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Q3 2022 Cellebrite DI Ltd Earnings Call

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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Cellebrite Q3 2022 Earnings Call. (Operator Instructions). I would now like to hand the conference over to your speaker today, Sabrina Mathews, Investor Relations. Please go ahead.

Sabrina Mathews *The Blueshirt Group - Director*

Thank you. Welcome to Cellebrite's Third Quarter 2022 Financial Results Earnings Call. Joining me today are Yossi Carmil, Cellebrite's CEO; and Dana Gerner, Cellebrite's CFO. This call is being recorded, and a replay of this recording as well as the presentation that accompanies this call will be made available on our website shortly after the call. A copy of today's press release and financial statements, including GAAP to non-GAAP reconciliations as well as supplemental financial information for the third quarter are available on the Investor Relations website at investors.cellebrite.com. Statements made during this call that are not statements of historical facts constitute forward-looking statements.

All forward-looking statements are subject to risks and uncertainties and other factors that could cause matters expressed or implied by those forward-looking statements not to occur. They could also cause the actual results to differ materially from historical results and/or from forecasts. Some of these forward-looking statements are discussed under the heading Risk Factors and elsewhere in the company's annual report on Form 20-F filed with the SEC on March 29, 2022, as amended on April 14, 2022. The company does not undertake to update any forward-looking statements to reflect future events or circumstances.

With that, I'd like to turn the call over to Yossi Carmil, Cellebrite's CEO.

Yossi Carmil *Cellebrite DI Ltd. - Founder, CEO & Director*

Thank you, Sabrina, and thank you all for joining us today. I'm pleased to share that we had a solid third quarter. And in particular, I'm happy with the results we delivered in the U.S. federal sector, which I will talk more about later. In Q3, our ARR grew 35% year-on-year to reach USD 232 million. Total revenue in the third quarter was up 9% to reach \$71.7 million. Additionally, our net retention rate for the quarter came in at 129%. As this represents the 15th consecutive quarter that we've delivered NRR of greater than 120%, we are proud of maintaining best-in-class retention rates, proving that our go-to-market strategy is bearing fruit. And, our existing customers continue to spend on our technology, resulting in 25 large deals closed in the quarter.

I would like first to spend time outlining what we are seeing in our market and some go-to-market updates, then I will go through a few exciting deals we closed in the third quarter before providing an update on our recent technology innovations and then we'll hand over to Dana to discuss the financials in more details.

So we continue to operate in an environment where the public safety gap is rapidly growing as digital evidence continues to be of growing importance to law enforcement efforts. As criminal cases become more complex and digital evidence volumes grow, agencies are under an enormous strain to sort through the massive amount of data and ultimately solve cases. To combat this issue, Cellebrite's suite of solutions and services offer an integrated experience for the entire digital evidence life cycle from Collect & Review to management and analytics.

Additionally, we offer training and certification for our platform to give law enforcement agents insights and best practices to properly fight crime with digital evidence. Our growing pipeline demonstrates that our solutions and innovations are maintaining high relevance, which is further underscored by our discussions with customers.

So during the third quarter, we made significant progress in addressing some of the hiring issues in our go-to-market organization that we alluded to last quarter. The actions we have taken have been effective and on a faster timeline than planned in terms of recruiting, onboarding and reaching productivity. So we are now well positioned to take full advantage of the market opportunity in front of us. In EMEA, Europe, Middle East and Africa, despite increasing headwinds in some parts of the region, we were able to grow our business faster than planned. We believe we have the right offering in place, and we are optimistic heading into the end of the year despite macro challenges, such as the Ukraine war and Continental inflation that are impacting many companies.

We've also made some notable updates to our executive bench with the addition of Lisa Cole as our new Chief Marketing Officer; and Ayala Berler Shapira as General Counsel.

Now, Lisa comes to us with extensive experience in various leading marketing roles. And Ayala, in addition to her notable experience with global technology companies and some of the leading law firms in Israel, brings a depth of knowledge in ethics and compliance, which aligns with Cellebrite ethical focus. So we are very excited to welcome these leaders to our organization as we grow.

An important part of our go-to-market motion has been increasing wallet share within our existing customers and our third-quarter net retention rate illustrates the success of that initiative. In the third quarter, we closed a number of exciting engagements with existing customers. And importantly, we are seeing a growing pipeline within both our existing customer base and with the new customers. And I would like to take you through a few examples.

