Upwork Q4 2018 Earnings Prepared Remarks

Welcome to Upwork's discussion of its fourth quarter and full year 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, uncertainties 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 Investor Relations website, as well as the risks and other important factors discussed in today's press 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, shortly after the call has concluded. Now I'll turn the call over to Stephane.

Stephane Kasriel - Upwork Inc. - CEO

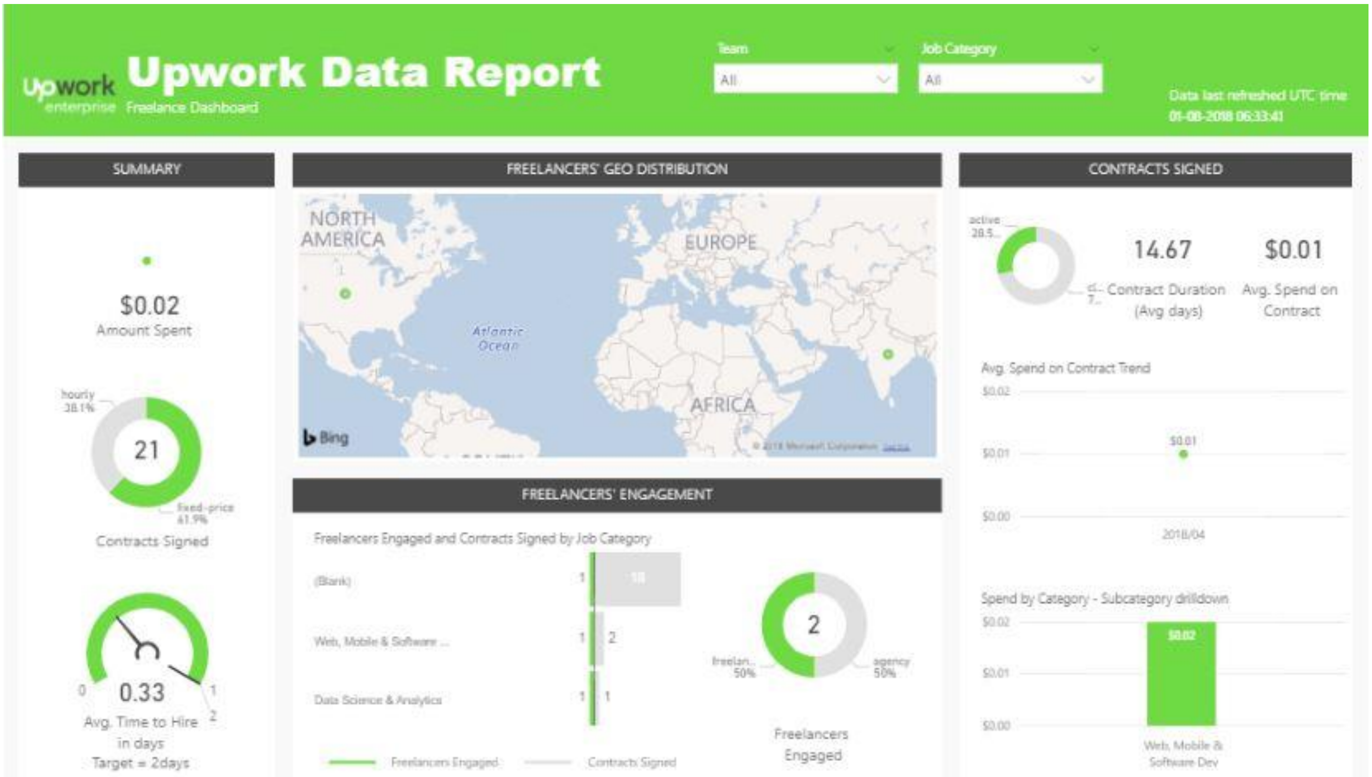
Good afternoon and thank you for joining us to discuss our fourth quarter and full year 2018 results. We are excited to have finished the year with a solid performance. I want to thank our employees and incredible community of skilled freelancers and clients working together via Upwork. Your loyalty and forward-thinking is at the core of everything Upwork has accomplished to date. Together, we are fueling our vision of work without limits. We are truly grateful for your role in our journey as Upwork drives positive change.

