PowerSchool Group LLC

Fourth Quarter 2021 Earnings Conference Call

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PRESENTATION

Operator

Good afternoon and evening, everyone, and welcome to PowerSchool's Fourth Quarter 2021 Earnings Conference Call.

With that, I would like to turn the call over to Alan Taylor, Investor Relations. Thank you, sir. Please begin.

Alan Taylor

Thank you. Good evening, everyone, and thank you for joining us for PowerSchool's financial results conference call for the Fourth Quarter and Fiscal Year ended December 31, 2021.

On the call today, we have PowerSchool's CEO, Hardeep Gulati, and CFO, Eric Shander.

Before we begin, allow me to provide a disclaimer regarding forward-looking statements. This call, including the Q&A portion of the call, may include forward-looking statements related to the expected future results for our Company and are therefore forward-looking statements. Our actual results may differ materially from our projections due to a number of risks and uncertainties. The risks and uncertainties that forward-looking statements are subject to are described in our earnings release and other SEC filings.

Today's remarks will also include references to non-GAAP financial measures. Additional information including definitions and reconciliations between non-GAAP financial information to the GAAP financial information is provided in the corresponding press release, which is posted on PowerSchool's Investor Relations site at investors.powerschool.com.

In addition, this conference call will be available for replay via webcast through the same website. Hardeep will begin with a review of PowerSchool's fourth quarter and full year highlights. Eric will then take you through a review of the financials before we proceed to Q&A. We have also made an earnings presentation available in the Events & Presentations section of our Investor Relations website, so please feel free to download the presentation and follow along with today's call.

With that, I'll now turn the call over to Hardeep.

Hardeep Gulati

Thanks, Alan, and good evening, everyone.

PowerSchool had an outstanding fourth quarter, finishing the year strong and laying the foundation for a continued growth and momentum into 2022. We exceeded the top end of our guidance range for both revenue and our Adjusted EBITDA. We delivered $146.1 million of revenue for our fourth quarter with 26% revenue growth and an Adjusted EBITDA of $33.2 million, a margin of 23%.

For the full year, we delivered a record $559 million in revenue or 28% year-over-year growth. Our Adjusted EBITDA of $161 million, a margin of 29%. These results highlight the scale and the durability of our business. Our industry-leading unified platform approach continues to differentiate us in the K-12 market, providing long-term growth opportunities for many years as customers look for ways to digitally transform, move to more integrated solutions, empower educators and offer best-in-class solutions for teachers, students and parents for improving education outcomes for every child.

No other vendor in K-12 SaaS can match our breadth, depth and presence in North America. We now offer 18 products, including our latest acquisition of Kickboard SEL solution and Kinvolved communication platform, giving us significant opportunity to expand our footprint within our customer base and new customers to whom we can cross sell. This cross-sell engine fuels momentum and growth across our business as we enter 2022.

Eric will share more details about our financial results and guidance for 2022. Firstly, I'd like to spend more time today sharing some exciting updates on the key dimensions of our business that highlight our stability, momentum and opportunity, adding to our confidence for 2022 and beyond.

I'll talk about the large durable K-12 market that we sell and our inarguable leadership position within that market, the proof points that show our platform strategy is working as well as a comprehensive platform ability to meet the changing needs of our customers, which create multiple growth vectors and the opportunity to continue expanding our offerings as well.

Let's start with the first key dimension, an update on the K-12 market. The North American K-12 market that we serve is very large and resilient. Education represents the second largest discretionary spend category in U.S. public spend. If you look at the K-12 funding environment, it has mostly grown steadily over the last 30 years. It is largely insulated from the inflationary or interest-related pressures seen by many industries today.

Education spend is largely noncyclical and bipartisan, creating a relatively protected budget for districts and, in turn, for our products. Breaking this down further, external IT-related spend is currently a small but fast-growing part of funding. Gartner recently increased their estimates for external IT spending in K-12 schools in the US and Canada and expected to grow at a 9% CAGR from $17 billion in 2020 to $26 billion by 2025.

Additionally, the market will benefit from the $122 billion in additional ESSER III funds, much of which is still largely unspent and will provide additional funding over the next few years.

Second, I'd like to update you on our continued leadership in K-12. We enjoy a clear market leadership position in North American K-12 cloud software. We currently have over 14,000 customers on our platform. We added roughly 2,000 customers since the end of 2020. Through these customers, we reach over 45 million students, representing over 70% of the K-12 student population in U.S. and Canada. This expansive reach fuels an incredible opportunity for growth across our product portfolio.

Even with this market-leading position, our market share represents only about 5% of Gartner-estimated K-12 software spend. We certainly see the opportunity for growth ahead of the market, considering the relatively low penetration rates we see across the product portfolio and the frequent cases where our solutions are mainly replacing paper-based processes, legacy or fragmented solutions.

