CORPORATE PARTICIPANTS

Danielle Royston
Chief Executive Officer, Optiva Inc.

Anin Basu
Interim Chief Financial Officer and Vice President, Finance, Optiva Inc.

CONFERENCE CALL PARTICIPANTS

Steven Li
Raymond James

Robert Young
Canaccord Genuity

Amy Dick
CIBC

PRESENTATION

Operator

Good morning, everyone. Welcome to the Fiscal 2019 First Quarter Earnings Conference Call for Optiva Inc.

At this time, all participants are in a listen-only mode. Following the presentation, we will conduct a question-and-answer session. Instructions will be provided at this time for you to queue up for a question.

Before beginning its formal remarks, Optiva would like to remind listeners that today's discussion may contain forward-looking statements that reflect the current view of the Company's outlook, objectives and strategy. Any such statements are subject to risks and uncertainties that would cause actual results to differ materially from those presented in these forward-looking statements.

Optiva does not undertake to update any forward-looking statements, except as required. More details with respect to the cautionary nature of forward-looking information can be found in the Company's first quarter 2019 MD&A dated February 6, 2019. These disclosure documents, along with the Company's earnings release and financial statements, are available on the Company's website, Optiva.com, and on SEDAR.com. I'd like to remind everyone that this call is being recorded today, Thursday, February 7, 2019.

I will now go ahead and turn the call over to Danielle Royston, Chief Executive Officer of Optiva Inc. Please go ahead.

Danielle Royston, Chief Executive Officer, Optiva Inc.

Thank you. Good morning, and welcome to our 2019 Q1 Earnings Conference Call. I'm Danielle Royston, CEO of Optiva, and I'm joined today by our Interim CFO, Anin Basu. As a following main point that I'd like to communicate today on our call.

We have completed another measurement period for customer success, and we anticipate it will come in around the high 30s, and we continue to invest heavily in cloud innovations, and on focusing our sales and marketing resources to make us the leading vendor in a transition to the cloud.

With that, I'm going to turn the call to Anin. Anin?

Anin Basu, Interim Chief Financial Officer and Vice President, Finance, Optiva Inc.

Thank you, Danielle, and good morning everyone. I will now take you through some additional details of our financial results for the first quarter ended December 31, 2018.

The Company's first quarter revenues declined by 20 percent, as compared to Q1 '18. The decline in revenues was mainly due to a continued decline in new software and services orders from customers as the Company continues its stated focus on improving customer success and investing in cloud innovations. Revenue from support and subscription remained flat as compared to Q1 '18.

The Company has adopted the new IFRS 15 revenue standard, commencing (inaudible) 2018. This adoption has impacted the accounting for certain customer arrangements containing software licenses for which the customer has the right to pay for the software, as it increases its capacity usage over a fixed term. Consequently, revenues related to these license arrangements that we have planned to recognize in 2019 and beyond were booked as part of the transition adjustment of $4.7 million by reducing our opening deficit as of October 1, 2018.

The Company's gross margin for Q1 '19 was 69 percent as compared to 42 percent in the same quarter a year ago. The higher gross margin in Q1 '19 is a result of our cost optimization, product mix, as (inaudible) the reversal of a loss provision related to a customer contract. If we exclude the impact of the reversal of the loss provision, our gross margin is approximately 63 percent.

The impact of the Company's restructuring efforts can also be seen in the reduction in our operating expenses and cost of revenue by $24.4 million in Q1 '19, relative to Q1 '18, while being able to continue our investment in research and development to improve code quality on existing products, and invest in cloud innovations.

Most of the Company's investment in research and development, including cloud innovation, is supplied by DevFactory, which is an affiliate of the Company's largest shareholder, ESW Capital, and the majority of the Company's personnel are contractors sourced from Crossover, which is another ESW affiliate. The Company's Q1 '19 expenses included $6.9 million spent with DevFactory, and $6.4 million spent with Crossover.

The Company consumes $1.9 million in cash from operating activities in Q1 '19, as compared to $16.8 million in the same quarter a year ago. We made restructuring payments amounting to $1.8 million in Q1 '19, as compared to $11.3 million in Q1 '18. The Company expects to complete its restructuring activities in 2019, with the majority of the cash impact tied to provisions recorded at December 31, 2018.