Successfully completing our IPO and transitioning to being a public company was obviously a highlight of 2018. We graduated from our chapter as a private company to the next level and gained more momentum than ever to lead our industry forward. We closed a pivotal year for Upwork, punctuated by exceeding our fourth quarter expectations for both revenue and adjusted EBITDA. I'm proud to have met our objectives for both the quarter and the year. We continue to invest in our platform to add innovative and dynamic options for our users. With the guiding principle of driving long-term growth with sound unit economics, we are committed to executing on our strategic priorities to better capture our large market opportunity.

Upwork continually seeks to enhance the customer experience for both the freelancers and the clients that use our platform. The partnerships and product updates we have implemented, and those that we will continue to roll out, support this goal. I want to take a moment to highlight some of our accomplishments in 2018 that I believe will contribute to our future growth.

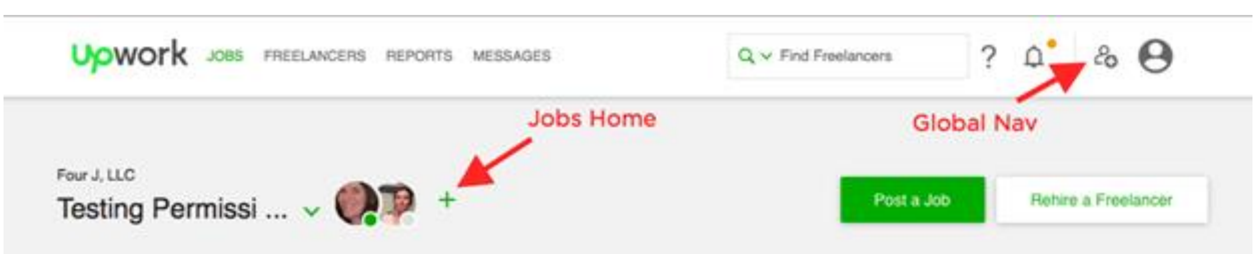
In December 2018, we announced a partnership with Microsoft to empower enterprises to embrace flexible teams. For context, enterprises increasingly recognize the need to transform the way they work to compete in a global economy. While enterprises today spend an estimated $3.5 trillion on contingent labor, the model for working with external talent is restrictive. Together with Microsoft, Upwork is empowering organizations to adopt a more flexible workforce model that delivers better visibility, greater access to skills, and richer reporting capabilities than can be gained through traditional workforce models.

The Microsoft 365 Freelance Toolkit provides built-in product integrations between Upwork and Microsoft products such as Power BI, Microsoft Teams, SharePoint and Flow. These integrations guide enterprises through the freelance engagement process. The Toolkit also includes templates and best practices to help organizations effectively launch and scale an enterprise-wide freelance program. We will offer the Toolkit to Upwork Enterprise customers and Microsoft will promote Upwork Enterprise to its customers of these products.



