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LZ.OQ - Q3 2021 LegalZoom.com Inc Earnings Call

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OVERVIEW:

LZ reported 3Q21 total GAAP revenue of $148m. Expects 2021 revenue to be $575-579m and 4Q21 revenue to be $142-146m.

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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the LegalZoom's Third Quarter 2021 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference may be recorded. (Operator Instructions) I would now like to hand the conference over to your speaker today, Danny Vivier, Head of Investor Relations. Please go ahead.

Danny Vivier

Thank you, operator. Hello, and welcome to LegalZoom's Third Quarter 2021 Earnings Conference Call. Joining me today is Dan Wernikoff, our Chief Executive Officer; and Noel Watson, our Chief Financial Officer.

As a reminder, we will be making forward-looking statements on this call. These forward-looking statements can be identified by the use of words such as believe, expect, plan, anticipate, will, intend, and similar expressions and are not and should not be relied upon as a guarantee of future performance or results. Results could differ from those contemplated by our forward-looking statements. We caution you to review the Risk Factors section of our reports and filings with the Securities and Exchange Commission for a discussion of factors that could cause our results to differ materially. The forward-looking statements we make on this call are based on information available to us as of today's date, and we disclaim any obligation to update any forward-looking statements, except as required by law.

In addition, we will also discuss certain non-GAAP financial measures. Our CEO and CFO use these measures to make their decisions regarding our business, and we believe these measures provide helpful information to investors. Reconciliations of all non-GAAP measures to the most directly comparable GAAP measures are set forth in the Investor Relations section of our website at investors.legalzoom.com. The non-GAAP financial measures are not intended to be considered in isolation or as a substitute for results prepared in accordance with GAAP.

I'll now turn the call over to Dan.

Daniel A. Wernikoff - *LegalZoom.com, Inc. - CEO & Director*

Thank you, Danny, and thank you all for joining our Q3 earnings call. At LegalZoom, we're on a mission to democratize law. We believe in harnessing the power of technology to unlock greater efficiencies, which in turn provides more affordable legal and compliant services to small businesses.

Our mission to democratize law is more important now than ever before with the pandemic reshaping industries, causing economic hardship and sparking a new wave of entrepreneurial activity.

As the clear category leader in an industry undergoing rapid digital transformation, we believe that we are just at the beginning of our growth journey. We'll continue to leverage our significant brand advantage, differentiated product experience, extensive network of credentialed experts and the history of navigating the complexity of the U.S. legal and regulatory system to further penetrate the $50 billion legal and compliance vertical.

Let me start with a summary of our Q3 results. Building on the strength of the first half of the year, we delivered total revenue of $148 million, above the top end of our guidance range for the quarter and up 12% year-over-year. The year-over-year deceleration from Q2 was expected and driven largely by challenging compares due to COVID-19.

As a reminder, in the second quarter of 2020, the onset of the pandemic shut down critical government functions across the country, including many Secretary of State departments responsible for processing new business applications. When restrictions were lifted throughout the third quarter, pent-up demand was filled, creating a spike in formations in Q3 of last year.

Given the year-over-year complexity, we pointed to the 2-year cumulative average growth rate, which we believe more accurately reflects the underlying growth trends in the business. In the third quarter, the 2-year revenue CAGR was 19%, roughly in line with the second quarter's 2-year CAGR.

Subscription revenue continues to be a highlight, up 24% year-over-year in the quarter, driven by the ongoing rollout of products and services to help our customers remain compliant after forming their business. I'll provide a more detailed operational update on LZ Tax later in the call, but we're excited to see its integration into the LLC formation flow drive a strong uptick in subscriber count in the period.

Adjusted EBITDA in the third quarter came in at $15 million or 10% of revenue as we continue to invest in our technology platform and media spend to build on our digital leadership. We will actively seek opportunities to invest strategically and more aggressively to accelerate our long-term growth potential.

Given the increased focus intra-quarter on the overall market for business formations, as measured by the U.S. Census data, I'd like to provide some commentary on the topic. First, it's important to note that an EIN application does not one for one translate to a business formation. EIN applications can and do diverge from Secretary of State (inaudible) data, which we believe is a more accurate benchmark for the total number of addressable formations. We use proprietary data to measure our performance relative to peers. We saw this divergence materialize in Q3 of last year when sole proprietors rushed to open business checking accounts in order to apply for PPP funding. We also see it during tax seasons as existing businesses often apply for an EIN at the advice of an accountant. When these onetime or seasonal events occur, we see a spike in EIN applications over and beyond the growth in our internal formations benchmark.