I'll now pass the call back to Danielle.

Danielle Royston, Chief Executive Officer, Optiva Inc.

Thank you, Anin. The last time I talked about our framework for 2019: first, to drive the Company every day towards attaining our customer success goal of 100 percent; second, continue to invest heavily in cloud innovation and focus our sales and marketing resources on making us the leading vendor in the transition to the cloud; and third, accomplish the first two objectives without incurring significant losses, or requiring additional financials.

We have finished another measurement cycle for our customer success program, covering the period from June to December, and we anticipate we will come in around the high 30 percentage points. As the (phon) revenue reporting to us said yes, they feel our teams and our results are aligned to their success, and we are helping them achieve their goals. This is several points higher than our previous measurement of 33 percent. As I said before, this is a lengthy process where you have to fix each customer one by one. We continue to believe that revenue will converge with customer success, and while revenue will continue to shrink, we will continue to focus on customer success, as we believe this is the best foreshadowing of our future success.

Next, let's talk about our transition to the cloud. I'm extremely proud of the exciting and compelling vision we have created for customers for the future. We are seen as the leading edge, most aggressive telco software player moving to the cloud. At the end of this month, we have our biggest event of the year, Mobile World Congress, held every year in Barcelona. Our solution that it's 10 times faster and a tenth of the total cost of ownership is creating excitement and interest amongst the telcos, and we have more new sales leads than in any time in my tenure.

Given the progress, we are changing our third commitment, which was to run at break-even and not raise additional financing. Based on the extremely robust interest in our cloud vision from customers, we are considering finding ways to accelerate our strategic plan to ensure we capitalize on the market demand and maintain our leadership position. In the interim, we are renegotiating our contract with DevFactory to accelerate our product innovation. We are also deferring the dividend payment so that money can be invested in the cloud strategy, given we'll yield a return that far exceeds the cost of deferring the dividend.

To deliver on our vision will require us to differentiate ourselves amongst the much larger competitors. I believe we have an opportunity by being the fastest and first to cloud, and I want to capitalize on it. But, I want to continue to caution you on this bold endeavour. This'll be neither fast nor easy. This industry moves slowly, adopts new technology cautiously. It takes 18 to 24 months to close deals, and we are having to educate everyone on why our vision is the right vision. Executing this vision is like threading the needle: we have to execute flawlessly in an environment with very low tolerance for failure.

Our restructuring work that we did over the past 18 months has moved us from a highly fixed cost structure to a more variable cost structure, and so we will leverage this capability to manage our expenses. We will continue to prioritize our goal of investing for cloud against other discretionary spending.

I love what we are doing. It is exciting and infectious, and our customers, once they understand how we are differentiated, love the message. It is a tall path to execute, but we are building the team and driving the message that our charging platform to the public cloud is a reality in 2019.

At this point, we're ready to open up the call for Q&A. Anne Louise (phon), we're ready for questions.

QUESTION AND ANSWER SESSION

Operator

Thank you. We will now take questions from the telephone lines. If you have a question and you're using a speakerphone, please lift your handset before making your selection. If you have a question, please press star, one on your telephone keypad. If at any time you wish to cancel your question, please press the pound sign. Please press star, one at this time if you have a question. There will be a brief pause while participants register for questions. Thank you for your patience.

We have a first question, from Steven Li from Raymond James. Please go ahead.

Steven Li, Raymond James

Thank you, Danielle, Anin. One question I had was your support revenues increased sequentially. Can you help us to reconcile this with the loss of customers and general reduction in orders? Thanks.

Anin Basu, Interim Chief Financial Officer and Vice President, Finance, Optiva Inc.

Hi Steven. The support revenues, although remain flat compared to Q1 '18 but sequentially it's increased very marginally, that's a function of orders that come in every quarter on support revenues. Certain quarters, there are orders that come in slightly later, and their catch-up is made in the following quarter. That could be—that is the main reason why there are these slight fluctuations quarter-over-quarter.

