announced in February, and I'm confident we can continue this performance in H2.

Given our strong H1 performance across all key metrics, ARR license and EBIT growth as well as cash flows and the visibility this gives us for the remainder of the year, we have raised our guidance for ARR and free cash flow. We now expect both to grow between 12% and 14% for the full year while reconfirming the remainder of our guidance metrics.

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We talked a lot about our competitive advantages at our last Capital Markets Day and gave some additional color on our win rates against our main competitors. Our market-leading position was validated in the IBS global sales awards announced a couple of weeks ago where Temenos ranked Nr. 1 across 8 categories, ranging from core banking to digital channels and retail payments to risk management.

Temenos has been at the top of the industry table for the last 18 consecutive years, which is a testament to the long-term success of the business model. It's the relentless focus on investment in R&D and innovation that is critical to our success, and this is applied to a single platform that is packaged for different financial services verticals.

We are seeing this pay off in some of the wins against our strongest global competitors in the last few quarters, including the most recent quarter we just closed, and this success is enabling us to build more and more credible references, in particular in SaaS and cloud, which is central to our growth plans over the coming years.

Now, looking at the sales and operational performance in the second quarter, the sales environment remained stable through the quarter as we have now witnessed the last 3 quarters. Banks do have better visibility on H2 and our working assumption is that the sales environment continues to be stable for the rest of the year, with some banks still cautious around IT spend.

We saw positive development in our pipeline through the quarter, and there are a number of large deals that are progressing well. Of course, as always, it can be harder to focus the timing of these large deals, which in any event we treat on a portfolio basis for our forecasting as we have said before.

The subscription transition is progressing well and is delivering value uplift in the expected range. We are seeing this value uplift across both new clients and existing clients coming up for renewal and the transition should be complete by the end of the year. Of course, term to subscription renewals will continue to happen for the foreseeable future as term contracts come up for renewals and based on 18 months data and track record, which by now we have, we believe this value uplift will help underpin our medium-term performance.

From a regional perspective, our U.S. business continued its strong performance with some great new wins like Convera, which is the largest nonbank global B2B payments provider.

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Convera selected Temenos' payments hub running in the Temenos Cloud to modernize its payments infrastructure and to benefit from the efficiency and scalability of moving to SaaS.

We beat all the major U.S. players to win this deal as well as other specialized payment providers, a testament to the superiority of our platform approach, which long-term beats specialized single-point software solutions. We also signed a deal with a top U.S. regional bank to implement our core banking software in their U.K. subsidiary and saw strong incremental SaaS consumption from our U.S. client base.

Turning to Europe, we had a solid quarter in the region and saw good pipeline development, which gives us confidence in further recovery in H2 as we have forecasted earlier in the year. Middle East and Africa continued to perform strongly and Asia Pacific facing tough comparatives performed well, especially in Asian countries.

With respect to our Services business, we continue to focus on restoring sustainable long-term profitability, delivered positive margins and completed a large number of projects during the quarter. As we partition our products more fully and make our solutions deployable in weeks rather than months in the SaaS world, our services revenues will shift more towards value-added services that allow our clients to maximize the value they receive from our solutions and away from lower margin implementation services. We expect that services will start benefiting from this shift during the second half of the year, both in terms of revenue as well as profitability.

Our EBIT grew 5% in the quarter, and we had a 200 basis points improvement in EBIT margin as we continue to benefit from investments made last year as well as good cost management, which is important, of course, in a high inflationary environment.

Now, with this, I'll now hand it over to Takis to talk through the numbers for the quarter. Over to you, Takis.

Panagiotis Spiliopoulos
Thank you, Andreas. Starting with slide 21, I'll give an overview of the quarter. All figures are non-IFRS and in constant currency unless otherwise stated. Firstly, we ended the quarter with 667 million of ARR, up 14% on the back of strong subscription and SaaS growth. Subscription licenses were 36 million, up 16%. Although the subscription contribution to the license mix was slightly lower at around 68% of licenses this quarter, I still expect subscription to make up close to 80% of the license mix for the full year.

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SaaS revenue was again up 30% in the quarter, in line with the growth in Q1 '23, and we had our highest-ever SaaS ACV of 20 million. This was driven by both new client wins like Convera and additional consumption from existing clients. I am confident in delivering SaaS growth of around 25% for the full year, which is unchanged from previous commentary.