Second, I mentioned on our last call that we did see a step-down in formation activity beginning in July. At the time, it was too early to know if the step-down was temporarily tied to the reopening of summer travel or the beginning of a new trend line. August and September data made it clear that the market had reverted to a more normalized seasonal pattern, below the elevated levels we saw earlier in the year. Still, business formations remain well above 2019 levels. And given the strong secular tailwind of digital enablement and the gig economy, we expect the market to remain strong in future periods as well.

Finally, it's important to remember that a growing share of our revenue is derived from subscription services. This revenue stream is recurring, predictable, high margin and performs independently of the seasonal components of our business. We will continue to prioritize growing our base of subscription revenue in favor of driving incremental transactional revenue. When we see an opportunity to accelerate the lifetime value of our customer, we will take it even if it means sacrificing in-period revenue and profitability. We believe this approach best positions us to deliver subscription growth beyond our long-term revenue growth targets.

I'd now like to provide an update on our 3 key growth vectors: scaling our core business, building an ecosystem of SMB formation-related services and integrating attorneys into our core experience, which we believe will collectively drive durable top line growth and long-term margin expansion.

The biggest near-term opportunities to drive growth relate to scaling our core offering by efficiently increasing our marketing spend, improving our product experience and ensuring efficient growth in our operations. In mid-October, we announced a new multiyear brand partnership with the National Basketball Association. The partnership, branded Fast Break for Small Business, will provide $6 million in grants and services to small business owners. We expect to support more than 6,000 small businesses over the life of the campaign, many of whom are from the communities most impacted by the endemic inequalities in the financial and legal systems. The program was created to address these disparities and give small businesses in these communities a fair shot at turning their dreams into reality.

Beyond the incredible opportunity for social impact, we're also excited about the opportunity to reposition the LegalZoom brand as an SMB-first solution. Despite a best-in-class improving aided brand awareness score of 74%, the majority of consumers still recognize LegalZoom primarily for its do-it-yourself state plans. In fact, only 40% of our potential customers know that LegalZoom can help them with a small business formation. And given formations drive the bulk of our revenue, particularly on the subscription side, it's critical that we increase awareness of our formation services by repositioning our brand message.

The NBA campaign is a major step in the right direction as it clearly distinguishes LegalZoom as the go-to destination to start your small business. This relationship is a great example of the kind of brand partnerships we're pursuing as we look to improve awareness of our formation services.

We're also continuing to leverage insights from our media mix modeling to inform spend allocations and test new channels. Historically, LegalZoom lacked the systems to measure attribution accurately across channels. As a consequence, we've been underinvested in emerging categories like digital video, display and social. In Q3, we ramped our spend here aggressively, driving a $5 million quarter-over-quarter increase. Though inefficient in period, we believe ongoing channel testing like this is critical investment that will enable us to efficiently scale our media spend over the long term.

And lastly, within operations, we're investing on our platform to increase automation, reduce turnaround times and improve variable unit economics. Turnaround times, or the time between when a business customer completes an online application on our site and when the entity is legally recognized by the state, is a primary driver of our Net Promoter Scores. We've made investments this year to reduce human involvement and automate a majority of the fulfillment process, driving down turnaround times and reducing costs.

Our second key growth vector is creating a small business formations ecosystem. We are aggressively evolving our product offering to include subscription services that our small business customers need at the critical time of formation. We added to that ecosystem through our acquisition of Earth Class Mail, a leading virtual mailbox solution for small businesses, which we announced this morning.

Earth Class Mail, which I'll refer to as ECM, makes postal mail paperless, easy and accessible 24/7 from any device anywhere in the world. As the digital economy continues to fuel the growth of remote-first work environments, small businesses are investing in tools to streamline operations, including software to manage physical mail, which can be often invoices and checks that need to be input into other back-office solutions such as Bill.com, QuickBooks and Box, for instance. We've been tracking the virtual mailbox space for a while now and believe ECM's national footprint, tech stack and seamless user experience stands out among the competition. ECM fits perfectly with both our channel and technology strategies.

With this acquisition, LegalZoom customers will be able to add a business address in virtual mailbox at the time of forming their business. We expect this subscription service to further increase customer lifetime value without any additional customer acquisition costs since it will be integrated directly into our formations product.

Also, ECM and our registered agent service use similar technologies, allowing us to leverage many capabilities that will allow us to streamline and advance our broader compliance offerings. I'd like to congratulate our team and welcome ECM's employees into the LegalZoom family. We look forward to partnering together.

In addition to this exciting acquisition, we continue to ramp new compliance services under the LegalZoom brand, most notably LZ Tax, while also partnering with category leaders to offer a best-of-breed selection of complementary services such as banking, point-of-sale solutions, website hosting and bookkeeping, to name just a few.