Steven Li, Raymond James

All right, but year-over-year this year, 2019, you'd still expect support to be down?

Anin Basu, Interim Chief Financial Officer and Vice President, Finance, Optiva Inc.

Yes, we would expect support to go down. It depends on when the customer terminations come fully into effect. This is not exactly in our control; we don't specifically guide on support and subscription revenues, but the trend is tending downwards.

Steven Li, Raymond James

Okay, that's helpful. Then, if I look at your different geographic regions, APAC was really the only one that was down substantially. Any colour would be helpful there. Thanks.

Anin Basu, Interim Chief Financial Officer and Vice President, Finance, Optiva Inc.

These are—again, APAC is a region where, in the past, we have had more software services revenue. Those orders have not been coming in at the levels we are expecting, and it is a function of our customer success efforts that we are putting in. We have seen a decline in that area, mainly because of that reason.

Steven Li, Raymond James

Okay, and then maybe a question for Danielle. If I exclude the restructuring disbursements, you'd be at cash flow break-even, about there. But given your comments about accelerating the product innovation—so for the rest of this year, would you then expect to be cash flow negative for the rest of the year? Thank you.

Danielle Royston, Chief Executive Officer, Optiva Inc.

Yes. I mean, like I mentioned in my commentary, we're making those trade-off decisions in terms of investing for the cloud, running cash flow break-even. As I mentioned, we're very thankful for the work that we did over the last 18 months with regard to restructuring to change our cost basis from being very fixed to being a lot more variable. We'll prolong those levers. I expect it to jitter.

From quarter to quarter, it's kind of hard to manage it right and land right on the dot, cash flow break-even. It's certainly—it continues to be a goal, but again, if we have the opportunity to accelerate things to the cloud, we might make that trade-off, like we're planning to, for example, with the dividend, to defer it, so that we can accelerate some spending for the cloud.

Steven Li, Raymond James

Okay, makes sense. Then maybe a quick one, how much restructuring disbursements is left in 2019? Thank you.

Anin Basu, Interim Chief Financial Officer and Vice President, Finance, Optiva Inc.

We have estimated disbursements of about $6 million in 2019, but remember, this is the current portion. In total, we have about $11 million to go.

Steven Li, Raymond James

Very helpful, thank you.

Operator

Thank you. The next question is from Rob Young from Canaccord Genuity. Please go ahead.

Robert Young, Canaccord Genuity

Hi, good morning. Just want to continue on one of Steven's questions, on the support revenue. Did you essentially say that Q4 and Q1, should we consider those together? I think Q4 was a bit lower, and then Q1 a bit high, but the average would have been down. Is that—is it just timing between the two that you were explaining there?

Anin Basu, Interim Chief Financial Officer and Vice President, Finance, Optiva Inc.

Yes, that's correct, Rob.

Robert Young, Canaccord Genuity

Okay. You're at, I guess, call it a $110 million run rate now, yet you're saying that you expect to see continued declines, no change there. But, is that previous range that you'd been sharing, $90 million to $120 million, is that still a relevant range?

Danielle Royston, Chief Executive Officer, Optiva Inc.

Yes, that's our goalpost. We're not updating that; we continue to hold to that. I think we've been using those numbers since about August of 2017. We feel like one of the most important things about our Company is really having a grasp of where this revenue is headed over the long-term. We've shied away from giving explicit guidance, but rather giving sort of a long-term view.

If you remember, back in August of '17, we wanted to create a plan that accounted for the customer losses, because we knew it would take time before growth would set in. It was really important to set our expense level relative to where we thought revenue was going to end up. Rob, I think you remember my goalpost better than anyone, it's kind of that $90 million to $120 million range. I'm not updating that; I'm still holding to that, and so, as Anin alluded to, we still feel that 2019 will be another shrink year, just because, assuming cloud kicks in, we're educating everyone, these are super long sales cycles. It will just take time for that revenue growth start to eclipse the shrink.

Robert Young, Canaccord Genuity

Great, and you didn't see any customer churn this quarter, but you're still expecting one or more customers to roll off in the future?

Danielle Royston, Chief Executive Officer, Optiva Inc.