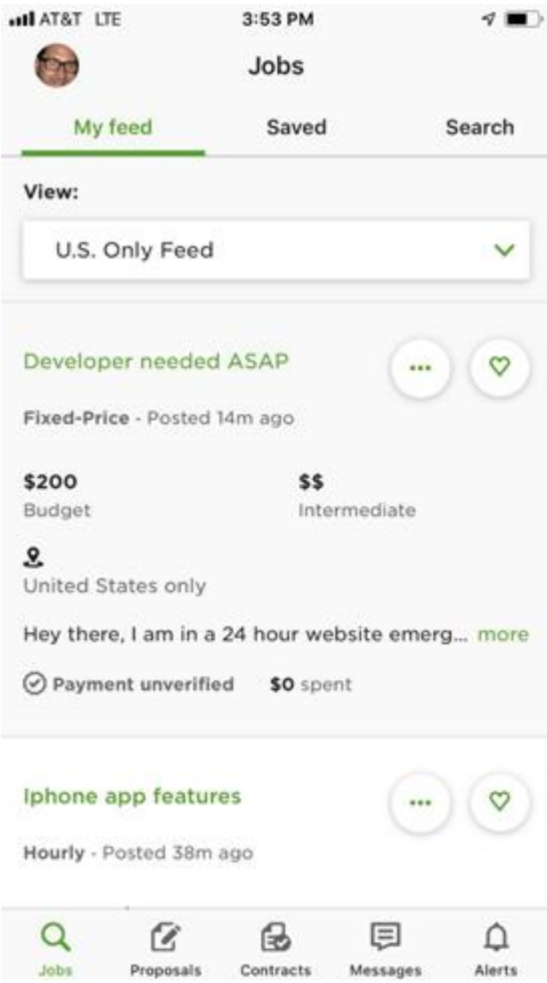
(Upwork Enterprise has partnered with Microsoft to build the Upwork Connector for Power BI. Clients using Upwork Enterprise can connect their Upwork data to an intuitive dashboard, pull reports with predefined datasets, and monitor key performance metrics through Power BI.)

I'd also like to highlight additional features we launched in 2018 that leverage the virality so innate in our product. On our prior earnings call we discussed a feature called **Help-me-Hire**. Since then, we have expanded this capability within the product to encourage current users to **invite a coworker**. These features allow current account administrators to invite and engage other hiring managers within their company with only one click. We have driven over ten thousand hiring manager sign-ups within existing accounts thus far — and we plan to continue to invest in these features in 2019. Without the need to deploy any Upwork sales or support functions, these features allow us to expand our SMB self-service clients' engagement.



(the above illustrates the new placement for inviting a co-worker in the upper right)

In our last earnings call I also discussed our mobile transformation. By the end of 2018, we largely completed the optimization of our mobile web experience, making the experience via mobile browser the same as it is via desktop browser. In early 2019, we took that a step further, relaunching our mobile iOS app for freelancers — which takes all current functionality beyond the confines of a desktop and mobile browser, and into a mobile app. As part of this, we also plan to relaunch our Android app for freelancers as well as relaunch both our iOS and Android apps for clients using this new architecture. Mobile will be a core part of the way we develop our platform and innovate going forward, and I commend the team for executing well on this huge undertaking.



(Newly-updated mobile interface allows for seamless use, regardless of platform.)

As we enter 2019, we continue to benefit from macro-level tailwinds. New research shows that demand for more flexible work models continues to grow. Our Future Workforce Report, which will be released next week, provides insights into how the world of work is evolving as millennials and Gen Zs ascend to managerial roles and have more hiring and decision-making authority. The research has positive implications for Upwork from both perspectives: on the worker side, younger generations are more likely to choose to freelance, and on the hiring side, younger generations are more than twice as likely to engage freelance talent as older generations.

Freelancers also serve an invaluable role as businesses attempt to bridge the skills gap. According to the Future Workforce Report, 60% of hiring managers in October 2018 said "talent scarcity" is their biggest hiring challenge. And businesses are not the only ones being held back by the skills gap. According to a new report from the Staffing

Industry Analysts, staffing firms believe talent scarcity is the biggest inhibitor to their business today — and will continue to be 10 years from now.

With freelancers engaging in skills training more frequently, they are more likely to possess the emerging skills businesses need. Earlier this month, we released our latest Quarterly Skills Index, ranking the 20 fastest-growing skills on Upwork. Our index represents the hottest skills among the knowledge work being performed via our site, from cutting edge skills such at Hadoop and Kubernetes, to security skills like Certified Information Systems Security Professional, as well as more traditional work, such as app store optimization and even employee training. The dynamic nature of this quarterly index shows how businesses are tapping freelancers to help up-skill their workforce real-time.