The third quarter was an inflection point for our LZ Tax offering with a number of significant milestones. First, throughout the quarter, we exposed a growing portion of LLC traffic to our tax offering at formation, culminating in 100% coverage by the end of the quarter. We're very encouraged by the early results, which include the more than 50% increase in tax subscription units quarter-over-quarter. And the growth isn't just for more traffic. We're also seeing improvements in attach rates as we continue to optimize our commercialization strategy and zero in on the things our customers care most about.

Second, we doubled our team of in-house experts, CPAs and enrolled agents and onboarded supplemental resources in preparation for our first annual tax season next spring. We continue to see demand outpace supply and are doing all that we can to scale supply quickly while also prioritizing an excellent customer experience.

Third, we continue to invest in the tech infrastructure needed to support this fast, scaling revenue stream. This includes the launch of all-new practice management software, streamlining workflows and automating customer outreach. We're very pleased by the momentum behind LZ Tax, which we continue to view as a multiyear growth vector for the business.

On the partnership front, you will have likely seen our recent press releases highlighting a handful of signed brands including Brex, Intuit QuickBooks and Square, all marquee service providers with high-value offerings for our small business customers. The nature of each brand relationship is unique. But our intent as we add new partners is to achieve the following core attributes: one, the relationships are bilateral. We acquire new customers for our partners and they acquire for us; two, the economics are shared in a recurring model whereby LegalZoom participates in the ongoing value delivery of the partner's service; and three, LegalZoom customers receive preferential pricing on the partner services by signing up through our platform.

As a leader in business formation services, we are uniquely positioned to establish trust with our customers very early in their business life cycle. We collect a vast amount of data from our customers oftentimes before they even start operating. We know their industry, location, hiring plans, et cetera, and can use this information to intelligently connect them with the right service providers for their unique situation.

Our vision is to partner with the most reputable technology-enabled SMB service providers to make it simpler and less costly for small business owners to get the resources and support they need, so they can devote their attention to running and growing their business. With more and more partner brands joining our curated network, the value of our ecosystem continues to grow.

Our third and final growth vector is attorney assist, a new hybrid model that leverages our core technology platform while also integrating access to attorneys throughout the user experience.

On October 1, we announced that LegalZoom subsidiary, LZ Legal Services, was approved and licensed by the Arizona Supreme Court to operate an Alternative Business Structure, or ABS, in the state. This announcement represents a big step forward in the ongoing push in the United States for regulatory reform that permits nonlawyer-owned entities to provide legal advice. With the ABS license, LegalZoom essentially now owns a law firm in the state of Arizona, enabling us to directly provide select legal services to our customers. While we will continue to fulfill the majority of demand through our independent attorney network, the new ABS structure provides a means for us to test new, innovative ways to empower consumers with access to affordable and transparent legal services online.

We will also be testing new business models that will allow LegalZoom to deliver additional legal services beyond the scope initially contemplated and participate in the ongoing economics of that value delivery throughout the life of the customer relationship.

In conclusion, we are committed to making the right strategic investments to capitalize on the large market opportunities that exist within the legal and compliance vertical. We are patient operators, and we'll continue to make decisions aligned to our long-term, growth-oriented mindset.

To that end, we will continue to strategically prioritize an accelerating mix of subscription revenues. These revenues perform independently of the broader formations macro and position us to deliver on our long-term growth and profitability targets.

With that, I'll now turn the call over to Noel to discuss our financial results.

Noel B. Watson - *LegalZoom.com, Inc. - CFO*

Thanks, Dan, and good afternoon, everyone. I'll start today with a review of our performance in the third quarter and end with our outlook for the remainder of the year.

Total GAAP revenue in the period came in at $148 million, up 12% year-over-year. As Dan mentioned, we lapped a challenging compare from Q3 of last year as the reopening of the economy led to a surge in pent-up business formation volumes. The 2-year revenue CAGR of 19% remains healthy, and we believe more appropriately reflects underlying growth trends in the business. Transaction revenue was $67 million in the quarter, representing 45% of total revenue.

We completed 106,000 business formations in the third quarter. Business formations include LLC, inc. and nonprofit formation events, which are critical entry points through which we cross-sell our suite of subscription services. Though down 9% year-over-year, business formations have grown 24% annually over the 2-year period, pacing well ahead of our internal market benchmarks.

Total transaction units, which also include other transactions involving intellectual property and estate planning, were 229,000 units in the quarter, performing in line with business formations. Average order value, which represents the average revenue contribution from each transaction unit, remained strong at $291 in the period. The quarter-over-quarter increase was due to improvements in order fulfillment rates.

Subscription revenue was $73 million in the quarter or 50% of total revenue. We added 49,000 net subscription units in the period, with a growing portion of those driven by the successful integration of LZ Tax within our LLC formation flow. Growing our base of subscription units remains a top priority given its impact on LTV.