Total software licensing was up 2% this quarter with no headwind from customized development licenses. Maintenance growth picked up to 4% and total revenue was essentially flat in the quarter, mainly due to the decline in services revenue. We continue to focus on profitability in our services business and also on our partner model. With the majority of red projects now live, we would expect services revenue to grow sequentially in both Q3 and Q4 of this year.

EBIT was up 5% in the quarter, largely from good cost management, the decline in services cost base, lower variable costs and the phasing of targeted investments. Our EBIT margin improved 2 percentage points to 35.4%.

We had a strong cash quarter with operating cash up 4% to 90 million and with our operating cash conversion at 108%. We delivered 63 million of free cash flow, up 26%. For the full year, I still expect free cash flow to grow in line with ARR of 12% to 14%, up from at least 12% previously.

DSOs ended the quarter at 124 days, down 1 day sequentially and we ended the quarter with 772 million of net debt and leverage at 2 times. I expect our leverage to come down from this level by the end of the year.

Moving to slide 22. I flagged the strength across all of our recurring revenue line items, subscription, SaaS and maintenance which all contribute to our strong ARR performance. There was a good number of sizable deals signed this quarter, supporting ARR, and we have more in the pipeline that are also progressing well, and I would hope to see them closing in the coming quarters.

Looking at the cost base, it was down 2% in the quarter due to the decline in our services cost base, sustained good cost management, lower variable costs and the phasing of targeted investments. Most of the red projects have now gone live and this will continue to drive profitability.

Excluding the services cost line, our other operating costs were up 2% in the quarter as we continue to make targeted investments and are benefiting from the investments we made last year.

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I expect our cost base to grow further in the coming 2 quarters as we will have the annual pay rises kicking in from July, growth acceleration driving higher variable costs such as commissions and also the phased impact of our targeted investments. Lastly, we delivered 85 million of EBIT in the quarter and our EBIT margin expanded 2 percentage points in constant currency.

Next, on slide 23, we have like-for-like revenues and costs, adjusting for the impact of M&A and FX. The figures are all organic and, therefore, in line with our constant currency growth rate. FX was a tailwind on cost this quarter, in particular with the rupee and Aussie Dollar weakening against the U.S. Dollar and the marginal headwind on revenues. Overall, we had a positive impact of EBIT from FX this quarter of around 2 million.

I have already outlined the main impact on revenue and cost this quarter. I would just like to flag that our net capitalized development costs reduced to 3.5 million this quarter, although this will pick up in the coming quarters with further R&D investments. Another highlight was 8% growth in overall deferred revenues, closely tracking the 9% growth rate in LTM recurring revenues. We would expect LTM recurring revenue growth to remain double-digit while deferred revenue growth will accelerate in Q3 and Q4 to double-digit growth rates as well.

On slide 24, net profit was up 6% in the quarter, slightly below EBIT growth with the impact from the higher tax rate. I expect our full year tax rate to be between 19% and 21%, probably above the midpoint of that range. EPS for the quarter was up 5%.

On slide 25, our Q2 '23 LTM cash conversion was 108%, well above our target of converting at least 100% of IFRS EBITDA into operating cash. We also expect our cash conversion to be at least at 100% for 2023.

Next on slide 26, we have the key changes to the group's liquidity over the quarter. We generated operating cash of 90 million and paid out a dividend of 88 million. And we ended the quarter with 101 million of cash on balance sheet and net borrowings of 772 million. Our leverage was at 2 times and expect it to decline further by the end of the year.

On slide 27, we have our 2023 guidance, which is non-IFRS and in constant currency. We have raised our guidance for ARR to 12% to 14% growth from at least 12% growth and consequently have also raised our guidance for free cash flow to 12% to 14%, in line with ARR. We started the year with a significant majority of our ARR locked in through committed SaaS revenue, subscription and maintenance, and we had a strong H1 across subscription SaaS and maintenance.