Yes, and it seems like—I'm coming up on my two-year anniversary, I think actually next week, Valentine's Day, so it's easy to remember. Two years ago, we got the list of people who were planning to leave. They'd already purchased competitive systems, alternative systems to move to; we know it takes a long time to migrate from one system to the other, this is like voluntary heart transplant—but some of our customers had taken that decision and started their projects.

Those projects are still moving along. I am thankful that they are moving slowly; it means that we get to continue revenues that we otherwise planned to be gone by this point. It gives us the opportunity to leverage those revenues into other investments. But, I don't see customers changing their mind. I mean, they've spent millions on another system, and I still see that they're going to switch.

I think what is going on is it has slowed down because maybe people are not as worried about our long-term viability, they're not such in a rush to get off of our system. I think there's some other market pressures with our competitors that are causing them to really think through what they're doing, and I think our cloud message is causing them to maybe look over their shoulder. I'm not seeing anyone really change their mind, but they're kind of looking back and saying, wait, what did you just say about cloud? Why don't you come talk to me about that?

No one left this quarter; the people that are leaving, think they're still leaving, no one changed their minds. But, I am seeing some people put a tap on their brake and that's kind of cool.

Robert Young, Canaccord Genuity

Okay. The shift that you talked about, that you shifted from a fixed towards a variable cost structure, I guess we see that here this quarter. The R&S is quite a bit lower than the average over the last four quarters. Looking forward here to 2019, just for modeling perspective, how do we think about quarterly R&D? We should have bounced back up to that $15 million level, or are you expecting it to be lower in 2019?

Danielle Royston, Chief Executive Officer, Optiva Inc.

Yes, at this point we're not ready to provide guidance on specific levels of R&D. Like I said, we want to have some flexibility to accelerate cloud innovation, product delivery; we had some customers that are beginning to consider starting pilots, and that'll cost money to get that going up in Google Cloud. At this point, it's going to be quarter-to-quarter, seeing how much we can put into investments versus our other priorities, our other spending, and I think it's just going to be quarter-to-quarter as we navigate this exciting journey.

Robert Young, Canaccord Genuity

Okay. Let me put it just a different way, I'm trying to reconcile what you said about accelerating the spend to take advantage of that cloud opportunity. I'm looking at the R&D drop here in Q1 and reconciling that with what you're saying about the spending environment going forward, taking advantage of that. I'm assuming, based on that, that I would expect it to grow from here. I'm not asking for guidance specifically, but maybe just some help around whether it's going to go up or down, or stay here?

Anin Basu, Interim Chief Financial Officer and Vice President, Finance, Optiva Inc.

Rob, on an average, our goal is to flow (phon) back cost savings into product innovation. We do expect some variability in our spend from quarter to quarter. It's kind of difficult to answer the question without—there are some moving pieces that we have to address and adjust—or ratchet it up and down accordingly, but on an average, obviously the amount that we spent in Fiscal 2018 was purely an aberration. It was—there were multiple things happening there.

We had product quality issues that we were fixing for future version releases; those type of spends are declining as the product quality has improved, and now, the dollars that will be spent in R&D is more geared towards the cloud innovation. Clearly, the allocation of our spend in R&D is going to be proportionately higher in cloud innovation than what we had in previous quarters.

Robert Young, Canaccord Genuity

Okay. Maybe I'll just ask you a couple questions on this cloud win in Australia, I'll pass the line. It's with an existing customer, but was it something where Optiva was responding to competitive cloud RFP, or was it a migration of the existing business?

Danielle Royston, Chief Executive Officer, Optiva Inc.

It is the latter, a migration of existing business. This customer has heard our cloud message. They are not running one of our charging products, which is, I think, where I'm really stressing our cloud move is the real-time charging nature of the majority of our revenue. That's the part I talked—that's very exciting about moving that to the cloud.

This customer was running a related product, it's a telco, and moved their entire estate with us into GCP and achieved some significant cost savings. They were already a Google shop, so it was pretty easy to get them over the hump of selecting Google. They heard our message, we invested how easy or difficult it would be to move their estate up into GCP; it was pretty easy and we were able to do it within a quarter, and then we made the announcement.