As these tailwinds continue to gain momentum, we are finding more and more that many of the people working via Upwork have chosen to leave full-time employment and become independent professionals to increase their freedom and flexibility, as well as their earnings.

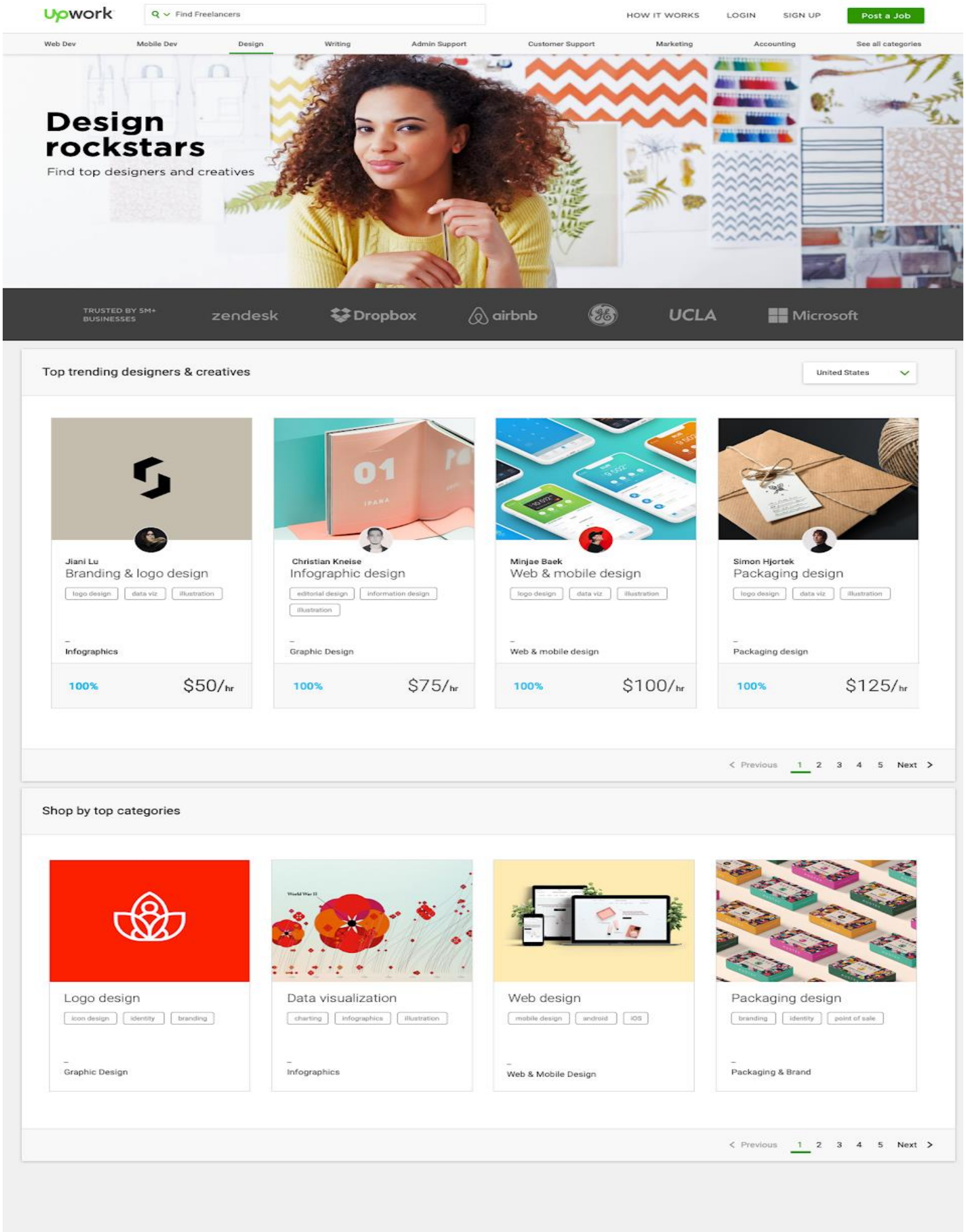
- For example: J is a marketing executive who left a Fortune 500 company after nearly a decade rising through the ranks, to regain control over his time and work. Choosing to freelance through Upwork, J focuses on presentation design, working with companies of all sizes — from entrepreneurs needing pitch decks, to major international brands needing specialized assistance for product launches, internal training programs and major marketing launch presentations. J sees freelancing and running his own business as the way of the future and is preparing his own children to be their own boss when the time comes.

