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CDK - Q2 2018 CDK Global Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to CDK's Second Quarter Fiscal 2018 Earnings Conference Call. (Operator Instructions)

I'd now like to introduce your host for today's conference, Ms. Katie Coleman. Ma'am, please go ahead.

Katie Coleman

Thank you. Good morning, and thank you for joining us for our Second Quarter Fiscal 2018 Earnings Call and Webcast. Presenting on today's call will be Brian MacDonald, CDK's CEO; and Joe Tautges, CFO. Brian will begin today's call with an overview of our results, followed by some highlights for the quarter. Joe will then take you through the details of the second quarter results and our guidance for fiscal 2018.

A few items before we get started. Throughout today's call, references to financial amounts are on an adjusted basis unless otherwise noted. Reconciliations of the adjusted amount to the most directly comparable GAAP amounts are included in this morning's press release and are available in the Investor Relations section of our website.

I would also like to remind everyone that remarks made during this conference call will contain forward-looking statements. These statements involve risks and uncertainties, including the risks detailed in our filings with the SEC, which could cause actual results to differ materially from those set forth in the forward-looking statements.

And finally, we anticipate filing our Form 10-Q later today.

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

Brian Patrick MacDonald - *CDK Global, Inc. - President, CEO & Director*

Thank you, Katie. Good morning, and thank you for joining us this morning. We are pleased with our earnings results for the quarter, which were largely driven by the continued progress towards our transformation plan goals.

Adjusted EBITDA margin for the quarter increased 350 basis points year-over-year and 220 basis points on a sequential basis to 36.3%. EBITDA dollars grew 14% year-over-year. Diluted EPS was $0.87, which includes $0.11 related to trueing up the year-to-date tax rate for the fiscal '18 benefit of the tax reform act. Revenue grew 3% year-over-year. While revenue growth was in line with our expectations, we're not satisfied with this level of performance and are focused on initiatives to improve our revenue trajectory.

Joe will provide more details on our financials in a few minutes, including our perspective on the impact of tax reform. But first, I'd like to provide a few updates from around the business.

First starting with sites. Last quarter, we discussed 3 areas we are focusing on to address site losses: One, renewal effort and customer experiences initiatives; two, the reorganization of our competitive deal pursuit team; and three, addressing product needs for our 1- to 2-site dealers.

I'd like to provide you an update on the progress we've made over the last 90 days. First, year-over-year auto sites were down 155 sites due to continued declines in smaller dealers with 1 to 2 sites, though we do continue to grow sites and revenue in our 3-plus dealer group customers. Our renewal efforts remain ongoing. While we saw a sequential gains this quarter, sites will likely fluctuate quarter-to-quarter, and we still expect a modest auto site decline on a year-over-year basis in fiscal 2018.

Next, I'm pleased to announce that the reorganization of our competitive deal pursuit team is paying off. Our pipeline continues to increase and sales momentum has been building all year. The second quarter sales finished strong and shows we're making progress in adding new DMS sites. We look forward to welcoming these customers to the CDK family in coming quarters.

And finally, we are focused on addressing the DMS product needs for our 1- to 2-site dealers. We are still working with the FTC related to the pending Auto/Mate acquisition and anticipate closing the acquisition in the coming months. Meanwhile, we continue initiatives focused on improving the customer service experience and are exploring internal product enhancement targeted to this dealer segment.

Now I'd like to highlight a few initiatives from our transformation plan. During this time of year, our customer experience teams are supporting dealers during their busy accounting year end. Through the first 3 weeks of the year, average service interactions are down 14% year-over-year, facilitated by our improved product quality, proactive training efforts and customers using tools and information available in our online resource center.

We're also investing in driving case backlog resolution, and year-to-date, we've been able to dramatically reduce open cases while closely monitoring customer satisfaction quality, we're pleased to see our customer-first focus continue to generate improvements in the critical metrics that drive dealer satisfaction.