The first one, we closed a large multiyear expansion deal with a major U.S. federal agency. Now this existing customer initially had approximately 100 Collect & Review licenses and 1 premium stand-alone system. Now our team sat down with the customer to better understand the mode of operation and quickly identified areas for their users to get more out of their existing solutions through training and release process bottlenecks that were putting strain on investigations by subscribing to our latest Collect & Review offerings.

Ultimately, this long-term customer ended up purchasing a wider range of Collect & Review technology with advanced capabilities, extending activities to the field with mobile Collect & Review as well as management licenses. They also purchased a large training package to ensure agents can harness the full power of Cellebrite's offering and are well-equipped to solve cases.

Second example in the U.K. So in the U.K., we had a significant expansion from an existing customer with Premium Enterprise. This expanded the premium advanced collection capabilities to approximately 70 UFED endpoints across 7 counterterrorism units. Before that, these customers were having to send locked phones to the central lab for data extraction, adding time and adding complexity to investigations.

Now this expansion has had a notable impact on their operation with our Collect & Review technology now being available across 7 districts. And there was another one, another similar large expansion deal in the EMEA region, expanding an agency's centralized extraction capability to 11 regional labs. This customer also added premium enterprise endpoints and now operates our premium Collect & Review capabilities in more than 100 sites.

Also, our partnership strategy is developing nicely. We closed in this quarter our first Chainalysis deal in the Asia Pacific region during the third quarter. This new partnership announced in July expedites the resolution of digital investigations involving cryptocurrency by enabling customers to easily identify and assess criminal activity. As the importance of cryptocurrency has increased in the past several years, there has been a rise in illegal uses to facilitate crime, resulting in cryptocurrency artifacts more commonly found in digital evidence. Now by combining the power of Cellebrite and Chainalysis, customers can leverage the transparency of blockchains and modernize investigations. Now while we are still in an early stage of this partnership, we look forward to continued traction and opportunities.

A little bit about our products. Our recent innovations continue to resonate well with the market. At the end of Q2, we launched Premium as a Service, which has already been adopted by more than 120 customers, and we continue to see growing pipeline for this product. We're continuing to maintain material product differentiation in this area within different customer profiles, which demonstrates the power and stickiness of our technology.

As for Guardian, Guardian also continued to show strong momentum. We ended the third quarter with 11 Guardian deals closed and more in the implementation process. Now notably, this SaaS offering is now serving more than 100 agencies. A key aspect is, or I would say, in how customers utilize the Guardian product is by leveraging the tool to share digital evidence in a well-controlled and compliant manner with our agencies. In turn, this process gives Guardian a wide degree of exposure to other agencies, many of whom may be seeing our capabilities for the first time. And we have noted that this exposure has created a valuable new set of potential customers. This, coupled with our industry-leading technology has contributed to a large list of future opportunities with Guardian that we look forward to updating you on in the quarters to come.

So heading into the end of the year, Cellebrite is well-positioned to capture the demand for our solutions. Our relentless pursuit to innovate is being reaffirmed by our customers who are giving us positive feedback on our product portfolio of industry-leading technology. I remain excited about Cellebrite's future and opportunity in front of us as we pursue our mission to protect and save lives, accelerate justice and ensure data privacy.

And with that, I will turn the call to Dana.

Dana Gerner Cellebrite DI Ltd. - CFO

Thank you, Yossi. As Yossi mentioned earlier, ARR grew 35% year-on-year, reaching \$232 million by September 30, 2022. As we mentioned last quarter, we continued to move customers to a subscription model from our traditional perpetual licensing model. This manifests itself in an incremental ARR growth in the quarter that reflects our transition efforts.

Revenue for the third quarter was up 9% from the third quarter of last year and reached \$71.7 million, while subscription services revenue were up 31% and continues to be a primary driver of total revenue. Total subscription revenue grew 8% year-on-year in the third quarter off of a strong compare from our Q3 of last year, in which we had some outsized deals with large upfront revenue recognition that benefited term license revenue.