On the client-side we've also seen compelling engagement, as companies look to augment and up-skill current teams:

- For example: CompuVision, a lean managed IT services organization that strives to be at the forefront of offering its clients cutting edge technology, recently started hiring freelancers to support its marketing team of one. Its Marketing Director quickly saw the opportunity to increase her impact with expert freelancers — from graphic designers, writers, video editors, voice-over artists and email marketers, to web developers — and has tripled output with a cost savings of $0.70 per marketing dollar. What is even more powerful is how the Marketing Director's example is paying off for the company — inspiring other departments to leverage freelancers — and freeing up more time to focus on strategic partnerships and new business opportunities.

These positive macro trends will continue to shape our priorities in 2019, along with our core mission to improve the future of work. These priorities fall into four key areas — 1) vertical category expansion, 2) self-service SMB customer opportunities, 3) growth in our domestic marketplace offering and 4) our enterprise business:

- First, we are focused on deepening the category specific experience on the site. The horizontal nature of our platform is one of our greatest strengths and we continue to invest in making each category more rich with category-specific capabilities. For example, in design we are working to enhance the job post and the search experience. Clients in the design category more often use a freelancer's portfolio of prior work to make their hiring decisions — as such, we will be making these portfolios more prominent in search results. As we tackle further **verticalization** of our product, we believe this will improve matching and the client experience in finding the best freelancers for their projects. Furthermore, Upwork will deliver additional features to enable freelancers to provide a crucial specialized "storefront" to market their business.



(Note: this image is a prototype of what the increased category support could look like. Actual product may differ once launched)

- Second, we will continue to build product features so that our **<u>self-service SMB clients</u>** can easily invite colleagues to bring their jobs to Upwork. We will add features that businesses need to be successful in managing their remote workforce.

- **Third, we are investing in our domestic marketplace** offering. The U.S.-to-U.S. domestic marketplace is the fastest growing corridor in our business. For some clients, location is an indicator of familiarity, trust and, for some projects, a necessity. Given that this dynamic is meaningful for a portion of the marketplace, we will be investing in features that amplify location, drive local freelancer supply and encourage clients to use local features to adopt Upwork.
- **And fourth, we believe our Enterprise** product and sales efforts will be an important growth driver in 2019 and beyond. The team is focused on building product features that will add larger, more complex projects on the platform. One lever for this is continued and enhanced support for agencies on the platform to shift spend from existing statements of work to Upwork.

As you may have already seen, underpinning our initiatives for 2019 is our continued strategy around multi-channel marketing and advertising. On January 15th we launched a major ad campaign called "This is Happening," which raises awareness of Upwork and the innovative ability to hire high quality talent remotely and for enduring projects. As a result of this ad campaign, there have been over 60 million impressions across channels including terrestrial radio, digital radio, television, and professional sports integrations.

(The campaign details three examples of how Upwork can avail itself to business owners. Blog can be found here)

With the foundation of 2018, and the power of our four key priorities I noted, we look forward to making 2019 another strong step forward into the future of Upwork.

Now, Brian will provide greater detail around the quarter and year, and our outlook for 2019.

Brian Kinion - Upwork Inc. - CFO

Thank you, Stephane and good afternoon, everyone. My remarks today will start with a brief update on our key operating metrics, then turn to the financial results and our guidance for the first quarter and full year 2019 which we provided in our earnings release filed earlier today.

