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SPSC.OQ - SPS Commerce Inc To Acquire Data Masons - M&A Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the SPS Commerce Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions)

I would now like to hand the conference over to your speaker today, Irmina Blaszczyk. Thank you. Please go ahead, ma'am.

Irmina Blaszczyk - The Blueshirt Group, LLC - MD

Good morning, everyone, and thank you for joining on today's call to discuss SPS Commerce acquisition of Data Masons. Before turning the call over to management, I'll read our safe harbor statement. We will make certain statements today, including with respect to the acquisition of Data Masons' expected financial results, go-to-market strategy and efforts designed to increase our traction and penetration with retailers and other customers.

These statements are forward-looking and involve a number of risks and uncertainties that could cause actual results to differ materially. Please note that these forward-looking statements reflect our opinions only as of the date of this call and we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Please refer to our SEC filings for a more detailed description of the risk factors that may affect our results. These documents are available at our website, spscommerce.com and at the SEC's website, sec.gov.

During our call today, we will discuss adjusted EBITDA financial measures. In our press release and our filings with the SEC, each of which is posted on our website, you will find additional disclosures regarding these adjusted EBITDA measures.

And with that, I will turn the call over to Kim.

Kimberly K. Nelson - SPS Commerce, Inc. - Executive VP & CFO

Thanks, Irmina, and welcome, everyone. Thank you for joining us on short notice. We're excited to announce the acquisition of Data Masons, which further expands SPS' leadership position in fulfillment system automation for Microsoft. SPS has acquired all equity interest in Data Masons for approximately \$100 million in cash. The transaction closed yesterday and will be reflected in our 2020 financial statements.

Given the timing of the transaction, we expect Data Masons to have a nominal impact to our fourth quarter and full year 2020 financial results. For modeling purposes in fiscal year 2021, we expect the acquisition will add approximately \$20 million in revenue and approximately \$3 million in adjusted EBITDA. This includes the estimated impact of approximately \$2 million of the deferred revenue adjustment related to purchase accounting.

We also expect the acquisition to contribute approximately \$5 million to adjusted EBITDA in fiscal year 2022. We expect customer count to increase by approximately 450, and our combined wallet share to increase by approximately \$175. In addition, Data Masons' recurring revenue mix is approximately 50%.

As a result, we expect the consolidated SPS recurring revenue to be in the low-90s percent range. Lastly, we will have an increase in amortization of intangibles. However, that amount won't be finalized until the acquisition accounting is complete.

We will provide those details when we issue our fourth quarter and 2020 financial results and provide full year 2021 guidance for the combined company in February next year.

And with that, I'll turn it over to Archie to discuss the strategic elements of the deal.

Archie C. Black - SPS Commerce, Inc. - President, CEO & Director

Thanks, Kim. We're excited to announce the acquisition of Data Masons, a provider of EDI solutions to hundreds of consumer goods, industrial and distribution businesses and resellers.

Together, SPS Commerce and Data Masons offer unmatched trading partner and system expertise for customers using Microsoft solutions. Combined, we have numerous partnerships in the Microsoft community that will extend SPS Commerce's leadership in this market.

We have worked closely with Data Masons since 2011, and we share a vision of providing the easiest to use, most automated EDI solutions that help suppliers optimize efficiency when transacting with their trading partners.

As part of the SPS Commerce community, Data Masons' customers will now have access to the SPS Commerce global retail network, which includes more than 90,000 trading partners in over 80 countries and expanded capabilities for connecting with global supply chain partners.

We would like to welcome Data Masons' employees and customers to the SPS Commerce community. We believe we have a large global opportunity in front of us, and this acquisition further extends the power of our retail community.

With that, I'd like to call -- open the call to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Scott Berg from Needham.

Scott Randolph Berg - *Needham & Company, LLC, Research Division - Senior Analyst*

And congrats on the acquisition. I guess first question is, Archie, on the fit of the technology, I had a chance to review the company's website this morning, and it doesn't look like it's a straight-up EDI fulfillment technology that you would typically buy and maybe migrate those customers in your -- on your platform. Can you help us understand how the technology is probably a little bit more complementary than just the typical customer value you guys have typically went after?