This quarter, we rolled out our new SmartQuote tool to our digital sales team. This tool is intended to streamline and simplify our quoting, contracting and billing processes. Other benefits include reducing contract error rates and providing better visibility into discounting levels. Over time, we will begin rolling SmartQuote out to the remainder of the sales organization.

Now let me turn to sales. Last quarter, we announced 2 new website endorsements. While these programs are just starting to roll out, we have already begun signing dealers up and are on track to see nice website growth in the second half of the year. We also see a number of DMS growth opportunities for our International segment. We're making investments in the business to bring new capabilities to the market and we're in a process of securing new OEM endorsements.

Now turning to M&A. I'd like to provide a quick update on the acquisition of Dashboard Dealership Enterprises and the Executive Eye reporting solution. We're getting a great response from dealers on the product and results are tracking ahead of our initial expectations. While still early, we are excited by the potential this type of tuck-in acquisition has when we put the power of our distribution channel behind it.

With that, I'll now turn it over to Joe.

Joseph A. Tautges - *CDK Global, Inc. - Executive VP & CFO*

Thanks, Brian, and good morning, everyone. As a reminder, our financial comments for the quarter as well as fiscal 2018 guidance will be on an adjusted non-GAAP basis. Reconciliations between these adjusted results and the most directly comparable GAAP results can be found in the schedules accompanying our earnings release.

Second quarter revenues grew 3% or 1% on a constant-currency basis. Revenue growth continues to be driven by increased revenue per site in both North America and International as well as additional advertising spend from dealers and local marketing associations. This was offset by lower OEM advertising spend and lower transaction revenues. We saw currency tailwinds from foreign exchange rate fluctuations, primarily in the euro, pound and Canadian dollar.

Our Retail Solutions North America segment revenues grew 1%. Average revenue per site was up 5%, which was offset by lower onetime and hardware revenues and an 8% decline in transaction revenue, primarily due to dropped point solutions. Total North America DMS sites increased slightly year-over-year. Auto sites were down 2%, while adjacency sites were up 3%. Dealer websites also increased year-over-year.

Advertising North America revenues were down 2% as we saw certain OEM program budgets reduced, which was offset by higher spending from dealers and local marketing associations. International revenues were up 14% or 8% on a constant-currency basis, primarily from increased revenue per site and slightly higher onetime revenue recorded in the quarter. Site counts continued to steadily increase on a year-over-year basis.

Pretax margins were up 120 basis points versus the prior year. Transformation plan benefits were partially offset by higher interest expense and approximately $4 million of implementation cost associated with the new revenue recognition accounting standard. Retail Solutions North America margins expanded 600 basis points. The Advertising segment was down 30 basis points due to a shift in revenue mix and International delivered 190 basis points of margin expansion.

The total CDK EBITDA margin expanded 350 basis points year-over-year to 36.3%. Diluted EPS grew 30% to $0.87 per share. Approximately $0.11 of EPS is related to the true-up of the year-to-date tax rate for the fiscal 2018 benefits of the enacted tax reform act. Beyond tax reform, growth is driven by higher earnings and an average lower share count achieved through our capital returns program. Our cash balance was $444 million, of which, $299 million is held outside of the United States.

We executed $301 million of open market share repurchases in the quarter at an average price of $67.12, bringing total shareholder returns, including dividends and share buybacks, to $755 million for the calendar year at an average price of $64.52. We continue to target shareholder returns of $750 million to $1 billion in calendar years 2018 and 2019.

And now I'll move on to the guidance for fiscal 2018. The year-over-year comparisons are, again, on an adjusted basis. We maintain our revenue growth guidance of 3% to 4%. We are seeing more favorable foreign exchange rates, which is offset by softness in advertising revenue growth. We currently expect to be at the high end of the EBITDA margin guidance of 35% to 36% for this fiscal year, with an exit rate of 36% to 38% as previously reported. We are raising our EPS guidance to $3.23 to $3.28, up $0.28 from the $2.95 to $3, which includes an approximate $0.23 impact from the ongoing benefits of tax reform.

