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F-Secure Oyj (FSC1V.FI)

Q1 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Henri Kiili

Investor Relations and Corporate Finance Director, F-Secure Oyj

Good afternoon, everyone, and welcome to F-Secure's Q1 Results Presentation. I'm Henri Kiili, responsible for Investor Relations at F-Secure. Soon, our CEO, Juhani Hintikka; and CFO, Eriikka Söderström, will give the presentation about the Q1. Throughout the presentation, you can submit your questions in English language in the webcast portal.

But, now, without further ado, Juhani, the stage is yours.

Juhani Hintikka

President and Chief Executive Officer, F-Secure Oyj

Thank you, Henri. Good afternoon from me as well and good to be back here and report a positive start of the year for F-Secure. We witnessed business growth for both corporate and consumer businesses. Let me dive into some of the highlights of the quarter. So, first of all, I'd like to point out that that we had a very positive development in terms of our deferred revenue growth. And this, of course, means that we have secured business growth over a longer period of time. We will come back to this later how this works but, essentially, it means the backlog over a longer period of time.

In our business security software, the growth in orders clearly outpaced revenue growth which was also a positive indicator. And in our Managed Detection and Response business, we have won several new customers across Europe.

In cybersecurity, the consulting performance – cybersecurity consulting performance improved in Q1. As some of you may recall, we had a challenging year in 2020 as we were witnessing the impact of COVID-19. And that has also, of course, been reflected in our guidance regarding consulting. But, overall, a good performance in consulting. Good start of the year in Q1.

And our consumer security unit continued the strong performance we witnessed last year. We had a revenue growth of 8% during our first quarter, again, a very strong start of the year. The overall revenue growth and improved performance in consulting resulted in our adjusted EBITDA margin of 17%, which also was an improvement over last year. So, both in terms of revenue and EBITDA, we saw an improvement over last year.

Then, I'd like to mention that F-Secure has also won the best-in-class award for the AV-TESTs. These are independent tests performed by independent authorities in this cybersecurity business and, of course, they – the

performance in these tests indicates also the quality of our products. F-Secure is the only company that has won seven out of these tests over the period of 10 years. So, during seven years, we have been ranked as number one. And that, of course, is a strong statement about the quality of our products and technology.

If we then look at those numbers in more detail, so, from the left-hand side, you can see the development in terms of performance against last year. So, in last year's Q1, we saw a revenue of €54.8 million, now, €57.8 million, a 5% growth. And here, you also see how this revenue growth was divided; €12 million for consulting, €19.5 million for corporate security; and then €26.3 million for consumer security. So, growth and maybe I'll point out here that for the consulting, albeit the growth was modest, Q1 of last year was still regarded as a fairly normal quarter before the COVID really hit. So we have, in a way, recovered that performance level.

And then, the same in geographies; as you can see, starting from the top, €19.3 million of revenue in the Nordics, €26 million in the rest of the Europe, €5.7 million in North America, and other regions, a slight decline with a revenue of 6.9%. And in the extreme right, you can see how EBITDA has developed for this quarter over the past years. As you can see, there's a steady improvement in those numbers.

Then regarding corporate security products, as you can see we have now witnessed a year-on-year growth of 5% in terms of the first quarter comparing revenues. And as said earlier, the orders clearly coming in outpaced the revenue growth. We're happy to report that this development is also coming from those countries where we have said we will focus and across the whole portfolio, which means that we have invested in products that are solving customer problems and doing well on the market.

We have also won several new customers in cloud platform security and had witnessed solid growth with EDR. A few words maybe about the cloud platform security. What does that mean? It essentially means that we are participating in cloud ecosystems as a partner, providing security for the other users of those platforms namely, for example, the users of Salesforce AppExchange companies. And we have seen a rise in contract duration and that, of course, is good because that says something about our long-term viability as a business, and it also kind of gives us a good backing in terms of our further development.

Looking at Managed Detection and Response which is high-growth segment in this market, we're happy to report that we have won new customers in such verticals as technology, finance, and professional services and also that we have won and closed several deals in UK, Germany, France, and Belgium that fall into our focus country categories.

