Upwork Q3 2018 Earnings Prepared Remarks

Welcome to Upwork's discussion of its third quarter 2018 financial results. Leading the discussion today are Stephane Kasriel, Upwork's Chief Executive Officer, and Brian Kinion, Upwork's Chief Financial Officer. Following management's prepared remarks, we will be happy to take your questions. But first, let me review the safe harbor statement.

Forward-Looking Statements

During this call we may make statements related to our business that are forward-looking statements under the federal securities laws. These statements are not guarantees of future performance but rather are subject to a variety of risks, uncertainty and assumptions. Our actual results could differ materially from expectations reflected in any forward-looking statements. For a discussion of the material risks and other important factors that could affect our actual results, please refer to our SEC filings available on the SEC's website and on our website, as well as the risks and other important factors discussed in today's earnings release. In addition, reference will be made to non-GAAP financial measures. Information regarding reconciliation of non-GAAP to GAAP measures can be found in the press release that was issued this afternoon on our Investor Relations website.

Please note that the prepared remarks corresponding to the information reviewed on today's conference call will also be available on our Investor Relations website at investors.upwork.com, once the call has concluded. Now I'll turn the call over to Stephane.

Stephane Kasriel – CEO

Good afternoon and thank you everyone for joining us for our first quarterly earnings call as a public company. We are excited to share our progress with you and to provide details on our financial performance.

But before I do, I would like to take a moment to express my gratitude to our investors, our clients, the freelancers on our platform, the freelancers who provide services to us, and our employees. Each of you has put your passion and trust in us over the years and I greatly appreciate it.

We were pleased with our IPO process and investors' reception to our offering. We are excited to share today that we exceeded our own expectations for the third quarter of 2018.

While our IPO was a major milestone for Upwork, it was just another step in the evolution of the company. We are addressing a large and expanding market opportunity of which we believe we have merely scratched the surface.

Upwork Story

Since many of you are new to the Upwork story, I wanted to provide a brief review of our business and our opportunity before we look more closely at the progress we made in the third quarter.

Upwork's mission is to create economic opportunities so people have better lives. The world is in the midst of a transformation in how we work. Technology is enabling people to work how, where, when and with whom they please. Upwork is at the forefront of addressing this opportunity, as our platform removes the constraint of location - making hiring faster and more efficient.

We operate the largest online marketplace for highly-skilled freelance talent, as measured by Gross Services Volume, or GSV. As a reminder, GSV is the total amount of business transacted through our platform. As we last disclosed, over 475,000 clients hired more than 375,000 freelancers in 180 countries through our platform, in the last twelve months.

Freelancers

Now that you have heard about the Upwork story, let's talk about what is going on in the freelance market. First, when you look at the number of service jobs that can be performed remotely, we believe we are addressing a large and expanding market opportunity, which we estimated to be $560 billion of GSV in 2017.

Upwork's success would not be possible without the highly-skilled freelancers that use our platform routinely. For these freelancers, Upwork offers a full value proposition: the flexibility to choose their clients and projects, to negotiate their own rates, and to manage their personal schedules on their own terms. We offer security and timeliness of payments; provide strategic insight into data relevant to the individual freelancer; and help the freelancer build their brand and reputation. Upwork serves as a powerful marketing channel for freelancers to advertise their businesses

Exactly a week ago, the fifth annual "Freelancing in America" survey, or FIA, was released. The FIA survey is the most comprehensive measure of the U.S. freelance workforce. It is conducted by independent research firm Edelman Intelligence, surveying more than 6,000 U.S. workers. We co-sponsor the survey, along with Freelancers Union, the largest U.S. organization representing independent workers. A five year scorecard of the U.S. freelance workforce includes these findings, which bode well for the market as well as the customers we serve:

- For one, the market is growing quickly, and evolving from “traditional” work: In the last 5 years, the growth rate of the U.S. freelance workforce was over 3x greater than the growth rate of the traditional U.S. workforce. The study found that 1 in 3 American workers, or approximately 56 million people, freelance.
- Also, freelancers are dedicating more of their bandwidth to freelancing: 28% of freelancers are now full time versus only 17% back in 2014.
- In addition, freelancing is being driven by Gen Z and Millennials: These generations are freelancing more than any prior generation, with 45% of Gen Z and 42% of Millennials freelancing.
- And finally, technology is a powerful tailwind: This year, 64% of freelancers had obtained a project online, versus only 42% five years ago -- a leap of 22 points.