We expect our effective tax rate to be 29% to 30%, down from 34% to 35%. As a fiscal year company, we will see further reduction in our effective tax rate. Based on our current interpretation of the tax reform act, we anticipate our future adjusted effective tax rate will be approximately 3 to 4 points lower than fiscal 2018.

As discussed in more detail in our second quarter Form 10-Q, we have made reasonable estimates of the impact of the tax reform act in certain areas and no estimate in other areas. We intend to finalize our accounting and record any necessary adjustments in the period we complete our analysis, but in any case, no later than 1 year from the enactment of the new tax law.

In summary, we're pleased with the performance this quarter and we are on track to deliver on our EBITDA margin targets of 35% to 36% in fiscal 2018 and remain committed to our target of exiting fiscal '19 at 40%.

I will now turn the call back over to the operator, and Brian and I will be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Ian Zaffino with Oppenheimer.

Ian Alton Zaffino - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Question would be on the transaction revenue decline. Can you just give us again an idea of, I guess, you said there were some maybe lower product sales. What was -- transaction revenues may be down. And if you can maybe break down the buckets that drove it down.

Joseph A. Tautges - *CDK Global, Inc. - Executive VP & CFO*

Yes, sure. Thanks, Ian. So when you look at transaction revenues, a couple of things that you should take into consideration. First, we discussed that our auto sites were down 2%, and so you would see that going through the decline in transaction revenue. The second area is we introduced a transaction point solution, a specific product for an OEM in Q4 2015, which was subsidized. That product, point solution, grew nicely in 2016, 2017. As the subsidy funding has gone away, the revenue in that product has gone down, which is driving the decline that you're seeing in transaction revenues. When we look at transaction revenues, particularly with this item, it will be behind us once we get past Q4 of this fiscal year.

Ian Alton Zaffino - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Okay. So those are the 2 major buckets?

Joseph A. Tautges - *CDK Global, Inc. - Executive VP & CFO*

That's right. That's right.

Ian Alton Zaffino - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Okay. And then on the dealer loss side, can you maybe give us an idea of what the margin was associated with those versus the core margin?

Brian Patrick MacDonald - *CDK Global, Inc. - President, CEO & Director*

Ian, it's Brian. Yes. We don't break out the specific dealers. I would say, generally, the dealers that are leaving, look -- that we've lost, look reasonably similar to the average dealer. It's a large enough sample set, it looks relatively consistent to the average dealer.

Ian Alton Zaffino - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Okay. So there'd be no necessarily move in the margins related to dealer losses or site losses?

Brian Patrick MacDonald - *CDK Global, Inc. - President, CEO & Director*

No, maybe it's a little -- maybe a little bit, slightly lower revenue per site, but not a significant margin delta.

Operator

Our next question comes from the line of Matt Pfau with William Blair.

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

First, wanted to touch on the websites. So they were down a bit sequentially, and I assume then that the Ford and Nissan agreements that -- or at least some of the initial conversations that you've been in with those dealers aren't included in that number yet. And so is that decline just sort of driven by the continuation of some of these agreements that went off exclusivity still impacting the results?

Joseph A. Tautges - *CDK Global, Inc. - Executive VP & CFO*

Yes, Matt, thanks for your questions. So when you look at websites, you're spot on. So what you see in the base right now is sort of the normal churn of the business. We are excited as we're getting traction within both endorsed agreements, in terms of sales, the backlog is filling up. And as we look at what we have line of sight to and the progress and momentum we're building, we'll have a busy second half installing the websites that come from the 2 endorsements. As you think about the revenue impact from the 2 endorsements, I would expect to see more of a meaningful impact as we think about it in 2019.