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For the remaining KPIs, we have reconfirmed the rest of our guidance, which is in line with our H1 '23 performance. We are guiding for total software licensing of at least 6%. This combined subscription term license and SaaS revenue, with SaaS revenue growth driven by ACV from new client wins, improved visibility on additional consumption from existing clients and overage revenues where we charge customers at a premium for consumption over the contracted volumes until they commit to more incremental ACV.

We are guiding for EBIT growth of at least 7% and EPS growth of at least 6%. We still expect cash conversion to remain at over 100% of EBITDA into operating cash. We have put the EBIT and free cash flow bridge into the appendix for reference.

Lastly, on slide 28, we have our midterm targets that we announced at CMD in February. These are for ARR to reach at least 1.3 billion, EBIT to reach at least 570 million and free cash flow to reach at least 700 million in the midterm.

With that, I will hand back to Andreas to conclude.

Andreas Andreades

Thank you, Takis. Concluding, we expect the sales environment to remain stable in H2, and our positive pipeline development gives us the confidence going into the summer. There are a number of large Tier 1 and 2 deals in the pipeline that are progressing well, and we'll have to see how the timing of this develop over the coming months which, again, we are looking, as I said, on a portfolio basis.

Our subscription transition is well advanced at this point and delivering value uplift across new clients and renewals, and we're on track to complete the transition by the end of the year. SaaS and Cloud are key drivers of demand across all client tiers and it is notable that we are seeing some larger banks opting for true SaaS, not just Cloud infrastructure.

With the focus on moving to a recurring revenue model, ARR and free cash flow should continue growing strongly and this is reflected in the guidance increase, with licensing revenues, profits and margins also benefiting and accelerating in the medium term.

So with that, operator, I'd like to open the call to Q&A.

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QUESTION & ANSWER

Operator
We will now begin the Question and Answer Session. Anyone who wishes to ask a question or make a comment may press * and 1 on their touchtone telephone. You will hear a tone to confirm that you have entered the queue. If you wish to remove yourself from the question queue, you may press * and 2. Participants are requested to use only handsets while asking a questions. Anyone who has a questions or comments may press * and 1 at this time.

The first question is from Levin Josh from Autonomous Research. Please go ahead.

Levin Josh
Hi, good evening. On the cost, it looks like R&D spend was stable quarter-over-quarter and G&A was down quarter-over-quarter. So, with regard to R&D, how do you think about what the right level of R&D spend is? And then on the G&A, what was really driving that? And then in terms of the CEO search, I know you can't say much, but can you tell us if the Board has interviewed any potential CEO candidates? Thank you.

Panagiotis Spiliopoulos
Okay. Let me take the cost one first. I think on the question of movement, clearly, G&A and as we mentioned, we had a lot of investments done in the last year and also plugging into moving into Q1, so what we have seen is basically efficiency gains continuing on one hand and some of the hiring pushed into or moved into the second half. The budget is there, but people are still taking the time to find the right candidates. So, I think this is what's driving the cost line on G&A and that should improve both sequentially and both for Q3 and Q4.

R&D, as you are aware and as Andreas highlighted at the last quarter, we constantly do also efficiency improvements on R&D which was at the end of last year you know in also in Q1. So, this is what you have seen right now in Q2. But I would expect clearly R&D costs to move quite a bit in the second half quite substantially. Yes. So you only... you also we will have the pay rises going into that. Maybe on the CEO search, I think we'll...

Andreas Andreades
I can take that, Takis. So, as we said before, the process is underway. It's led by our Chair, Thibault de Tersant. The Board is involved and the Board will be updating the market when it is appropriate.

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Levin Josh

Thank you.

Operator

The next question will be from Daria-Ioana Sipos from JPMorgan. Please go ahead.

Daria-Ioana Sipos

Hi, thank you for taking my question. How should we think about the shape of the EBIT growth through the remainder of the year, given that Q1 growth of 11% came above the guidance of at least 7%, but Q2 came in below at 5%. And then the same question, please, for total software licensing growth. We had Q1 above at 12% and then Q2 coming in below that at least 6% guidance. Thank you.