As technology helps freelancers connect to more work, it’s also helping businesses find freelancers with the cutting-edge skills. According to Upwork’s Quarterly Skills Index, the fastest-growing skills on Upwork include many innovative technological skills, such as blockchain, augmented reality, and machine learning. Fast-growing non-tech skills include social media management, brand strategy and influencer marketing.

Clients

On the client side, the value proposition stems from the access to top talent, reduced time to hire, cost savings and the efficiencies of streamlined workflows. Clients often receive multiple bids within minutes of posting a job, with the median time to hire being 23 hours in 2017. Our deep dataset, search and machine-learning algorithms are the backbone of the speed in matching. Additionally, the Upwork platform’s software streamlines the interviewing, screening and contracting process. Our marketplace’s direct-to-talent approach reduces the need for costly and inefficient intermediaries such as staffing firms, recruiters and traditional agencies.

We continue to see strong adoption on the client side. Growing existing small business clients’ spend on the platform and acquiring new small business clients remains a priority for us as they represented approximately 80% of our GSV, in 2017, and are the vast majority of our customers.

We continue to make progress in growing our direct sales efforts, which are focused on mid-market and large business clients with 100 or more employees. As of Q3, we had more than 30% of the Fortune 500 using Upwork products, whether through our Upwork Standard or our Upwork Enterprise offering. The priority for our sales team is to grow Upwork Enterprise clients through a land-and-expand strategy. In the last twelve months, we have had many customers that have spent millions of dollars on our platform across consumer packaged goods, technology and media verticals and we are just getting going in the Enterprise space.

We are continuing to bring these large businesses together to have high-level discussions about the future of work and help guide them on how to change their talent strategies. In August, we hosted our second annual Work Without Limits Executive Summit, which brought together over 100 executive leaders from Fortune 500 companies to discuss how they're embracing flexible teams.

Product and Engineering

Now I'd like to discuss some of our product and engineering accomplishments that will drive our larger business goals.

In this vein, we added features to further enhance viral loops within our marketplace product offerings. One is called "Help Me Hire" and is targeted at encouraging clients to invite additional hiring managers within their organization to review a potential hire. We also soft launched the "My Jobs Dashboard." This new feature will make it easier for clients to get inspiration for new projects and manage current projects, by sharing jobs posts and favorite freelancers. Both of these features are examples of our "expand" existing client strategy through product innovation.

Our most successful Enterprise clients run a flexible talent program within their organizations. In Q3 we launched a Program Owner experience within the Upwork Enterprise product. This new feature provides larger companies with the resources and insights they need to build, scale and measure the impact of their flexible talent program.

While we've invested in mobile for years, our approach had been to fund our mobile web, iOS, and Android applications as separate teams so that we could build the best experience. It was difficult to ensure that all of our product functionality was available across devices. In 2018, we spent much of our engineering efforts year-to-date transforming our product to be "Mobile First." We have migrated 90+ of our most important web pages to be accessible via mobile browsers to ensure product parity across all end-points. This will be an ongoing effort that affects how we make decisions about all elements of our product roadmap moving forward.

We also plan to focus on - and verticalize - the more than 5,000 skills offered across the 70 categories on our platform, as the ability for clients to hire across multiple categories is a key differentiator for us. We will also continue to invest to further enhance the software and functionality of the platform as we are always trying to improve the user experience on our website and mobile apps. Additionally, we continue to invest in trust and safety capabilities to stay a step ahead in making our platform the most trusted to get work done. In short, we are just getting started in changing the world of work – and that is what drives us at Upwork.

Before I turn the call over to Brian, I wanted to once again thank everyone who made our IPO a reality.

From the early days of oDesk and Elance to the united front of Upwork, many years of tireless innovation and collaboration from our dedicated employees and Upwork's internal team of freelancers made our IPO last month a possibility.

Also to our clients, to the freelancers who find work on our platform every day, and to our investors, we truly appreciate the confidence you have placed in Upwork, and look forward to achieving great milestones together in the years to come. We thank you.

With that, I would like to hand it over to our Chief Financial Officer, Brian Kinion.

Brian Kinion – CFO

Thank you Stephane. Good afternoon everyone. My remarks today will start with a brief update on our key operating metrics for the third quarter. Then turn to the financial results and our guidance for the fourth quarter that we provided in our earnings release filed today. Numbers are rounded for the sake of convenience, and I'll make comparisons on a year-over-year basis unless otherwise noted. I'll be referring to GAAP measures, unless explicitly cited as non-GAAP measures.