We will continue to leverage our unique position early in the SMB life cycle to connect our customers to the right set of tools and services they need to operate their business. ARPU, or the average annual revenue contribution per outstanding subscription unit, was $231, up 5% year-over-year. We continue to expect modest growth in this metric over time as higher ARPU services like LZ Tax account for a growing share of our subscription units. As a reminder, we provide ARPU on a last 12-month basis to account for the fact that the majority of subscriptions are billed upfront on annual terms.

Partnership revenue was approximately $8 million in the quarter, representing 5% of our total revenue. In the near term, we continue to expect lower sequential performance in our partner revenue as we transition away from legacy partners that do not align with our strategic direction and we evolve our relationships from bounty-based economics to recurring revenue. However, we are very excited about the opportunity that our newest partnerships represent and remain confident in the long-term opportunity to build an ecosystem of marquee brand partners, complete with high-margin recurring revenue structures.

Now turning to expenses and margins, where all of the following metrics are on a non-GAAP basis. Cost of revenue, which includes government filing fees and other fulfillment and care costs, was $45 million in the period, up 8% versus last year. Gross margin came in at approximately 70% of revenue, up 200 basis points from Q3 of last year due to improvements in order fulfillment. We expect a typical seasonal decline in gross margin in the fourth quarter and anticipate additional downward pressure driven by our investments in LZ Tax ahead of the spring tax season.

Sales and marketing costs were $65 million in the third quarter or 44% of revenue. Within that, customer acquisition spend of $50 million was up 46% year-over-year as we continue to scale our media budgets to grow transaction and subscription volume and build on our category leadership. As Dan mentioned, we allocated incremental spend in the third quarter to new channel testing. We leverage results from these tests to inform our media allocation and to drive greater efficiencies over the long term. Inclusive of this in-period testing spend, we believe we are continuing to generate LTV in a highly efficient manner.

Technology and development spend was $12 million in the third quarter or 8% of revenue, up $1.6 million quarter-over-quarter. The sequential increase was expected as we continue to build out a best-in-class product and technology organization and make investments to modernize our infrastructure.

Finally, G&A spend was $11 million in the quarter or 7% of revenue, in line with Q2. The year-over-year increase in G&A was driven by incremental public company costs and headcount investments. We expect G&A to increase sequentially in the fourth quarter, primarily due to additional consulting costs.

Adjusted EBITDA was $15.1 million in the quarter or 10% of revenue. Our base of deferred revenues remained roughly flat in the period as growth in subscription bookings was offset by improving transaction fulfillment times.

Free cash flow was $17 million in Q3, down from $29 million in the same period last year. As of September 30, 2021, we had cash and cash equivalents of $311 million and no debt outstanding.

I'll now turn to guidance for the fourth quarter and full year 2021. We expect full year revenue of $575 million to $579 million or year-over-year growth of 23% at the midpoint. This full year range implies a fourth quarter revenue of $142 million to $146 million, up 18% year-over-year at the midpoint. Our revenue guidance considers discontinuation of a more normalized seasonal pattern of business formations and our proactive decision to drive subscription bookings in favor of in-period transaction revenue.

We expect full year adjusted EBITDA of $45 million to $47 million or 8% of expected revenue at the midpoint. We are continuing to invest in the business to drive durable multiyear growth. In the fourth quarter, we will deploy incremental spend to support the NBA campaign, which we view as a unique opportunity to accelerate our brand repositioning efforts. We are also continuing to ramp investments in LZ Tax, both in people and infrastructure, to keep pace with outsized demand for that service.

Because of these investments and the strength that we're seeing in the subscription side of our business, we remain confident in our ability to deliver on long-term growth and profitability targets. We will not provide explicit 2022 guidance at this time, but plan to do so in our Q4 earnings call early next year.

And quickly, before wrapping, we will be participating in several upcoming investor conferences, including Credit Suisse, Barclays and Raymond James. With that, let's open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Sterling Auty with JPMorgan.

Sterling Auty - *JPMorgan Chase & Co, Research Division - Senior Analyst*

So 2 questions from my side. One question, one follow-up. So on the business starts and the comment that you made about the transactional portion. I think as you guys came through the IPO process, you mentioned the long-term growth goals. There was a belief that you could drive acceleration north of 25%. What do you still need even with kind of the modification of the transaction subscription that you mentioned in the call? What do you need as a baseline in terms of business starts to still be able to deliver upon that goal?

Daniel A. Wernikoff - *LegalZoom.com, Inc. - CEO & Director*

Yes. Well, thanks for the question, Sterling. And I think when we talked about this on the road show, there's really 3 dimensions to growth. One is the macro itself, and we still feel really good about the macro tailwind. If you look at the current new business starts relative to where they were in 2019, and we're still seeing solid growth, and obviously, there was a little bit of a step-down in Q3, but long term, we feel good about that.