Numbers are rounded for the sake of convenience, and, unless noted otherwise, comparisons for the full year 2018 are on a year-over-year basis, while comparisons to the fourth quarter of 2018 are to the fourth quarter of 2017. I'll be referring to GAAP measures unless explicitly cited as a non-GAAP measure.

Key Metrics

We monitor and measure our business performance using the following key operating metrics: gross services volume or 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 25% in the fourth quarter to $472 million and increased 28% year-over-year to $1.76 billion. Growth in GSV was driven by an increase in both core clients and an increase in our client spend retention.

Core clients, defined as a client that has spent in aggregate at least $5,000 in their lifetime on our platform and has spent in the last 12 months, increased by 22% to over 105 thousand as of December 31, 2018.

Client spend retention was 108% on a trailing 12-month basis at December 31, 2018, compared to 99% at December 31, 2017. Based upon analysis of our current cohorts, we continue to expect client spend retention to stabilize in the 106 to 108% range for the near term.

Financial Results

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

Total revenue increased by 23% to $67.3 million in the fourth quarter and increased by 25% to $253.4 million for full year 2018.

Marketplace revenue increased by 24% to $59.7 million representing 89% of our total revenue for the fourth quarter and increased by 26% to $223.8 million for the full year. Growth in marketplace revenue was driven by an increase in the number of core clients and higher client spend retention, evidenced by strength from our small business customers, growth in our U.S.-to-U.S. domestic marketplace offering, and an increase in direct sales from our enterprise offering. We also benefited from better timing of our weekly billing cycle in the fourth quarter as our business results are impacted in part by the number of Mondays in a given quarter. The most work in a given week is typically completed on a Monday, which is also the day we recognize our client payment and administration fee each week. There were fourteen Mondays in the fourth quarter, while the first quarter of 2019 has twelve.

Managed services revenue increased by 12% to $7.7 million in the fourth quarter and by 20% to $29.5 million for the full year 2018. Managed services revenue is growing, as expected, at a slower rate than our marketplace revenue and we anticipate this trend to continue.

Our take rate, which we define as revenue divided by GSV, was 14.3% in the fourth quarter, consistent with the third quarter of 2018, but down slightly from 14.5% in the fourth quarter of 2017. For the full year 2018, our take rate was 14.4% compared to 14.8% in 2017. This deceleration in take rate was expected and reflects our long-term strategy to align our incentives with both (1) freelancers that have longer-term client relationships and now bill at the 5% fee tier and (2) clients that continue to adopt ACH as a payment method which waives the 2.75% payment processing and administration fee. We believe these are both beneficial for the business in the long-term as it encourages larger and longer projects and lowers the overall cost of working with Upwork which, in turn, encourages additional project work and recurring spend on our platform. In 2019 we plan to launch additional value-added products and features to offset some of the take rate decline.

Non-GAAP gross profit in the fourth quarter increased by 25% to $46.6 million and non-GAAP gross margin was 69%, slightly up from 68% in both the third quarter of 2018 and the fourth quarter of 2017. For the full year 2018, non-GAAP gross profit increased by 25% to $172.2 million and non-GAAP gross margin was 68%, which was the same as the prior year. Gross margins are influenced by multiple factors:

- First, the mix of revenue between our marketplace and managed services offerings.
- Second, payment processing costs, which is our primary component of cost of revenue, increased by 21% in the fourth quarter and increased by 23% for the full year 2018. We are seeing more customers adopt ACH as a payment method, which reduces our take rate and revenue but is beneficial to gross margins.
- Third, the cost of revenue for freelancer services to deliver managed services increased by 17% in the fourth quarter and increased by 23% for the full year 2018. This was mostly due to an increase in spend from a client and, to a lesser extent, the use of more costly service providers.
- And fourth, our spend on Amazon Web Services, which as of the fourth quarter was growing slower than revenue compared to a year ago.