It's really exciting in that it's our first, but I feel like there's a couple of early adopters that are sniffing around and really starting to consider moving to GCP or installing a hybrid cloud project, so it's starting. As Anin was just talking about R&D, every day we're making decisions of—okay, we freed up some cost, so we want to put it into R&D and accelerate some product innovation; we want to put it into sales and marketing, maybe go bigger at MWC, or maybe hire some more salespeople to have a bigger footprint around the world. It really is a month-to-month decision of where we're going to deploy our resources.

Robert Young, Canaccord Genuity

Okay, and this is limited, like you said, to wholesale billing, so not the core charging product. Is this a baby step towards that, do you think? I don't think a lot of people are very clear on what the differences are, so maybe you could just explain those? Then I'll pass the line.

Danielle Royston, Chief Executive Officer, Optiva Inc.

Yes, I guess the main easy way to describe it is billing a settlement that is not required to be real-time, and charging is real-time. Think of—it's billing, it's getting a bill 30 days after the event. The speed is not quite as important as, say, charging, where someone's waiting to complete a call or complete a transaction, and until the charging engine is complete, it won't go through. I think the timing is the easiest way to describe the differences.

I think it is a baby step, right? It's proving that it works, it wasn't that difficult, the cost savings are real. What it doesn't really prove is the speed, because speed is not important in wholesale billing. But it's the beginning. People are starting to dip their toes.

As I visit customers, my last 12—let's say, six months ago, I was really excited to say the word cloud, and I would see everyone's initial response of, like, you're crazy. Now people are like, wait, what did you say? Talk to me more. I'm getting a lot more positive response and a deeper conversation around cloud, so I feel like our message is getting out there, the education is working.

We still have a long way to go, it's still going to take a long time, but people are calling us back, they're asking for this total cost of ownership analysis for us to do so that they can understand, what does this mean for them. I wouldn't say that flywheel is spinning, but it is sort of moving, so that's really exciting.

Robert Young, Canaccord Genuity

Okay, thanks for answering all my questions. I'll pass the line.

Danielle Royston, Chief Executive Officer, Optiva Inc.

Yes, no worries, thanks.

Operator

Thank you. Once again, please press star, one on your telephone keypad if you have a question.

We do have a question, from Amy Dick from CIBC. Please go ahead.

Is there anyone on line? If you're using…

Amy Dick, CIBC

Oh, hi there, sorry. Can you hear me?

Operator

Yes, we can hear you now.

Amy Dick, CIBC

Oh, hi, thanks. This is Amy on for Todd, just a quick one from me. I know you're not giving specific guidance, but can you give us, maybe, on how to think about gross margins going forward?

Danielle Royston, Chief Executive Officer, Optiva Inc.

Yes. On gross margins, I think we have a note in our MD&A about sort of the way that we're thinking about some of our R&D spend. As part of my work, coming into Redknee/Optiva, really starting to understand when we're deploying certain R&D efforts, where is it going? Is it really going to build future products that the customer base can leverage, or is it going to a specific customer that only assists their implementation?

When I came in, we had a very, very wide base of installed versions across the Orga base, across the old Nokia base, and even across the old Redknee base. As we've gotten our processes cleaned up, we have a lot more visibility into the hours spent and the dollars spent to fix, let's say a defect in the product. We know where those defects are going.

One thing that we've done is taken just a stronger look on what we're considering is R&D and what should be considered in cost of goods sold. I think—again, we don't really give guidance. I think high 50s, low 60s is kind of where we—I think, ish, we should be, given where—what's installed out there in the actual real world. I think as people start to adopt cloud and start to get onto more current versions, adopting the latest version, I think that's the opportunity for maybe an increase, but until people do that, I think gross margin's going to stay in that sort of low 30s range, would be a good way to think about it.

Amy Dick, CIBC

Okay, perfect. Thank you. That's it for me.

Danielle Royston, Chief Executive Officer, Optiva Inc.

Okay, cool.

Operator

Thank you. There are no further questions registered at this time. This concludes the conference.

Please disconnect your lines at this time, and thank you for your participation.