The second piece is really around share gains. We know that we have a superior offer to the offline alternatives. And so we continue to be aggressive in marketing to go after share.

And then the third piece is we don't think of our business as a transactional business. We think of ourselves as a formation service. And so the more that we continue to add subscription services that people need right when they're forming a business, the more successful we'll be not only in terms of solving for in-period results but really accelerating long-term growth with higher visibility. So those are really the 3 dimensions of how we think we exceed, hopefully, the long-term targets that we put out there.

Sterling Auty - *JPMorgan Chase & Co, Research Division - Senior Analyst*

Got it. And then the follow-up is, you talked about choosing subscription versus transaction. How much control do you have to drive the business in that subscription side? And what are the leading subscriptions that investors should look for you to drive to make that happen?

Daniel A. Wernikoff - *LegalZoom.com, Inc. - CEO & Director*

Yes. That's a great question. And actually, one of the things that we think about a lot and that we also test for a lot, because when people come into our solution, they're doing a combination of buying a transaction, the registration of their business and even some other ancillary transactions like an operating agreement or an EIN. But they're also adding subscription services that help them stay compliant as a business. And even further now, we're getting into more back-office operations with something like the acquisition of ECM.

And so what we do is we often test different forms of commercialization. And what we typically see is there can be both a combination of increase in the overall value of a shopping cart, but also really a transition in the mix of the cart to be heavier into the subscription side.

Now one of the interesting things is we knowingly will lean into some of the subscription bookings even if we know it has a short-term impact on revenue and actually bringing revenue down because it's reducing the transactional revenue that's recognized in-period. Because we know it's the right decision to make for long-term growth, and we're building up this larger subscription base over time.

So a lot of this is testing. And as all of you know, we run a lot of different tests to try and understand the consumer behavior in the cart. And the more services that we can add during formation, the more things we have to test and learn on.

The biggest one, and I'll just add it, is LZ Tax. LZ Tax, as an example, is a service that's a much higher-priced ARPU. And also the revenue is further deferred because it's not recognized in current period. It's actually mainly recognized in the tax season itself. So today, we're building up a lot of infrastructure. We're building up capabilities. We're building up headcount to support a future tax season. And so you can see that even in the Q4 guide in EBITDA, and we're really investing for the future.

Operator

Our next question comes from Mario Lu with Barclays.

X. Lu - *Barclays Bank PLC, Research Division - Research Analyst*

Just wanted to hone in on this quarter as the drivers came in a little bit different than what we expected, with ARPU being a little bit higher, volumes being a little bit lower. So just wanted to see if we could double-click, especially on the transaction side, like how sustainable are these levels of ARPU going forward. And then conversely, on the volume side, when should we expect that to kind of tick up sequentially? Is it -- seasonally, you guys talked about 1Q being stronger. Is that what we should expect going forward?

Daniel A. Wernikoff - *LegalZoom.com, Inc. - CEO & Director*

Yes. Thanks for the question, Mario. I think you were saying should we expect AOV on the transactional side to continue to go up, because that did increase slightly this quarter. ARPU was relatively flat, just slightly better than what it was in the prior quarter. And so I'll answer that, and then you can correct me if that's not the question.

On the AOV side, we actually did benefit a little bit from increased fulfillment rates. One of the things that is really a key focus area for us is the customer experience. And then one of the top drivers of both promotion in terms of Net Promoter and the traction is turnaround times. And so we've done a pretty significant investment on the fulfillment side. We continue to automate. And some of that did pull in orders that essentially would increase the AOV in-period. That's along with the historical increases in AOV that have been really commercialization-driven, a better job of marketing the product.

We don't expect AOV to continue to climb, even just aligned with the question I just answered. In some ways, we'd be comfortable if AOV goes down and really that we see a higher mix of ARPU and subscription services going forward. And so you'll -- you can almost think of AOV as a trade-off between CAM spend in a way. In some cases, we might test lower prices in order to reduce our CAM spend reliance. And so it might even be the opposite, but that's all things that we test into and try to understand from watching consumer behavior.

Noel B. Watson - *LegalZoom.com, Inc. - CFO*

Mario, this is Noel. Just to add in, AOV was up 30% quarter-over-quarter. Year-over-year in Q2, it was up 16%. This year, I think as we mentioned on the prior call, we expected the growth rate in AOV to decelerate sequentially in each quarter in the back half of the year. And so we -- I would reiterate that here, that we'll see -- because AOV was increasing sequentially each quarter last year, that the year-over-year growth would be closer. They absolutely will be closer, and the year-over-year growth would decelerate even in Q4.

Operator

Our next question comes from Elizabeth Elliott with Morgan Stanley.