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

Got it. And then wanted to hit on International as well. It seemed like a good result there, and you've mentioned it seems like potentially some incremental investments in your International geographies. Is the strength there driven by the market improving? Or is there something else that you guys have done with CDK that's driving some improvement in those international geographies?

Brian Patrick MacDonald - *CDK Global, Inc. - President, CEO & Director*

Yes, it's Brian here. So we have -- we've made some changes in International. We have a new president. We're increasingly focused on growth there. We want International to grow at a rate above the company. And so we've made some operational improvements to be able to install faster, which gets us to revenue faster. We continue to win new business and grow. So we do have some investments to make to reach that growth, but we're quite excited about the prospects for the International business and our ability to grow there.

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

Got it. And last one, Joe, I don't know if I missed it, but you mentioned in the guidance that FX -- the FX, positive FX impact has increased, while advertising revenue is maybe a bit lower, and so those 2 have offset each other. And how do you maintain guidance? Did you quantify what the additional FX benefit is?

Joseph A. Tautges - *CDK Global, Inc. - Executive VP & CFO*

We didn't. And just given how much fluctuation there is, we won't break that out. I think we did say roughly a point in our last quarter earnings discussion. And so it's improved from there, but that's all we'll share at this point.

Operator

Our next question comes from the line of Rayna Kumar with Evercore ISI.

Rayna Kumar - *Evercore ISI, Research Division - Research Analyst*

What were your market share trends in the second quarter at the high end of the market?

Brian Patrick MacDonald - *CDK Global, Inc. - President, CEO & Director*

Yes, we continue -- Rayna, it's Brian. Look, we continue to grow penetration in the 3-plus dealer segment. What we've had obviously some site losses, primarily in the lower -- smaller dealer market, 1 to 2 sites, and that's why we're focused on closing the Auto/Mate transaction, which is fit-for-purpose product for many dealers in that segment of the market.

Rayna Kumar - *Evercore ISI, Research Division - Research Analyst*

Are you seeing any new competitive entrants at the high end of the market?

Brian Patrick MacDonald - *CDK Global, Inc. - President, CEO & Director*

Yes. Look, I would say, overall, the market is pretty competitive regardless of what segment you're talking about. It's a competitive market. Dealers are very focused on their own economics. And I'm involved personally in a lot of deals, and each and every deal is competitive. So I think there's a number of competitors out there and it's a very competitive market and every deal is competitive.

Rayna Kumar - *Evercore ISI, Research Division - Research Analyst*

Understood. That's very helpful. And if I can sneak one last question in. Beyond FY '19, what's your game plan for revenue growth and margin expansion?

Brian Patrick MacDonald - *CDK Global, Inc. - President, CEO & Director*

Yes. We haven't given guidance beyond FY '19. We'll do that later this year. We think -- obviously, we're not satisfied with the rate of growth that we had this quarter, and we're focused on improving the revenue growth. And later on this year, we'll give guidance of beyond '19 for both profitability and revenue growth.

Operator

Our next question comes from the line of Brian Essex with Morgan Stanley.

Brian Lee Essex - *Morgan Stanley, Research Division - Equity Analyst*

I was wondering if maybe I could address that low end of the market again, just to follow up on that. Where do you see Auto/Mate coming in? And is the pending transaction deferring any efforts you might have with regard to improving go-to-market of existing product in the bottom end of the market? Any impact, for example, with Dash and how competitive you might be? And problems that Auto/Mate might solve in that segment?

Brian Patrick MacDonald - *CDK Global, Inc. - President, CEO & Director*

Brian, it's Brian MacDonald. So look, I think fundamentally the trend that we're experiencing in the 1- to 2-dealership part of the market is pretty consistent with the trend that the company's been experiencing for quite a number of quarters here. Namely, we're losing a lot of the smaller dealers to competitors. And so we see Auto/Mate as a really fit-for-purpose product for smaller-footprint dealers. And so we're working with the FTC and we hope to close the transaction in the coming months. And we're in the second review process now and working constructively with the FTC through that review. So I think we're optimistic about being able to close the transaction in the coming months.