Third, I'd like to update on the exciting success we are seeing with our strategy. Our platform and cross-sell strategy is working. Over the past two years, we have seen a 65% increase in the number of customers who use four or more PowerSchool products, a cohort that grew from just over 1,100 to more than 1,800 customers. In fact, these most loyal customers now represent nearly half of our ARR. This platform strategy creates a flywheel effect in which unified products benefit from each other, which compounds the value for the customer and increase the stickiness for our solution.

We're continuing to see successes in these multiproduct implementations across schools and districts of all sizes across North America. Take as an example the Washington County in Utah. As a long-time customer using our student information system, ERP, our Schoology LMS, our formative assessment, they've added Unified Insights in Q4 to further their performance monitoring and administrative management capabilities across the district.

Anne Arundel, the fourth largest school district in Maryland, representing about 90,000 students, is the poster child of the platform strategy working. They use 13 of our products today and continue to expand usage, including extending their high school-focused Naviance implementation into roughly 19,000 additional students within their middle school.

We saw a 15% increase in active students year-over-year for Naviance across U.S. during this time of the year, with 6.4 million college applications year-to-date filed using our solution. These stories, which reflect the success and impact our customers are seeing from our solution, validate the power of platform strategy. With over 14,000 customers in total, a broad portfolio of 18 products we offer and 5% of software spend captured by PowerSchool today, the opportunity in front of us is quite large with a ton of room for growth.

Fourth, the strength of our diversified comprehensive platform creates multiple growth vectors across our solution areas with the most mission-critical systems to power districts in K-12. Our breadth and depth give us the confidence in our ability to grow no matter how our customers' needs evolve.

A recent third-party conducted brand survey of K-12 customers lists a variety of key priorities and challenges for the next 24 months across different functions. You can find this in our earnings presentation. We believe we are in a unique position to address most of the must-have critical K-12 administrations need today.

Our customers also recognize this. The survey also shows PowerSchool has the highest brand awareness and about double the consideration of any pure play education software company. Take examples for 2021. Districts elevated their focus on identifying unfinished learning, which led many of them to our insights and assessment products. We are seeing these needs for student insights continue into future years, and we are well positioned to meet these needs.

In fact, very excited to share a top five school district by student enrollment in U.S. just selected our Performance Matters assessment platform for a district-wide assessment solution in addition to their existing multiple products PowerSchool footprint. One of the key challenges districts are facing today is talent shortage with higher teacher attrition given the stress and the impact from last two years of COVID. We recently published our TalentIndex survey with a third-party firm, which clearly shows that teacher equipment, their well-being and the retention are the three top priorities for all our customers in 2022.

Unified Talent helps them manage their staff from hire to retire. And in Q4, we saw a state Department of Education select Unified Talent as their statewide educator recruitment platform for the entire state.

We're also seeing heightened focus on providing an integrated academic, behavioral, special need and a social emotional support to give a holistic view of the student. Kickboard, our behavior solution acquired recently in November, helps districts identify students who need behavioral support. And we are further innovating to enable a holistic multi-tier system of support process for districts.

We are seeing that student and community engagement is more critical than ever in this challenging time. Districts are seeing major challenges with absenteeism and a need, a centralized, equitable way to reach the families they support. Our most recent acquisition of Kinvolved extends our product footprint in a way to help address this need.

This takes me to my last point, the opportunity we have to continue expanding our platform and the market opportunity globally. We saw these needs growing within our customer base, and the acquisition of Kickboard and Kinvolved are great examples of how we quickly provide a solution and in turn drive cross-sell.

Kinvolved, which closed in February 1, is the latest addition to our portfolio, bringing us a modern, best-in-class solution for K-12 communication and attendance intervention. Kinvolved addresses a massive market need for family engagement and reducing student absenteeism and improving student engagement and outcome.

Alongside this M&A, we continue to focus our R&D dollars on innovation to launch new products and capabilities, including a competency-based learning management system across our SIS, LMS and formative assessment platform, a new graduation planning capability leveraging our Naviance and SIS, utilizing Kickboard to tie SEL and academic data together, our data lake project, and, as I mentioned earlier, developing a new product to help districts better manage their MTSS workflow.

All these investments are foundations for us to build and expand into the global personalized learning market, which represents a $100 billion market opportunity. Our vision, the platform and the investments allow us to lead the charge towards game-changing innovation to transform K-12 education globally.

The combination of these factors I shared, the strong market, the clear leadership position, the cross-sell momentum from our platform strategy, the multiple avenues to drive growth and the potential to continue expanding our platform speak to our success, our opportunity and the durability of our business, allowing us to capture the large opportunity in front of us. We have a clear visibility into driving predictable and profitable growth well into the future, generating free cash flow, which, in turn, gives us the ability to continue to invest and expand our platform.