Elizabeth Mary Elliott - *Morgan Stanley, Research Division - VP of Equity Research*

I just wanted to dig in on kind of the share gains as an element for one of the key drivers of your growth. Can you let us know what you're seeing in terms of LegalZoom's share within overall business formations? How should we think about the balance between maybe some weaker macro year-over-year versus the accelerating digital penetration to help offset?

Daniel A. Wernikoff - *LegalZoom.com, Inc. - CEO & Director*

Yes. Thanks for the question, Elizabeth. This is one of those things that depends on how -- what you're looking at as the macro. And we know that the published macro data that everybody is viewing is the census data. Q3 data on the census was sequentially down 19%, and it was also down year-over-year, 17%. Now it's also worth noting that the 2-year CAGR is up 22%. But it definitely was a step down.

And one of the things that I'd say is unique is we have our own internal data source, which really links directly to the majority of the Secretary of State's data sources directly. And so what we actually saw was a little bit different in September than I think what Census printed. And actually, I would say it was lower than what they actually had on their numbers, which, again, we've always said this, the EIN data is not perfect. It's a superset of what we essentially see in terms of business formations, because some people have an existing business and then they go get an EIN because they hired an employee or they're opening a bank account. And so we often see it have variation.

What I would say is, given the fact that September was lower in our own view, and you can see the data as it relates to our share relative to the Census macro, we did gain share in the quarter. I mean it's pretty clear. But we will not be sharing our own internal data. It's a pretty unique data source, and it gives us more visibility than we think any of our competitors have. And it also helps us from a forecasting perspective and from a marketing spend perspective, so we consider it pretty proprietary.

Elizabeth Mary Elliott - *Morgan Stanley, Research Division - VP of Equity Research*

Got it. And then just a follow-up on some of the retention. I think the retention rates are on kind of a 13-month basis. And kind of you really started to see the tailwind for demand in July and August last year. So now that we [lost] that 13-month period, any color how retention rates have trended, especially for some of those cohorts that might have come on quickly?

Daniel A. Wernikoff - *LegalZoom.com, Inc. - CEO & Director*

Yes. That's a really good question. And actually, we had a sense of this, that this would happen. Some of those businesses were pretty ephemeral. And so we did see a reduction in the cohort that was acquired in July and August on the 13-month retention. What's interesting is we actually saw a strengthening in all of our other cohorts. So the overall churn rates improved. And what I'd also say is it was very specific to that July and August cohort, and we've already seen it start to climb back up on the 13-month retention side as well.

Operator

And we have a question from Andrew Boone with JMP Securities.

Andrew M. Boone - *JMP Securities LLC, Research Division - Director & Equity Research Analyst*

I've got 2, please. So the first, can you talk about any learnings on LZ Tax and just your level of confidence as you build supply ahead of the 2022 tax season? And then a macro question, just going back to formations. Admittedly, I'm asking for an opinion here. But just given the strong job market, do you feel like that is more of the headwind for business formation, and so we should be looking at job numbers as well? Or is the hiring market less correlated with business formations?

Daniel A. Wernikoff - *LegalZoom.com, Inc. - CEO & Director*

Yes. Let me take that last one first. It's a really interesting question in that there are a significant amount of job openings out there, but there still is a pretty significant amount of unemployment. And it feels like there's a nice behavior change that seems to be happening of people both being willing to go out on their own or even also have a potential side business.

And so when you start to look at the data itself, I actually feel like that unemployment data is a little bit of a misnomer in that the great resignation in many ways is actually like the great entrepreneurial bloom in some ways. So we're really bullish on this. Like we look at this macro and we see a very stable floor at this point, which we're forecasting off of. We're not assuming any improvements. And by the way, we reforecast off of our own internal macro data on a monthly basis. And so we start to build off of that.

I wouldn't be surprised if there's a little bit more of a recovery, just given the fact that it's never been easier to start a business than it is today. I mean you have all of the enterprise-level tools. You have the ability to get started quickly. You can test something and try it. You can run it as a side business. You can do it when you're working from home as well. So we feel pretty good about that.

Anything you'd add there, Noel, before I jump into the LZ Tax question? Okay. Yes. LZ Tax, we're learning a lot. This is one of those services where I think I've said in the last call, one of the things that was a massive surprise for me when I joined was that we would get as many tax questions when someone forms a business as we get legal questions. And it's playing out that way. We're seeing attach rates that are very similar to what we see in our legal subscription service.

Now along the way, we're growing so fast that we're making sure that at the same time, we're providing a great experience. So we've deployed practice management. We've been hiring experts ahead of the tax demand, and we're also augmenting that with other service providers. And so we have a combination of many different ways that we're trying to solve for the season's tax business.