Brian Lee Essex - *Morgan Stanley, Research Division - Equity Analyst*

Yes. Okay, that's helpful. But is that deferring any of your transformation efforts that you may have targeted at the bottom end of the market?

Brian Patrick MacDonald - *CDK Global, Inc. - President, CEO & Director*

No. We continue to make a lot of moves in -- across our product, the things we're doing, our go-to-market. And we don't stand still. So we have a lot of things that we're working on, some that we've executed, some that we'll be announcing in the near future. But no, we're definitely not standing still in terms of addressing the needs of that part of the market.

Brian Lee Essex - *Morgan Stanley, Research Division - Equity Analyst*

Okay, great. And then maybe just as a follow-up for Joe. As we kind of fine tune the models here, I mean, nice progression on margin expansion, so that's great to see. As we bring it on down to cash flow and kind of build out our models kind of going forward, any summary of transformation cost that you may expect for the remainder of the year and how that might translate to cash flow conversion, either this year or going forward? So we can kind of get a normalized rate of cash flow contribution.

Joseph A. Tautges - *CDK Global, Inc. - Executive VP & CFO*

Yes. I think what we've said in the past is we'll spend, for the total transformation program, roughly $250 million for the program. I think you can look in and see what we've spent to date, and the balance, I would say, will be spent between Q3, Q4 and 2019. As we look to beyond, we will work to arrange it so that the programs are self-funded within the operating results of the segments.

Operator

Our next question comes from the line of Gary Prestopino with Barrington.

Gary Frank Prestopino - *Barrington Research Associates, Inc., Research Division - MD*

Brian, could you -- on an apples-to-apples basis, if you factor out the small dealer losses, the 1- to 2-site losses, are -- could you guys give us some kind of a range of are you up on dealer sites, ex the losses from the smaller dealers?

Brian Patrick MacDonald - *CDK Global, Inc. - President, CEO & Director*

Yes, we are.

Gary Frank Prestopino - *Barrington Research Associates, Inc., Research Division - MD*

Could you give us some idea? Or is that not something you want to share?

Brian Patrick MacDonald - *CDK Global, Inc. - President, CEO & Director*

I don't think we want to share that. I think -- but we're -- look, we're quite comfortable with our growth in 3-plus dealers and above. And we continue to grow in that part of the market. And obviously, we're losing in the 1 to 2. So that's fundamentally a product issue that we're working to solve.

Gary Frank Prestopino - *Barrington Research Associates, Inc., Research Division - MD*

Okay. And then in terms of -- we continue to see the average monthly revenue per site go up which I think is very important metric. Can you talk about some of the key drivers of that, where that's coming from? As well as, like, what inning are you in, in terms of getting that number even higher? Is it the third inning? Sixth inning? Can you give us some idea?

Joseph A. Tautges - *CDK Global, Inc. - Executive VP & CFO*

Gary, it's Joe Tautges. So when we look at it, it's all about we have a solid footprint with the core DMS. And within the full portfolio, to go penetrate that with layered applications. And so we're in the beginning stages, call it, the inning 1, 2, around metric-ing in a much more detailed way around our layered applications, splitting it by region and really targeting the platforms for penetration across the base. So we are quite happy with being able to bring the increased value-added services to the dealerships, them seeing the benefit of that and then us metric-ing and aligning comp plans and such to be able to go drive increased revenue per site within the portfolio.

Gary Frank Prestopino - *Barrington Research Associates, Inc., Research Division - MD*

So as you look at the layered apps, I assume it's obviously -- it could be the same ones that have been driving it for a while. Was there an inventory layered app? There was something on the served -- the service side as well?