I'm extremely proud of our team and all we have accomplished. I'm also proud to help schools and districts through this pivotal time of rapid change and evolution. It is our goal to move education forward by giving schools and districts the tools and the real-time access to meaningful data, which unlocks the keys to better student outcomes and thriving staff.

With that, I'll hand it over to Eric to provide a financial update for 2020 (phon) and share more about our guidance for 2022. Eric?

Eric Shander

Thank you, Hardeep, and good evening, everyone.

We had a great finish to 2021. Top line performance was strong driven by our continued cross-sell momentum and strategic M&A. In addition to driving double-digit revenue growth, we maintained a strong Adjusted EBITDA margin, which included absorbing public Company-related costs as well as additional go-to-market investments we made to fuel our future growth.

For the full year, total Company revenue was $558.6 million, an increase of 28% year-over-year, which included a beat on the top end of our Q4 guidance range by $4.1 million. We ended the year with an annual recurring revenue balance of $538.6 million, an increase of 26% year-over-year, and our net revenue retention rate was 106.4%, up 80 basis points on a sequential quarterly basis, highlighting both the stickiness of our products and our ability to expand within our customer base.

Full year gross profit totaled $317.7 million or 56.9% margin, up almost a full point from the prior year. On a non-GAAP basis, adjusted gross profit was $375.7 million or 67.3% margin, an improvement of 138 basis points from the prior year. Margin expansion was driven by our top line performance, coupled with improved operational scale across our cloud operations and customer support organizations.

Full year operating expenses were $312 million or 55.9% of revenue, which was approximately 5 points higher than the prior year, primarily driven by the addition of public Company-related costs and an increase of $16.3 million year-over-year of stock-based compensation expense. We delivered full year Adjusted EBITDA of $161.2 million or 28.9% margin, which exceeded the top end of our guidance range by $2.2 million, reflecting the strength and durability of our business model.

We generated strong free cash flow in the year of $103.2 million, up 78% versus the prior year. In addition, we significantly strengthened our balance sheet, ending the year with $86.5 million in cash and cash equivalents, up $33.7 million versus the prior year, and we reduced our net leverage by more than 50% while still investing significantly in our business.

Now turning to our quarterly results, which were strong. Total revenue came in at $146.1 million, up 26% year-over-year and exceeded the top end of our guidance range. Subscription and support revenue in the

fourth quarter totaled $128.2 million, up 29% year-over-year, driven by our growth across all our solutions. Services revenue was $14.4 million, up 12% year-over-year, driven by increased product deployments.

Gross profit for the fourth quarter was $80.3 million or 54.9% margin, representing an improvement of 80 basis points year-over-year. On a non-GAAP basis, adjusted gross profit for the fourth quarter was $96.2 million or 65.8% margin, up 31 basis points year-over-year.

Now turning to expenses. R&D expense for the fourth quarter was $27.9 million or 19.1% of total revenue compared with 19.4% a year ago, which reflects the continued investments we're making in the platform to deliver the products and capabilities for our customers that rely on us to support their mission-critical operations.

SG&A expense in the fourth quarter was $45.9 million or 31.4% of total revenue versus 21.8% from a year ago, which was primarily driven by an increase in anticipated public Company-related costs.

Our Adjusted EBITDA was strong, coming in at $33.2 million or 22.8% margin, exceeding the top end of our guidance range. We continue to focus on optimizing our business and we are pleased with the performance over the first few quarters as a public Company.

Overall, we had a great fourth quarter and ended 2021 with a stronger financial profile. The investments we made within the year position us well heading into 2022. We continue to benefit from a favorable and resilient funding environment. Our market leadership remains a competitive advantage, and we have a broad product platform that fuels a sustainable cross-sell strategy for years to come.

Now turning to our first quarter and full year 2022 financial guidance. We expect to deliver total revenue for the first quarter of $145 million to $148 million, representing a growth rate of 23% to 25% year-over-year. Adjusted EBITDA in the first quarter is expected to be in the range of $40 million to $42 million, representing a 28% margin at the midpoint.

For the full year, our guide reflects the Rule of 40 business, and we believe we can continue to operate in that range well into the future.

We expect total revenue for the full fiscal year in the range of $620 million to $626 million, representing 11% to 12% year-over-year growth. Please note, starting in March, we lapped the acquisition of Naviance in our year-over-year comparisons. As a result, full year guidance is primarily organic revenue growth given our most recent acquisitions of Kickboard and Kinvolved are not material.

Full year Adjusted EBITDA is expected to be in the range of $180 million to $184 million, representing a 29.2% Adjusted EBITDA margin at the midpoint. For modeling purposes, we expect capital expenditures, which excludes capitalized software of approximately $7 million and share-based compensation expense of approximately $60 million to $65 million for the full year. Fully diluted shares for the year are expected to be in the range of 200 million to 205 million shares.