And to be totally clear, we're throttling the volume as well. Like we are not reaching our full potential. We just ramped it up on LLC. We're not including it in our other workflows, like inc. and nonprofit. And we're not really marketing actively to our existing base at this point, because the goal here is providing the best experience possible in our first tax season.

Operator

Our next question comes from Matt Pfau with William Blair.

Matthew Charles Pfau - *William Blair & Company L.L.C., Research Division - Analyst*

Nice results. On the EBITDA guidance implied for the fourth quarter, I think it would be helpful if you can just give us some more details on the magnitude of the LZ Tax and NBA partnership and investments and where these expenses sit on the income statement. And then are these going to be more onetime? Or should we think about them as ongoing when we put together our models?

Noel B. Watson - *LegalZoom.com, Inc. - CFO*

Matt, this is Noel. I'll take this one, and Dan can jump in if he has anything to add. So certainly, in Q4, we're continuing to be aggressive in terms of how we're investing in the business, and that starts with our investment in people or aggressively hiring to increase capacity and capability in the business and continue to focus on the technology function.

On the marketing side, we talked about the investment we made this quarter into testing new channels. We're going to continue to do that aggressively in the quarter.

And then 2 items. As you pointed out, in terms of the NBA partnership, we're certainly investing a fair amount in terms of from a brand standpoint to just help launch that campaign in the proper way. And so it will be a little heavier in Q4, but it's a longer-term partnership. So there will be continue -- we'll continue to allocate dollars to that investment moving forward.

And then LZ Tax, we're -- the [brand cost] of the NBA, they sit in the -- obviously, in our CAM spend. And then for LZ Tax, we're investing wholly to scale operations in support of the growth there and in particular, as we ramp up for tax season. The tax experts, where we're really focused on hiring and are most critical for that support, they sit in our cost of sales. So you'll notice in our prepared remarks, we talked about the sequential step-down in gross margin, and that's in part related to the tax investment that we're making there.

And as Dan mentioned earlier, again, as we grow the subscribers on the tax side, all that recent growth in subscriptions related to LZ Tax, a lot of that revenue or the majority of that revenue will be recognized in 2022. So this is a bit of an investment in advance of that revenue.

Daniel A. Wernikoff - *LegalZoom.com, Inc. - CEO & Director*

Yes. And the only thing I'll add, and it's maybe a gratuitous add because it's not the question you're asking. I think on the brand side, we've talked about this before that we have a very high-aided brand awareness. You talk about 74%. But one of the big challenges we have is more on the brand familiarity and product knowledge side. So a lot of people who know who we are, but they're not exactly sure what we do, and they still probably have a legacy view of us being focused on estate planning.

And so just to put that into context, only 40% of our potential consumers are aware that we have a business formations product. So that is a big limiter to growth and growth in share, and that is why we're making such a significant investment on the brand side.

So if you think about that NBA partnership, I mean it is called Fast Break for Small Business. Or if you think about what type of partner we are, we're not the legal partner. We're the online business formation partner. And this is very explicitly done because we're reintroducing our brand primarily as a small business brand.

And the analogy I would use is it's almost like if everybody knows what Coca-Cola is, and there's 90% awareness. But imagine 60% of the people thought you eat it with a fork. I mean that's essentially the challenge we're trying to get through right now. It's a big opportunity. In many ways, this is unrealized potential, and it's why we think this brand spend is so important.

Matthew Charles Pfau - *William Blair & Company L.L.C., Research Division - Analyst*

Got it. That's helpful detail, guys. I appreciate it. Just one follow-up on the LZ Tax revenue recognition. Does -- so first, does that flow through the subscription line? And then second of all, is that more seasonal in the way it gets recognized? And maybe it's too immaterial now, but do you expect that to create some seasonality with respect to your revenue on maybe the first and second quarters of the year?

Noel B. Watson - *LegalZoom.com, Inc. - CFO*

Yes. Matt, this is Noel. Great question. So LZ Tax is recognized in our subscription revenue line. It's largely monthly subscriptions. And so there is -- there are components of it that we separate in terms of our revenue recognition. Some of it is recognized ratably over the term. And then there are pieces that are tied to kind of the various entitlements like tax preparation that will be more seasonal in nature. And so you will see, especially as it becomes more material, a bit of a seasonal impact from it.

Daniel A. Wernikoff - *LegalZoom.com, Inc. - CEO & Director*

Yes, just to punctuate that, too. The -- we originally deployed this as with different choices. We had a choice of a SKU that was tax advice and bookkeeping and then a different loan, which was tax prep. And what we realized is everybody want a tax prep. And so we've shifted. And the way we're commercializing it is 2 flavors of tax prep, which then again has the exact impact that Noel just talked about, which is more of that revenue is deferred into tax season.