Brian Patrick MacDonald - *CDK Global, Inc. - President, CEO & Director*

Yes, service. Gary, it's Brian. So we have good traction on service. We're very optimistic about websites, some other products. So I think it's -- we feel good about our ability to continue to drive penetration in layered apps across our DMS install base.

Joseph A. Tautges - *CDK Global, Inc. - Executive VP & CFO*

And when you look at the recent acquisition of Dealership Dashboard, I mean, it's a great example of being able to take an application that the dealers find a lot of value in and being able to take that through our distribution base. And we're seeing really good performance out of the gate on that as well.

Gary Frank Prestopino - *Barrington Research Associates, Inc., Research Division - MD*

And lastly. Do you see the OEM advertising starting to pick up as we get deeper into this quarter and next quarter?

Joseph A. Tautges - *CDK Global, Inc. - Executive VP & CFO*

Yes. So when you look at the advertising revenue performance, when you look at it and segment it, the dealer direct advertising spend as well as local marketing association spend is growing nicely. The OEM direct is declining. After we get past this quarter, the comps will get easier in Q3, Q4. But I wouldn't -- I don't expect it to necessarily grow. And what I would say is it just tends to be choppy. One quarter could growth double digit, the next quarter, it can be down. And so we've taken a pretty balanced view in terms of how we factor it in our forecast for the balance of the year.

Operator

Our next question comes from the line of Tim Willi with Wells Fargo.

Timothy Wayne Willi - *Wells Fargo Securities, LLC, Research Division - MD & Senior Analyst*

I had 2 questions. The first one, just your comments around the deal pursuit teams and the progress you're making there. Could you just talk a bit about what those steps are? Sort of what was not at level you wanted, so you made these tweaks that seem to be showing some progress? And then I had a follow-up.

Brian Patrick MacDonald - *CDK Global, Inc. - President, CEO & Director*

Yes, sure, Tim. It's Brian here. So historically, we had our team that focused on winning new logos, interspersed, if you will, with our normal sales channel. And what we decided to do is to really pull that out and create a dedicated channel for winning new logos, and typically, specialization focus works. So basically, we created a separate channel, if you will, for pursuing new logos effective July 1 of last year. And it takes a little while to put the team together and really clean up the data to create leads and to put the processes in place. So that happened over the last 6 months, and we're quite satisfied with the progress we're making.

Timothy Wayne Willi - *Wells Fargo Securities, LLC, Research Division - MD & Senior Analyst*

Great. And then my follow-up was, this might be a hard one to answer, I guess, but in terms of just the tax reform. I mean, I would assume that depending upon how your dealerships are structured as corporations, partnerships, S corps, whatever, that they're going to see some kind of benefit. And then there's also, obviously, the consumer and their paycheck. I'm sort of curious what you've heard or sensed as you have talked with dealers about what they intend to do with their tax benefit regarding reinvesting in their business versus taking it home for themselves, and then how they think the consumer might react in terms of new purchases or new leases of vehicles.

Brian Patrick MacDonald - *CDK Global, Inc. - President, CEO & Director*

Yes. I think on the -- so first on the dealer side, there's obviously lots of different structures that dealers have. If you look at some of the publics, they've made their own comments about tax reform and their C corps. And so I think there's, obviously, that benefit. I think the consumer, I think that, obviously, as people look at their 401(k) statements and start to get their paychecks with some after-tax cash flow, I think the feeling is pretty good. And I think we'll see that benefit in vehicle sales this year. And so I think the market just seems to be feeling pretty good given tax reform and kind of where the capital markets are. And so I think the mood is reasonably optimistic in the dealer channel.

Operator

And I'm not showing any further questions in the queue at this time. I'd like to turn the call back to Mr. MacDonald for any closing remarks.

Brian Patrick MacDonald - *CDK Global, Inc. - President, CEO & Director*

I want to thank everybody for joining our call today. And we are continuing to make great progress here at CDK. And we look forward to talking to you soon.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program, and you may now disconnect. Everyone, have a great day.