We monitor and measure our business performance using certain key operating metrics which include GSV, core clients and client spend retention. We believe these metrics are key indicators of our growth and the overall health of our business.

GSV, which includes both client spend and additional fees that we charge for other value added services, increased by 27% in Q3 to $449 million. The growth in GSV was driven by an increase in core clients and an increase in our client spend retention.

Growth in core clients is an important operating metric for two reasons: 1) core clients have historically been more likely to continue using our platform, and 2) they represent approximately 80% of our GSV. We define a core client as a client that has spent in aggregate at least $5,000 in their lifetime on our platform, and have spent in the last twelve months. As of September 30, 2018, we had approximately 101,000 core clients, representing a 22% increase.

Client spend retention was 108% on a trailing twelve month basis at September 30, 2018, compared to 95% at September 30, 2017. Client spend retention is derived by dividing recurring client spend by our base client spend, from the same clients, over the four quarters ended one year from the date of measurement. We are pleased that client spend retention has continued to improve over time and has reached its highest levels since the combination of Elance and oDesk in 2014. Client spend retention illustrates the recurring nature of our business even though our clients are not contractually required to spend on a recurring basis. We expect client spend retention to stabilize in the 106% to 108% range for the near term based upon our analysis of our current cohorts. However, we are focused on increasing recurring spend from existing clients on our platform by building new products, features and functionality as well as marketing and sales efforts.

Now let me provide some additional insight into our business model. We monetize by charging both freelancers and clients different fees in our two-sided B2B marketplace. Our overall take rate, which we define as total revenue as a percentage of GSV, has multiple components and can fluctuate from period-to-period impacting revenue growth rates as well as gross margins. Let me explain the three largest drivers of our take rate today in more detail:

First, the majority of our total revenue is generated from our marketplace offerings, where we recognize revenue on a **net basis**. We also have a managed services offering where we engage freelancers for projects, invoice the client directly and assume responsibility for the work performed, from which we are required to recognize the revenue on a **gross basis**. Therefore, GSV and revenue are the same amount for our managed services offering. The mix of revenue generated in a quarter from our marketplace offerings versus our managed services offering will impact overall take rate. Our marketplace revenue grew at a faster rate year-over-year in the third quarter as compared to our managed services revenue, which resulted in a lower overall take rate but generated a higher gross margin.

Second, for our Upwork Standard offering, we charge freelancers a tiered service fee which we introduced in June 2016. We charge 20% for the first $500 for each unique freelancer/client relationship, 10% for the next $9,500, and then 5% thereafter. We have seen over time more of these unique relationships getting to the 5% billing tier. We view this as a positive trend for our business as the goal of the pricing change was to incent long-term relationships and recurring use of our platform, which increases client spend retention and generates incremental GSV and revenue.

Third, for our Upwork Standard offering, we charge clients a payment processing and administration fee which we also introduced in June 2016. This fee is generally 2.75% of client spend. However clients can also opt to pay a small monthly subscription fee instead of the 2.75% fee if they choose to pay via ACH (Automatic Clearing House). We have experienced an increase in ACH adoption over time since introducing this client fee. We view this as a positive trend for our business and our clients. ACH adoption lowers our take rate but increases gross margins, as we incur lower payment costs.

Our take rate was 14.3% in the third quarter as compared to 14.8% in the third quarter last year. This downward trend was expected given what I just described. While we have many levers to increase take rate, we plan to be thoughtful about how and when we launch these features. We want to ensure that we are aligning our incentives with those of the freelancers and clients on our platform and that we are adding value when we introduce any additional fees.

With these key operational metrics in mind, I will now turn to our financial results:

Total revenue increased by 23% to $64.1 million. Marketplace revenue increased by 23% to $56.8 million and represented 89% of our total revenue. Growth in marketplace revenue was driven by an increase in the number of core clients and higher client spend retention which was evidenced by strength in our small business segment, growth in our U.S.-to-U.S. domestic marketplace offering and an increase in direct sales from our Enterprise offering. One additional note is that in the third quarter we started lapping the launch of our U.S.-to-U.S. domestic marketplace, and therefore third quarter and our upcoming fourth quarter of 2018 have tougher comparables than our first half results.