Archie C. Black - *SPS Commerce, Inc. - President, CEO & Director*

Yes. Thanks, Scott. I think there's a couple of things. One, they were a straight competitor in the fact that you could buy Data Masons and they would build out to your trading partners, one at a time, not in the same manner. And then second, we were a partner where they use the systems automation where you'd be able to connect the retail network of SPS Commerce back into Microsoft systems. And the primary system that we're really excited about is D365, which is moving to the cloud, and we're able to draft off of the momentum from Microsoft to be able to move many of the on-prem customers into a cloud-based solution as they move to D365.

So I would say it's both complementary and competitive. And as those customers move to a cloud-based solution, I think we'll be able to take that onetime revenue that they have and converts that into recurring revenue.

Scott Randolph Berg - *Needham & Company, LLC, Research Division - Senior Analyst*

Got it. So that 50-50 revenue split that Kim mentioned on the services side, it doesn't sound like that mix split will be kind of continuing in the future as those customers move?

Kimberly K. Nelson - *SPS Commerce, Inc. - Executive VP & CFO*

The 50-50 split, Scott, is based on what it currently is. And you are correct, over time, expect that more of that percentage will be recurring revenue.

Scott Randolph Berg - *Needham & Company, LLC, Research Division - Senior Analyst*

Great. Helpful. And then last question for me, and I'll turn it over. Of the 450 customers, should we assume that those are all new customers? Or were there examples of that complementary offering where maybe there's some overlap of those 450?

Kimberly K. Nelson - *SPS Commerce, Inc. - Executive VP & CFO*

The 450 is the net new. We did have some overlap with complementary customers, but the 450 is what would be a net new customer to SPS.

Operator

Our next question comes from the line of Jason Celino from KeyBanc.

Jason Vincent Celino - *KeyBanc Capital Markets Inc., Research Division - Senior Research Analyst*

Great. Just a couple for me. I think by the numbers, this is the largest acquisition in the company's history. Should we just see this as a natural progression of the M&A strategy?

Archie C. Black - SPS Commerce, Inc. - President, CEO & Director

Yes, I think that's right. I mean, we're in a position where, although this is the largest acquisition as both the percentage of revenue of the company and based on market cap, it is not the largest but as we continue to grow. Now having said that, as we've stated in the past, most of our acquisition opportunities are this size or smaller. So we'll continue to be on the look for acquisition opportunities. But my guess is that the vast majority will be this size or smaller just because of the landscape of opportunities, not because of our willingness.

Jason Vincent Celino - KeyBanc Capital Markets Inc., Research Division - Senior Research Analyst

Got it. Okay. And then from a -- I know the growth profile will likely change going forward. But are you able to discuss maybe how fast Data Masons was growing as a stand-alone company?

Kimberly K. Nelson - SPS Commerce, Inc. - Executive VP & CFO

Sure. So they would have similar growth rates to our business. So you can think about we're sort of a 10%-plus revenue growth, they have similar dynamics in their growth rates.

Operator

Our next question comes from the line of Mark Schappel from Benchmark.

Mark William Schappel - The Benchmark Company, LLC, Research Division - Director of Research & Equity Research Analyst

Congratulations on the deal. Most of my questions have been answered. But just one, how much professional services revenue did they have as a percentage of total sales?

Kimberly K. Nelson - SPS Commerce, Inc. - Executive VP & CFO

Sure. So when you look at their mix of business, about half is more onetime in nature, and we would consider professional services onetime in nature and about half of it's that recurring revenue. So the onetime revenue is going to be a mix of when they're getting a customer up and running to ongoing requests that may come in from that customer in more of their on-prem model. So the split is about 50%, onetime, 50% recurring.

Mark William Schappel - The Benchmark Company, LLC, Research Division - Director of Research & Equity Research Analyst

Okay. And then employees, how many employees do they have?

Kimberly K. Nelson - SPS Commerce, Inc. - Executive VP & CFO

They have about 150 employees.

Mark William Schappel - The Benchmark Company, LLC, Research Division - Director of Research & Equity Research Analyst

And our -- I assume most of them are coming on board with SPS?

Kimberly K. Nelson - SPS Commerce, Inc. - Executive VP & CFO

Yes. Our plan is our -- we think the combination of the 2 companies put the consolidated company in even a better position. So yes, the employees are part of the transaction. We're very excited to welcome them all to the SPS business.