Operator

We have a question from Brett Thill with Jefferies.

Sang-Jin Byun - *Jefferies LLC, Research Division - Equity Analyst*

This is John Byun for Brent Thill. Another question into the LZ Tax. Just trying to get a better understanding how much you're ramping into there. I mean is it more tax experts as opposed to the infrastructure and technology underneath it? And then when you ramp this up, I mean in terms of the mix, I mean will it be primarily tax prep as opposed to bookkeeping? And how much will it impact in terms of headcount overall? I mean does that mean the headcount is going to ramp to much higher percentage versus what it is today? And then I have a follow-up on the AOV.

Daniel A. Wernikoff - *LegalZoom.com, Inc. - CEO & Director*

Yes. Well, I mean I would think of this as we're creating a very large-scale tax practice. And so essentially, all of those are being built in parallel. I mean we started with the foundation of a very small acquisition. So we had some of the capabilities already. But as I mentioned in the opening remarks, practice management is an investment, bringing in CPAs and enrolled agents is an investment. Marketing is an investment. There's a sales component because we also have lots of customers coming into our general floor, and we're able to introduce it through the sales team.

And so it's a pretty across-the-board investment that, just to the last question, will predate the actual recognition of the revenue, which primarily happens in tax season. I think, again, the value here is very much overweighted on tax prep relative to bookkeeping. But we also feel like the 2 things have such a strong relationship that we really want the small businesses to be successful and keep the right books and get the right ongoing advice from accountants, so we offer those in combination.

Sang-Jin Byun - *Jefferies LLC, Research Division - Equity Analyst*

Great. That's very helpful. And then on AOV, you mentioned the fulfillment -- improved fulfillment. Is that -- I guess just to clarify, does that mean that you were able to bring those in faster, so you're able to recognize the revenue a little bit faster than it might have been in the past?

Noel B. Watson - *LegalZoom.com, Inc. - CFO*

Yes, that's right. This is Noel. So you got to remember from a year-over-year standpoint, last year was really unique. There was significant impacts from COVID, both on our fulfillment operations as well as the Secretary of State in its processing time. So a lot of those impacts have largely eased. And so our fulfillment productivity has improved.

We've also made investments in our fulfillment process, well, both in our customer experience as well as in the infrastructure that supports our fulfillment. And so we're realizing a durable efficiency improvement in our fulfillment productivity and are just able to get customer orders out the door faster. And our fulfillment of orders is tied to our -- the timing of our revenue recognition.

Daniel A. Wernikoff - *LegalZoom.com, Inc. - CEO & Director*

And we view it as like a durable benefit. Like this is something that even over time, we expect to be faster, we expect to continue to automate. So this is something that's a really critical focus. And I mentioned before, it's really driven by what customers want. I mean customers oftentimes are forming a business because they have an immediate need. Like they need a bank account or they're working with a trading partner who requires them to be incorporated or to be an LLC for liability reasons. And so they need it as fast as possible, which is really the underlying reason for that investment.

Operator

And our next question comes from Stephen Ju with Credit Suisse.

Unidentified Analyst

This is [Francois] on for Stephen. So I think one of the key strategies you outlined is to improve the service levels for the consumer with the attorney assist. Could you update us on sort of the type of level of uptake you're seeing for those solutions in the verticals and products you have rolled it out to? And sort of any incremental update on the split between DIY versus attorney assist?

Daniel A. Wernikoff - *LegalZoom.com, Inc. - CEO & Director*

Yes. It's still very early in the journey on attorney assist. The main place where we've deployed it is on our trademark product. And we've seen the mix of customers who are choosing to get assistance from an attorney continue to rise and essentially be pretty close to half of the customers who are looking for trademark help, which is a great indicator.

What we haven't done yet is deploy this into our formation product lineup, which is the much bigger opportunity. And this is an area where we have a couple of things going in parallel. One is we're working to innovate on being able to provide the service ourself and test and learn, which is part of getting what's called the alternative business structure. And the second is commercialization testing as well. And so you'll continue to see stuff that we're doing to try and learn how customers want this product delivered. And that's something that we'll start to see next year.

Operator

And there's no further questions in the queue. I'd like to turn the call back to Dan Wernikoff for closing remarks.

Daniel A. Wernikoff - *LegalZoom.com, Inc. - CEO & Director*

Great. Well, thanks, everyone, for dialing into the call, and thanks for your questions. Really appreciate everything that you guys are asking.

To the LegalZoom team, I want to thank you guys for the quarter, not only for the amazing execution but also the incredible passion and energy you bring to work each and every day. I also want to thank our newest team members from Earth Class Mail. Welcome aboard. We're thrilled to have you and can't wait to get to work. We'll talk to all of you soon. Thanks again for your time.

Operator

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