We are focused on driving gross margin leverage. We continue to see more ACH adoption and are focused on managing our AWS costs to grow at a slower rate than revenue growth in the near term.

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. We expect our gross profit to grow at a faster rate than revenue in the near term.

Operating expenses

Turning to operating expenses, non-GAAP sales and marketing expenses increased by 12% to $17.3 million in the fourth quarter, representing 26% of total revenue compared to 28% in the fourth quarter of 2017. For the full year 2018, non-GAAP sales and marketing expenses increased by 38% to $71.3 million representing 28% of total revenue compared to 26% last year. These increases were driven by investments to build out our enterprise sales team, online marketing and offline advertising activities to drive brand awareness and attract new users. We intend to continue to invest in sales and marketing with a focus on sound unit economics to drive long-term profitable growth. We have also made a decision to smooth our online performance marketing investment throughout 2019 versus spending a larger share of it in the first quarter as we have done in the past. This could have short-term impact on GSV and revenue, but we believe it will allow us to acquire customers at a lower cost.

Non-GAAP R&D expenses in the fourth quarter increased by 6% to $13.3 million, representing 20% of total revenue compared to 23% in the fourth quarter of 2017. For the full year 2018, non-GAAP R&D expenses increased 19% to $52.2 million representing 21% of total revenue compared to 22% last year. Our R&D spend in 2018 was focused on efforts to develop new products and features as well as our mobile-first transformation. The absolute spend on R&D was relatively consistent throughout 2018 and grew relatively in line with our revenue growth. Our R&D team worked on more capitalizable projects in 2018 than in prior years, such as our mobile-first transformation, which will benefit the platform over the long-run. We believe continued investment in R&D is important to further our long-term strategic objectives.

Non-GAAP G&A expenses in the fourth quarter increased by 18% to $11.9 million representing 18% of total revenue which is consistent with the fourth quarter of 2017. For the full year, non-GAAP G&A expenses increased by 32% to $41.3 million representing 16% of total revenue compared to 15% last year. These increases were primarily due to our efforts to support being 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, they may fluctuate from period to period.

Our provision for transaction losses in the fourth quarter decreased by 13% to $1.2 million representing approximately 2% of total revenue, and increased by 37% to $5.8 million representing approximately 2% of total revenue for the full year 2018. These results are within our normal range of 2% to 3% of total revenue and we expect our reserves to increase proportionally in this range as our GSV grows.

I'd also like to note the accounting for two common stock warrants.

First, in connection with the establishment of the Upwork Foundation Initiative, in May of 2018, we issued a common stock warrant to purchase 500,000 shares of our common stock at an exercise price of 1 cent per share. This warrant becomes exercisable for 1/10th of these shares on each anniversary of the IPO. We incurred a charge of approximately $225 thousand in the fourth quarter of 2018 related to this warrant. We expect a non-cash charge recorded in G&A related to this warrant of approximately $900,000 during 2019. We plan to exclude this expense in deriving our adjusted EBITDA and non-GAAP net income on a go-forward basis.

Second, as we noted on our third quarter earnings call, we had a preferred stock warrant that was converted to a common stock warrant upon our IPO. As a result, we incurred a non-cash expense of approximately $2.4 million in the fourth quarter. This expense will not recur in future periods.

Net loss was $(5.4) million for the fourth quarter of 2018 compared to a net loss of $(5.2) million in the fourth quarter of 2017. Our basic and diluted net loss per share in the fourth quarter was $(0.05) on 103.4 million weighted average common shares outstanding. For the full year we incurred a net loss attributable to common stockholders of $(19.9) million compared to a net loss of $(10.6) million in 2017. Our basic and diluted net loss per share for the full year was $(0.38) on 52.3 million weighted average common shares outstanding.