Operator

Our next question comes from the line of Joe Vruwink from Baird.

Joseph D. Vruwink - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Great. Just on the last question, are there things about adding Data Masons that enables SPS to maybe change some of the investments you had alluded to last quarterly call into 2021, specifically thinking if you add 150 new colleagues, does that change the kind of organic investment intent on the SPS side of things?

Archie C. Black - SPS Commerce, Inc. - President, CEO & Director

It actually doesn't. And the rationale -- the primary rationale of this deal is that combined, we think we can sell more, and we think we can have a better customer service [experience] So that's really the rationale of the deal. So in the non-Microsoft space, it's business as usual in the Microsoft part of our business, it will be an acceleration. So we really don't -- this is not a cost synergy play. This is really a growth plus customer experience story.

Joseph D. Vruwink - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Okay. That's helpful. And then I was hoping you could maybe walk through some of the differences between your 2 businesses, just surfing their website this morning. There's some illusion to growing revenues by 130% in 2019, record rates of growth. Client retention seems to be very high. And as you alluded to, Kim, the wallet share is quite a bit bigger than SPS. So there would seem to be some differences there that I'm just hoping you can walk through.

Archie C. Black - SPS Commerce, Inc. - President, CEO & Director

Yes. So I don't know about the 130% growth. I know they didn't grow 130% this year. So that must be some segment of -- some segment of some other segments. So it must be a small number, but their growth profile is very similar to ours. So again, they had a competitive product where you could build out the network, which we have competitors out there. And then also, I think where the synergy really comes in is they have this strong knowledge and technology to be able to integrate to Microsoft. And in particular, what we're most interested in is the D365 space. So think of this as very much a similar to a large deal we did with SWK and MAPADOC in late 2019. And so a very similar partner, but they did have a competitive solution as well. So we're gaining customers, and we're also gaining a very talented team at Data Masons.

Operator

Our next question comes from the line of Nehal Chokshi from Northland Capital.

Nehal Sushil Chokshi - Northland Capital Markets, Research Division - MD & Senior Research Analyst

It looks like a nice tuck-in acquisition synergistics on all levels. Kim, you mentioned that greater wallet share. Just want to be clear, is it actually greater wallet share? Or is it larger customers that Data Masons is bringing?

Kimberly K. Nelson - SPS Commerce, Inc. - Executive VP & CFO

Sure. So we will be adding approximately 450 customers. So that's how you would model the change on the customer. As it relates to the wallet share, the combined wallet share would increase by about \$175. The reason why the wallet share increases, to your point is they tend to have larger customers than our average customer size.

Archie C. Black - SPS Commerce, Inc. - President, CEO & Director

But remember that underneath the covers of our customers, we do have a segment of customers that are this size or larger. So this is in a new customer segment. We just underneath the covers, have very small customers, medium customers and large customers. They tend to have more just the medium and then some large.

Nehal Sushil Chokshi - Northland Capital Markets, Research Division - MD & Senior Research Analyst

Got it. Okay. That's really helpful. And then what percent of the SPS customers before acquisition were exclusively using Microsoft solutions?

Archie C. Black - SPS Commerce, Inc. - President, CEO & Director

We have a significant number of customers using Microsoft solutions. I don't know the exact number because we have 2 types of customers, those that are integrated back into Microsoft. And then those that are not in our -- just our straight fulfillment product without integration, but my guess is a pretty significant number.

Nehal Sushil Chokshi - Northland Capital Markets, Research Division - MD & Senior Research Analyst

I guess another way to think about it is like what percent of a market does the Microsoft-only solution represent?

Archie C. Black - SPS Commerce, Inc. - President, CEO & Director

It's one of many, many different solutions. So for us, it's not the largest segment, but I think it's just knowing what Microsoft's done, especially moving things to the cloud. I think there's an opportunity in the Microsoft space because of their movement to the cloud, and they're doing so aggressively that -- that's a touch point to be able to move them to a complete SaaS model. So that's why we're excited about it, and this is one of our 5 focus areas. In channel sales, when you look at our channel sales group, in particular, they have the SAP market, the Oracle market, the NetSuite market. And I know those -- that Oracle owns NetSuite, but they really are different markets. And then the Sage market and then the Microsoft. Those are our 5 focus areas. So this has already been one of our 5 focus areas. And so we think it's a pretty meaningful opportunity.