Panagiotis Spiliopoulos

Yes. Let me take this one. There is a reason that we only guide for the full year and not on individual quarters because there can be a variation based on individual deal signings or not signing. So, if you look at the first half performance, we're spot on with the guidance, both for total software licensing at 6% and EBIT growth as well. So clearly, Q3 is a relatively easy comparison base and then Q4 is a bit stronger. So, I think you should expect total software licensing growth maybe for Q3 being ahead of the full year guidance given the comparison base, the same for EBIT growth and then Q4 probably a bit below to arrive at the full year guiding. Clearly, we remain... as Andreas said, it's a stable environment. We remain prudent, clearly happy to have the first half already at the guidance. Q2 is a relatively easy comparison base but we remain prudent.

Daria-Ioana Sipos

Okay. Thank you.

Operator

Next question is from Knut Woller from Baader Bank. Please go ahead.

Knut Woller

Yes, thank you. 2 questions. The first one on the U.S. Andreas, you said that you had a strong quarter. Looking at total software licensing, if I've done the math correctly, it was slightly down year-over-year. So, can you give us some color here?

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And then to get a better understanding, looking at the European environment, you cited the large deal with the partner. What was the performance if we strip out this large deal to get a better feeling whether there is truly a broader recovery in Europe or whether that was just helped by the one large deal, it's there, but just getting a feeling here? Thank you.

Andreas Andreades

Sure. I'll take the U.S. We did have a very strong U.S. business. First of all, the numbers that we see are for Americas. So, we need to be careful when looking at that. But the U.S. business has a much, much higher element of SaaS in the mix. So, the market has moved much more aggressively towards cloud and SaaS. And therefore, you see the strong performance in the ACV number in a very big way, which as you know, it flows through total software licensing over the following quarters.

Panagiotis Spiliopoulos

Let me add this one. So clearly, if you look at the math, it's only... or at the chart, it's only down to 39% in the Americas from 40%. While if you look at the LTM, which smoothens out the, let's say, quarterly volatility, it's still up about 42% from 37% on an LTM basis, yes.

Now on Europe, clearly, we're not stripping out individual deals. As we repeatedly have mentioned already since last year, we look at the portfolio of opportunities, a portfolio of deals and partner deals are, as we have seen last part of the strategy communicated, are there. If you wanted to exclude that one, Europe would still have shown an improvement, yes.

Knut Woller

Thank you Takis, and thank you Andreas.

Operator

Next question is from Orson Rout from Barclays. Please go ahead.

Orson Rout

Hi, thanks for taking my question. 2 from me. First is just on sort of the pipeline and the backdrop you saw in Q2, 9 new client wins. I think that's one of the weakest Q2 in terms of number of new clients in a decade or so. We're just wondering, were there any deal slippages in Q2 also of delayed decision-making? Or was this in line with expectations going into Q2?

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Then the second one was just on the percentage of subscription, which decreased a bit versus Q1. Can you give some more color on this? Was this just some large deals skewing it? And how do you expect the phasing to be there for the rest of the year? Thank you.

Andreas Andreades

I'll take the pipeline, if I may. As I said in my prepared remarks, we had a good development of the pipeline over the quarter. We saw deals progressing according to expectations. Quarter-on-quarter, you may get variations between new and existing, and I wouldn't add new client wins as it were and sales to the existing customer base, I wouldn't read anything into 9 being a low number or in Q1 probably was a little bit higher than that.

As I confirmed also, we've been for the 18th year in a row, leading the IBS league table, which measures a number of new deals per year, and we are very confident about our competitiveness in the market. Also specifically, just to answer the question, no, we did not see deal slippage. Deal development was asked per our expectations.

And finally, the last point to know is that as we are developing our SaaS business, because the SaaS business is a cumulative business, you are likely to see in the above charts, if you like, the share of existing customer mix going up simply because of the way SaaS revenues work. But again, that doesn't mean loss in competitiveness. On the contrary, it means incremental growth from the existing customer base. Takis, can you take the second question?

Panagiotis Spiliopoulos

Yes. So, if you look at the evolution of subscription share in our license mix since we started, it went up and then remained actually stable for around 3 quarters, Q2 to Q4, and then Q1 was again strong. Still, the 68% is substantially ahead of the 44% we generated for the full of 2022.