In closing, we had an outstanding fourth quarter that capped off a record year for PowerSchool in terms of revenue and cash flow generation. We significantly improved our balance sheet paying down debt and setting the stage for another year of strong cash generation. We have a large and growing customer base and our unified platform approach and market-leading position provides significant cross-sell opportunities for us.

K-12 funding environment remains resilient as educators look for ways to digitize their systems, integrate data and improve student outcomes. Our expansive product footprint and low penetration in this market

gives us confidence as we head into 2022. I'm excited about the opportunities ahead as we grow our market share and invest for long-term growth.

With that, we're now happy to open the call for questions. Operator, will you please open up the line for Q&A?

Operator

Our first question comes from the line of Stephen Sheldon with William Blair. Please proceed with your question.

Stephen Sheldon

Hey. Thanks. Nice results and guidance here.

First, what can you share about the size of your sales team now versus maybe where it stood a year ago? How much capacity do you have in case you start to see a big increase in demand as some of the stimulus funding flows through the system? Do you have the capacity in place at this point to capitalize and start to see that pick up in 2Q, 3Q and over the next couple of years?

Maybe just one other one. It sounds like the M&A pipeline continues to be strong. How should investors be thinking about the potential for additional M&A this year, and how can the visibility into state and school district plans for the stimulus funds maybe influence what targets you decide to pursue?

Hardeep Gulati

Going back to, Steve, making sure I repeat both the responses. Number one, on your sales, we have a pretty good coverage to cover all the large strategic enterprise and insight accounts. Also, we have overlay solution team that sells to the solution. To your point, we have increased our sales team year-over-year by a dozen quota-carrying people plus additional support staff to continue to focus on the additional demand we're seeing.

The second part of your question on the M&A, we—as we mentioned that our big focus is on the organic cross-sell, how we are selling our 18-plus products into the base. But then we do continue to expand our platform to further our goal towards personalized learning, which is building that system of intelligence, everything about the student. We are seeing opportunity in adjacencies, both from a tuck-in and scaled options, which we'll continue to pursue into the year. Hope that helps.

Stephen Sheldon

Great. Thank you. Yes. Perfect. Thanks.

Operator

Our next question comes from the line of Matt Hedberg with RBC Capital. Please proceed with your question.

Matt Hedberg

Hi, guys. Thanks for taking my question and congrats on a strong close to the year.

I remember during the IPO process, you talked about, I think, the potential $2.5 billion of upsell in your base, which is always an impressive statistic. Seeing that now I think half of your ARR comes from customers with more than four products is, I think, really indicative of that opportunity. Could you talk about how you've had some success there and maybe how you could even push that success even higher with even additional cross-sell to tap into that opportunity?

Hardeep Gulati

Great point, Matt.

For the first, the $2.5 billion, that cross-sell TAM continues to expand as we bring more integrated solutions and more acquisitions. Take example of the whole communication side with our Kinvolved. That adds close to $0.5 billion of additional TAM for us to cross sell into our base. We continue to expand that cross-sell total opportunity.

As I mentioned also in my prepared remarks, we are actually seeing a lot of increase with our adoption of our multiple products, especially, as we shared, almost 65% increase in year-over-year on customers who have more than four products. We definitely see an acceleration of that cross-sell.

We're still early in this game. We only have about 12% of our overall customer base which have more than four products. To your point, there is still a huge opportunity, especially if you look at from an ARR contribution from those sticky customers, we can have five or six-fold increase of our ARR by just continuing these cross-sell motions.

We have both our internal cross-sell strategies on plus 1 product, really giving customers an opportunity to just add one of our other 18 products and a lot of go-to-market focus and functions around it. There is definitely an upside opportunity there to (inaudible) that, and we continue to drive our go-to-market functions on it.

Matt Hedberg

That's really great to hear.

Then Eric, one for you. The trend in software this earnings season has been strong results but lower margin guidance for 2022. You guys aren't doing that. You're guiding to, it looks like, about 30 basis points of improvement to start the year, if that math is correct. Can you talk about how you're prioritizing those investments? Then maybe just remind us about how we think about that balance between growth and obviously strong and expanding profitability.

Eric Shander

Yes. Thanks, Matt.

First, I would just say, we were really pleased with where we ended the year and certainly ahead of our expectations. We wanted to continue to signal the expansion on the margins, which we did in the guide. As I've mentioned, we've got a lot of opportunity to continue to drive leverage. In fact, we could increase the margins even more. However, we do choose to look at longer-term growth investments, so we really like to continue the margin expansion but then also—and really want it to be a Rule of 40 plus.

But we are reserving capacity, as I've mentioned before, in the out years as we look at international and some of our other longer-term growth opportunities. We feel really, really good. Strong finish to the year. We're going to show expansion into next year, this year. Certainly, I'd say, we could be well into the 30%

margin EBITDA from a total perspective. But we are reserving that capacity for these longer-term growth opportunities, which we feel really confident in.