Managed services revenue increased by 21% to $7.3 million and grew at a slower rate year-over-year than our marketplace revenue. We expect this trend to continue in the coming quarters.

Non-GAAP gross profit increased by 23% to $43.7 million. Non-GAAP gross margin was 68%, remaining consistent with the third quarter of 2017. Gross margins are influenced by multiple components.

- First, the mix of revenue between our two offerings.
- Second, payment processing costs. This is our primary component of cost of revenue, and increased by $1.3 million or 18% year-over-year, which grew slower than revenue.
- Third, our spend on Amazon Web Services which grew faster than revenue compared to a year ago, as we are currently lapping the move of all of our services to AWS, which we completed in Q1-18.
- Fourth, the cost of revenue for freelancer services to deliver managed services increased by 23% to $6.1 million as more costly freelancer resources were used to provide managed services in this quarter.

In future periods, we expect cost of revenue to increase in absolute dollars. Although the level and timing of revenue and cost of revenue items could fluctuate and therefore affect our cost of revenue and gross profit in the future.

Operating expenses:

Turning to operating expenses.

Sales and marketing expenses on a non-GAAP basis in Q3 increased to $18.6 million and represented 29% of total revenue compared to 26% last year. This increase was driven by investments to build out our enterprise sales team as well as marketing and advertising activities to drive brand awareness and attract new users. We intend to continue to invest in ROI positive opportunities in sales and marketing to drive profitable growth.

R&D expenses on a non-GAAP basis in Q3 increased to $13.8 million and represented 21% of total revenue compared to 21% last year. Our R&D spend was focused on our mobile first transformation as well as efforts to develop new products and features. We believe continued investments in R&D are important to further our strategic objectives.

G&A expenses on a non-GAAP basis in Q3 increased to $10.1 million and represented 16% of total revenue compared to 14% last year. This increase was tied to our efforts to support our transition to a public company.

We expect sales and marketing, R&D and G&A expenses to increase in absolute dollars, although as a percentage of total revenue may fluctuate from period-to-period.

Our provision for transaction losses increased by $800 thousand to $1.9 million in Q3 and consists primarily of losses from bad debt expense associated with our trade and client receivable balance and credit card charge backs. Transaction losses increased due to an increase in trade and client receivables and related allowances, and we expect our reserves to increase as GSV grows. Historically, transaction losses have fluctuated between 2% and 3% of total revenue. We focus on the tradeoffs between increasing GSV and mitigating losses on our platform and we are comfortable with transaction losses in this range.

We incurred a net loss of $7.3 million for the third quarter compared to a net loss of $300,000 in the third quarter of 2017. Our basic and diluted net loss per share in the third quarter was negative 20 cents on 36.1 million weighted average common shares outstanding compared to negative one cent on 33.3 million weighted average common shares outstanding in the third quarter of 2017. Our Q318 net loss was largely driven by the remeasurement of our convertible preferred stock warrant liability of $3.3 million, which relates to a warrant issued in 2013. The value of the convertible preferred stock warrant liability increased significantly as of September 30, 2018. This was due to the proximity of our IPO and the final IPO offering price being significantly higher than the historical estimated fair value used to revalue the convertible preferred stock warrant liability. We have approximately $2.5 million of additional expense in Q42018 related to this warrant. Upon IPO our warrant liability was converted to additional paid-in capital.

We incurred a non-GAAP net loss of $1.4 million in Q318 compared to a non-GAAP net income of $1.9 million in the third quarter of 2017. Our basic and diluted non-GAAP net loss per share in the third quarter was negative 4 cents compared to an earnings per share of six cents in the third quarter of 2017.

Adjusted EBITDA, a key metric for us in operating the business, was close to break-even in the third quarter as compared to positive $2.8 million a year ago. We continue to balance investing in sustainable profitable growth while expanding on our leadership position of this very large and expanding addressable market opportunity.

In April 2018 we established the Upwork Foundation Initiative, to further our mission of creating economic opportunities to make peoples' lives better. This program includes a donor-advised fund created through the Tides Foundation. In May 2018, the Company issued a warrant to purchase 500,000 shares of its common stock at an exercise price of one cent per share. This warrant is exercisable for 1/10th of the shares on each anniversary of the IPO. The proceeds from the sale of such shares will be donated in accordance with the company's directive.