As we saw the U.S. dollar significantly strengthened against European and other major currencies than, relative to Q3 2021, our total revenue and total subscription revenue were unfavorably impacted by changes in ForEx rate of approximately \$3.1 million and \$2.5 million, respectively, representing adjusted year-over-year growth of 13% on both total revenue and subscription revenue. I would also like to highlight that our transition from perpetual to subscription has seen continued success with more than 98% of our software revenue is now subscription. Total subscription represented 78% of the quarter's total revenue, in line with the same period of last year. We saw good performance in professional services revenue, which was up 9% compared to a strong Q3 last year, contributed by the Cellebrite's Advanced Services executing on large contracts, supporting law enforcement agencies overcoming digital device backlog. This growth in professional services remains important to us as it helps drive larger deals and retention.

Our GAAP gross margin was 80% in Q3 as compared to 82% from the third quarter of last year. That is mainly a result of introducing costs related to our SaaS and cloud solution infrastructure and hosting services into our cost of goods sold expenses. This business is still in the early stages of development. And as it matures, we expect to streamline and optimize some of these costs resulting in better gross margins.

Moving to operating expenses. I will discuss this on a non-GAAP basis. So the share-based compensation, amortization of intangible assets, acquisition-related expenses and one-time expenses are all excluded. Non-GAAP operating expenses were \$54.1 million in the quarter. Similar to last quarter, although expenses increased compared to last year, they only grew marginally on a sequential basis. The year-on-year growth reflects our cost structure as a public company, resumption of in-person activities, the operational costs associated with adding SaaS and often offering to our development efforts and our ability to execute on hiring. Adjusted EBITDA in the quarter was \$5.1 million or 7% on a margin basis. Our Q3 adjusted EBITDA results reflect our continued investment in headcount to capture

Cellebrite's significant growth opportunity as well as maintaining our technical leadership by demonstrating operational efficiencies. Looking at the remainder of the year, we are focused on further optimizing our spend for efficiency while supporting our go-to-market efforts and ongoing commitment to product innovation.

We ended the month of September with 1,005 employees, up 18% from the end of September last year, and we will continue to monitor our staffing level to maintain our technological leadership and our go-to-market capabilities. Non-GAAP net income in Q3 was \$3 million and non-GAAP fully diluted EPS was \$0.01. Operating cash outflow in the third quarter was \$0.6 million. And in the last 12 months, we generated \$14.6 million of cash inflow. We ended the month of September with approximately \$168 million of cash, cash equivalents and investments.

Heading into the end of the year, we feel that we have the right products in place to capture the significant demand for digital intelligence solutions. EMEA business is traditionally above 30% of our total revenue and the strengthening of the U.S. dollar has negatively impacted our revenue and ARR results for the quarter. As such, we expect to finish financial year of 2022 at the lower end of our guidance range issued last quarter. Further, we remain confident in our ability to execute the targets we set forth and believe Cellebrite is positioned well for long-term growth.

With that, I would turn the call to the operator to open the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Our first question comes from Jonathan Ho with William Blair.

Jonathan Frank Ho *William Blair & Company L.L.C., Research Division - Technology Analyst*

I just wanted to maybe start out with some of the strength that you're seeing in the U.S. federal government vertical. And can you give us some additional color on really what's driving that success? What types of agencies, what types of opportunities you see ahead? And maybe help us understand how you can target that market a little bit more effectively with your go-to-market?

Yossi Carmil *Cellebrite DI Ltd. - Founder, CEO & Director*

I will take that, I will start. The strength on the federal markets from a Cellebrite perspective is based on a few components. First of all, a very strong position within the account and a very well experienced and a group of accounts, managers and account executives. The second one is strong penetration and stickiness with relationship for several years by now. Combined, I would say, with the ability to address and understand the specific way. Business has been down over there. It's a very unique segment. It's actually a dedicated segment within the Cellebrite customer segmentation, the federal in North America, with the ability to build the right personnel, not only in sales but also in presale and customer success, including cleared personnel on the ground.

And I would say that as for the future, based on that stickiness and strong position that we have right now, we can see that we are being -- we are capable to approach, I would say, larger budgets and also specific projects to expand the offering, our current offering and even beyond. As for the -- I will not go into specific names of customers, but one can say that in that area, we are working with most of the 3 later agencies. And in the areas of the DoD and the civil, we cover I think something like 130 accounts today in North America. Would you like to add something Dana? No. I hope I answered that question.