Here is an example of MDR. How does this work in practice? What does a Managed Detection and Response really mean and what are we competing against? Over the timeline that you see here from July 2020 going to March 2021, it's – here, we are explaining how the customer has been acting in terms of their purchasing decisions. So, it all starts from the left corner when the customer suspects that they're being attacked. Next comes an evaluation of Managed Detection and Response vendors that we need somebody who will help us identify where we have been breached and what are we going to do about it.

But then, we see competition. And competition, in this case, is the called – so-called S-O-C, SOC, security operations center competitors. These are competitors that are providing a broader category of managed services that come in and essentially manage the whole landscape of the security products and solutions the customer is using. And their proposition is that, let me come in, let me take care of everything.

Customer does the audit and makes the decision that they are actually going to purchase those services from this SOC provider, a more comprehensive, bigger, bigger bunch of services. But at the same time, there is a clear

opportunity for F-Secure that is emerging as the customers are hiring some consultants from us for advice as they're unable to get to the bottom of it, what is it that – what's happening and where were we breached and how can we respond.

And this story ends happily for F-Secure. The conclusion is that MDR is a specific market niche where you need a premium provider of specific solutions that is backed by strong technology platform. And we come back, and F-Secure Countercept is taken into use. We sign the deal with an annual value of €200,000. So, this is what it means in practice. So, we are highly specialized. We provide a premium service. We work very closely with the customers, and this is how we differentiate from the competition in the market.

Regarding the consulting, as I mentioned earlier on, our starting point last year Q1 was roughly at the same level in terms of revenue, €11.9 million. And then we saw a sharp decline during the year of 2020 where we were clearly being penalized by the COVID-19 situation. Of course, in this business which is done by consultants, customers are and were used to meeting people face to face. And also, delivery was typically in the customer premises face to face. We had to learn, both us and the customers, during the year how we would do this differently, how we would build up that capability, and this is what we did.

As you can also see, witnessed by the revenue numbers, a steady increase and, of course, typically Q4 being a strong quarter in our industry and now starting this year with a solid revenue number. We have improved our customer acquisition, and we have also seen a strong demand for our incident response assignments. What is incident response? It actually – it's like the fire brigade that comes in when something's wrong. And there seems to be a lot of that demand in the industry at the moment.

Another example, this is a customer example from the consulting side and this – actually, the context for this is the TIBER which is a framework published by the European community or the European Central Bank actually where, essentially, they are keen to have financial institutions be tested against their resilience in terms of what their security posture is. And this is, in a way, explaining how a vendor like F-Secure is able to actually come in there, and ultimately provide high value services for that customer.

This customer case, which we are not naming, starts from 2016 with us doing transactional small-scale assessments like penetration testing, Web testing, those kind of things. Then, we move further. And by the time we are in 2019, where there is this requirement for those financial institutions to do this kind of a larger scale testing, and so-called red team attacking, we are in a [ph] power (00:11:33) position because we have actually built that trust. We have demonstrated our performance, and this is where we can come in and actually sell higher-value services.

And this is quite a good illustration of the sales cycle that we need to do also a certain entry level services is in order to be there and gain the trust of the customer.

Consumer, again, very, very strong performance. Revenue grew by 8%. As you can see here, we have had consistent steady performance now since Q1 of last year that we are depicting here. The growth is coming for our core endpoint solutions that we are selling both through our partners and also directly. We have seen an increased subscription and solid renewal performance, very positive. And also our new products have been rolled out, the ID PROTECTION and SENSE into the customer bases. And we have signed some new customers and partners for those. So overall, positive performance with F-Secure TOTAL and the renewal performance continued on a good level.

And like I mentioned in the very, very beginning, stole my own thunder, how F-Secure has won this AV-TEST Best Protection Award in 7 of the last 10 years. We're the only company in the industry having done that. And here you can see the benchmarking how we fare against the competition. And this tells its own story about the quality of our offering.

With that, I'm happy to hand over to our Chief Financial Officer, Eriikka Söderström, to walk you through the financials in bit more detail. Thank you.