Now I think what we should also bear in mind is, is there basically a trend line? And the answer is clearly yes. So, we're not looking at individual quarters because the timing in terms of closing individual deals, which have been in the pipeline, including some term deals, there could still be some variation. So, we have a lot of confidence, no change to that in completing the transition by the end of the year. Well, we have seen a strong trend in H1 and even stronger in H2. So, we stand by what we said that for the full year, you should be around 80% of the license mix should be subscription for full 2023.

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Orson Rout

Okay. Great, thank you.

Operator

Next question is from Justin Forsythe from Credit Suisse. Please go ahead.

Justin Forsythe

Hi, Andreas, Takis, thanks for letting me on. Just a couple of questions here for me, if you don't mind. First, perhaps one for Andreas around the TAM. I think you re-presented that TAM slide that you gave in the CMD. It's quite a nice chart. I like that. Just wanted to parse into the breakdown between Transact and Infinity a little bit. So, from the chart, it looks like roughly half of that is split between Infinity and Transact. But if I recall, it's not quite the same mix of your TSL revenues. I thought maybe in the teens or slightly more than that comes from the asset management solutions.

So maybe you could talk a little bit about the positioning in that market, where your strengths are and maybe a little bit, let's say, is there any strength coming from your existing core Transact clients where you're cross-selling the asset management arms and maybe there's independent software providers who are stronger for other independent asset managers? That would be my first question.

The second was a little bit more on the margin cadence for Takis. Just a couple of points here. It seems like the services margin stayed negative. We're meant to have some SaaS gross margin ramping over time perhaps this year due to hyperscaler mix. But it seems like on the OPEX side, you're maintaining your guidance, and you're talking about OPEX increasing significantly in 2H over maintaining that EBIT guidance. It kind of seems like you're talking to EBIT margin degradation in 2H. Perhaps you could just put a little more color around the phasing there? Thanks.

Andreas Andreades

Thank you, Justin. I'll take the first question. First of all, let me say that if I were to take back office and front office if you like, in our business, clearly, we've been in the back office software business far longer than the front office. And therefore, you would expect the revenue share given also because of accumulated maintenance revenues to be lower in the front office and the back office, and we remain consistent with what we said before with a mix of about between 15% and 20% for front office and about 2/3rds of total for back office.

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Now increasingly, we are becoming more and more competitive in the front office. And as we have one platform for composable banking, and we are able to operate both in a bundled way but also in a stand-alone basis within the front office space.

Now, we haven't given out a split for the fund management business. But let me say that we are a very strong player in that segment as well. We... our solution is... has probably got one of the largest market shares in the biggest, if I take the top 20 fund administrators in the world, we have a very significant position there. So, that said in a summary, I don't know it addressed the question. Takis, can you take, please, the second one?

Panagiotis Spiliopoulos
Yes, Justin. We didn't guide on margin. If you take our implied margins in terms of TSL and EBIT, it will be up more than 100 basis points. So clearly, in Q1 and Q2, in Q1, we benefited from a strong performance; in Q2, as we mentioned, the costs, especially on investments, were quite a bit lower, lower variable costs. Clearly, we believe this will come back, yet.

So mathematically, the margin in Q3 and Q4 should be lower than Q2, which benefited from this trend. But I think for the full year, you're going to still see a pretty good margin improvement. Keep in mind, Q3, we got the pay rises, which is 15 million plus kicking in from July, which we'll do every year. There is a growth acceleration in the easy base. So, you will have more variable cost, which is mainly commission. We have services which should grow sequentially in terms of revenue growth, so with also some more costs coming in.

And then finally, investments, the budget is still unchanged, but I think the phasing is now... and this is something we see already. So, the phasing will be more in Q3 and Q4. So sizable cost evolution in H2. And this is why, yes, margin can't stay on the 35% level of Q2.

Justin Forsythe
Yes, got it. And Andreas answered my questions. So thank you both. Appreciated.

Operator
There are no more questions at this time. I would like to hand back the Conference to Andreas Andreades. Please go ahead, Sir.

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Andreas Andreades

Thank you, operator, and thank you, everybody for joining the call. Looking forward to updating you at our Q3 results call. Thank you very much.

Operator

Ladies and Gentlemen, the Conference is now over. Thank you for choosing Chorus Call, and thank you for participating in the Conference. You may now disconnect your lines. Goodbye.

- END -

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