Jonathan Frank Ho *William Blair & Company L.L.C., Research Division - Technology Analyst*

Yes. And then just as a follow-up, can you give us a sense of how much impact from FX there was on your full-year guidance? I think you quantified it for the quarter, but I just wanted to get your assumptions on the full-year impact relative to FX.

Dana Gerner *Cellebrite DI Ltd. - CFO*

So the reason that we have referred to the quarter is because we have provided a guidance -- an updated guidance last quarter. And as such, we have looked at how much was the change since that. The guidance that we have provided last time took into consideration already some of the ForEx impact at the beginning of the year. So this is why we have focused on Q3.

Operator

. Our next question comes from Tal Liani with Bank of America.

Tomer Zilberman BofA Securities, Research Division - Analyst

This is actually Tomer Zilberman on for Tal Liani. Just 2 quick ones from me. Last quarter, you talked about some lengthening sales cycles as well as some deal slippage. So on the first one, is that something that you're currently seeing? And is that something that's still impacting the full-year guidance as well as on the deal slippage, I think you mentioned last quarter that you expected most of them -- most of those delayed deals to close in Q3. Have those subsequently been closed?

Dana Gerner Cellebrite DI Ltd. - CFO

So maybe I'll take it and Yossi, you can follow up. I think that the challenge of closing new deals is still something that is becoming part of our go-to-market processes and capabilities. We did have some slippage last quarter more than we usually have because of the size of these deals. We will always have some slippage from one quarter to the rest, but I think it is becoming more of a normal course of business. And indeed, we closed substantially most of the deals that have been slipped, last quarter between Q3 and early Q4.

Yossi Carmil Cellebrite DI Ltd. - Founder, CEO & Director

I would add that in principle, we see still longer sales cycle. This is one element, especially in the large deals. And yet, I would like to answer such that we currently do not lose any deals due to these longer sales cycles. And there is, for example, one to the question, are they all being closed? Some of them, yes. And I have in mind at least one which was relevant for Q2 and will be closed in Q4 for sure.

Operator

Our next question comes from Mike Cikos with Needham.

Michael Joseph Cikos Needham & Company, LLC, Research Division - Senior Analyst

You have Mike Cikos here, I wanted to make sure that I was clear on the guidance. I think that was the thing that I wanted to drill into first with you guys. So if I'm looking at the slides that you have posted on the webcast, I think it was Slide 16, you showed your updated guidance expectations for '22. And the reason I'm bringing that up is when I look at what's changed, it looks like only the ARR guidance has been taken down versus what we had last quarter. And I just wanted to make sure that I was interpreting this properly. So when you're talking in the press release, I know that there was some commentary that you expect to come in at the lower end of your previous range. Is that comment only for ARR? Or is that across the board when we think about revenue or gross margins or adjusted EBITDA? Can you just clean up that question for me because I do want to make sure I'm thinking appropriately about what the rest of this year looks like for you?

Dana Gerner Cellebrite DI Ltd. - CFO

So first, Mike, thank you for the question. The ARR -- the guidance that we provide on Slide 16 is actually exactly the same as we have updated last quarter, both on ARR revenue, gross margins and EBITDA. So we did not change these guidance numbers. What we were saying during the call is that we will find ourselves on the lower side of this guidance on the ARR, I would say, revenue and adjusted EBITDA. And I hope this answers your question.

Michael Joseph Cikos Needham & Company, LLC, Research Division - Senior Analyst

It does. And I did want to come back. I think it was Patrick, who had asked the first question, but one of the things that we're trying to do on the outside is figure out what the FX impact has been as we think about Q4 and the reason for the adjusted guidance, I think we're aware that your previous guidance probably incorporated some of the FX impact that you guys had been faced with. We're trying to get maybe a snapshot of what that delta has been or what that change has been in the last 3 months. Is there any way for you to size up what that impact has been on -- from 2Q to 3Q where we stand today?

Dana Gerner Cellebrite DI Ltd. - CFO

So if I look from -- I would say, from the early of Q3 to the end of Q3 from an ARR perspective, it was about between \$2.5 million to \$3 million impact on ARR. So we would have expected our ARR to be instead of \$232 million more towards the \$235 million, I would say, if there were no ForEx -- if we would look at the ForEx impact as of the beginning of Q3, and I would say around \$750 million to \$1 million more on the revenue on Q3 compared to early Q3 ForEx numbers.