Eriikka Söderström

Chief Financial Officer, F-Secure Oyj

Thanks, Juhani. So let me move on and let's look at the key numbers for the Q1 from our perspective. So as Juhani was highlighting, the revenue growth 5% Q1, €57.8 million. So a solid start for the year especially consumer security, €26.3 million, 8% growth continuing with good growth levels. Also corporate security products now at 5% growth, €19.5 million revenues. And consulting at €12 million, 1% growth. And while we are so positive about consulting while we need to remember that the comparison year – or comparison quarter a year ago was still a normal time before COVID, so in that sense, we are pleased with the 1% growth in consulting.

So, our adjusted EBITDA 17% of revenue and €9.6 million, so an increase of 33%, and then EBIT, €6.2 million, 11% of the revenue. And the net cash at minus €12.2 million or cash positive – net cash, €12.2 million, net debt negative, and cash flow from operations before financial items and taxes, €6.3 million. And earnings per share, €0.03, and personnel, 1,670.

And if we look at a bit more in detail now some of these KPIs, starting now from the deferred revenue, so, we wanted to highlight here that the deferred revenue growth in Q1 was once again strong, 14%. So, €84 million while a year ago, €73.7 million. And here, it's important to look at now the current versus noncurrent split. So, with the current deferred revenue, that is the revenue that gets recognized from those orders within the next 12 months while the noncurrent is then beyond a year.

And if we look at the right-hand side where you see the line representing now the current deferred revenue growth in Q1 year-on-year 4%, and 41% for the noncurrent. And what does this mean? This means that we have received a good order intake in Q1, but especially we have received like multiyear deals, even up to five years. So, those won't be visible immediately within the next 12 months. But we have the backlog which is in supporting our revenue ambition going forward.

And then looking at the profitability using adjusted EBITDA and, here, we see the curve. So, a good strong 17% margin now in Q1, €9.6 million, clearly stronger than a year ago. But, once again, there is some impact now related to COVID. And already at this stage, I would want to highlight that our outlook for the profitability remains the same. And I'll come back to the outlook just to remind you how it is. But good strong start for the year.

And in the receivables, we see that the receivables have been increasing and that the cash flow was at somewhat less than in Q1 a year ago. Couple of things, the net working capital, we had some one-off accounting changes that impacted Q1, so it's not that dramatic. But then also I think it's important when you look at the trend to understand that we made significant progress in the collection of all the receivables during 2020, and that kind of like progress is they're not so easy to be repeated when you are in a better level already. But good cash flow also considering now what I described.

And then, finally, just repeating how we see year 2021 outlook. So we expect the corporate security products to grow at the high single-digit rate. And the cybersecurity consulting is also expected to grow with a caveat related

to COVID-19. Well, things do look better now at this stage, we could say, but no one knows how things develop. Consumer security, 6% was last year, and our outlook says that we expect to grow approximately at the same rate as in 2020.

And as I already mentioned, the adjusted EBITDA outlook is to remain approximately at the previous year's level. Though we had a very strong start for the year in profitability terms, we plan to continue to grow and we have investments in our minds what we are doing, so adjusted EBITDA outlook also unchanged.

So now it's time for the questions and answers and Henri probably will facilitate us to any questions.

QUESTION AND ANSWER SECTION

Henri Kiili

Investor Relations and Corporate Finance Director, F-Secure Oyj

A

Henri Kiili>: Yes. So let's dive into the questions. We have a lot of them coming here. First from Danske, we have Veikkopekka Silvasti asking, so growth rate in B2B products was slower than you have guided for the full year 2021. But deferred revenue shows solid growth. Is there a risk that you signed licenses for longer maturities that you miss the growth target of high-single-digit growth in 2021, and the growth would then accelerate more significantly in 2022?

Eriikka Söderström

Chief Financial Officer, F-Secure Oyj

A

Shall I take it?

Henri Kiili

Investor Relations and Corporate Finance Director, F-Secure Oyj

A

Yes.

Eriikka Söderström

Chief Financial Officer, F-Secure Oyj

A

Yeah. So, first of all, there is no reason for us to change the outlook. So, it is totally valid at this point. And, surely, these longer duration contracts then support us in the longer period as you also mentioned.

Henri Kiili

Investor Relations and Corporate Finance Director, F-Secure Oyj

A

All right. Then next one goes for – is about consulting, I guess, goes for Juhani. So, could you open up a bit more what you mean by improved performance of consulting business as it essentially was flat year-on-year in revenue terms?