Matt Hedberg

That's really good to hear, the balanced growth and profitability. Thanks a lot, guys, and best of luck.

Eric Shander

Yes. Thanks, Matt.

Hardeep Gulati

Thanks, Matt.

Operator

Our next question comes from the line of Fred Havemeyer with Macquarie. Please proceed with your question.

Fred Havemeyer

Hey. Thank you.

Hardeep, I think I wanted to start on ESSER funding. I know it's a topic that we've talked about in the past. But now with ESSER funds distributed and at this point, I believe, fully funding all of the state-level education plans, could you talk a little bit more about how this is shaping some of your purchasing conversations with schools? Also, as we progress with ESSER funding through the 2023 time line, do you see any risk of customers that have purchased PowerSchool or education technology with ESSER funding churning? Or do you think that they would continue with the products after ESSER funding?

Hardeep Gulati

Great question, Fred.

Let me first put it into perspective, right? We're talking about, when you look at the full education spend yearly, it's almost $700 billion and ESSER money is about $122 billion additional for—to be spent over the next few years, which they can even do purchases for the next—can do a purchase in 2024 for the next three or four years as well. It is going to get spread out over the next—a lot of years.

As you can see, it's actually another 10% or 15% additional benefit for school districts of having these additional funds. We typically don't need the stimulus money to really fund our solutions. Most of our districts would actually buy from their normal fund, typically for IT spend, which they have allocated. As you know, that's still small. That's only 2%, 3% of the overall. When they're buying these technologies which are must-have, whether it's for classroom, for student system or college career readiness, they are not necessarily tapping it based on the stimulus.

Stimulus does help them to leverage it for a quick budget management so they can really tap into it while they work out the long-term funds. We are not really expecting any kind of a really change because once these solutions are in, they are really sticky. They're must-have. You're not really selling any nice-to-have capabilities. All of these are—once you roll out to all the teachers and students and parents, you're not

going to really take them off. Majority of our funding of our solutions still is happening from their core budgets.

Fred Havemeyer

Thank you there.

Then I wanted to just also ask about the cross-sell that you're seeing here because that growth in customers adopting more than four products was looking particularly impressive during 2021. Wanted to ask, could you talk about what has really been clicking with your cross-sell motion that has driven this increase? I think it was brought to 1,800 customers now with more than four products. Also, can you give us some color on where in your portfolio you're seeing the most cross-sell traction? Thank you.

Hardeep Gulati

Great.

Fred, a couple of things. One is the flywheel effect I mentioned, right? The more customers buy our solutions, the more they need to integrate platform. As they buy our student system or Schoology learning management and they want assessment, they want analytics, they want special ed, they want communication, so it really creates more stickiness for them to buy additional solutions. That's a flywheel effect we are seeing with more and more of our integrated customers who are taking advantage of that.

In terms of your second part of the question, how do you really—which areas we are seeing, it is a little bit dependent upon the areas I mentioned in the study, the survey which talks about that customer needs are evolving. Coming out of the pandemic, customers' focuses are evolving. There was a lot of focus on assessment and analytics over the last year. We are seeing increased focus on talent management because they're trying to recruit and onboard, manage substitute teachers and as well as retain teachers.

We're also seeing increased demand for social, emotional and understanding the whole child and providing the right interventions and as well as the communication piece, which I mentioned is why we acquired Kinvolved. We're seeing a huge demand for really trying to engage kids on and where—their absenteeism to address that area and reach out to the family.

We're really hitting on—as the customer needs evolve, we have an ability to really hit their key priorities. That's the beauty of our platform that we can really manage to the entire broader aspects of what the customer needs for their digital transformation journey.

Operator

Our next question comes from the line of Saket Kalia with Barclays. Please proceed with your question.

Saket Kalia

Okay, great. Hey, guys. Thanks for taking my questions here.

Hardeep, maybe for you just to start. Given that it's year-end, we've got a nice guide here for next year, can you just remind us roughly what was the number of students that are currently on the platform as of the end of 2021 and how you're thinking about that balance of growth in students versus growth in revenue per student next year, even directionally? Does that make sense?

Hardeep Gulati

Yes, that makes sense, Saket.

As you know, we are—when we really talk about we're reaching 70% of the North America market, that's roughly 45 million students across all of our different components.

To your point about how we look at the ARPU in terms of per student share of the wallet, when you look at the funding environment, which is largely stable in these times, we are looking at almost 12,000-plus on average. With IT spending of software components, that's almost like they're spending about $150 to $200. There's a lot of room for us to grow that student and per share of the wallet. We'd really focus on less about from a dollar perspective as much about getting one more additional product for our districts. That way, our cross-sell motions are more designed to really get more stickiness of the platform.