Michael Joseph Cikos Needham & Company, LLC, Research Division - Senior Analyst

Okay. And I also wanted to make sure, if I'm thinking about Q4, and it's rough numbers here, but if I think about that \$2.5 million to \$3 million impact on ARR at the end of Q3 versus the beginning of Q3, is it safe to think that it's probably a similar \$2.5 million or \$3 million impact on the 4Q ARR? Or is it more or less? How do I think about the guidance for the rest of the year now?

Dana Gerner Cellebrite DI Ltd. - CFO

So I would say that the impact will be, unless the exchange rate will dramatically change upward and down or the dollar behavior towards the European main currencies will change dramatically. I would say that it will be similar and might be slightly higher.

Michael Joseph Cikos Needham & Company, LLC, Research Division - Senior Analyst

Okay. And then one more question, if I could. I apologize. But I did want to ask about the subscription gross margins. So I know that you guys have spoken about you're investing in the hosting capacity and the SaaS-based solutions, which obviously have an upfront cost associated with it when I think about the infrastructure. Is there a way for us to start thinking about when those gross margins should start expanding? And I don't know if it's Q4 or more of a calendar '23 event, but how should we think about those gross margins playing out over time?

Dana Gerner Cellebrite DI Ltd. - CFO

So I would say that our leading selling SaaS solution that really started to show top-line impact in Q3. We'll see them in Q4, but this is still in early stage of launching these solutions. I wouldn't look at expanding the margins on them before '23 and maybe even half of '23. We are still working on that. So it's a work in progress.

Operator

(Operator Instructions). Our next question comes from Louie DiPalma with William Blair.

Michael Louie DiPalma William Blair & Company L.L.C., Research Division - Analyst

Cellebrite reported a very strong net revenue retention. How much of the NRR growth is coming from the existing base upgrading to premium and premium enterprise versus cross-selling like newer products like Guardian and Pathfinder?

Dana Gerner Cellebrite DI Ltd. - CFO

You want me to answer that?

Yossi Carmil Cellebrite DI Ltd. - Founder, CEO & Director

Go ahead.

Dana Gerner Cellebrite DI Ltd. - CFO

Most of our revenues are still coming from the Collect & Review and as such, also the expansion between customers are coming from the more advanced Collect & Review solutions. So it's mainly the premium -- it's various flavors, premium, premium enterprise solution and also premium as a service, which we launched end of Q2 and was very, very well accepted by our customer base in Q3. We did see some expansion on the Pathfinder. We are seeing, as we reported, 11 deals of Guardian in Q3, which also provides some expansion. But again, most of the expansion is coming from Collect & Review solutions.

Michael Louie DiPalma *William Blair & Company L.L.C., Research Division - Analyst*

And are we still in the early innings of penetration for premium enterprise? On past calls, I think you quantified a number of specific target accounts that you're looking to upgrade to premium enterprise. Do you have any sense of what's the penetration of premium enterprise within those target accounts?

Yossi Carmil *Cellebrite DI Ltd. - Founder, CEO & Director*

I would like to say that we are in an early stage. That's for sure. Do you have the number?

Dana Gerner *Cellebrite DI Ltd. - CFO*

I don't have the number out of my head, but we are at an early stage. We have a few tens of customers on premium enterprise with a lot of opportunities and growing pipeline. The introduction of Premium as a service has allowed us to introduce premium to additional customer base that initially could not have participate or enjoy the premium due to the pricing of the offering. But Yossi?

Yossi Carmil *Cellebrite DI Ltd. - Founder, CEO & Director*

But Louie, I would say that -- well, I would say, I don't have the exact, but since we are monitoring it all the time, the good news is that we are first, again, in an early stage. And if I look at the strategic accounts and the mid prime accounts, which are the most relevant for the premium enterprise, we are lower than 20% penetration.

Operator

At this time, I show no further questions. I would now like to turn the conference back to Yossi Carmil for closing remarks.

Yossi Carmil *Cellebrite DI Ltd. - Founder, CEO & Director*

So thank you, everyone, for participating and for the questions, and thank you. Have a great day.

Operator

This concludes today's conference call. Thank you for participating. You may now disconnect.

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