Juhani Hintikka

President and Chief Executive Officer, F-Secure Oyj

A

Yeah. I said that in the context of a challenging last year that we talked about in our earlier sessions. So, throughout 2020 and after Q1, Q2, Q3 were challenging in terms of the consulting performance, as I explained. We were witnessing operational challenges because of COVID-19. And I think we have overcome those

challenges partly. I think the situation has improved in some of those countries where we operate, but also partly because both us and our customers have learned how to operate remotely in terms of engagement and delivery.

Henri Kiili

Investor Relations and Corporate Finance Director, F-Secure Oyj

A

All right. Thank you. Next one will go about the consumer security. So, in the longer term, how do you see about the revenue growth? Will it be the current level of 5% to 6% also in 2022 to 2023?

Juhani Hintikka

President and Chief Executive Officer, F-Secure Oyj

A

Well, we have given our guidance and we, of course, stand behind that regarding the consumer security market. But it's clear that we are witnessing also positive momentum in that market. And the fact that everybody is more or less working remotely has, of course, accentuated the need for cybersecurity products also on the consumer side.

Henri Kiili

Investor Relations and Corporate Finance Director, F-Secure Oyj

A

Next up, we have Atte Riikola from Inderes. So, MDR Q1 revenue grew only slightly. What were the reasons behind that?

Eriikka Söderström

Chief Financial Officer, F-Secure Oyj

A

As we have commented earlier, so in the MDR, the lead times are long, as was described also in the example that Juhani shared with you. So, that is one of the reasons that there's lumpiness on the quarterly basis. But then also from the renewal rate perspective, like in Q1, it was not perfect as we have said sometimes. So, it was still very good, but we did lose some cases.

Henri Kiili

Investor Relations and Corporate Finance Director, F-Secure Oyj

A

Okay. Then, this one also goes to Eriikka. So, was there still some COVID effect in sales and marketing expenses during Q1?

Eriikka Söderström

Chief Financial Officer, F-Secure Oyj

A

Yes. Yes. There clearly was also an impact of COVID related to sales and marketing, similar kind of reasons that we saw last year like related to arranging events, travel, etcetera. So, it has an impact.

Henri Kiili

Investor Relations and Corporate Finance Director, F-Secure Oyj

A

Then, about the competitive environment, Juhani. CrowdStrike is growing fast and winning more and more customers also in the SME segment. Do you think that the competition is tougher also in the EPP market?

Juhani Hintikka

President and Chief Executive Officer, F-Secure Oyj

A

Well, I think this is a very large, fragmented market, and there are a lot of competitors. It's hard to kind of pick one and compare oneself to that. But it's fair to say that the competition is tough. At the same time, we are quite

confident that we are doing well. We – our products are performing. We have excellent people and competency. So, we think we like that kind of environment where we can present those capabilities to the market.

Henri Kiili

Investor Relations and Corporate Finance Director, F-Secure Oyj

A

Thank you. Then next one, are you planning on giving any updated financial targets for the coming years?

Juhani Hintikka

President and Chief Executive Officer, F-Secure Oyj

A

We haven't given out any statements regarding that, but we will be organizing a Capital Markets Day in June where we will talk about our – in a broader sense our strategy going forward.

Eriikka Söderström

Chief Financial Officer, F-Secure Oyj

A

And, Henri, good time to advertise, though. Was it June the 15th?

Henri Kiili

Investor Relations and Corporate Finance Director, F-Secure Oyj

A

Yes. June the 15th. Stay tuned. Next one goes to Eriikka, so now talking about the sales and marketing expenses. They were approximately 41% of revenue, our lowest level in ages. Still, your marketing expenses seem to be high as a percentage of revenue. Is there room to scale down this cost during the next few years?

Eriikka Söderström

Chief Financial Officer, F-Secure Oyj

A

Well, the sales and marketing activity is very crucial when you seek for growth. And as we have been discussing now on the elements of our P&L where the R&D is kind of, like seemed to have less leverage going forward because you need always the new technology parts. But for the sales and marketing, clearly, we balance that with the growth ambitions that we have. But the timing, I wouldn't comment at this stage.