When we talk about the adoption of four-plus customer, let me share another key fact. Take example of districts who are more than 25,000 students. We now have more than three-plus products on average with them. Generally, for a broader population, that's two-plus average.

For our larger customers, now we actually have three-plus products with them. That's the motion, is really to get more stickiness and more adoption of our platform with our customer base.

Saket Kalia

Got it. That's very helpful.

Eric, maybe for you, a follow-up and somewhat related. Great to see the stabilization in net revenue retention. Can you just talk about the path from here as we go into 2022 on that metric? I know there are some mechanics in there that are just worth reminding everyone about. Just how that progresses through 2022, even directionally?

Eric Shander

No. Yes, absolutely, Saket. Appreciate the opportunity.

Yes, look, as we turned in Q4 at 106.4%, which was up 80 bps from the third quarter, obviously that was really reflecting the strong cross-sell that we saw in the quarter. As we get into 2022, you should expect the NRR to continue each quarter to increase and improve. When we get to the end of the year, I think people will be pleased. We'll see at least a point of improvement.

The other thing I would just say to keep in mind and we had mentioned this, as you look at the impact of NRR since it is a trailing 12-month metric, there are two items in there that have impacted it. We've got roughly a point of impact from Naviance. When we made that acquisition, certainly, their retention rates weren't as high as the PowerSchool profile, so you would have added a point on to the 106%.

Then obviously, when we were in 2020, we had extraordinarily strong bookings related to COVID, which would have been about another point. You can think about 2 points of adjustment to that. But as you look at the trailing or the trending into 2022, expect continued improvement from here on out every quarter.

Saket Kalia

That's very helpful. Thank you.

Eric Shander

Thanks, Saket.

Hardeep Gulati

Thank you.

Operator

Our next question comes from the line of Brent Thill with Jefferies. Please proceed with your question.

David

Hi, guys. This is David on for Brent. Thanks for taking the question.

I wanted to ask about the funding environment. The last numbers I saw, the majority of the ESSER funds are still yet to be spent. I'm curious why that is. Do you anticipate that all $122 billion will be spent by the time the school year period is up?

Hardeep Gulati

Sure. When you look at—from the funding approval, to your point, only—less than—between 5% to 10% is what's actually spent. But what we have seen as progress since the stimulus is that there is approvals now from states about how the funding needs to be spent and that approvals are now coming to very much majority of the states as well. It is going to trickle down to a lot of districts, and districts have started using some of these funds as additional dollars to that.

A good example is one of the top school districts I mentioned who use our formative assessment platform, they're using a decent chunk from their current budget, but they're also using some of the ESSER money to help them with the initial set of implementation in here. Districts will tap into these funds over the time. It is something they don't have to necessarily spend all of it by the 2024. They can spend for the period for these even longer.

I do want to reiterate the overall funding environment is very stable. One of the key things we want to keep driving to the factor is that we see a lot of discussion about interest rates and interest rate. We're largely insulated in the funding environment of K-12. Stimulus is giving an additional jolt to help with the speed of the velocity. But largely, when you look at our deals, we—given the key features we sell, which are must-have, funding is really helps accelerate things but not a required component for districts to adopt our solution.

David

Got it.

Then maybe just as a follow-up on LMS and obviously, a big beneficiary in 2020, and I think it's roughly half of K-12 schools are not using a paid LMS. Would just love to hear how that product is doing. Obviously, I'm assuming it's cooled off after a big (inaudible) during COVID, but any update there would be appreciated. Thanks.

Hardeep Gulati

Yes. You're absolutely right.

In 2020, there was a huge amount. We've talked about we almost added 4 million-plus students on the core platform in LMS. But what we do see is, every year, we are seeing about a million to 2 million additional adoption on LMS. When you look at the full 60 million population in North America, half of that still doesn't have a best-in-class paid LMS. There is still a lot of room to continue to us to grow and add that 1 million to 2 million students and grow double digit on our classroom products for many years to come given how much the market opportunity still exists.

David

Great. Thanks, guys. Appreciate it.

Hardeep Gulati

Thank you.

Operator

Our next question comes from the line of Gabriela Borges with Goldman Sachs. Please proceed with your question.

Gabriela Borges

Good afternoon. Thank you for taking my question.

Hardeep, I wanted to get a little bit of commentary on what you saw during 2020 and 2021 in terms of buying pattern for your customers. How do you think about how much of what you saw during COVID was temporary versus maybe the sense we're like getting is there's also something structural happening in terms of the rate of willingness to invest in education and analytics and technology? Maybe just some of your reflections on what you see as temporary versus permanent in the last couple of years.

Hardeep Gulati

Absolutely, Gabriela.

The two factors, one is, COVID, definitely in the last two years, has put a broader enlightenment about how the school districts don't have the right infrastructure support to handle disruptions like what we just encountered. That visibility has not gone just to the district owners and the teachers. I think pretty much every person and every parent can voice for that as well that this technology can play a bigger role to help kind of manage school disruptions of any kind.