There was no impact to our Q3 financials. Based on today's stock price of approximately $20 per share we expect a non-cash charge recorded in G&A related to this warrant of approximately $1 million over the next twelve months including approximately $250,000 in the fourth quarter of 2018. We plan to exclude this expense in deriving our Adjusted EBITDA and non-GAAP net income on a go forward basis.

Balance sheet:

Now to the balance sheet and cash flows.

Our cash balances, funds held in escrow and escrow funds payable, trade and client receivables and accrued expenses on our balance sheet and related cash flow from operations are primarily impacted by the timing of funding our escrow account. Clients pay into an escrow account and payment is released to freelancers after services are completed, approved and any relevant review period has lapsed. Escrow regulations require us to fund the escrow account with our company's operating cash if there is ever a shortage due to the timing of cash receipts from clients for completed hourly billings. Freelancers submit their billings for hourly contracts to their clients on a weekly basis every Sunday. As of Sunday each week, we have not yet collected funds for hourly billings from clients as these funds are in transit. Therefore, every Sunday we fund any shortage of cash into the escrow with our own operating cash and collect this cash shortage from clients within the next several days. Consequently, any quarter that ends on a Sunday like it did on September 30, 2018 and December 31, 2017 temporarily reduces our operating cash balances and cash flow from operations. To help fund the escrow account, we drew down $15 million at quarter-end from our revolving line of credit which we repaid on October 1st. Please note that the quarter ending March 31, 2019 and June 30, 2019 both end on a Sunday and therefore you should expect a similar impact on our balance sheet and cash flow from operations and for us to use the revolving line of credit in a similar fashion.

During Q3 2018 we used $18.6 million in operating activities which was largely driven by the funding of the escrow with our operating cash on the last day of the quarter. We used $1 million in investing activities and had $15.3 million of cash provided by financing activities mostly due to the draw on our line of credit of $15 million.

We recently signed a new lease for our Chicago office and are in negotiations for a new location in Silicon Valley. We expect to invest between $4 and $5 million in capital improvements in the remainder of 2018 for these new office locations.

As a final point on the balance sheet and shares outstanding, we have provided a table in our press release that shows the pro forma basis impact of the IPO as if it occurred as of September 30, 2018. We raised a net amount of $109.4 million in our IPO which closed on October 5th. We also repaid $10 million from our revolving line of credit in early October.

We had 36.9 million common shares outstanding at September 30, 2018. Upon the IPO, we issued 7.8 million shares of common stock and converted 61.3 million shares of preferred stock to common stock on a one-to-one basis. Therefore, as of the date of the IPO we had approximately 106 million shares of common stock outstanding.

If we were a public company at the end of Q3, dividing our non-GAAP net loss of $1.4 million in Q3 2018 into the pro-forma 106 million shares of common stock outstanding, would result in a net loss per share of negative one cent.

Guidance:

Turning to guidance.

For the fourth quarter, we expect revenue in the range of $64.5 to $66.0 million and adjusted EBITDA in the range of negative $750,000 to positive $250,000. We expect weighted average common shares outstanding to be in the range of 103 to 104 million for the fourth quarter.

For full year 2018, we expect revenue in the range of $250.5 to $252.0 million and adjusted EBITDA in the range of negative $500,000 to positive $500,000. We expect weighted-average common shares outstanding to be in the range of 52 to 53 million for the full 2018.

As an additional note we are planning to provide revenue and adjusted EBITDA guidance ranges for the first quarter and full year 2019 on our Q4 2018 quarterly earnings call. Thereafter, we will provide subsequent quarterly guidance and update our full year guidance for revenue and adjusted EBITDA.

With that, I'll turn it over to Stephane for some final thoughts.

Stephane Concluding Remarks:

I am very excited about the trends we are seeing in online remote work. The world is now in the Fourth Industrial Revolution. This revolution is a chance to make a more positive future of work with more economic opportunity a reality. Upwork is a leading force in this positive future of work. Our innovations bridge the skill gap to reduce friction in the labor market. At Upwork, we ourselves practice a "work without limits" model that includes a distributed team of on-site and remote employees, and we also engage with over 1,000 freelancers all over the world for our own specialized projects. It is amazing to have access to this highly-skilled global workforce, which we believe to be a key component of our business success.

Again, thank you to our employees, the freelancers who provide services to us, the freelancers and clients who use our platform, our partners and our investors. I believe Upwork can provide economic opportunities for millions of people. We are excited about the opportunities in front of us and we look forward to sharing this journey with you.

We are now happy to take your questions.