Non-GAAP net income was $2.7 million in the fourth quarter of 2018 compared to a non-GAAP net loss of $(8.9) million in the fourth quarter of 2017. Our basic and diluted non-GAAP net income per share in the fourth quarter of 2018 was $0.03 compared to a loss per share of $(0.27) in the fourth quarter of 2017. For the full year 2018, we incurred a non-GAAP net loss of $(600) thousand compared to a non-GAAP net loss of $(900) thousand in 2017. Our basic and diluted non-GAAP net loss was $(0.01) per share for 2018 and $(0.03) per share for 2017.

Adjusted EBITDA, a key metric for us in operating the business, was positive $3.6 million in the fourth quarter as compared to negative $(1.9) million in the fourth quarter of 2017. For the full year 2018, adjusted EBITDA was positive $3.8 million compared to $7.9 million in the prior year. We exceeded our prior guidance due to better than expected revenue and lower transaction losses. We continue to take a long-term view and balance investing in sustainable profitable growth while expanding our leadership position of this very large and expanding addressable market opportunity.

Balance Sheet and Cash Flows

Moving to the balance sheet and cash flows. We ended the year with $129.1 million in cash and cash equivalents compared to $21.6 million at both September 30, 2018 and December 31, 2017.

As of December 31, 2018, we had $24 million in debt outstanding from our two term loans. During the fourth quarter, we repaid $10.0 million that we had used to repurchase shares in 2017. We also repaid during the fourth quarter $15.0 million on the revolving line of credit that we had drawn at the end of the third quarter to provide working capital to fund our marketplace accounts receivable due to September 30, 2018 being a Sunday. Please note that the quarters ending March 31, 2019, and June 30, 2019, both end on a Sunday. Therefore, you should expect a similar impact on our balance sheet and cash flow from operations to fund our escrow accounts and for us to use the revolving line of credit in a similar fashion as we did at September 30, 2018.

Looking forward, just to note our first principal payments to pay down the term loans begin in April 2019.

Operating activities provided $21.9 million in the fourth quarter which was largely driven by the return of operating cash from escrow related to the Sunday effect.

We used $2.9 million in investing activities in the fourth quarter primarily related to the build-out of our new Chicago office and capitalized software for the mobile first transformation project.

Cash provided by financing activities for the fourth quarter was $83.1 million primarily driven by the completion of our IPO from which we raised $109.4 million, net of underwriting discounts, and partially offset by $25.0 million in debt repayments.

Looking forward, we have some one-time expected capital expenditures coming up in the next six months. We just signed a lease for a new office in Santa Clara due to our Mountain View lease expiring in the second quarter. We anticipate spending approximately $7.5 million to build the site out to our needs over the next two quarters.

Guidance

Turning to guidance. For the first quarter of 2019, we expect revenue in the range of $68 to $69 million and adjusted EBITDA in the range of -2 to -1% of revenue.

We expect weighted average common shares outstanding to be in the range of 106.5 to 108 million for the first quarter.

For the full year, we expect revenue in the range of $298 to $304 million and adjusted EBITDA in the range of break even to approximately 1% of revenue. We expect gross profit to grow at a faster rate than revenue as our mix shifts more towards marketplace revenue and additional clients adopt ACH. We expect weighted average common shares outstanding to be in the range of 109 to 114 million.

As a reminder our first and second quarter of 2019 are lapping the first year of our U.S.-to-U.S. domestic marketplace. As noted earlier, the number of Mondays in a given quarter impacts our revenue growth when comparing sequential and year-over-year.

We are still assessing our transition to the new revenue recognition standard or 606 as we will adopt this standard at the end of 2019.

And now I'll turn it to Stephane for some closing comments.

Closing: Stephane Kasriel - Upwork Inc. - CEO

Thanks Brian. We are really excited about our 2019 outlook and strategy. Our marketplace is truly a place where high quality work gets done and freelancers can earn a meaningful living. 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.

With macro-trends at our back, we are investing in our products, our brand and our sales capabilities to go after our long-term addressable market. 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. We are looking forward to success in 2019 to build a company for the ages.

With that, we will be happy to take your questions.