We are seeing a broader demand shift on having additional discussions around broader digital transformation as well as the—to your point, more insights to help understand where the students are. I had a Department of Education superintendent for a state talk about that while the learning loss created 25% of the students in that state who actually had learning loss, they were already, to begin with, had 30% to 40% of the students, which were not meeting the national standards. That learning loss visibility is also pretty big.

Most of the things what we're talking about on the digital transformation, the visibility on analytics as well as better understanding and communicating with the students, these are systematic shift and we are seeing the demand really happening across the entire nation on that.

Gabriela Borges

That's helpful. Thank you.

A follow-up if I may. You made a couple of comments on the work you're doing with data warehousing with Snowflake. Would love to hear how you're thinking about that opportunity longer term and whether it creates an additional avenue of monetization that's accretive to the analytics work that you're already doing. Thank you.

Hardeep Gulati

Absolutely. Our Unified Insights is right now the most broadest insight platform that exists in K-12. Not only we can do the stated and engagement data, the achievement data, the CL data, we can bring the whole child view as well have predictive understanding of how the students really are impacted.

We are definitely, with our Snowflake implementation, accelerating to bring all kinds of additional data, which will feed into the district so they have a better way to not just improve their operational efficiency but also understand better the student and personalize education. That is the nirvana which completely transforms K-12 education, and our initiatives are definitely in the direction to make that happen.

Gabriela Borges

Thank you for the color.

Hardeep Gulati

Yes. Thanks, Gabriela.

Operator

Our next question comes from the line of Karl Keirstead with UBS. Please proceed with your question.

Karl Keirstead

Hey, great. Thanks.

Hey, Eric, as we model unlevered free cash flow for '22, an obvious starting point is to look at the 50 bps increase in your Adjusted EBITDA margin based on your guidance and grow unlevered free cash flow margins by the same. Is that a reasonable starting point? Or anything funky you'd call out in terms of cash flow in calendar '22?

Eric Shander

Yes. No, I think that's a reasonable cash flow assumption, Karl. The only other thing I would say is I provided the Capex less the product cost, software product development costs that's been capitalized. For that, I would just use very similar ratios that we had in 2021. But there isn't anything unusual to expect in there.

Karl Keirstead

Got it. Good to hear. Thank you.

Operator

Our next question comes from the line of Brian Peterson with Raymond James. Please proceed with your question.

Brian Peterson

Thanks, gentlemen, and congrats on the strong close to the year.

Eric, maybe just starting with you. As we think about the seasonality of the business, as you're looking ahead to 2022, is there anything that you would share in terms of seasonality, in terms of ARR or revenue metrics as we progress through the course of the year? Any help on that?

Eric Shander

Yes, absolutely, Brian.

First, I appreciate the opportunity to continue to remind everybody around the seasonality of the business because our business is a little bit unique. What I would say is if you think about ARR, you'll continue to see upward growth. But then very similar to what you saw in 2021, a lot less growth going from—sequentially from Q2 to Q3. The reason for that is because the majority of our renewals happen in Q3. To the extent that there's any churn, that's going to be impacted there.

We'll continue to provide at least directionary color around that. But again, I think from an ARR perspective, just the phenomenon of Q2 to Q3, not as big of a growth, as you will see in other quarters. Then certainly, from a revenue standpoint, I would just remind everybody that when you think about sequential revenue from Q3 to Q4, that will dip down as it did this past quarter, and it's all—our subs and services continue to grow and we continue to see the positive momentum there. But the decline from Q3 to Q4 is all related to services revenue because of the decline in terms of projects that are happening near the end of the year. Schools aren't focused on projects as well as training declined.

Then our L&O, so license and other activity, in the fourth quarter is traditionally lighter just because the majority of the renewals happen in Q3. Again, just I think it's important and we'll continue to remind everybody about that seasonality as we get into the subsequent quarters. But I certainly appreciate you asking the question and giving me the opportunity to be able to just reemphasize that to everybody.

Brian Peterson

That's great color, Eric.

Hardeep, maybe just following up with you. We heard a lot about the cross-sell success this year. Obviously, there's a lot that you guys can go and attack in terms of the market and the value you're providing to the customers. But I'm curious if there were maybe one or two product categories that you really feel optimistic about 2022 in terms of the cross-sell, what would those be? Thanks, guys.

Hardeep Gulati

Thanks, Brian.

The number one, I think, we just touched upon in the last answer was the analytics. We're almost seeing 30% growth, and we expect that to continue, in fact, even higher numbers because that is a universal

need. For most of districts, 90% of the districts do not have good understanding of the broader data and an insight. We do see that category continue to do extremely well.