Henri Kiili

Investor Relations and Corporate Finance Director, F-Secure Oyj

A

And maybe just to add to that sales and marketing, it's good to note that we are, of course, accessing the market in several ways. We are working through partners, channel, ecosystems directly. And, of course, that is also reflected our in our marketing expense. And also, there is a difference between consumer-driven marketing and B2B marketing.

Henri Kiili

Investor Relations and Corporate Finance Director, F-Secure Oyj

A

Yes. Thank you. Then continuing on the sales and marketing topic a little bit, on practicality. So, what is actually in the sales and marketing expenses? And the other question related, do you include some provisions or incentives for the sales channel partners in this figure? Eriikka?

Eriikka Söderström

Chief Financial Officer, F-Secure Oyj

A

So, if I start now from this partner, so the partners trust the end customers and they take their own share, and then they pay to us the sum that we have agreed based on the formula. So, we do get the net directly, so it's not

as a cost. And the sales and marketing cost as such, so there we have, of course, the FTE costs. We had the marketing events, activities, or travel, anything that relates to sales and marketing. And we have quite a wide country organization so which is also one of the reasoning behind our sales and marketing cost that we have.

Henri Kiili

Investor Relations and Corporate Finance Director, F-Secure Oyj

A

Yes. Thank you. Then, Juhani, taking a look at the increasing noncurrent deferred revenue, so the one which goes beyond the next 12 months, which products are mainly contributing here?

Juhani Hintikka

President and Chief Executive Officer, F-Secure Oyj

A

Well, we haven't opened up the revenues per product as such. But, of course, I think as we said in our Q1 that we actually saw growth across the whole portfolio. So, there's a bit of contribution from everything.

Henri Kiili

Investor Relations and Corporate Finance Director, F-Secure Oyj

A

Yes. Then going on about the planned investments, taking a look ahead, are those planned investments focused on sales and marketing or R&D?

Juhani Hintikka

President and Chief Executive Officer, F-Secure Oyj

A

So, we will probably be talking more about our strategy and longer-term vision in June at the Capital Markets Day on June 15th. But it is our intention to continue to focus on growth, which, of course, means making sure that we remain competitive, and we can support that growth with our sales and marketing investment, and also stay competitive in terms of technology, which means being able to invest in R&D.

Henri Kiili

Investor Relations and Corporate Finance Director, F-Secure Oyj

A

Juhani, in the presentation, you mentioned that we had solid growth with the EDR. So is that growth coming from customers that already have EPP or from net new customers who buy both?

Juhani Hintikka

President and Chief Executive Officer, F-Secure Oyj

A

Yeah. We have seen very positive development with a completely new sales and new partners and that this is also something that is important for us. Historically, we have had a very, very big amount of partners. Some of them are relatively small and the transactions also have been relatively small. Now, we have been able to grow our partner base also in the larger side. And that, of course, has yielded in larger deals on average and also a larger share of the revenue than before.

Henri Kiili

Investor Relations and Corporate Finance Director, F-Secure Oyj

A

The next one for Eriikka. How much cost benefit did you still have in Q1 from, for instance, travel-related costs that were lower?

Eriikka Söderström

Chief Financial Officer, F-Secure Oyj

A

We have to say approximately a couple of million overall. That would probably be a good number to give.

Henri Kiili

Investor Relations and Corporate Finance Director, F-Secure Oyj

A

Then touching also on consumer security. So why does the consumer growth come only now? You would expect that you have started already a year ago when people had started to remote – work remotely?

Juhani Hintikka

President and Chief Executive Officer, F-Secure Oyj

A

Well, working remotely, of course, is one factor. It's not the only factor. I think there are other things. We have also been very focused on our portfolio. We've been developing that continuously together with our partners, but also for our direct channel. And we like to think that the development is also a result of good, solid, long-term work that we have done around our portfolio and, of course, working with our partners how to take it to market.

Henri Kiili

Investor Relations and Corporate Finance Director, F-Secure Oyj

All right. Thanks a lot. Thank you, both, for answers. Thanks for the Q1.

Juhani Hintikka

President and Chief Executive Officer, F-Secure Oyj

Thank you.

Eriikka Söderström

Chief Financial Officer, F-Secure Oyj

Thank you.

Henri Kiili

Investor Relations and Corporate Finance Director, F-Secure Oyj

Thank you.

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