Nehal Sushil Chokshi - Northland Capital Markets, Research Division - MD & Senior Research Analyst

I see. Okay. And then last question is that can you talk about the genesis of the acquisition when the talk start and sincerity and what was the catalyst for them for moving forward? Because as you mentioned, you guys have been partners since 2011?

Archie C. Black - SPS Commerce, Inc. - President, CEO & Director

Yes. I mean we've had a long-term relationship with them. I've known Glenn McPeak. The -- 1 of the 2 Founders for, I guess, over a decade. And we've talked over the years and now seem to be a good time to pull it together. And one of the things is on these acquisitions, it's always important is it's the seller, he's got -- they've got a very strong, solid business. Weren't in a position where they need to sell. And so you really need to find the

timing where the Founders are ready to sell. And I think this was the right time for a lot of different reasons. And it was -- it's the right time for us as well, especially as Microsoft moves to the cloud. I think the timing just makes us almost ideal for us.

Operator

Our next question comes from the line of Koji Ikeda from Oppenheimer.

Koji Ikeda - *Oppenheimer & Co. Inc., Research Division - Director & Senior Analyst*

Great. Congrats on the acquisition. Just a couple of questions from me. First question, it sounds like a lot of the focus of the acquisition was for technology and going after this Microsoft D365 opportunity. So the first question is, what was it about Data Masons, maybe the differentiation on the technology that made the company attractive to acquire? And then the second question is, a lot of focus on Microsoft D365. I mean why is going after the D365 opportunity more strategically here going forward? Why is that important for SPS Commerce?

Archie C. Black - *SPS Commerce, Inc. - President, CEO & Director*

Well, I think a couple of things. One, they have been very, very focused on the Microsoft solution for 15 years and focus that's given them great technology. They also -- we think of this as people, process and technology. They also have an extremely strong team and a strong culture. So I think that was really important. And I think we've always seen the Microsoft space as strategic as we do Oracle SAP, Sage and NetSuite. We have very early on, built an extremely strong solution for NetSuite, which allows us to be in that space, very strong. We made -- we had built a solution, and we built some -- bought some technology a few years back in EDI admin to help us in the Oracle SAP space. About 1.5 years ago, we bought SWK and MAPADOC that really helped us further penetrate into the Sage space, and I think this is the same here. So it's just an acceleration of our product road map. There's nothing new, but they do have name recognition and also relationships and obviously, a meaningful amount of customers. I think what's important is when we look at it, the customers that are paying more the onetime fees, we're going to continue to service those customers and do whatever they want to do and service them in the way they've become accustomed to. But as they move their on-prem solution to a SaaS model at Microsoft, they're naturally going to want to move to a SaaS model for the EDI component. And that's why, in particular, this is a little bit of a unique timing that, that wasn't the case 4 years ago. And I think if we look forward in 4 years, many of those customers will have moved.

Koji Ikeda - *Oppenheimer & Co. Inc., Research Division - Director & Senior Analyst*

Got it, Archie. Super, super helpful. And just a question on the net new 450 customers you guys are adding to your platform. On the geographic reach of those customers, is it right to think that they're mostly the U.S.? Or is there an international component to those 450 net new customers?

Kimberly K. Nelson - *SPS Commerce, Inc. - Executive VP & CFO*

Sure. The majority are North American customers. They do have a small international presence, but the majority of it is North America.

Koji Ikeda - *Oppenheimer & Co. Inc., Research Division - Director & Senior Analyst*

Got it. And then last question for me. Apologies if you guys went over this already. But on the recurring revenue piece of 50% of the revenue that you're coming from Data Masons is what's the pricing model for that? Is that similar to SPSC? Or is it a little bit different?

Archie C. Black - SPS Commerce, Inc. - President, CEO & Director

Well, going forward, we will have 1 -- we have a new pricing -- we'll have a new pricing model, which they had moved towards. So from a customer standpoint, I think it will be very seamless.

Operator

Thank you. At this time, I am showing no further questions. Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.

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