I mentioned talent management. A lot of focus on right now in future attrition and recruitment and how to handle that. We are definitely seeing double-digit growth on that platform, and we are seeing tremendous demand across the aspects as well.

But then I do see coming out of the COVID, as I mentioned, the broader digital transformation, whether it's enrollment, whether that's our student information system, our ERP products, we are seeing more increased focus on it. Now this is where different districts are at different points. The demand is much more spread, and that's the beauty of our platform. We can meet the different evolving needs of our customers, and we do really see exploration of growth in certain of our product categories, but then we do are able to still have all of our products grow because there are definitely districts who are further behind in the transformation journey.

Brian Peterson

Thank you.

Hardeep Gulati

Thank you.

Operator

Our next question comes from the line of Joe Vruwink with Robert W. Baird. Please proceed with your question.

Joe Vruwink

Great. Hi, everyone.

A question on the total customer growth being in the high teens this year. Are there any commonalities in where the new logos are coming from? And any trends maybe in new logos landing larger? I understand that a lot of your bookings come from existing accounts, but—and thinking of the 65% growth in the core product customers. Are there actually new logos contributing to that performance as well?

Hardeep Gulati

There is definitely sweet deals we still see through the later part of the question on—a great example, Vanguard Academy challenged a public school—challenged a private school. We are seeing districts and charter school organizations and even private school organizations who are buying multiple products and suite and directly moving to the four-plus category.

But to your point, broadly, when you look at the total view, there's a lot of insight accounts, which we typically would be the charter schools and districts who are small. But we are seeing a broader interest in even new logos, District Bellevue in New Jersey or Fall River in Massachusetts, they are kind of really moving into our SIS and the broad platform, so that view adoption is coming from multiple sources.

Naviance definitely also contributed to that as well, so that's again the beauty of the overall platform. We are able to address the multiple growth vectors across the different sides of the customers as well.

Joe Vruwink

Okay, great.

In the earnings presentation, looking at Slide 7 and just the time lines associated with new systems, if I read between the lines a little bit, so most of your solutions gather interest six to 12 months maybe before they needed their implementation. You've also said that most of the stimulus is still on the horizon, I'd say a catalyst on the horizon. Putting that together, would you actually expect FY '23 to be a more consequential year of growth than even FY '22?

Hardeep Gulati

Yes. I think the broader—to your point, Joe, is that both, based on the trends we are seeing on digital transformation, our own cross-sell momentum as well as funding environment to be very stable, rich and further helped by the stimulus. We do expect that our growth is largely derisked not just for this year but even for next year and so on. We are definitely sitting at a very comfortable environment, and we continue to expect the growth rates to be—to continue to build on.

Joe Vruwink

Great. Thank you very much.

Hardeep Gulati

Thanks, Joe.

Operator

Our next question comes from the line of Koji Ikeda with Bank of America. Please proceed with your question.

Koji Ikeda

Hey, guys. Thanks for squeezing me in here. I'm hopping on a little late, juggling on a couple of calls, so apologies if this question was asked. It's actually a question on the EBITDA guidance here, looking at the first quarter versus the full year. It seems to imply a little bit of back-end loaded EBITDA linearity here on the profitability. Could you just maybe help us out? Is that the right way to think about it? Or is there any sort of seasonality in the spend that we should be thinking about that could affect some of the quarterly seasonality with the EBITDA going throughout the year? Thanks, guys.

Eric Shander

Yes. Thanks, Koji.

The way to think about it is if you look at Q4—or Q3—well, Q4 to the first quarter, we are showing expansion going from roughly 23% Adjusted EBITDA in Q4 to roughly 28% in Q1. It continues to improve in each quarter subsequent to that getting us to the midpoint of 29.2%. We just see a continued progression. I think they're—just the way that some of the models may have had the public company costs spread throughout the year, probably just needed to be readjusted a little bit. But there is no notion of back-end loading from a margin standpoint.

Koji Ikeda

Got it. Thanks, Eric. Thanks for taking my questions. Appreciate it.

Operator

There are no further questions. I'd like to hand the call back over to Hardeep Gulati for closing remarks.

Hardeep Gulati

Well, thank you, everyone. Thank you for your continued support for PowerSchool and our mission. We are very excited, as you can tell from the results, on both knocked (phon) our performance as well as the opportunity ahead for us in 2022 and beyond. But the markets we serve are very durable. Our leadership, as you know, is very clear and inarguable. Our momentum you're seeing on the cross-sell platform definitely shows that our platform strategy is working and as well as we have an ability to really meet the different evolving customer needs given our comprehensive platform really puts us into an opportunity to continue to expand our adjacencies as well. We are very confident about our growth ahead.

Thanks again, and I appreciate and have a wonderful evening.

Operator

Ladies and gentlemen, this does conclude today's teleconference. Thank you for your participation. You may disconnect your lines at this time, and have a wonderful day.